



KPMG response to the CC’s Working Paper on “Nature and Strength of Competition”

1 Executive summary

- 1.1 In this paper we set out our response to the Competition Commission’s (CC’s) Working Paper “Nature and Strength of competition in the supply of FTSE350 audits” (the “Working Paper”). We welcome the chance to comment on the paper at this stage in the CC’s analysis.
- 1.2 We are concerned that in this Working Paper, the CC has underestimated the strength of competition outside of tendering events. The CC states that ‘many FTSE350 companies had not switched auditor for a long time’¹ and that tenders are infrequent². Nevertheless, we believe that taken in the round the evidence is that these factors are consistent with a situation of healthy competitive pressure. This is also consistent with the CC’s conclusions in previous inquiries, where it has found that even extremely low rates of switching are consistent with competition functioning well³.
- 1.3 We also agree with the CC that, it would need to conduct a proper assessment of the bargaining position of FTSE350 companies in order to draw any conclusions about the strength of competition outside of tender events⁴.
- 1.4 However, we are concerned that the CC’s preliminary assessment significantly underestimates the strength of companies’ bargaining positions. Specifically, the CC’s conclusions appear to be based on three main concerns which in our view are unsupported by the evidence and from which such conclusions should not be drawn. We discuss each of these in turn in the next three paragraphs.
- 1.5 **The CC’s concern that information from benchmarking is incomplete or inaccurate:** The CC’s view appears to be that outside of tender events companies are in a weaker bargaining position because they gather less or less accurate information than is gathered during tender events. The CC argues that this is for two main reasons: i) a small minority of companies do not conduct formal benchmarking activities; and ii) benchmarking might give inaccurate or out of date information. We disagree for two main reasons. First, benchmarking activities are pervasive and effective and there is no evidence to suggest that they provide less accurate information than tender events for the purpose of negotiations with providers. Companies are very well informed of the competitiveness of their incumbent audit

¹ Paragraph 101 of the Working Paper.

² Paragraph 195 of the Working Paper.

³ London Stock Exchange plc / Deutsche Börse AG and Euronext N.V merger inquiries.

⁴ Paragraph 169 of the Working Paper.

firm's offering regardless of the specific way they choose to gather information. Second, even if some companies have less information this would in no way imply that a supplier of audit services to that company would be in a stronger bargaining position because of it. Third, as the CC itself recognises⁵ FTSE 350 companies are experienced and knowledgeable buyers.

- 1.6 **The CC's concern that switching costs are substantial and switching rates are low:** the CC reiterates its view from the working paper "Evidence on switching costs (and implications for barriers to entry)" that switching costs might be substantial in aggregate, and suggests that this might weaken the bargaining position of companies. We set out in our response to that working paper our view that there are no material switching costs such that would imply we face anything other than fierce competitive pressure to retain our existing clients, and most other audit firms also stated that there were not material switching costs. In addition, the CC's working paper "Evidence on switching costs (and implications for barriers to entry)" found that audit firms themselves absorb many of the costs of switching to the extent they exist. The CC also raises concerns about the frequency of tender and switching events. As we mentioned above, and as recognised by the CC in the paper itself, low tendering and switching rates are consistent with effective competition and do not *per se* indicate a weaker bargaining position. We do not reiterate these points further aside from saying that in our view the CC has in this Working Paper failed to address our arguments and has not provided any evidence for its view that switching costs might be substantial or lead to less than effective competition.
- 1.7 **The CC's concern that ACs' / FDs' alumni status might reduce choice:** The CC suggests that the alumni status of many ACCs and FDs might make them more favourably disposed to the appointment of one of the largest four audit firms. In numerous previous submissions⁶ we have set out our view that this suggestion is wholly unsupported by the evidence. We do not repeat our views in this response but would note that the CC has not responded to or dealt with our previous concerns or provided any further evidence in this Working Paper. We would therefore challenge strongly the CC suggestion that the alumni status of ACs and FDs in any way restricts competition.
- 1.8 As well as making a proper assessment of companies' bargaining strength, the CC should also recognise the evidence on the strength of competitive pressures in the supply of statutory audit services and the variables over which audit firms compete. The evidence we submitted in numerous submissions to the CC, and presented in the Working Paper and in this response clearly demonstrates that the audit market has all the attributes of a fiercely competitive market both during and outside of tender events. Specifically:

⁵ Paragraphs 76, 88 and 92 of the Working Paper.

⁶ Section 4.5 of our response to the CC's working paper "Framework for the CC's assessment and revised theories of harm"; paragraph 6.8.1 of our response to the CC's working paper "Restrictions on entry and expansion"; section 3.2 of our response to the CC's working paper "Barriers to entry: reputation and experience".

- audit firms compete hard to win new clients, during tender events and by targeting their rivals' clients outside of tender events⁷;
- audit firms have strong incentives to retain their existing clients, and this exerts competitive pressure⁸;
- FTSE350 companies are informed buyers of audit services and have bargaining power⁹;
- FTSE350 companies can use the threat of switching (implicit or explicit) to gain fee reductions outside of tender events¹⁰.

1.9 However, in our view the CC's assessment of the evidence of competitive pressure is also flawed in that it does not recognise the strength of competition through innovation and investment in quality improvements and efficiencies. We make substantial ongoing investments to ensure we meet client demands for quality and efficiency and can compete effectively with our rivals. It is therefore in our view crucial that the CC recognises this additional manifestation of ongoing competitive pressures in order to form an accurate assessment of the strength of competition to win new clients and retain existing ones.

1.10 Overall, we agree with the CC's conclusion that competition during tender events is strong¹¹. However, based on all of the available evidence we fail to see how the CC can come to any other conclusion than that competition is also fierce outside of these events.

1.11 In sum, we believe that the concerns expressed by the CC on the allegedly weaker competition outside of tender events are directly in contradiction with the available evidence. We constantly engage in strategies to make sure our clients get the best possible service at the most competitive price, whether or not a tender is looming. We invest continuously to improve our services and regularly review our fees. All audit firms actively engage in activities to persuade companies to change provider and the consequences of losing any client are very significant for any audit firm. In this environment (and consistently with economic theory and previous CC practice) low tendering and switching rates do not signal a lack of competition and are fully consistent with a competitive market.

