STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of hearing with Kingston Smith and Association of Practising Accountants members held on 4 July 2012

Background

1. The Competition Commission (CC) invited Kingston Smith to the hearing together with some members of the Association of Practising Accountants (APA). Those attending the hearing were:

   - Sir Michael Snyder represented Kingston Smith and chaired the APA and also the Professional and Business Services Group. He was accompanied by Tessa Park, Kingston Smith’s Technical Partner;
   - Mr Clapson represented Price Bailey;
   - Mr Goodyear represented Lubbock Fine and chaired Russell Bedford International;
   - Mr Gratton represented Duncan & Toplis; and
   - Mr Stevens represented Reeves and chaired Kreston International.

2. Kingston Smith said that it was important to understand how APA members might be interested in providing audit services to FTSE 350 companies should market parameters change in any way. Similarly it was important to understand what parameters APA firms felt needed to be changed in order for them to participate in a market currently dominated by the Big 4.

Barriers to entry

3. Kingston Smith described barriers to entry into the market for audit services for listed companies. Contractual clauses limiting audit services to the Big 4 either explicitly or implicitly were one significant barrier. This amounted to the old fashioned perception that using a large firm was the only audit option (the ‘IBM Factor’).

4. Limitation of liability was another key barrier for medium-sized audit firms wishing to enter the market. Kingston Smith told us that the Government’s current framework for limitation of liability had not worked. There was no incentive for any of its clients to forego unlimited liability by entering into the voluntary contractual limitation required. Kingston Smith favoured the introduction of proportional responsibility and proportional liability so that firms took responsibility for their own negligence. A fixed cap on liability would be counterproductive as it would only benefit the large firms.

5. Kingston Smith said that there was a misconception around liability insurance. Although Kingston Smith agreed that the Big 4 had extensive cover and substance to be able to support any negligence claim, it considered that most medium-sized APA members could provide reasonable levels of professional indemnity (PI) cover. The other misconception related to the quality of audit. Kingston Smith had heard many assertions from the Big 4 that their quality of audit was better than the non-Big-4 firms and that others only aspired to achieve their standards. Kingston Smith thought that that perception was wrong and was fostered by the Big 4 themselves. Kingston
Smith explained that it provided excellent service quality and standards for audit. Most firms used similar systems for audit procedures.

6. Kingston Smith noted that recent Audit Inspection Unit (AIU) reports on the larger firms criticized the quality of some Big 4 audits and specifically whether they were auditing subsidiaries as individual companies or whether they were taking a materiality level that was based more on the group figures. Taking this approach meant that the individual subsidiaries did not require a great deal of work and so the audit was cheaper for the whole group.

**Liability insurance**

7. Kingston Smith explained that it was never clear-cut how PI claims were made. For example, a fraud in a company might have been the result of management failing to have the right systems in place. It was common practice now to claim from the auditors as they typically had the most financial resources available and it was a joint and several liability. While the directors might have been found by the judge to be culpable, if they did not have funds available, the whole claim would be financed by the auditors, or the insurers. If proportional liability was introduced, the judge would have to make two decisions: what proportion of responsibility belonged to the auditors and what proportion was the responsibility of the directors or perhaps the lawyer if it was a transaction. That would benefit the audit firm as it would be able to better understand and control the degree of risk for which it was responsible.

8. Kingston Smith agreed that even under the proportional model, the expected size of the potential liability would still increase with a larger client. Reeves explained that it still was a barrier to entry because all auditors dealt with the PI affairs of their businesses and needed to declare all their renewals and public quoted work. Insurance premiums could make new work for public companies uneconomic. Kingston Smith agreed that the liability was a barrier to entry but was also a fact of the nature of the audit profession. However, Kingston Smith considered that not having to accept total liability for a problem that the auditor did not cause reduced the quantum of the barrier to entry. Kingston Smith told us, however, that it (proportional liability) would not reduce the risk sufficiently for it to be able to carry out audits on a FTSE top 10 company. One risk was financial and the other risk was reputational. Given both of those risks, Kingston Smith would not consider auditing the FTSE 150 or 200 even with the reduced level of liability.

