



KPMG Response to CC's Working Paper "Restrictions on entry or expansion"

1 Introduction and summary

- 1.1.1 This note sets out KPMG's response to the Competition Commission's (CC's) working paper "Restrictions on entry or expansion" (the "Working Paper").
- 1.1.2 We welcome the opportunity to comment on this paper at an early stage of the CC's work on these topics. While we agree with many aspects of the CC's approach, there are nonetheless several points where we are not in agreement but which we consider important. At a high level we can summarise these as including the following:
- The CC's framework does not appear to recognise that endogenous sunk cost investments (and the resulting level of concentration in the industry) arise because of competitive pressures. In other words these are not "features" of the market that can be thought of as leading to particular outcomes, rather they themselves need to be assessed and understood as responses to customers' needs. In other words they are outcomes of the competitive process.
 - Specifically, the CC appears to not recognise that economies of scale and scope, to the extent that they exist to a material extent, are also a result of these competitive pressures. They arise because of investments that can be characterised, as the CC does, as endogenous sunk costs that are a competitive response to customers' needs and the behaviours of other firms competing in the market (including smaller firms).
 - In relation to strategic barriers to entry:
 - the CC mischaracterises endogenous sunk costs as a strategic barrier to entry; and
 - we do not recognise tying and bundling, nor 'low balling', as strategic barriers to entry and do not engage in these activities.
 - As with the Working Paper on 'The framework for the CC's assessment and revised theories of harm', we think the CC is wrong in categorising some quality differences between providers as switching costs.
 - In relation to incumbency advantages:
 - we welcome some of the CC's comments on reputation but do not agree with its suggestion that reputation might not reflect true quality – since clients are able to judge quality as an engagement progresses; and
 - we disagree that 'lobbying', thought leadership or an influential alumni network constitutes an incumbency advantage in practice; and
 - large audit firms' international network and higher quality staff are the result of competitive pressures.
 - In summary, we do not believe that the hypothesised regulatory barriers to entry are likely to be significant.

- 1.1.3 In this response we first set out some brief high level remarks on the approach to the analysis used by the CC in the Working Paper. We then set out our comments on specific issues raised by the Working Paper.
- 1.1.4 In relation to the CC's outlined next steps, we look forward to engaging with the CC on that analysis when the CC publishes its analysis in more detail.

2 The CC's approach to the analysis of barriers to entry and expansion

- 2.1.1 The CC's approach to the analysis of barriers to entry and expansion and concentration in the supply of statutory audit services set out in this Working Paper appears not to fully recognise the nature of competition in this industry.
- 2.1.2 As we stated in our Submission in response to the CC's Issues Statement ("Main Submission") (paragraphs 21-24), audit firms are under pressure to keep investing due to three main factors:

"the level of audit quality required to be competitive in the marketplace calls for substantial investments over time. Failure to undertake these would come at the risk of an audit firm failing to meet the needs of its clients and letting its capabilities fall behind those of its competitors."

"there is a need to minimise the probability of audit failure. The probability of audit failure occurring is mitigated by an experienced and competent staff that complies with risk management processes. This needs to be achieved by: development of specialist and industry knowledge; the ability to recruit, develop and retain talented professional staff; the application of consistent methodology; and the presence of highly effective quality control systems, among other factors, all of which require substantial investment" and

"audit firms need to comply with increasingly tight and demanding regulations."¹

- 2.1.3 The CC recognises the existence of these investments in its discussion of endogenous sunk costs².
- 2.1.4 However, in our view the CC's treatment of these investments is incorrect. The CC characterises endogenous sunk costs as 'strategic barriers' to entry and / or expansion, which it defines as resulting 'from existing firms in the market acting to deter entry'³. The CC also suggests that these sunk costs are undertaken in order to maintain market concentration or in order to increase sunk costs of entry⁴. This characterisation appears not to appreciate that competitive pressures drive these endogenous sunk cost investments. Far from being undertaken in order to deter entry, maintain concentration or increase entry costs, these investments are made in order to retain existing audit clients and compete

¹ Paragraph 22 of our Main Submission.