1.12 Finally, the precise way in which companies choose to benchmark our services, or the frequency with which they do so, does not in any way translate into different bargaining strengths. All our clients are very well informed buyers of our products. But even if they were less informed than they are (which

⁷ Paragraph 176 of the Working Paper.

⁸ The consequences to audit firms of losing a FTSE350 client's audit are substantial and go beyond the lost profit on that particular engagement (as recognised by the CC at paragraphs 138 and 195 of the Working Paper).

⁹ ACCs and FDs are experienced and knowledgeable purchasers of audit services (as recognised by the CC at paragraphs 74 – 76 and 88 of the Working Paper) and the majority of companies review their audit every year and almost all companies review their audit every five years (as recognised by the CC at paragraphs 66 and 93 of the Working Paper). See also paragraphs 138 and 192 of the Working Paper.

¹⁰ Paragraphs 9, 65 and 100 of the Working Paper.

¹¹ Paragraph 165 of the Working Paper.

the CC seems to be concerned about) audit firms would not be in a position to spot or exploit this. Companies do not need perfect information to negotiate effectively with their incumbent audit firm and given the pervasiveness of their review processes and the information sources they have access to, we cannot afford to consider them anything other than well informed.

1.13 In the rest of this response we focus on what in our view are two key failings in the CC's analysis in this Working Paper: first, its assessment of companies' bargaining position and second, its failure to take properly into account competition through innovation and investment. As we set out above we do not repeat in this response our views on switching costs and the alumni status of ACs and FDs, aside from noting that in our view the CC's position on these issues is flawed and unsupported by the evidence. In Annex 1 to this response we set out more detailed comments on the Working Paper.

2 FTSE350 companies have a strong bargaining position outside of tender events

2.1 Introduction

2.1.1 The CC makes a distinction between competition to win new clients and competition to retain existing ones, which in our view is relatively arbitrary. Whilst for the purposes of presenting our available evidence we made our comments separately on these two dimensions in our Main Submission that should not be seen to imply that there is a clear dividing line between competitive strategies and actions to win new clients and those to retain existing ones. The efforts audit firms go to in targeting new clients, agitating for a tender and then ultimately in responding competitively to a tender are evidence of competitive actions to win new clients, but also of strong competitive pressure on incumbent firms who need to maintain the competitiveness of their offering if they are to retain their existing clients. That is why we make long term investments in quality in order to retain existing clients and to win new ones. The CC should recognise that these strategies are both manifestations of the same competitive process.

2.1.2 In this section we address first the CC's concerns that information from benchmarking is not complete. Second, we consider the consequences to audit firms of losing a client and the efforts we go to in order to retain them, which is further evidence of the strength of companies' bargaining positions.

2.1.3 Overall, it is our firm view, based on our commercial experience that companies have a strong bargaining position, and this exerts strong competitive pressures on incumbent audit firms if they are to retain their existing clients. The CC's conclusion that "*when companies ask firms to reduce fees, it appears that fee reductions are often secured*"¹² is strong evidence of these competitive pressures. This

¹² Paragraph 65 of the Working Paper.

competitive pressure is also independent of any 'trigger points'¹³ – for us any trigger point occurs whenever we have any concerns around clients thinking we are not giving them the best quality service at the best possible price.

2.2 The CC's concerns about benchmarking information are unfounded

2.2.1 Overall, the results of the CC-commissioned survey ("CC's survey") demonstrate that companies review their audit fees and quality regularly, in a variety of ways:

- the very large majority (over 90 per cent) of FTSE350 companies conduct a post-audit review of quality and value every year¹⁴;
- the very large majority (over 90 per cent) of FTSE350 companies renegotiate fees every year¹⁵; and
- the very large majority (90 per cent) of FTSE350 companies have conducted either a benchmarking exercise or requested a formal proposal by another audit firm¹⁶.

2.2.2 In our view this is strong evidence that customers are not only well informed (as the CC acknowledges¹⁷) but that they are fully engaged in the process and actively review the relative quality, and cost, of the services audit firms provide, with the clear purpose of extracting the best value from their suppliers. In other words this evidence shows clearly that competition is very intense outside of tender events.

2.2.3 However, despite the survey evidence, the CC appears to be concerned that:

"in practice [a company's] bargaining position with respect to their incumbent auditor, outside of a tender process, is weakened by the limited effectiveness of benchmarking¹⁸".

2.2.4 The CC appears to have two concerns in relation to benchmarking: first, that the information companies gain from benchmarking might not be fully accurate¹⁹; and second, that some companies benchmark the performance and fees of their audit firms less extensively than others²⁰.

2.2.5 We disagree strongly with the CC on these points, both on the facts and on what conclusions should be drawn from them. First, in terms of the quality of benchmarking, the CC has provided no evidence that these assertions are borne out in practice. We believe that they are not and that benchmarking, which is conducted in a number of ways, including on the basis of the approaches to companies from rival audit firms, is pervasive and highly effective.

¹³ Paragraphs 188 to 198 of the Working Paper.

¹⁴ Slide 46 of the CC's survey presentation.

¹⁵ Slide 46 of the CC's survey presentation.

¹⁶ CC's response to Norton Rose PwC query, 15 October 2012.

¹⁷ Paragraphs 76, 88 and 92 of the Working Paper.

¹⁸ Paragraph 141 of the Working Paper.

¹⁹ Paragraph 194 of the Working Paper.

²⁰ Paragraph 193 of the Working Paper.

