COMPETITION COMMISSION

Audit Market Inquiry

Summary of hearing with KPMG held on 3 October 2012

Background

1. KPMG LLP is a limited liability partnership, controlled by KPMG Europe LLP, which together with a wholly owned subsidiary, KPMG Europe Holdings Ltd., holds all the voting rights in KPMG LLP. The capital in KPMG LLP is contributed by its non-voting members (partners) many of whom are also members of KPMG Europe LLP. . It employed over 11,000 people. On 30 September 2011 it had 579 partners. For its financial year 2011, it had revenues of £1,707m. It was regulated by the, the FRC, the ICAEW and the FSA.

Introduction

2. KPMG believed that the audit market was competitive. FTSE 350 audit clients were an important and significant element of its UK, European and Global business. KPMG competed hard to retain its clients and targeted those FTSE 350 companies that were currently not its clients. Its clients were highly sophisticated audit committees and the boards of its clients employed experienced and informed purchasers as Audit Committees and finance directors. These audit committees and finance directors approached external audit in a very professional way.

3. KPMG considered it had a strong reputation in the UK and the profession as a whole had a strong reputation for rigour and transparency within its regulatory system with quality and professional judgement at the heart of it.

4. From the perspective of competition, audit was a very international market and would remain highly competitive. Whatever public good issues arose was not a result of the lack of or obstacles to competition.

Scale rates and recovery rates

5. Historically, KPMG indicated that scale rates were calculated based on costs. However today, audit fees were negotiated in their own right and scale rates did not have much resemblance to actual fees. The main purpose of scale rates was to serve an internal purpose to set a kind of target as to what staff should aim to achieve. KPMG was unlikely to move scale rates down.

6. KPMG considered an acceptable recovery rate would be in the region of [✂] per cent across the audit practice for the UK as a whole. To cover its costs, it would expect to need to recover between [✂] per cent and [✂] per cent.[1] Partners largely had discretion to price and resource audits within these boundaries. Before reaching a final decision on price, partners tended to consult internally, although this was not a formal process and all partners were unlikely to be aware of where the floor for an acceptable level of recovery was, even in terms of ensuring that costs were recovered. However, for large clients, fees were discussed at a panel every year to consider the overall appropriateness and acceptability of the fee. KPMG said it did not have a single pricing matrix as its fees varied depending on the complexity and specialisms of the industry of clients. Further, seasonal factors also applied. KPMG

[1] This refers to engagement level costs and does not necessarily cover all the fixed cost investments.

might be much more competitive for a July audit of a non specialist nature than for a January audit involving very complicated financial services. It was not unusual for KPMG as a business not to be absolutely clear of where its floor was because audit was an industry characterised by components that required significant investments, improvements of quality, with quality differentials between different types of engagement, different elements of investments indicating knowledge of the industry and where bilateral negotiations took place.

7. KPMG did not consider its audit business to be high margin, relative to its other service lines. It said that it was a static business, not growing, that felt relatively risky to it. Its [✂] per cent margin did not reflect central costs or full salaries of the partners so did not take into account the full cost of partner contributions to earning that revenue. [✂] However, KPMG did not have a margin target.

8. KPMG considered that audit had become more competitive over the last few years because audit committees were generally much more focussed on their responsibilities in relation to the external audit, sophisticated and had become better buyers of audit products. Companies were also looking more closely at their own cost base and KPMG felt negotiations were feeling tougher. KPMG said this was exemplified by [✂] still down and why firms could not expect to recover 100 percent of their scale rates which they might have expected to do ten years ago. KPMG had decided against lowering its scale rates. It was always looking to encourage people to obtain increases in their recovery rates and lowering scale rates may give staff the wrong message.

9. KPMG accepted that the more efficient its clients control systems and processes became, the more efficiently its audits could be conducted. This could place downward pressure on its recovery rates. In KPMG has seen this driven by clients.