9. Kingston Smith further explained that audit firms were currently subject to joint and several liability. This meant that the audit firm was responsible for total liability in the first instance and needed to recover costs from another party after establishing that they contributed to the problem. If the other party did not have any finances, the ability to recover was useless. This was often the case as other parties typically had no finances available to fund the big claims so the injured party claimed against the auditors as they knew they had PI insurance. For this reason, the auditors were typically the first party against which claims were made. The insurers understood this so the price of insurance premiums and excesses increased.

10. Kingston Smith told us that a fixed cap on liability would not be helpful for the medium-sized audit firms and could increase market concentration as it would help the Big 4. For example, a number of years ago, PwC proposed to put a £30 million cap on liability. The Big 4 would be able to sustain that loss without PI insurance. However, a non-Big-4 firm would have no ability to sustain a £30 million loss. Kingston Smith noted that there was one other model for liability that was worth exploring: the multiple of fees option. The difficulty of this option and indeed any
other change in the liability regime, however, was that it would require statutory change because businesses would not be willing to forego their rights.

11. Kingston Smith explained that no firm, including the Big 4, had the total amount of cover necessary to withstand a very large claim. Kingston Smith said that the price of insurance was too high for medium-sized firms. It was easier to spread the liability risk if an audit firm had multiple cases than with one or two large cases when insurance became very expensive.

12. Kingston Smith said that it had tried to address the misperception over insurance cover held by the Big 4 but that it was almost impossible to do either individually or collectively. For example, Kingston Smith held a dinner with financiers, venture capitalists and banks aimed at influencing how audits were placed. It had only achieved limited success.

**Shared audit**

13. Kingston Smith considered that if shared audit became a requirement, medium-sized firms like Kingston Smith would have a real opportunity to break into the market. Shared audits involved more than one auditor carrying out the audits of the components of a group, but only one company carrying out the audit of the holding company. Kingston Smith said that in the 1980s, there was a wider spread of audits of large companies when the Big 8 dominated the market. As a result of predatory pricing, mergers and the influence of the ‘IBM factor’, the market polarized until it evolved into the Big 4. Kingston Smith thought that there should be a mechanism to encourage audit committees to use shared audits because otherwise firms outside the Big 4 would not have an opportunity to provide audit services to the FTSE 350. This could come about, for example, if the Financial Reporting Council (FRC) required that a FTSE 350 company had to have 20 or 25 per cent of the component audits carried out by other firms.

14. Shared audit would provide a more level playing field for tenders for subsidiaries. It would also improve audit quality. Under shared audit, medium-sized firms would be carrying out full scope subsidiary audits as opposed to fixing materiality at group level as the AIU reports criticized the Big 4 for doing. If a requirement for shared audits became the norm, Kingston Smith explained that it was more likely to carry out audits for overseas-owned subsidiaries in the UK and it would be much more difficult for the auditors of a company like [a large German group] to insist on a single firm carrying out all the audits of its subsidiaries. Reeves considered that a requirement for shared audits would bring in the top 75 or 100 audit firms to join the Big 4 market. All these firms would have the capability to do a degree of this work.

15. Kingston Smith explained that these barriers to entry were all very significant. Shared audits could address the capacity-building issue for the non Big 4, for example, if UK firms carried out the audit of all the subsidiaries of an overseas-owned group. Kingston Smith referred to an example that occurred 15 to 20 years ago when it provided audit services to the main UK subsidiary of a large German group and all of its subsidiaries. The turnover of the group was around £700 million and Kingston Smith was well able to manage the audit. It was very cost effective for the UK group and the parent company in Germany was content with the process. However, the auditors of the parent company in Germany, who were a Big 4 firm, insisted that they conduct all the audits for the group and its subsidiaries globally. Kingston Smith subsequently lost the contract.
Establishing relationships with the FTSE 350

16. Lubbock Fine said that it had tried to establish relationships with listed companies as a first step to making a bid for business, but not for audit, rather for tax advice and one or two other service areas. It had not tried for audit because it would not be capable of carrying out a FTSE 100 audit. Lubbock Fine was, however, keen to establish a relationship with the FTSE 100 for audit services and considered that this could only be achieved if shared audit was made compulsory, so that FTSE 100 companies were forced to engage with firms in the audit area and Lubbock Fine could gain experience.