- 2.2.6 Second, on the implications to be drawn by these facts, we believe that even if it was the case that some companies' reviews and benchmarking activities were less informative than those of others (or than in tender events), this would in no way imply that a supplier of audit services to that company would be in a stronger bargaining position because of it²¹.
- 2.2.7 When assessing the pervasiveness and effectiveness of benchmarking, it is important to consider that the manner and frequency with which these exercises are carried out depends on factors specific to a company. In the absence of significant organisational change or change in the audit scope, there is little need to go through thorough exercises every year to benchmark with other companies since the relative position is unlikely to change. However, that does not mean there may not be challenging discussions about the fee and in-depth reviews of audit quality, as shown by the CC's survey results in paragraph 2.1.2 above. In addition, as the survey shows, companies that do review the quality and value of their current audit firm somewhat less frequently than others are a small minority. Since a provider of audit services will not be in a position to know exactly what comparisons a client is performing, it will have to deal with every client as if they are their most informed client. The consequences of losing a client (as we discuss in section 2.3 below) are severe. As a result, the less informed companies will be in as strong a bargaining position as the more informed ones.
- 2.2.8 In addition, companies speak to other audit firms, who will be targeting other audit firms' clients. This activity provides clients with further information which can be used to benchmark the quality and fees of their audit firm. From our experience speaking with our own target audit clients (ie clients of other audit firms), this may take the form of informal discussions, or more focussed conversations on what could be offered in terms of the statutory audit. We are never aware of the content of any of the discussions our audit clients have with our rivals (aside from any information shared by our audit clients for the purposes of negotiating with us) and have to assume these discussions could be happening in relation to all of our audit customers.
- 2.2.9 We have discussed previously the activities we undertake to target new clients in our response to the Market and Financial Questionnaire ("MFQ") and in our Main Submission. The CC recognises that all of the largest four audit firms actively target companies that are currently audit clients of their rivals, for example approaching the company specifically to discuss their proposed approach, including how this is different from their current audit firm's, to the audit engagement together with a proposed fee

²¹ This is consistent with standard economic theory, for example see Muthoo 'Bargaining Theory with Applications' CUP, 1999. Ch 9.6 on 'Bargaining power and uncertainty', in particular proposition 9.2.

structure²². The CC's survey also shows that the large majority (71 per cent) of companies have been approached by audit firms (other than their existing audit firm) in the last five years²³.

2.2.10 The CC recognises that these targeting activities exert important competitive constraints on incumbent audit firms:

"Competing firms may persuade companies to challenge the incumbent auditor on the ground of fees (with the hope of triggering a tender), scope and efficiencies of the audit. In these cases we observe that incumbent auditors face indirect competitive pressure from competitors trying to win new clients"²⁴.

2.2.11 As a result, we consider that whatever form of reviews or benchmarking our clients perform we have to assume it is an appropriate amount of information gathering to put them in a strong position to form a credible negotiating position

2.2.12 In addition, as we set out at the hearing with the CC on 3 October (the "Hearing"), during negotiations companies will generally only need to point to other companies that are broadly comparable to their own with lower fees. In practice, the onus is then on the incumbent audit firm to justify why the audit fee should not be lower / at the level of the audit fee(s) of the comparator company (ies) and provide evidence on the competitiveness of incumbent audit firm's offering. Needless to say our clients thoroughly challenge us on this evidence. We referred in our response to the MFQ to the example of the [X] audit which we lost to [X] in [X] - we believed we could not match the client's expectation in relation to the overall fee given our knowledge of the scope of the audit required, illustrating the intense pressure we are under in relation to audit fees. Overall, the reality of these processes is such that all some companies may need to do is to find some reference to lower audit fees and argue that that is a relevant comparator.

2.2.13 Regardless of whether or not we think that information is accurate, we (as any other provider) will not be in a position to avoid fully engaging with that claim. We will need to show our approach and fees are competitive and often will have to reduce our fees as a result. This is due to the unsolicited approaches companies receive from rival audit firms and the serious consequences of losing any audit client (discussed in section 2.3 below). In other words, this is due to the fiercely competitive nature of the marketplace.

2.2.14 The CC also states that companies may not put their audits out to tender because they do not expect there to be gains to be had from doing so (or at least, not gains that outweigh their perception of the costs). These statements from the CC appear confused. We believe, and have explained to the CC

²² Paragraph 155 of the Working Paper.

²³ Slide 81 of the CC's survey presentation.

²⁴ Paragraph 176 of the Working Paper.

several times in our previous submissions²⁵, that it is important for the CC to recognise that any cost benefit assessment on which a decision of switching may be based, is crucially dependent on the performance of the incumbent. The performance of the incumbent depends on the competitive pressures it faces, and as a result the fact that many companies find that there may not be good reasons to switch is entirely consistent with the market being competitive and with credible threats by customers forcing incumbent firms to perform well²⁶.

2.3 Consequences to audit firms of losing a client are significant

2.3.1 The CC recognises that the costs to audit firms of losing a client are significant, and go beyond the profitability of the individual engagement²⁷. We welcome this conclusion, which we also discussed in our Main Submission²⁸. As the CC also recognises, this strengthens the negotiating position of FTSE350 companies²⁹.

2.3.2 We consider that the efforts we go to retain clients provide further evidence of the competitive pressures we face as incumbent audit firms, as also recognised by the CC³⁰.

2.3.3 As the CC recognises, these efforts take many forms, including, for example, responding to client demands to fix fees beyond the first year of an engagement³¹.

2.3.4 In addition, we conduct surveys and performance reviews³² to monitor our performance and keep up to date with client demands. Whilst the CC has referred to our surveys of FDs and surveys through the Audit Committee Institute (ACI), it has not referred to the full extent of our activities to monitor client views and satisfaction³³. For instance, the CC has not mentioned (in the main text or in the annex of this Working Paper) our Client Insights programme, which gathers and analyses detailed feedback from clients (which we set out in our response to the MFQ³⁴). This is a substantial programme, requiring considerable investment and further evidence of the intense competitive pressures we are under to ensure we remain competitive and keep our clients satisfied.

²⁵ Section 4.3 of our response to the CC's working paper "

²⁶ This is also supported by the CC's survey which finds that the most common reason why companies have not switched is that they are satisfied with their current audit firm.

²⁷ Paragraphs 138 and 195 of the Working Paper.

²⁸ Paragraphs 259 – 264 of our Main Submission.

²⁹ Paragraph 138 of the Working Paper.

³⁰ Paragraph 177 of the Working Paper.

³¹ Paragraph 196 of the Working Paper.

³² Paragraph 177 of the Working Paper.

³³ In Annex 1 of the CC's working paper on "Evidence relating to the audit selection process: Tendering, Annual renegotiations and Switching" the CC refers to our survey of FDs and of ACCs but not to the client insights programme.

³⁴ Paragraphs 102.4 to 102.7 of our response to the MFQ.

2.3.5 In addition, the CC has not mentioned the extensive quality assurance programmes that we have in place to monitor quality across all of our engagements, which we described in detail in our Main Submission³⁵ and our response to the MFQ³⁶. In our view our investment in these programmes provides strong evidence of the competitive pressure to maintain and improve our quality on the audits of existing clients.