Rivalry and innovation

10. KPMG said that the core audit product was defined by auditing standards and the absence of strong demand for extending the role of audit. KPMG was very keen to develop its audit offering. It said it was constrained by the historic nature of financial statements. It noted that it and other providers of audit services had been criticised for the financial crisis for a failure to flag the corporate failures that had occurred. KPMG said that more innovation was capable but audit was constrained by statute and the willingness to pay for innovation.

11. KPMG's innovations included its audit insights product that gave feedback about the company's business and about the controls it had in place. KPMG said it would be good to be able to give some of that information to the shareholders. This would give shareholders an insight into some of the debate and discussion that happened inside the audit committee. KPMG said that a safe way of doing this needed to be found and the regulators needed to be onside as well. At the moment, companies did not want to make such information public because there was no incentive for them to do so. KPMG thought that innovation in this area was not possible as a product of competition. It mentioned the Policy and Regulatory Group, which it currently chaired, tried to engage with stakeholders including within Government, regulators and investors to see if how audit could be developed further. KPMG considered that development needed to occur on a profession wide basis to overcome the natural reluctance from individual companies and investors to take a lead. KPMG found it difficult to engage with investors at a sufficient level to make change happen and considered that the regulated nature of audit and the lack of incentives on the part of companies from developing it was a feature that was inhibiting competition. However,

KPMG noted that if not mandated by statute then it would be questionable if the audit would exist at all.

12. In KPMG's view, insufficient stakeholder engagement was preventing sufficient development of the standards. Standard bodies were responsive to a wide range of stakeholders, if they received pushback from some companies and insufficient resistance from investors then change tended not to happen.

Switching, tendering and marketing

13. KPMG indicated that companies were achieving a competitive outcome outside tenders because: they held annual performance reviews of their auditor; they had annual fee negotiations; and there were regular in depth reviews of auditors, quite often, every three years or so, where companies may ask other firms to participate to achieve some kind of benchmark, but this would not be a full blown tender. As an example, KPMG said that a current client, [✂], was undertaking such a review. That company had asked two other firms to provide a fee quote and some documentation as a starting point to decide whether or not to go out to tender. [✂] had undertaken a similar process before going out to tender. KPMG considered that this sort of pre-tender trawl has happened from time to time in the past but perhaps in slightly different ways. It gave an example of a client, [✂], that it had picked up six years ago, that had tendered at the time because of an initial approach by KPMG.

14. KPMG believed that other ways in which audit committee chairs (ACCs) augmented their own experience from other companies and made themselves aware of rival offers was by synthesising public information from tender outcomes and publicised reductions in current audit fees, speaking with other ACC's and finance directors and from being approached by other auditors. They and other audit committee members often had multiple responsibilities and so were exposed to other firms. In KPMG's experience, ACC's tended to use such information in conversations with them.

15. In KPMG's view, bigger, more complex and geographically spread organisations tended to stick with their auditors for longer periods of time than a simple UK based business. KPMG also suggested that such organisations were likely to receive the best quality service from their auditor because they may be considered as flagship clients by the firm. Such clients were likely to be more valuable than just the fee generated by the client, allowing firms to build its brand from serving such clients.

16. [✂].

17. Utilisation rates for KPMG staff were quite high. It was lower for its audit partners who would otherwise be engaged in business development activities or acting as lead partners on non-audit accounts. KPMG would expect its senior partners to spend a substantial proportion of their time on non chargeable business development and other non-chargeable activities. Its junior partners may be utilised in audit work for sometimes almost all of their time. KPMG indicated that its senior partners were required to spend so much time in non-chargeable activities because that is what the market requires and all of its rivals were doing exactly the same. In KPMG's view, it was unlikely to win an audit unless its senior partners spent time building the right type of relationships and learning about its clients businesses through such business development activity or through its non audit work.

18. The relationship aspect was important because KPMG said it needed to know, trust and work with its audit clients while at the same time accepting that it also needed to maintain a distance from the client because it was reporting for the benefit of the shareholders. KPMG said that there was often a good deal of healthy tension

between the finance director and the audit team and it was important to know that it could work with someone through such tension.