² Paragraphs 31 to 33 of the Working Paper.

³ Paragraph 27 of the Working Paper.

⁴ Paragraph 31 of the Working Paper.

for new ones, maintain high quality and prevent any possibility of audit failure that might threaten the firm.

- 2.1.5 Indeed, if the endogenous sunk costs were not linked to customer demands and competitive pressures, we fail to see how they could have any impact on the ability of other firms to enter the market or for smaller audit firms to expand. In other words, if the endogenous sunk costs were unrelated to client needs, then we fail to see how these could have an impact on client preferences for the largest four audit firms (and any other audit firms which have made these investments) over other audit firms (who have not).
- 2.1.6 In reality, since these endogenous sunk cost investments improve the competitiveness of those audit firms that have made them, these investments may have an impact on the ability of other firms to enter or expand into the supply of statutory audit services. Market outcomes such as the level of concentration in the industry and economies of scale and scope are in turn the result of these investments and hence of the competitive pressures that drive audit firms to make these investments.
- 2.1.7 In summary, these investments are the outcome of a competitive process that, to the extent that it leads to economies of scale and scope, may have an effect on the degree of concentration. However, this process cannot be characterised as one where firms engage in these investments with the objective of excluding rivals. If audit firms are simply responding to competitive pressures, then there is no “strategic” element to their behaviour. Were they not responding to such pressures, and were audit firms instead investing beyond what customers wanted (and hence competitive forces would dictate) it is difficult to see how this behaviour (even if it occurred) could be seen as leading to any increase in barriers to entry or expansion, as even if this investment was made, it would not provide a competitive advantage over rivals.
- 2.1.8 We are not in a position to comment at this stage on the merits and detail of the CC’s assessment and approach to measuring and assessing economies of scale and scope. We would anticipate doing so when the CC provides more detail on its proposed analysis and interpretation of economies of scale and scope, and look forward to engaging constructively with the CC on this issue.
- 2.1.9 In section 3.1 below we discuss in more detail the CC’s characterisation of endogenous sunk costs as well as the literature the CC has used in developing its approach to endogenous sunk costs. In the rest of this response we set out our views on the CC’s discussion of barriers to entry and expansion in more detail.

3 Strategic barriers to entry

3.1 Endogenous sunk costs

- 3.1.1 In paragraphs 31 to 33 of the Working Paper, the CC suggests that ‘endogenous sunk costs’ could act as a strategic barrier to entry. While we recognise the existence, and importance, of endogenous sunk cost investments in the supply of statutory audit services, we have serious concerns with the CC’s characterisation of these investments (already briefly discussed in section 2). We have discussed endogenous sunk costs in our Main Submission⁵.
- 3.1.2 The CC refers to a quote from Shiman (2008) as a summary of Sutton’s theory in relation to endogenous sunk costs.
- 3.1.3 The quote that the CC uses from Shiman makes a number of points which we recognise in relation to the supply of statutory audit services, for example that:
- audit firms have an incentive to make investments because this increases the quality of their audit services that allow firms to gain a competitive advantage over other firms in the market;
 - however, other firms also make these investments, competing away any competitive advantage; and
 - any firm that tried to avoid making these investments would not be able to compete for and win new audit clients, and therefore would not be able to retain market share.
- 3.1.4 In other words, the incentive to invest comes from the expected profits that may be gained by attracting customers from rivals, because firms that invest can offer a more attractive product or service, which better meets customer demands and the result of these investments is the level of concentration observed in the market. In addition, and importantly, these investments increase audit quality and reduce the cost of delivering audit services.
- 3.1.5 However, Shiman also suggests that these investments ‘in the long run mostly serve to raise the cost of participating in the market’⁶. We disagree that this is the main outcome of these investments in this case – rather the main outcome of these investments is better quality audits (both from a technical and service quality perspective), because of competitive pressures on firms to improve quality in order to retain and win market share.
- 3.1.6 Shiman’s summary also stresses the importance of an expanding market in incentivising endogenous sunk cost investments. However, an expanding market is not required for firms to have an incentive

⁵ Sections 5.2 and 8 of our Main Submission.