17. Lubbock Fine gave an anecdote about a chairman of an audit committee of a listed company who had originally come from one of the Big 4 firms. He was determined to contract a Big 4 auditor but the chairman of the company insisted on getting Grant Thornton. The chairman of the audit committee changed his mind about the quality of the audit after seeing that the quality of Grant Thornton’s work was better than the previous audit provided by one of the Big 4. Lubbock Fine explained that changing perception was a very slow process and questioned whether it was possible without market intervention.

18. Kingston Smith said that it had tried, to a limited extent, to sell non-audit services to FTSE 350 companies as a first step towards audit services. The barrier to include audit was difficult, however, due to the incumbent audit firm—a company would always go to the incumbent audit firm first as it knew and trusted it.

19. Reeves explained that that it did sell non-audit services to FTSE 350 companies but that it was in defined areas where it had a particular specialism, for example, VAT or duty recovery. It was comfortable selling those particular services to FTSE 350 companies but would not be comfortable selling full audit services due to its own perception of barriers. Reeves, however, said that all its offices provided (or had provided) internal audit services to the FTSE 350, for example audit procedures and stocktakes on an internal audit basis. Lubbock Fine clarified the difference between offering an internal audit service as opposed to statutory audit services. Internal audit services involved the potential to limit the terms of service rather than the unlimited joint and several liability involved with statutory audit.

20. Kingston Smith emphasized that it was unreasonable to imply that it was a fault of its own for not seeking to provide audit services to the FTSE 350 companies. Kingston Smith did not consider it possible to break into the FTSE 350 market and at any rate, it would not be capable of providing audit services to, say, the top FTSE 150 because it needed to build capacity. The capacity issue would need to be dealt with in the event that the CC found that there was a market failure/competition issue. Kingston Smith knew that at the top end of Group A of the medium-sized audit firms, they were constantly trying to enter the FTSE 350 audit market and found it very difficult to do so. In summary, Kingston Smith said that it was not actively targeting any particular firms in the FTSE 350 to offer statutory audit services, nor had it ever been asked to tender for a FTSE 350 statutory audit.

Big 4 clauses

21. Kingston Smith told us that it had lost a client when the client entered the FTSE 350 but that that had been around 15 years ago. It had not had a client since who had entered the FTSE 350.

22. Kingston Smith said that in reality it lost clients before they entered the FTSE 350 because if they needed any additional funding to develop, they would engage a Big 4
auditor at that stage. Kingston Smith did not have examples to hand of how Big 4 clauses, explicit or otherwise, had influenced a company’s choice of auditor but it said that it received many comments from its partners that a bank or a financing institution preferred a Big 4 auditor. It either did not tender for these companies or was replaced as the auditor. It thought that this happened tens of times a year. It said that the Big 4 clause used to appear in contracts but given some of the media coverage, it had not seen one recently but it often appeared in correspondence. If it was not in a letter, it was made absolutely clear as often some of Kingston Smith’s clients came to one of its partners in some distress as they did not want to break the relationship with Kingston Smith but they needed to do so in order to secure funding. They were often quite upset as Kingston Smith had provided good advice that had helped them develop their business and they wanted to continue to work with it.

ISA 600

23. Kingston Smith told us that the pressure on firms to use a single auditor across a group typically came from the audit partner of the Big 4 firm who wanted to increase fees. Duncan & Toplis said that pressure could even come from a former partner of a Big 4 firm. Kingston Smith noted the membership of audit committees typically comprised former employees of the Big 4. Kingston Smith told us that although there was nothing in the way the ISA 600 was drafted that precluded using more than one auditor, it could more explicitly make clear that it was permissible, if not beneficial, to engage other auditors where appropriate.

24. Duncan & Toplis said that the way ISA 600 was drafted implied that where there was shared audit, additional work was necessary, and the main auditor used this to argue that it should undertake all the work itself. Once again, that was a misconception.