3 The CC has underestimated competition through innovation and investment

3.1 The CC recognises in the Working Paper that there is scope to innovate in relation to a number of areas of the audit product and service, in particular: i) the possibility for additional testing (such as our 'extended audit' product); ii) how work is documented and the focus of auditing financial statements; iii) industry-specific audit approaches; iv) IT, software and systems; v) detailed reports on financial controls, such as journals postings; and vi) insightful reporting of audit findings to the AC and management.

3.2 However, the CC also states that tender proposals rarely mention innovation, which the CC takes to imply that firms do not compete on innovation during tenders³⁷. In our view the CC has missed the point in relation to innovation. Innovation is not necessarily mentioned as an item in a proposal. At an immediate level we seek to innovate every day, purely by providing innovative and bespoke solution to each client's audit. This may not be explicitly categorised as "innovation" in pitch documents however in practice, this is what it is.

3.3 In addition, we make investments in innovations which drive both cost efficiencies and quality improvements, which are crucial in order to remain competitive in relation to the fees and quality of our audit offering. In pitch proposals we therefore emphasise the competitiveness of our fees, efficiency of audit process and our high quality offering which are the product of investments to innovate even if they are not explicitly mentioned.

3.4 On this issue, the CC appears to draw a distinction between innovation that drives cost efficiencies on the one hand, and innovation that drives quality improvements on the other³⁸. However, in reality, innovation often improves both cost efficiency and the quality of the product we provide to clients. For example, improvements in the software used to deliver a statutory audit (for example our eAudit tool)

³⁵ Section 5.1.7 of our Main Submission.

³⁶ Question 101 of our response to the MFQ.

³⁷ Paragraph 39 of the Working Paper.

³⁸ Paragraph 39 of the Working Paper.



can make the process more efficient while also ensuring greater consistency (including across jurisdictions) and provide greater reporting and feedback to the client³⁹.

- 3.5 In addition, it is important to recognise that quality is not driven solely by what the CC might recognise as 'innovation'. We have to make other investments which are also essential to maintain quality and to develop the characteristics desired by our clients. We highlighted a number of these investments in our Main Submission⁴⁰, including investment in staff training and recruitment, investment in the international network, investment in sector-specific and other technical expertise and investment in quality assurance and monitoring.
- 3.6 Overall therefore, the CC should recognise that competition goes well beyond competing aggressively day-to-day to retain existing clients, target new ones or respond to tender events.

³⁹ See also our discussion of innovation in the CC's hearing, (pages 13 – 14 of the draft hearing transcript).

⁴⁰ Section 5 of our Main Submission.

Annex 1: Detailed commentary on the Working Paper

Para	Our comments
5	We have previously agreed with the CC's characterisation that audits display some characteristics of an experience good. However, there are observable factors which companies can use to assess the quality of audit firms <i>ex ante</i> ⁴¹ . Once an audit firm has been appointed the CC suggests that certain individuals might not be able to 'appraise accurately certain aspects of the product'. It is unclear exactly which individuals the CC had in mind, but as we have set out in previous responses, ACs and FDs are well placed and able to accurately judge the quality of the audit they receive ⁴² , something the CC have previously acknowledged ⁴³ .
9	<p>We welcome the CC's recognition that a threat to put an engagement out to tender is a source of competitive pressure. As we have set out in the main text of this response companies have strong negotiating positions and we face intense competition to retain clients.</p> <p>We would add that the threat to tender does not have to be explicit –the implicit threat and the constant awareness that clients could go to tender is just as important in exerting competitive pressure on incumbent audit firms.</p>
13	We agree with the CC's assessment that the audit report is the end product of a wider audit process and that a broad description of the audit process is appropriate to capture the elements of an audit and the elements of audit quality and parameters of competition.
16, footnote 4	As we set out in our response to the CC's working paper on "Barriers to entry: reputation and experience", reputation reflects an audit firm's underlying quality ⁴⁴ .
16	The CC notes that fees for audit related services need not be published. We note that the FRC's 2010 guidance for ACs suggests ACs should set out, or cross refer to, the fees paid to the auditor for audit services, audit related services and other non-audit services, with effect from 30 April 2011.
17 to 20	The output of the audit is defined by the required components of an audit report and in the standards for auditing (ISAs). However, as we note in various submissions ⁴⁵ , we make considerable investments in our audit efficiency and in training of our staff in a bid to provide the best possible product to clients and differentiate our offering in the areas covered by the CC in these paragraphs. We would argue that these investments represent continual innovation, an area we explore in our discussion of paragraph 39, 84, 112 and 167 below. However, the nature of the competitive market for the supply of statutory audit services is that

⁴¹ Paragraph 17 of our response to the CC's "Barriers to entry: reputation and experience" working paper

⁴² Section 3.3 of our response to the CC's "Framework for the CC's assessment and revised theories of harm" working paper

⁴³ Paragraph 63 of the CC's "Framework for the CC's assessment and revised theories of harm" working paper

⁴⁴ Section 2 of our response to the CC's "Barrier to entry: reputation and experience" working paper

⁴⁵ Section 8 of our Main Submission, Paragraphs 22.18 – 22.20 22.9, 26.22 – 26.35, 100.14 – 100.18, 103.2 – 103.3 of our response to the MFQ