⁶ Paragraph 32 of the Working Paper. This interpretation is not found in the original Sutton work – but Shiman’s interpretation is unpublished and not an official FCC working paper.

to make these investments. Rather, there are a range of market settings in which firms, according to Sutton's theory, will have incentives to undertake sunk cost investments aimed at improving quality. Ultimately, it is customers' preferences for quality which determine the investments firms undertake, and as set out above, it is our view that this is what incentivises audit firms to invest in quality.

- 3.1.7 Finally, as we set out in section 2 above, the Working Paper treats these 'endogenous sunk costs' as 'strategic entry barriers' that 'may result from existing firms in the market acting to deter entry'⁷.
- 3.1.8 We are not aware of any economic models or academic literature in which endogenous sunk cost investments, driven by long term competitive pressures, are used by incumbent firms as a strategic barrier to entry. We note that most economic theories of strategic entry barriers in relation to other parameters of competition (for example, pricing) rely on the incumbent firm having substantial market power or a position of dominance. In the audit industry no single firm has a dominant position or individual market power, and so this makes it even more difficult to identify what economic theory the CC might have in mind. In addition, the CC does not set out how it would propose to test such whether the level of investment undertaken by existing audit firms would constitute a strategic barrier to entry.

3.2 *Tying and bundling*

- 3.2.1 In paragraphs 28-30 of the Working Paper, the CC considers the potential for tying and bundling to act as strategic entry barriers in the provision of statutory audit services.
- 3.2.2 We welcome the CC's recognition that there is little evidence to suggest that audit firms pursue strategies of 'pure bundling'⁸ or tying⁹. As we set out in our Main Submission, to the extent that we sell audit-related or other non-audit services to audit clients this does not amount to bundling in any form and there are in addition good efficiency reasons for this joint provision¹⁰. In addition, independence rules limit the scope for non-audit services to be provided to audit clients.
- 3.2.3 The CC states that it will gather evidence on mixed bundling by comparing audit fees between companies who purchase a high level of other services and those that do not. As stated in the previous paragraph, we set out in our Main Submission that we do not engage in any bundling strategies, and our experience is that mixed bundling does not occur in relation to the supply of statutory audit services.

⁷ Paragraph 27 of the Working Paper.

⁸ Paragraph 29 of the Working Paper.

⁹ Paragraph 30 of the Working Paper.

¹⁰ Paragraph 332 of our Main Submission.

- 3.2.4 In addition, we do not think that the CC's proposed analysis could provide evidence that mixed bundling occurs, and if it does, that it acts as a barrier to entry, for two broad reasons. First, the CC's theory that mixed bundling theory could give rise to a barrier to entry in the supply of statutory audit services depends on an audit firm having market power in relation to the provision of non-audit services. However, far from having market power in non-audit services, audit firms face a large number of competitors, as recognised by the CC itself¹¹.
- 3.2.5 Second, for any mixed bundling to have any potential impact on competitors, audit and non-audit fees would have to be set *at the same point in time* and in such a way as to link the prices or the offers of the audit and non-audit services. Only in this way would a client really be put in the position of choosing between purchasing audit and non-audit services jointly or from different providers. In other words, an analysis simply looking at total annual audit fees and total annual non-audit fees earned from a given client would miss the nature of the fee and scope negotiations for audit and non-audit services that happened at different times of the year, in different competitive environments¹² and (often) between different people. As noted in paragraph 3.2.2 above, independence rules limit the scope for non-audit services to be provided to clients, and in addition prevent audit fees from being influenced or determined by the provision of non-audit services to the audit client¹³.