25. Price Bailey considered that ISA 600 was not drafted well and it encouraged the Big 4 group auditor to say that more work would be required if it did not carry out all the work. Kingston Smith said that it was true that some additional work was required if other auditors were engaged within the group but even taking into account the costs of a non-Big-4 auditor carrying out, say, 25 per cent of the work plus a small amount of extra expense for the liaison, the total expense was less than giving all the work to one of the Big 4. The exception was when one of the Big 4 undercut on price (ie ‘low balling’) due to applying a different materiality level, issues with materiality having been referred to in the recent AIU report (on its 2011/12 inspection cycle).

Personal preferences

26. The other influencing factor was a change of personnel at the client firm such as a new finance director or new lawyers, which happened all the time. Price Bailey said that personnel changes influenced a company to change its auditor but that was human nature rather than an investor explicitly influencing a company to change its auditor. Kingston Smith reiterated that across the market a new finance director would often recommend someone from their previous firm.

Big 4 competitive strategies

27. Price Bailey provided an example of the Big 4’s tactics for selling audit services to companies before they became listed onto AIM and before they moved on to the FTSE. Price Bailey had audited some biotech start-up companies. Once it became clear that they could achieve an AIM listing and then perhaps obtain a full listing, other audit providers, and predominantly the Big 4, would start asking for their audit at a price matching Price Bailey’s and fixed for three years. Price Bailey explained
that it could not compete with that approach as it did not have the international branding of a Big 4 firm. Price Bailey had experienced many examples of these situations, that one being only within the last six months.

28. Kingston Smith told us that it had also experienced many of these situations and particularly with AIM companies: the Big 4 would always come and undercut fees. The Big 4 would definitely carry out an audit in these circumstances at well under any of their basic cost of labour and overheads to attract growing companies.

29. Kingston Smith reiterated that it was difficult for it to be asked to carry out non-audit services for the big companies, let alone the FTSE 350 whereas it was impossible to be asked to carry out the audit. These companies naturally turned to their trusted adviser, that is, the incumbent auditor. It also depended whether the incumbent auditors were allowed to carry out the non-audit work under the ethics regulations but it was easier, although still difficult, to supply services other than audit. Where Kingston Smith had provided services to these companies, the client was happy and had retained Kingston Smith. Targeting the non-audit work as a way of overcoming barriers to the audit work was, however, unlikely to be successful.

Attracting and retaining talent

30. Kingston Smith considered that it was not at a disadvantage when attracting and retaining talent when compared with the Big 4. If someone wanted to work 80 hours a week during the busy season and wanted to earn, for example, £3,000 to £4,000 more a year as a starting salary, they might be attracted to the Big 4 but the pay differential at entry was slight. Reeves had no difficulty with attracting and retaining talent. Reeves trained staff continuously and took a number of students each year. Reeves thought that the medium-sized firms provided very good training and that anyone trained at Reeves could generally get a job at any firm of auditors in the UK. Reeves needed to foster its staff as they were regularly poached.

31. Kingston Smith explained that retaining staff was more difficult than recruiting them. When people approached the end of their training contract after three years, they might be looking to move from audit and accounts. People were attracted to commerce more generally rather than the Big 4 specifically. Sometimes people decided to make a lifestyle decision to relocate to another part of the country and moved firms but, in Kingston Smith’s experience, virtually no one went to one of the Big 4.

32. Duncan & Toplis had lost people to the Big 4 in London possibly due to people wanting to relocate there. The draw was money and a perception that they would gain wider experience. Reeves explained that its people were attracted to the Big 4 and other competition such as the wider financial sector. Kingston Smith noted that three years ago banks were offering a salary of £55,000 to newly qualified chartered accountants. Duncan & Toplis told us that its staff were attracted to the Big 4 when they qualified because of the training they received and this was a positive aspect of the training Duncan & Toplis provided.

33. Price Bailey explained that all of its newly qualified staff would be approached by a larger firm, a national or Big 4 firm. Staff, however, received practical all round experience with Price Bailey and the other medium-sized audit firms. One of Price Bailey’s newly qualifieds could go into one of the Big 4’s audit departments and be productive straight away.