19. KPMG considered that any firm that could show knowledge in a sector and experience of advising firms and boards of that sector could demonstrate that it could audit such firms in the FTSE 350. Smaller firms might find it difficult to demonstrate this for the FTSE 10 or 20 but should not find it so difficult for the rest of the FTSE 350. KPMG were surprised that Mid Tier firms had not undertaken more targeted investment approach and nibble away at particular sectors of the FTSE market. It noted for example that [✂].

20. KPMG agreed that if audit reports contained more information about the judgements taken and risks considered then it would be easier to justify reputations. However, it was keen to ensure that reports did not become subjective opinions and remained objective as it did not want the auditor's judgement to be substituted for the management's judgement. However it agreed that reports could be more comprehensive.

Tender process and choice

21. KPMG indicated that because of the relationships it had built up with FTSE 350 companies, it tended to be aware when tenders within FTSE companies were taking place, even where it was not the incumbent auditor. KPMG was aware that Mid Tier firms provided many non audit services to FTSE 350 companies but did not know why they may not be as aware of audit tenders as the Big 4 seemed to be. KPMG noted that it worked hard to build relationships with FTSE 350 clients but even it had to selectively target areas and companies where it thought it would be most successful. It did not know why Mid Tier firms did not undertake a similar approach, commensurate to their size.

22. KPMG indicated that it was very careful and wary of companies that were trying to shop for second opinions on existing judgements, to see if another firm might give it a more favourable opinion or judgement than its incumbent auditor. It noted that there were professional standards in place to protect against this.

23. KPMG considered that companies could control whether they wanted a particular firm to tender or not. If an existing advisor already did a lot of non audit work for a company then it was in the company's control to allow that advisor to stop such work in order that they can pitch for the audit.

24. KPMG considered that it would not be an obstacle to it or a company to quickly stop non-audit work as most such work was of a short duration. There were only a limited number of instances where other types of conflict, such as working for a competitor would prevent it from bidding for an audit tender. Clients were increasingly not tolerating anyone not bidding seriously for an audit since they wanted competition within a tender and firms risked jeopardising non audit work if they did not take a tender process seriously.

25. KPMG considered that for some sectors, where there may be only two audit firms servicing the sector, the other firms had the ability to develop expertise in the sector in other jurisdictions to become a challenger. It gave the example of Statoil where it brought in a [✂] partner who had expertise in the sector and it won the audit. It noted that for some sectors, there may only be two or three companies in that sector.

26. Clients of KPMG used a number of techniques to benchmark from observing the public audit fees of similar companies to analysing turnover or asset base to audit fee

ratios. Clients also spoke to each other. KPMG were unsure if the benchmarking company's undertook accurately reflected what the company might achieve in a competitive tender process where all bidders would have much more information to base their bids on. KPMG considered that all a company needed to do was to find a comparator which was lower than the fee it was currently paying and put the onus on the firm to justify its fee level. The company did not need to get into a more complex or detailed process.

Switching costs

27. KPMG considered there was a greater inherent risk of an audit failure in the first year of an assignment than any other year because the firm would be on a learning curve about the business and associated risks. KPMG mitigated this risk by applying more resource in year one, although it would not expect to make a loss on an audit assignment in the first year. It would expect to put in 10 to 20 percent more hours in the first year than subsequent years. KPMG would expect to reach a steady state margin for a new client in year three plus. KPMG indicated it was able to afford this resource because it had a sufficient portfolio mix to absorb the increased costs in a small number of audits.

Quality and reputation

28. Finance Directors and ACCs could gain visibility about overall audit quality in advance of an engagement from reviewing the publically available reports of the audit inspection unit. On an ongoing basis, large clients would expect to be reviewed by the AIU once every three years and so could gain some insight from such ongoing reviews. Companies could also derive some comfort regarding the expertise of the auditor and the team from the tender process when bidders would be meeting with company personnel to learn about the audit. KPMG considered that FD's and ACCs could also fall back on other appointments they held as most were members of more than one board. Many were also likely to have been a member or partner of at least one of the audit firms and so would have some knowledge form their time there.