3.3 Signalling aggressive behaviour

- 3.3.1 The CC stated it would consider whether signalling an aggressive response on the part of an incumbent, or targeting mid-tier firms' clients who have potential to move into the FTSE350 could constitute strategic barriers to entry¹⁴.
- 3.3.2 We do not think that any such strategic barriers to entry might be said to exist in the supply of statutory audit services. Strong competition for new clients is instead a reflection of the fierce competition that exists between audit firms, and of competition working well in the supply of statutory audit services. Indeed, the CC itself recognises that it has no evidence that this is a strategic barrier to entry, as it has heard 'allegations' but no 'specific examples' of this 'sort of behaviour' occurring¹⁵.

¹¹ Paragraph 30 of the Working Paper.

¹² KPMG, for instance, does not face the same competitors in audit services as it faces in management consulting, for example.

¹³ ES 4.

¹⁴ Paragraph 34 of the Working Paper.

¹⁵ Paragraph 34 of the Working Paper.

3.3.3 In addition, the CC states that were these sorts of actions to be widespread, it might expect margins to be lower on average for those clients that were won by the largest four audit firms from mid-tier firms¹⁶. However, in carrying out any such analysis, the CC should be wary of heterogeneity in the nature of different audits, which would need to be controlled for in order for any comparison of margins to be meaningful.

4 Switching costs

- 4.1.1 At paragraphs 25 and 26, the Working Paper refers to the notion of ‘switching costs’ incurred by audit clients. The CC suggests that switching costs are substantial (in particular, management time, educating the new auditor and an increased risk of an audit error or omission during this period) in comparison to the potential gains from switching¹⁷.
- 4.1.2 As we set out in our response to the CC Working Paper “The framework for the CC’s assessment and revised theories of harm”, in our view the CC has continued to apply the wrong framework to its analysis of these costs, by characterising them as ‘switching costs’. In particular, the CC’s characterisation of the increased likelihood of an audit error or omission as a ‘switching cost’ is incorrect. We set out more detail on the appropriate framework for the analysis of this issue in our response to the CC Working Paper “The framework for the CC’s assessment and revised theories of harm”¹⁸.
- 4.1.3 In addition, as we also set out in our response to the CC Working Paper “The framework for the CC’s assessment and revised theories of harm”, evidence from the CC commissioned survey suggests that those costs that might more reasonably characterised as ‘genuine’ switching costs (e.g. management time), are limited¹⁹.
- 4.1.4 Finally, the costs to audit firms from losing a client are likely to be more substantial than the switching costs faced by companies. We discussed those costs in our Main Submission²⁰. As we set out in our Main Submission, these costs faced by audit firms will strengthen the bargaining position of their customers in annual fee negotiations.

¹⁶ Paragraph 34 of the Working Paper.

¹⁷ Paragraph 25 of the Working Paper.

¹⁸ Section 4.3 of our response to the CC’s Working Paper on “The framework for the CC’s assessment and revised theories of harm”.

¹⁹ Paragraph 4.3.7 of our response to the CC Working Paper “The framework for the CC’s assessment and revised theories of harm”.

²⁰ Paragraphs 259 – 264 of our Main Submission.

5 The ability to forecast costs

- 5.1.1 The CC states that new entrant firms may be less able to judge the costs and risks associated with audit engagements, as they will not have the same degree of prior experience as existing audit firms. The CC considers that this may increase the risk to new entrant firms from taking on a new audit engagement and may reduce the reliability of the new entrant's fee estimate²¹.
- 5.1.2 In our view there is unlikely to be any significant effect from any increased ability of the largest four audit firms to forecast costs. Estimating the cost of a first year's audit is always difficult, for any audit firm. In addition, audit firms all generally know that recovery will be lower in the first year or two of an audit as the new audit firm learns more about the company's business.
- 5.1.3 To the extent that the largest four audit firms have any comparative advantage in forecasting costs, in our view this is just another example of the superior quality that the largest audit firms are able to provide, which has arisen through their investments in developing the capabilities to audit large companies, as well as through learning about potential clients' businesses. Forecasting the cost of an engagement is an important aspect of quality since clients will prefer to have certainty over fees they have been charged.