Para	Our comments
	any new offering is quickly followed by other firms. For example our extended assurance product ⁴⁶ is now also offered by other audit firms.
23	We agree that the regulation provides only minimum standards for quality or the level of testing, and we compete fiercely to provide quality above these minimum standards.
39, 84, 112 and 167	<p>The CC states that tender proposals rarely mention innovation, and that it is rare to see an audit firm lose a tender process because a competitor offered a more innovative approach. In our view the CC has missed the point on innovation. At an immediate level we seek to innovate every day, purely by providing innovative and bespoke solution to each client's audit. This may not be explicitly categorised as "innovation" in pitch documents however in practice, this is what it is – and differences between the approaches of different audit firms' pitches are very often the reason why an audit firm wins or loses a pitch.</p> <p>In addition, our audit function is required to constantly innovate in order to improve quality and efficiency. We emphasise our quality and efficiency during tender events and outside of tender events. Section 3 of the main body above considers this in more detail. Furthermore, as we discussed at the hearing, in our view innovation in the nature of the statutory audit product itself is limited to some extent by the legal definition of the audit product, and by clients' willingness to commission assurance over a broader information set than required for statutory purposes.</p>
43 and 49	<p>We agree that ACs are able to access the substantial amount of information also available to managers in relation to the audit. As we have set out previously⁴⁷, in our experience ACs discharge their duty to shareholders effectively and diligently. This is reiterated by the CC in paragraph 92 of the Working Paper.</p> <p>We agree that ACCs are the most influential in the selection of the audit firm. This is in line with their duty to shareholders, which they discharge effectively, as we discussed in our response to the CC's working paper "Framework for the CC's assessment and revised theories of harm".</p> <p>Furthermore, ACCs also have a personal reputation to maintain, which would be seriously at risk if they were to neglect their duty to shareholders⁴⁸. In our experience ACCs are therefore are scrupulous in relation to monitoring and ensuring audit quality.</p>
43, 88 and 99	In regard to the depth of scrutiny placed on the audit by the AC and ACC, we note that ACs have an obligation under the UK Corporate Governance Code to oversee the audit team and the audit process. How the AC does this is a matter of judgement and will likely vary over time and in the context of specific circumstances. We note that there is an overriding incentive on ACCs of FTSE 350 companies to have a well informed view when it comes to audit scrutiny, and in previous submissions we have provided evidence around the background of

⁴⁶ Paragraph 23.17 of our response to the MFQ

⁴⁷ Section 3.2 of our response to the CC's "The framework for the CC's assessment and revised theories of harm" working paper

⁴⁸ Paragraph 3.2.3 of our response to the CC's "The framework for the CC's assessment and revised theories of harm" working paper

Para	Our comments
	<p>ACCs and their ability to carry out this task. The CC sets out this evidence in paragraphs 74 to 76 and paragraphs 88 and 92 of the Working Paper, noting that ACCs are “highly qualified and experienced individuals”, “experienced and knowledgeable purchasers of the audit services” and “sophisticated purchasers of audit services”.</p> <p>The evidence before the CC is therefore that ACCs appear generally to have the incentives, skills and resources in order to discharge their roles effectively.</p> <p>Finally, we would also note that most ACs would have the power, within their Terms of Reference, to seek the employment of additional advice and resources as they believe fit.</p>
44	<p>The paragraph makes reference to certain elements of the audit not being available to some stakeholders over the course of the audit process, and that this results in judgments being made by these stakeholders absent this information. We note in our response to the CC’s “Barriers to entry: Reputation and Experience” working paper that clients use indicators, such as the experience of the audit firm in a relevant industry, or the experience of an audit firm in dealing with large and complex companies, to judge, <i>ex ante</i>, the audit’s quality. Other attributes include technical expertise, good working relationships, independent reports on the audit firm’s quality and (in particular for companies with a significant overseas presence) a strong international network⁴⁹. Companies can also judge audit firms’ quality if they provide the company with non-audit services. Companies’ FDs and ACCs are also able to judge the quality of the audit directly once an engagement is underway. We note in our response to the CC’s “Barriers to entry: Reputation and Experience” working paper that clients also assess quality <i>ex post</i>⁵⁰. This is based on the actual work done, and clients are quick to tell us if we are not meeting their expectations. Furthermore, they will talk among themselves and so knowledge of our quality (or any failure to deliver quality) will go beyond an individual client⁵¹.</p> <p>We note that it is not clear which stakeholders the CC has in mind in this paragraph. In relation to shareholders, we have set out in response to paragraphs 43-49 above that in our view ACs discharge their duty to shareholders effectively and diligently and ultimately safeguard shareholders’ interests. We discuss their ability to monitor technical quality in section 3.3 of our response to the CC’s “The framework for the CC’s assessment and revised theories of harm” working paper.</p>
49	<p>A more important issue in relation to shareholder action on the appointment of the audit firm is whether the CC has identified any instances where the majority of shareholders opposed the reappointment of an audit firm, yet the reappointment went ahead. We are not aware of any examples where this has happened.</p>
51	<p>ACCs are effective at discharging their duties to shareholders, are aware of the shareholders’ demands and their incentives are aligned – something we set out in our discussion of paragraphs 52-58 below.</p>
52 to 58	<p>We note that the qualities listed as important to ACCs and FDs throughout this section are also likely to be important to shareholders and supports the view that</p>

⁴⁹ Paragraph 16 of our response to the CC’s “Barriers to entry: Reputation and Experience” working paper

⁵⁰ Paragraphs 18-19 of our response to the CC’s “Barriers to entry: Reputation and Experience” working paper

⁵¹ Page 51 of the CC Hearing transcript

Para	Our comments
	ACCs' interests are aligned with those of shareholders.
55	We note that 23 per cent of ACCs and 25 per cent of FDs considered the ability to offer value added services as important. In our view, 23-25 per cent represents a substantial minority of customers who view these services as important.
65, 176 and 177	The CC notes that " <i>when companies ask firms to reduce fees, it appears that fee reductions are often secured</i> " (paragraph 65). In our view, as discussed in the main body of this response, this is extremely strong evidence of the strong bargaining position of our clients and ultimately of the competitive pressures we face to retain existing clients. All of our clients have the ability to demand fee reductions, and as a result we are constantly aware of the intense competitive pressure we are under to retain all of our existing clients.
66 and 93	As we set out in the main body of our response ⁵² , the fact that a substantial majority of customers review audit quality and renegotiate fees every year means that companies have substantial bargaining power and that we are under intense competitive pressure to retain our existing clients.
67	<p>We disagree that one of the main variables in which we compete for FTSE 350 engagements is reputation. We do not compete over reputation. Instead, we compete to provide the highest quality and most efficient audits. Over time, this gives rise to a reputation for quality but it is incorrect to say that we directly compete for reputation.</p> <p>We would note that the delivery of the audit, as well as insights provided as a by-product of the work conducted in order to deliver the statutory audit, are not included in the CC's list of the variables over which we compete. However, in our view, we also actively compete on these variables which provide a key opportunity for differentiation.</p> <p>In regards to paragraph 68, we compete on experience and quality, as well as the fee, both during and outside of tender processes. We do not negotiate on quality, whether competing for a new client or during renegotiations with an existing client. This does not diminish the constant competitive pressures we face to maintain both technical and service quality.</p>
71, 141d and 141e	We do not agree with the CC's view that the credibility of a threat to tender or switch can be determined from the frequency of tendering/switching. The frequency of switches does not have any bearing on the credibility of a threat to tender. As noted in previous responses, we take any drop in client satisfaction very seriously and by seeking to maintain our quality and keep fees competitive we aim to avoid clients switching or going out to tender ⁵³ . The CC has provided no evidence that threats to tender are not credible, and instead there is substantial evidence that they are taken very seriously, in particular the CC's recognition that threats to tender usually lead to reductions in fees. We also discussed our views on the CC's statements on the frequency of tenders and switching in paragraphs 1.2 and 1.6 of the main text of this response.