34. Kingston Smith told us that firms needed to have a minimum amount of experience if they were to train auditors (rather than chartered accountants). The number of audit firms in September 1993 was 9,336 and in May 2012 the number had dropped to
3,815 in the UK. The Institute of Chartered Accountants in England and Wales had estimated that the figure would be around 3,700 by the end of the year. Kingston Smith explained that most of these firms would not be able to train auditors. Kingston Smith was approximately the 18th largest audit firm in the UK and took around 30 trainees a year, which was relatively high.

35. Kingston Smith explained that that of the 30 trainees it recruited, it would largely depend on the market as to how many it would want to retain, but typically it wanted to retain around 15 to 20 trainees for two or three years. The numbers would then gradually decline. Kingston Smith was currently retaining more trainees due to the state of the market and in particular the downturn in the banking sector.

International capabilities and networks

36. Kingston Smith spoke about the requirements for an international audit and how this worked with its current clients. Kingston Smith was part of an association of firms with over 156 offices worldwide. It was through this association that Kingston Smith was able to carry out audits across a number of countries. Kingston Smith had not had any need to use auditors in another organization when it had been the UK auditor, although it noted that it had never audited worldwide groups with an extensive number of global subsidiaries.

37. Reeves explained that its own network, Kreston, worked in a similar way in that it was a network of independent firms around the world. Kreston covered approximately 200 countries. Kreston was a network that meant that the firms working across the network needed similar methodologies of working, audit systems and independent checking that might not occur within an association. Reeves considered that there was a greater closeness of cooperation and shared systems in the network as compared with the association model. Lubbock Fine was also part of the Kreston network.

38. Mr Gratton explained that he was the chairman of an international network of auditors that was similar to Kreston. The network had coordinated audit quality control procedures and independence records in place, and was used regularly for cross border audits and other cross border work. The network worked well and audits were conducted in many countries, particularly in Europe, coordinated from the UK.

39. Price Bailey explained that it was a member of an association of auditors, AIPA. AIPA had a presence in over 60 countries and Price Bailey worked closely with the other members of the association when it was the parent auditor. It used other firms in the association to audit foreign subsidiaries and vice versa. Price Bailey considered the association to work very well.

40. Kingston Smith said that these networks and associations in which APA members operated, enhanced quality because they (and their clients) did not have to use the firm overseas that the association suggested. This compared with the Big 4 which did not leave clients a choice of firms to use overseas. Kingston Smith believed that having a choice of auditor overseas enhanced quality because the overseas firm had to provide a good service or lose the work. Kingston Smith found that where there was a holding company working with a subsidiary auditor in another country, the auditor of the subsidiary could charge higher prices because it was in a captive relationship with the auditor of the holding company. In an association or network, the auditors in another country needed to be competitive and provide a good service because their relationship depended on it.
41. Kingston Smith told us that it typically coordinated the work of around ten subsidiary entities when conducting multi-jurisdictional audits. Price Bailey said that the highest number of subsidiaries it coordinated was between ten and 15 with the majority of cases being around three to four. Reeves explained that the most important issue was not the international aspect but rather the scale of the organization. Price Bailey told us that it did not have the capacity within its networks to cope with international audits covering numerous overseas subsidiaries and it would have to seriously consider whether it would want to carry out that type of work.

42. Lubbock Fine said that, for a group of companies that was extremely large and international, they would have great difficulty auditing it in terms of technical expertise and capacity. For example, Lubbock Fine did not consider that any audit firm in the group (the APA) could audit Barclays Bank. Lubbock Fine thought that out of the FTSE 350 companies, the lower 100 companies were not as complex and it would have the capacity to provide audit services to these companies through its network. Lubbock Fine explained that it was difficult to provide a definitive answer without researching the complexity of the companies in question. Some companies involved complex industries that it did not have the technical capability to audit such as an insurance company or a bank.

43. Kingston Smith told us that it really did not know the proportion of FTSE 350 it could audit but estimated that it might be around 50 to 75 companies. Lubbock Fine thought that the number could be higher. Reeves considered the nature of the trade of the company in question to be an important factor. Trades such as banking were too specialized for it to audit but there were other entities such as professional services firms, advertising, and commercial manufacturing, where its partners had experience.

44. Kingston Smith explained that it was a specialist in a number of sectors including professional firms, marketing services, TV and film, manufacturing and engineering.