6 Incumbency advantage and the importance of reputation

6.1 General remarks

- 6.1.1 The CC considers a number of dimensions that it believes may contribute to a first-mover, or incumbency, advantage²². The CC states that an incumbency advantage may be reinforced by the strategic actions associated with raising sunk costs of entry. We discussed the flaws in the CC's approach to various hypothesised 'strategic barriers to entry' in the previous section. In the rest of this section we set out our views on some of the other factors that the CC states may contribute to an audit firm having an 'incumbency advantage'.

6.2 Reputation and the virtuous circle

- 6.2.1 In this section we set out the CC's discussion in relation to reputation. We begin by setting out those aspects of the CC's characterisation and discussion of reputation with which we agree, before discussing some parts of the CC's discussion where we disagree.

²¹ Paragraph 24 of the Working Paper.

²² Paragraphs 35 to 51 of the Working Paper.

- 6.2.2 Both here and in the Working Paper on the “The framework for the CC’s assessment and revised theories of harm”, the CC recognises the important role of reputation in the supply of statutory audit services, in that it reflects previous investments in developing the capability to deliver high quality audits (both technical quality and quality of service), and the delivery of high quality audits in practice²³. In general, we welcome the CC’s characterisation of reputation. We also agree with the CC on the role that reputation has in mitigating potential principal-agent problems between audit clients and audit firms, as set out in more detail in paragraph 3.3.7 of our response to the CC’s Working Paper on “The framework for the CC’s assessment and revised theories of harm”.
- 6.2.3 In other words, reputation is earned through investments in delivering high technical quality. Similarly, it must be maintained through continued investments in quality. The quality of the work done and continued investments in quality, which comprise reputation, will (deservedly) get an audit firm invited to tenders, and may be important in getting an audit firm appointed. However, as we also set out in our Main Submission²⁴ and in our response to the CC’s Working Paper on “The framework for the CC’s assessment and revised theories of harm” if a firm does not work to maintain its quality of work, reputation is quickly lost and not easily regained.
- 6.2.4 The ease with which a reputation can be lost means that audit firms are incentivised to provide an audit of high technical quality. Any reduction of technical quality implies a greater risk of audit failure, greater risk of claims against an audit firm and therefore loss of reputation. The CC recognises this important aspect of reputation, when it states that large audit firms have reduced incentives to lower audit quality opportunistically in order to retain any single client²⁵.
- 6.2.5 However the CC also states that:

“[to] the extent that reputation is [not] an accurate reflection of capacity, quality, expertise, and efficiency [...] then any inaccuracy may distort companies’ decisions as to choice of auditor”²⁶.

- 6.2.6 We disagree with this hypothesis. In particular, to the extent that some large and/or complex audit clients have any false impression of the technical quality and the quality of services of audit firms, we would not see the potential for this misapprehension to persist over time and across clients. Any significant mismatch between perceived reputation and actual quality would be put right in the short to medium term. Indeed, as the CC recognises in its Working Paper on “The framework for the CC’s assessment and revised theories of harm”, “the management and ACC of the company have a high degree of visibility on many aspects of the technical quality of the audit and the quality of

²³ Paragraphs 37 to 39 of the Working Paper.

²⁴ Section 8.3 of our Main Submission.

²⁵ Paragraph 40 of the Working Paper.

²⁶ Paragraph 38 of the Working Paper.

services"²⁷, which would undermine any hypothesis that audit firms' reputation for high quality is unjustified.

- 6.2.7 We also note that the CC did not mention independent regulators' reports on audit quality amongst the various factors that contribute to an audit firm's reputation²⁸. We believe this is an important factor to take into account when considering the establishment and maintenance of the reputation of large firms²⁹.

6.3 *International network effect*

- 6.3.1 We agree with the CC's observation that "the strength and quality of the international network appears particularly valuable to large audit clients with a global presence"³⁰.
- 6.3.2 However, whilst we also agree that being a member of an international network provides the opportunity for referred income we do not agree that maximising referred income is, as the CC infers, the most significant factor in the ability of the global firm to attract and retain the best member firms internationally. Whilst the referred income may be a *consequence* of network membership, we believe the primary attraction is the confidence of membership of such a network brings in the ability to deliver high quality services to a member firm's own clients outside of the member firms own jurisdiction. This in itself is likely to be a response to competitive pressures, namely an audit firm serving audit clients with international operations will need to respond to the demands of those clients for high quality international network in order to retain those clients.

