9 February 2016

Policy & Planning Officer
Financial Reporting Council
8th Floor
125 London Wall
London
EC2Y 5AS

Dear Sirs

Consultation on the Financial Reporting Council’s draft plan and budget and proposed levies, 2016-17

Following the publication of your draft plan and budget for 2016-17, we are pleased to provide our comments on the proposals. We have responded to the specific questions posed in turn below.

We are pleased with the direction of travel that the FRC has taken recently to ensure that regulation is more proportionate, particularly the proposed derogations to the Ethical Standards to allow a broader range of non-audit services to be provided to smaller market capitalisation AIM and ISDX companies. However, there are still some issues that need to be addressed particularly in relation to the provision of tax services. These are not specifically relevant to this consultation and we have responded on these issues separately, however we would stress that the practical implementation of regulation in a proportionate fashion is just as, if not more, important as proportionality in the drafting.

We remain concerned that the introduction of tendering every ten years on a comply or explain basis has had no real impact on market concentration – whilst it is evident that competition for audit appointments has increased within the Big Four it has had no impact whatsoever on increasing competition for larger listed audits more widely. With the introduction of mandatory tendering and rotation for PIEs as a result of the Audit Regulation and Directive (hereafter ‘ARD’), in our view the situation will only get worse, as there is a risk of audits rotating off mid tier firms and on to Big Four firms without equivalent movements in the other direction. We recognise that neither the FRC nor BIS can change the relevant legislation but we do believe the FRC should keep the situation under review and consider ways in which companies – and the institutional investor community – could be encouraged to regard mid tier firms as the credible alternative supplier of audit services that they are.
1. Do you have any comments on the regulatory approach we are proposing for our new three year strategy?

We agree that the FRC’s role should be to reinforce best practice and apply an effective and proportionate regulatory regime. We also agree that it makes sense for further changes to codes and standards to be avoided as far as possible, not least while the changes driven by the implementation of the ARD, and of FRS 102, bed in.

However, we are somewhat concerned by the suggestion there is a need to promote a ‘step change’ in audit quality, not just continuous improvement. In our view UK auditing and reporting is already world leading and – whilst we agree that the FRC should look for continuous improvement in audit quality – we would note that the majority of audits reviewed by the AQR do not identify any significant issues or indeed any suggestion that the audit opinion was incorrect. It is simply not the case that UK audit firms do not take audit quality seriously. Our main concern in respect of this issue is that the AQR may apply a ‘tick box’ mentality to the review of audits conducted by mid tier firms, and perhaps more so to ‘whole firm procedures’. The fact that a mid tier firm’s procedures may be different from those at a Big Four firm – perhaps because of differing levels of resource – does not mean either that the procedures are automatically ineffective or that audits performed by such firms are of lower quality.

Whilst we appreciate the FRC’s indications that it will apply a proportionate approach to implementation of the ARD and the resulting regulation, this is not always supported by press comment (for instance the unhelpful piece on Economia’s website on 5 January which quoted the FRC as stating that audit firms’ systems for monitoring the quality of audit work they conduct are ‘not up to scratch’ – a rather harsh interpretation of the thematic review report on audit quality monitoring which was being referred to).

It is essential that implementation of the ARD includes not only a proportionate approach to the regulation of mid tier and smaller audit firms with PIE audit clients but also balanced and constructive public comment on that regulation. This must include the language used in the reports on firms, which will be in the public domain – an important change for firms not previously subject to FRC monitoring, as the results of monitoring visits undertaken by the Recognised Supervisory Bodies have previously been confidential. The publication of adverse findings regarding a mid tier or smaller firm could well have a negative impact on its reputation which it may not be able to shrug off in the way a Big Four firm could - and indeed could have repercussions for its client base. Whilst we accept that there may be scenarios where a firm has genuine issues in undertaking PIE audits to an acceptable level of quality we do not believe this is the case for the majority of such firms.

We are also concerned by the proposal for increased investor involvement in the work of the FRC and particularly that investors want more information about the reviews of individual audits. We are not convinced that information on AQR reviews of individual audits should be in the public domain, not least for reasons of client confidentiality.

2. Are there areas of our work where we could reduce the regulatory costs we impose without compromising the quality of corporate governance and reporting in the UK?

Given the FRC’s increased responsibilities under the ARD we think it is unlikely there is scope for reducing regulatory costs. Indeed the likelihood is further increase.
3. Do you have any comments on the FRC’s proposed projects and activities in 2016/17?

We welcome the ongoing focus on clear and concise financial reporting. As noted above, we also welcome the proposed derogations to the Ethical Standards to permit the auditor to prepare the financial statements for smaller market capitalisation AIM and ISDX companies and believe this will have a positive impact on the quality of financial reporting at such companies.

We have commented in our response to question 1 on the need for proportionality in implementing the ARD, both in drafting relevant Standards and in applying them in practice.

We note that the FRC proposes to issue an annual assessment of the quality of auditing in the UK which will include views on the current state of the audit market. We would urge the FRC to ensure that the issue of competition is included in this assessment and specifically the level of participation of non Big Four firms in the listed/ PIE audit market.

As stated earlier in this letter we remain concerned that market concentration is likely to get worse rather than better under the ARD because of the impact of mandatory tendering and rotation. Given the FRC’s secondary duty following the Competition and Markets Authority’s enquiry into the larger listed entity audit market to promote competition, we believe this issue needs to be carefully monitored over the initial implementation period of the ARD and appropriate references made in this report – for instance to any increase of concentration as a result of mid tier firms losing tenders to a Big Four firm, or firms exiting the PIE audit market entirely.

4. Are the proposed indicators helpful in assessing progress towards the FRC’s objectives; and are there other indicators that should also be taken into account?

We do not have any specific comments.

5. Do you have any comments on our proposed budget for 2016/17?

We recognise that increases are required as a result of the need to increase FRC resource, not least as a result of the FRC being confirmed as Single Competent Authority under the ARD and the consequent need for an increase in AQR staff.

6. Do you have any comments on our proposed funding requirement for 2016/17?

We do not have any specific comments.

7. Do you agree with our proposed levy rates for 2016/17?

We do not have any specific comments.

We hope that our comments are useful to you. If you have any questions, then please contact either Sir Michael Snyder or Tessa Park.

Yours faithfully

Kingston Smith LLP