⁵² Section 2.1 of the main body of this response.

⁵³ See the discussion of paragraph 153 in our response to the CC's "Evidence relating to the selection process: Tendering, Annual Renegotiations and Switching" working paper

Para	Our comments
78	<p>The CC suggests that tenders are held over a relatively short time frame. The CC does not appear to have any basis for this conclusion. Six weeks to three months seems a common time frame for tenders in other professional services industries and the public sector. In any case, it is not clear what the CC might conclude from the length of the tender process in relation to competitive pressures – it is for companies to judge whether the timeframe gives them sufficient time to assess bids and for them to provide audit firms with appropriate levels of access. It is certainly a long enough time frame to allow sufficient access to the client/potential client to allow bidders to form well developed proposals (whether they had advance notice of the tender opportunity or not).</p>
82	<p>We agree with the CC's conclusion in this paragraph that the tender processes generally provide FDs/ CFOs and ACCs with detailed information on the capabilities of the audit firm.</p> <p>In relation to information on how a particular engagement will be conducted, which the CC suggests we provide less often in tender proposals, we would argue that detailed information on this issue is probably not of as much interest to companies. We would happily provide this if requested, and in some cases this will have undoubtedly been covered in discussions or meetings held prior to submission of the main proposal document.</p>
84, 103, 108, 181, 182 and 187	<p>The CC references in these paragraphs of the Working Paper to the assertion that companies may not put their audits out to tender because they do not expect there to be gains to be had from doing so (or at least, not gains that outweigh their perception of the costs). Further, the CC suggests that threats to do so might not be credible.</p> <p>These statements from the CC appear confused. We believe, and have explained to the CC several times in our previous submissions⁵⁴, that it is important for the CC to recognise that any cost benefit assessment on which a decision of switching may be based, is crucially dependent on the performance of the incumbent. This should be clearly recognised by the CC (for example in paragraphs 84 and 103) and it is critical for interpreting the evidence, since the performance of the incumbent is of course dependent on competitive pressures. This is why the fact that many companies find that there may not be good reasons to switch is entirely consistent with the market being competitive and with credible threats by customers forcing incumbent firms to perform well.</p> <p>That this is actually the case is confirmed by the evidence from the CC's survey, which shows that the main reason companies do not put their audit out to tender is that they are satisfied with their current audit firm. Of course, this means that companies do not perceive there to be benefits to switching, but this is because competition is forcing the incumbent to perform well. At the same time it does not imply that companies would not tender their audit were the performance of their current audit firm to drop. In other words it does not in any way imply that threats to switch are not credible, this should be clearly reflected in paragraph 108.</p> <p>Similarly in paragraphs 181, 182 and 187 the CC should be clear that long tenures</p>

⁵⁴ Section 2 of our response to the CC's "Evidence on switching costs (and implications for barriers to entry)" working paper, Section 4.3 of our response to the CC's "The framework for the CC's assessment and revised theories of harm" working paper

Para	Our comments
	are consistent with strong competition. In a market where there are inefficiencies associated with frequent switching and given the fact, which the CC recognises, that frequent switching is not necessary for there to be effective competition, one should expect long tenures as a product of an effective competitive process and not a driver of less than effective competition.
86, 105, 133 and 141	<p>The CC notes that the section following paragraph 86 relies on the analysis set out in its working paper on switching costs. Our response to that working paper set out our views on switching costs in more detail, but for this response we reiterate that we disagree with the CC on certain factors discussed in this paper, namely that:</p> <ul style="list-style-type: none"> ■ a perception of switching costs might be sufficient to deter tendering or switching; and/ or, ■ collectively the switching costs that the CC identifies might constitute a barrier to entry or expansion. <p>We disagree that there are substantial search and switching costs. We would again point to the CC's own evidence that companies which have switched have not found the process costly⁵⁵.</p>
95	We note that the CC has since circulated a revision to figures concerning the number of companies carrying out benchmarking or other formal comparisons or requesting formal proposals or presentations before reappointment. Only a very small proportion (10 per cent of FTSE350 companies) have not carried out these activities.
97, 102, 108, 141a – 141c, 180, 193 and 194	<p>The CC has provided no evidence to support its hypothesis that benchmarking exercises might be limited in scope and might not provide accurate information. In addition, the evidence shows that companies review their audit fees and quality regularly (as discussed in paragraph 2.2.1 in the main body of this response).</p> <p>Companies obtain information from a variety of sources. These include:</p> <ul style="list-style-type: none"> ■ a variety of quality reviews and benchmarking activities conducted by the very large majority of companies. The vast majority of FTSE 350 companies carry out post-audit reviews of quality and value of service provided annually⁵⁶; ■ the information companies obtain from the approaches they receive from rival audit firms – the largest four firms are continually targeting clients and making them aware of their offerings⁵⁷. We set out a selection of our own efforts in this area in our response to the MFQ⁵⁸; and ■ the knowledge that FDs have from previous directorships, and the sharing of this knowledge across the community as a whole. This is the same for ACCs, of which nearly all in the CC's Survey sat on other boards. Although these may not necessarily be in companies in similar industries, FDs and ACCs are highly qualified professionals who are able to transfer knowledge of other