29. After an audit, quality was gauged from audit debriefs and ACCs speaking with the other Audit Committee members. FD's might seek feedback from their management and across the divisions of the business possibly by surveys that might be carried out to see how the audit had gone.

30. In KPMG's view it would be difficult for investors to have similar visibility. They were more likely to rely on the board and the ACC specifically around the audit. Investors would have access to regulatory reviews which were in the public domain.

31. When selecting auditors, KPMG considered that a firm's reputation would play a role in the selection process but reputation would not be something the firms would fall back on to not provide optimum quality every time. Reputation takes a very long time to build but could be lost very quickly and so the fear of losing it kept the firms striving. Clients were generally very quick to tell KPMG if they were unhappy and had failed to meet expectations. Clients would also tell other clients/customers.

32. In response to the AIU's concerns about costs being taken out of the audit sector and possible consequences on quality, KPMG noted that it had developed its IT tools to help improve efficiency. This tool helped KPMG produce a higher quality as to how it documented its audits and over time, input lower hours. It was also looking at reducing testing in low risk areas which it considered was unnecessary. KPMG

indicated that it was making [✂] people redundant in its audit department which was significantly less than its normal attrition rate.

33. KPMG considered in relation to partner rotation that it would lead to a 'fresh pair of eyes' to the key difficult judgement areas, as opposed to necessarily the entire audit approach which would occur if there was a change of audit firm. In terms of making the rotation as seamless as possible, KPMG said that was about bringing the new partner up to speed with the issues in the audit, before he took over, rather than ensuring that he took exactly the same view to everything as his predecessor.

34. In KPMG's experience, clients tended to express unhappiness with an incoming partner, not when there was a different judgement call being made, but when issues were not being managed well. For example, if an issue was dealt with at the last minute rather than upfront or if there was a breakdown in the service level. KPMG said it would be very concerned if a client pressured it in relation to an accounting judgement and that would be escalated to senior levels.

Sunk costs

35. KPMG said on average its partners were [✂] per cent utilised spending most of their remaining time on business development. However, this varied between junior and senior partners and different parts of the business. It was difficult for KPMG to measure the return on the resource partners spent on business development.

36. Some partners would be targeting specific clients as part of their business development activities. They may do this through some non-audit work. If they had no existing connections with the client than they would try and demonstrate to the company sector knowledge and an understanding of the current drivers and risks in the industry. KPMG would generally try and find a contact within a company to get 'air time' with the right individuals and then try and demonstrate an understanding of the company's industry. Overall, this aspect of partner activity tended to be quite tightly managed and controlled.

37. Given the scale of this resource, KPMG suggested that a new entrant may be more successful targeting very specific sectors rather than the whole market en masse. KPMG indicated that even it would not be able to target everything across the FTSE 350; it was selective in targeting those company's it thought were more likely to be productive. It considered there was nothing to stop the mid tier firms doing the same.

Liability and risk

38. KPMG indicated that it spent an enormous amount of time pre-empting risk, mitigating and analysing and reacting to risks in its audit business. KPMG believed that is why claims, payouts and litigation were very low for its audit business. It also summarised the risk in its audit business as low frequency, high impact. It considered the time period the CC had chosen to examine claims activity, over the last ten years, was a particularly benign environment for UK audit firms. KPMG considered that audit was the riskiest part of its business which had the highest losses and insurance premiums compared to other parts of its business.

39. KPMG believed that it could survive the impact of a high financial claim and it gave the example of [✂]. It said, fundamentally, its reputation was not damaged by this because it was a one-off and was perceived as such. It considered that if it had a sequence of claims against it, which is what it considered contributed to Anderson's demise, then that would damage its reputation for integrity and honesty. KPMG

believed that fundamental to reputation was a reputation for integrity and honesty. It said loss of this was fatal for Anderson. A sequence for the loss of integrity or systematic malpractice was unlikely to be survivable by a Big 4 firm. A rogue partner could be survivable but a rogue office was less likely to be.