45. Duncan & Toplis said that it was a specialist in any trade within the food chain, charities and not for profit, transport and building construction, and property. Kingston Smith told us that one of the strengths of the audit firms outside the Big 4 was that they could be a specialist in more than one sector without detracting from their ability to provide a quality service. Price Bailey agreed and said that experience of working with different industries was very positive when serving clients in another industry.

46. Kingston Smith explained that it had originally established its association, KS International, as a defensive mechanism. Previously when it needed to have an audit conducted overseas, it would have gone to a name it recognized, such as one of the Big 8. These firms were, however, likely to then poach the client in the UK either by predatory pricing or another means. The outward referrals to an auditor in another country were of equal importance to the inward referrals Kingston Smith received. Kingston Smith said that last year, it received roughly the same amount of inward referrals as it made outward referrals at around $1.8 million a year. That compared with the accountancy, audit and tax part of Kingston Smith’s group of around $36 million. Reeves said that it was the most important component of the association in the UK although the largest business within Kreston was an American firm operating in the UK. Reeves was one of Kreston’s top ten largest firms.

47. Lubbock and Fine said that in its organization, it had a representative in the UK but there were other firms in Brazil and Germany that were larger. Reeves told us that it was the second largest firm in its network.
48. Kingston Smith believed that if the market was not as concentrated as it currently was, the pricing models of the Big 4 would have to change. The Big 4 currently had the ability to move the profit they made from audit services to non-audit services and vice versa. Kingston Smith noted that the FRC had announced that this was the first year that combined audit and non-audit services had slightly reduced. If the Big 4 could not make guaranteed returns in certain parts of their business, they could not underprice their business in other areas. Kingston Smith expected that prices would therefore reduce marginally with decreased market concentration and that audit quality would increase if shared audits were introduced.

49. In the absence of shared auditing, Kingston Smith thought that if there were six or seven large firms (as opposed to the current four) prices would be unaffected but quality might increase. Quality could be expected to increase for two reasons: companies would have to audit their subsidiaries fully unless under the proposed legislation, the holding company chose to accept liability for the subsidiary and take an audit exemption; and audit committees would become more discerning in terms of what service they were receiving as they had more options from which to choose.

50. Duncan & Toplis explained that a greater pool of auditors would increase the pool for benchmarking purposes. Lubbock Fine told us that it was unsure whether there was much evidence to suggest that the Big 4 were competing in certain areas of the market because the Big 4 tended to retain audits for a very long term. Kingston Smith told us that it knew of one example where one of the Big 4 had retained an audit for 47 years. Lubbock Fine added that PwC (and previously Coopers) had provided audit services to BP for 100 years. Lubbock Fine told us that these examples provided little support for an argument that there had been real competition across the top end of the market for audit services.

51. Kingston Smith explained that the Big 4 did not all carry out bank audits: three of the Big 4 carried out bank audits while two of them carried out insurance audits. It was a much more even market in the 1980s with the Big 8, plus a number of others such as Crowe Clark Whitehill that until relatively recently carried out the Sainsbury’s audit. It was a much more competitive market and Kingston Smith had the sense then that it could secure any auditing work. There was a genuine choice for companies when appointing auditors. A company needed to keep its costs down, fulfil its statutory audit requirements and receive other benefits from the audit. An increased number of auditors and greater choice would facilitate audit committees considering these additional benefits more fully.

52. Kingston Smith thought that it would be difficult to achieve innovation in reporting in the audit market but that a greater number of participants in the market might help innovation evolve along with support from regulators and the legislative framework. Kingston Smith explained that due to legal requirements, it could not vary the form of public reporting and that the potential for innovation was greater in the delivery and methodology of how audits were conducted. Kingston Smith clarified that it was not speaking about what was privately reported to a board which was already being innovated by audit firms. Kingston Smith explained that more participants alone were unlikely to innovate reporting for the benefit of shareholders. The legislative framework for reporting needed to be changed first. Kingston Smith also cautioned against providing more information with the result of complicating the accounts for the ordinary shareholder. The amount of information reported needed to be balanced against the accessibility of that information.