⁵⁵ Slide 67 of the CC's Survey presentation

⁵⁶ Slide 46 of the CC's Survey presentation

⁵⁷ Slide 82 of the CC's Survey presentation

⁵⁸ Paragraph 22.14 of our response to the MFQ

Para	Our comments
	<p>businesses to be used in comparison.</p> <p>We have noted (and the CC note in paragraph 98), comparisons in audit fees across other companies is difficult, but as we explained in the hearing they can provide some information⁵⁹. However, as we explain here, companies can use a wide variety of information to overcome these difficulties.</p> <p>Finally, even if benchmarking did not provide fully accurate information this does not in our view imply that competition to retain existing clients is any weaker, as we set out in the main body of our response.</p>
101	<p>As noted in our discussion of paragraph 100, the threat to switch does not need to be made explicitly. We are always aware of our clients' ability to switch and the constant implicit threat to go to tender. Furthermore, we provided a considerable number of examples of explicit threats to switch in our response to the MFQ⁶⁰, so are somewhat puzzled by what the CC defines as "often".</p>
116	<p>The CC finds that firms outside of the largest four do not see the cost of tenders, or a lack of financial or personnel resources as holding them back from participating in tender processes. This provides further support for our views that there are strategies available for mid-tier firms to grow their businesses, set out in our response to the CC's "Barriers to Entry: Reputation and Experience" working paper⁶¹ and its "Evidence relating to the selection process: Tendering, Annual Renegotiations and Switching" working paper⁶².</p>
120	<p>The CC suggests the alumni status of ACCs and FDs may make them more favourably disposed to select one of the largest four audit firms, and/ or may make them less aware of the offerings of the mid-tier.</p> <p>In previous submissions we have set out our view that this suggestion is wholly unsupported by the evidence⁶³. We will not repeat our views in this response but would note that the CC has not responded to or dealt with our previous concerns or provided any further evidence in this Working Paper. We would therefore challenge strongly the CC suggestion that the alumni status of ACs and FDs in any way restricts competition. See also paragraph 1.7 in the main body of this response.</p>
126	<p>The CC states that there may be a "large minority" of FTSE 350 companies which have limited auditor choice. We would make two points in response to this suggestion. First, in our experience there are only one or two clients, if any, where we wouldn't tender because of the non-audit services we provide – as we pointed out at the Hearing, increasingly clients expect participation in tender processes and</p>

⁵⁹ Pages 39, lines 3-20 of page 40, lines 6-11 of page 42 from the transcript of KPMG's hearing with the CC

⁶⁰ Question 91 of KPMG's response to the MFQ

⁶¹ Paragraphs 8-11 of our response to the CC's "Barriers to Entry: Reputation and Experience" working paper

⁶² Our discussion of Paragraph 114 in our response to the CC's "Evidence relating to the Selection Process: Tendering, Annual Renegotiations and Switching" working paper

⁶³ Paragraph 6.8 of our response to the CC's "Restrictions on entry or expansion" working paper, Paragraph 3.2.1 of our response to the CC's "Barriers to Entry: Reputation and Experience" working paper and Paragraph 4.5.3 of our response to the CC's "The framework for the CC's assessment and revised theories of harm".

Para	Our comments
	<p>would take a dim view of our not doing so simply to enable continued provision of non-audit services⁶⁴. The CC also found that there are usually at least three firms participating in a tender.</p> <p>Second, there is no evidence that this a limitation in choice has any adverse effect. As the CC find in paragraph 145 of the Working Paper, the number of audit firms participating in the tender does not appear to have any effect on the characteristics of the proposal. In relation to negotiations, it is sufficient for companies to have one credible outside alternative.</p>
138 and 195	<p>We welcome the CC's conclusion that the cost of losing a FTSE 350 audit client is not limited to the lost profit on the individual engagement. An audit firm is constantly aware of the potential loss following client switching away from its audit services, both in terms of the monetary value and the loss of relationship specific investments. We explore this at length in paragraphs 259 - 264 of our Main Submission.</p>
140	<p>We agree with the CC's conclusion that during a tender process the incumbent audit firm does not have a higher chance of winning. We note in our response to the CC's "Evidence on switching costs (and implications for barriers to entry)" working paper that almost all of our proposal documents state that we absorb all transition costs⁶⁵. This is consistent with switching costs not being substantial.</p>
141h	<p>Paragraph 141 (h) of the Working Paper states that ACCs and FDs have a limited incentive to tender in order to achieve a reduction in fees alone unless these are expected to be substantial. KPMG believes that the CC understates the position - as Directors and senior officers of the company the FD and ACC can be expected to, and do, exercise their positions in the interests of the Company and shareholders and do look for value for money, including where appropriate by pressure on audit fees at the annual review and tender. Also, however, it is clear that fee levels may not be the main feature of a decision to retain or appoint a particular audit firm and that quality and value for money are- reasonably-judged more broadly.</p> <p>Any threat to switch in response to fee pressure is taken very seriously. This is evidenced by the CC's conclusion that when clients ask for a fee reduction they are usually successful in getting them⁶⁶. We discuss these issues in more detail in section 2 of the main text.</p>
143	<p>The CC states that tender events are frequently limited to the largest four audit firms. There is no evidence that this has any adverse effect on competition. It makes sense for a company to invite to tender the number of firms it thinks it needs in order to generate a very competitive tender process. The evidence in paragraph 145 suggests the characteristics of proposals received during a tender do not vary according to the number of competitors invited to the audit. When invited, non-Big 4 must have a non-negligible chance of winning.</p> <p>In addition, in regards to paragraph 143, we would point out that the CC's Survey</p>

⁶⁴ Line 14, page 37 to line 5, page 38 from the transcript of KPMG's hearing with the CC

⁶⁵ Paragraph 3.6.3 of our response to the CC's "Evidence on switching costs (and implications for barriers to entry)" working paper