40. KPMG considered that the financial crises had shown that the scope of the statutory audit had failed but it did not think that the currently defined statutory audit product had failed. KPMG considered that the financial crisis how thrown up wider questions than just whether auditors had done a proper job.

Shareholders

41. KPMG accepted that the statutory audit opinion was to provide assurance to shareholders. It believed that it would be too cumbersome to compete for this customer base directly and this was the reason why the position of ACC had evolved, to represent shareholders. Although KPMG had dialogue with shareholders and investors in a broad way, it noted the practical difficulties in this given that it was required to communicate with all shareholders at the same time. KPMG was increasingly speaking with institutional investors to discuss issues generally but found it very difficult to have a substantive and meaningful discussion about an individual company. Some of these conversations took place at a profession level, for example under the Corporate Reporting Advisory Group which some investors attended. However KPMG said it found it very difficult to get investors engaged and it saw very little shareholder demand for products or information that they were willing to pay for, as opposed to having just a wish list.

42. KPMG was incentivised to speak to investors to see if it could make its audit more meaningful and useful and to try and spot any disconnect between the investor and the company. Further, if KPMG could convince investors that a broader assurance product was valuable, then commercially that would be good for it also.

Audit Committee Chairs

43. KPMG considered it was quite difficult for investors to determine if the ACC was doing a good job. It was slightly surprised that there was not more engagement between the investor community and audit committees. KPMG assumed that this must indicate that investors were generally comfortable with the performance of the company and so must be happy with the ACC as well. KPMG noted that there was increasing demand from some investors for more transparency around the audit process which was reflected in the recent proposals by the FRC on changes to the guidance to audit committees and to the stewardship code. This gave investors more hooks to ask questions of they wanted to. KPMG said that it remained to be seen whether investors did ask more questions.

44. KPMG noted that any individual could look at the reputation of the audit committee, including their: shareholdings; qualifications; its output in terms of the audit committee report and the accounts to form a judgement on whether the audit committee was addressing all of the issues etc. This would allow them to build a picture, although it would not be as tangible and direct as speaking directly with the ACC. Publication of board effectiveness reviews was also becoming more common place and was another source of information.

45. KPMG considered an important factor was that ultimately, ACCs were putting their own reputation on the line and would not want to be associated with a failed company which incentivised them to do a good job. A number of non-executives

approached the auditors seeking information about companies before accepting appointments on the boards of companies. KPMG undertook to revert with examples of an ACC's reputation being tarnished as a result of being ineffective in the role[2].

46. ACCs were usually able to obtain whatever resources they required and most always seemed to be very well briefed, putting in as much time as necessary for the role. In KPMG's experience ACCs were very strong in understanding the judgement areas that an auditor had considered but some may have struggled with the complexity of the accounts for which they placed more reliance on management and the auditor. There were occasions when the ACC would take responsibility, on behalf of the rest of the audit committee, to get more involved with management or the auditor, if there was a particular issue that needed deeper consideration and could involve them obtaining external advice, for example, if there was suspicion of fraud. KPMG gave the example of [✂] where the AC requested an external review.

47. KPMG did not consider that it was the Audit Committee or ACC's role to get involved in the details of the audit. It was more appropriate for them to consider information at a higher level with enough detail to be able to ask intelligent questions and probe areas if needed. KPMG accepted that it was inevitable that the effectiveness of audit committees varied but in its experience major companies took time in carefully selecting their ACC and they tended to attract the highest calibre of people who all took the role very seriously. Further, the audit committee comprised other members who may also be financial experts. In relation to ACCs having more than one engagement, this could be an advantage to allow them to compare between different companies. However, if they were members of too many large complex organisations, then that may become difficult for them to manage.

48. KPMG believed the views of shareholders and management were reasonably aligned.

[2] In its response of 19 October 2012 to the CC's follow-up questions on ACCs to main parties, KPMG provided eight examples where ACC reputation may have been tarnished.