⁶⁶ Paragraph 65 of the Working Paper

Para	Our comments
	does not show two thirds of tender lists being limited to the largest four audit firms only, it shows 61 per cent.
147 to 148	<p>The CC suggests that choice might be limited in certain sectors within the FTSE350. As we set out in response to paragraph 126 above, there is no evidence that this has any impact on competitive pressures.</p> <p>In addition, these paragraphs fail to take into account the limited number of large companies in sectors, and how this distorts market shares. Based on the 2010 audit fees in the data available from the public dataset, BP Plc and Royal Dutch Shell Plc are responsible for over 75 per cent of total audit fees for the Oil and Gas sector (Supersector 500). If we conduct this analysis based on market shares by turnover of the firms, this increases to 89 per cent. BP is an audit client of EY; Royal Dutch Shell is an audit client of PwC. As a result, it is unsurprising to see low market shares for Deloitte and KPMG.</p> <p>Furthermore, we note in our response to the MFQ our active approach in working across all sectors⁶⁷.</p>
155	<p>We welcome the CC's recognition that audit firms actively target companies who are currently clients of rival audit firms.</p> <p>We also welcome the CC's recognition of our investment in factors such as training and recruitment, IT systems, knowledge and methodology in order to win new clients. These investments are driven by competitive pressures and are equally important for the retention of existing clients.</p> <p>The CC also refers to "marketing activities", but as we set out in our response to the CC's working paper on "Barriers to entry: reputation and experience", such marketing activities are simply the promotion of the underlying quality which we deliver; they cannot create or preserve reputation, but are designed to raise awareness of it.</p> <p>As we also set out in that response, we invest in underlying quality, which gives rise to our reputation, rather than in reputation itself.</p>
158	<p>The CC notes that many of the largest four firms have advance warning of tenders. Our awareness of tenders before their formal announcement is a result of the investment we make in building client relationships through informal approaches and targeting programmes⁶⁸. This builds on the evidence noted by the CC in its "Competition Commission survey results" working paper⁶⁹. This is something that is clearly not confined to the largest four firms, with BDO also having such awareness. In our view there is no reason why other mid-tier audit firms could not engage in similar targeting activities to increase their awareness of forthcoming tenders.</p>
161	<p>The content of the proposals submitted will be different for each individual tender, since each audit is bespoke (as recognised by the CC⁷⁰ and discussed in our</p>

⁶⁷ Paragraphs 56 – 58 of our response to the MFQ

⁶⁸ Paragraph 22.14, our response to the MFQ and line 25 on page 31 to line 15 of page 33 of the "Notes of a hearing with KPMG" transcript

⁶⁹ Paragraph 59-61 of the CC's "Competition Commission survey results" working paper

⁷⁰ Paragraph 57 of the CC's "The framework for the CC's assessment and revised theories of harm" working paper

Para	Our comments
	<p>response to the CC's "Framework for the CC's Assessment and Revised Theories of Harm" working paper⁷¹.</p> <p>However, the number of participants in the tender will not have a bearing on the characteristics of tender proposals. We are not aware of exactly how many other participants there are in each individual tender as we indicated in our response to the CC's tender information request⁷². Rather, we are aware that in each tender there is likely to be at least one (and in almost all cases more than one) highly competitive rival audit firm, and therefore that we will need to submit an extremely competitive proposal if we are to stand any chance of winning the tender.</p>
162	We welcome and agree with the CC's finding that audit firms compete aggressively during tender processes.
163	<p>The conclusion that the largest four audit firms generally accept invitations to tender accords with our own experience, as set out in our response to paragraph 126 above.</p> <p>The only instance we have identified where we have not done so in recent years was in relation to the tender for the [§] audit, where the company asked for a fee below a level we would be comfortable would allow us to also provide a high quality, robust audit⁷³. This example also illustrated the intense competitive pressure we can come under from clients.</p>
175 and 193	<p>Adjustments for wage inflation and exchange rate movements are consistent with a competitive market. This is efficient adaptation in long term contracts in the presence of relationship-specific investment (e.g. escalation clauses related to certain costs in pipeline contracts). The same applies to written and non-written contracts.</p> <p>In addition, to the extent that audit fees increase in line with inflation this is usually linked to CPI. Professional staff salary inflation is often considerably higher than CPI and therefore CPI does not fully reflect the inflation in our own costs. Therefore we have to find efficiency savings just to maintain our margins.</p>
179	We welcome the CC's recognition of our views that the length of auditor tenure observed in the market is consistent with companies being satisfied with the audit product and receiving a competitive audit product and service. We note that the CC's survey found the primary reason for companies not tendering their audit was "receive high quality service" ⁷⁴ .
184 and 186	In paragraphs 184 to 186 the CC sets out some analysis of the impact of switching on audit fees. In our view this analysis is likely to be highly biased, as the CC recognises in paragraph 186 where it discusses that this analysis suffers from selection bias. As a result in our view the CC can place no weight on this analysis. Indeed, we are somewhat concerned that by publishing this analysis the CC is

⁷¹ Section 4.2 of our response to the CC's "The framework for the CC's assessment and revised theories of harm" working paper

⁷² Page 4 of KPMG's Audit Data Request cover letter

⁷³ Page 203 of our response to the MFQ

⁷⁴ Slide 60 of the CC's Survey presentation

Para	Our comments
	intending to place some weight on its conclusions, which we would strongly challenge. If the CC was intending to rely on such analysis we would expect to be given full opportunity to respond.
191	We do not see the rationale, or any evidence, behind the CC's hypothesis that audit firms can be fairly confident that a small increase in fees is unlikely to risk the loss of an audit client. Competition to retain clients is fierce, and as such we can never be confident that increases in fees will not be challenged or risk losing a client. We discuss the competitive pressure to retain clients at length in the main text of this response.
196	We agree with the CC's findings on fees being agreed for an extended period in many tender proposals, and that firms do not take advantage of audit clients when it comes to maintaining fees after any "learning by doing" efficiencies have been realised. As we set out in our response to the CC's "Evidence relating to the Selection Process: Tendering, Annual Renegotiations and Switching" working paper, for KPMG at least 14 of the proposals submitted for the CC's consideration proposed that fees are agreed for periods of between two and four years ⁷⁵ .
188 to 198	We note that the CC does not define a "trigger point" in the Working Paper. For us, a "trigger point" occurs whenever we have any concerns around clients thinking we are not giving them the best quality service at the best possible price. The CC's survey reflects this view, with complacency of the audit firm being the most cited reason for a company to switch its auditor for both Finance Directors (FDs) and ACCs of FTSE 350 companies ⁷⁶ . The CC recognises that complacency was "by far the most frequently mentioned (reason)" for switching in the Working Paper ⁷⁷ . To the extent that we feel our offer may be less than competitive than the potential offering of our competitors, we would look to take immediate steps to resolve the situation, regardless of any exogenous factors in play.

⁷⁵ Our discussion of paragraphs 47 and 67, in our response to the CC's "Evidence relating to the Selection Process: Tendering, Annual Renegotiations and Switching" working paper

⁷⁶ Slides 68 and 74 of the CC's Survey presentation

⁷⁷ Paragraph 130 of the Working Paper