6.4 *Technical resources*

- 6.4.1 The CC comments that the technical resources may be greater for firms who have greater experience of auditing large / complex / international companies. This is undoubtedly the case on the basis that those firms serving such companies are larger than those firms who do not serve such companies, and it is therefore inevitable that the larger firms need greater access to such specialist resources in order to serve its client base. Smaller firms would not need such large numbers of specialist resources and there would be no structural barrier to such firms to obtaining specialist resources for those firms prepared to invest in their recruitment.

²⁷ Paragraph 63 of the Working Paper on 'The framework for the CC's assessment and revised theories of harm'.

²⁸ See Figure 1 of the Working Paper.

²⁹ As shown in the CC commissioned survey, adverse comments by a regulator is one factor FTSE350 FDs and ACCs look for when deciding whether to (re)appoint a statutory audit firm (see slides 33 and 38 of the CC commissioned survey presentation).

³⁰ Paragraph 45 of Working Paper.

6.5 Thought leadership

- 6.5.1 The CC comments that the more experience a firm has in auditing and providing other services to large listed clients the more credible and in demand its pronouncements are likely to be. The volume of thought leadership available from all sources (including the accounting profession) is very significant and at the same time senior executives have limited amounts of time to devote to consideration of such material. We have no statistics on “demand” for thought leadership from different firms, but we would believe that any demand reflects the relevance and quality of the thought leadership.
- 6.5.2 We also note that much of our thought leadership is not focussed on audit, accounting and financial reporting matters (ie those elements most relevant to the audit). Instead, much of it is either based on specific sectors or topics relevant to other parts of our business. Therefore whilst there is some benefit in general terms (for example in enhancing KPMG’s reputation for quality of thought and solutions to business issues) from well-received thought leadership, much of our thought leadership is generated outside of our audit function and is more likely to be of direct benefit to those other (Tax and Advisory) functions.

6.6 Lobbying

- 6.6.1 The Working Paper discusses ‘lobbying’³¹, which it defines as participation in the regulatory process in order to influence it in some way. We do not see how this activity could constitute a barrier to entry.
- 6.6.2 As we stated in our Main Submission³², our participation in the regulatory process does not translate into ‘influence’. We respond to consultations and actively participate in the regulatory debates as an informed stakeholder. Much of our public policy work is done with the perspective of the audit profession in mind, either through professional bodies or through the Policy and Regulatory Group which brings together the 6 largest audit firms, a representative from the Group A firms and the English and Scottish institutes.
- 6.6.3 Second, the CC has not correctly understood the role of secondments of staff (whether to public or private sector clients). Government and other agencies (as well as private enterprises) often require talented staff on a temporary basis. We pitch for these positions in a similar fashion to the way we pitch for other tendered work and compete fiercely in the marketplace, on quality, scope and fees. This has nothing to do with ‘lobbying’.

³¹ Paragraph 49 of the Working Paper.

³² Sections 2 and 9.4 of our Main Submission.

6.7 Attracting talent

- 6.7.1 The CC states that the largest four audit firms may have a greater ability to attract talented staff because of the draw of the largest four audit firms' FTSE350 clients, as well as the higher salaries and non-salary benefits that the largest four audit firms are able to offer³³.
- 6.7.2 We agree that the largest four audit firms are able to attract higher quality staff. However, this is a result of the investments the largest four audit firms make in attracting and retaining staff, as set out in our Main Submission³⁴, which results from client demands and competition between the largest four audit firms.

6.8 'Influential alumni network'

- 6.8.1 At paragraph 51, the CC refers to the existence of an 'influential alumni network' as a potential incumbency advantage. As we set out in our response to the CC's paper on 'The framework for the CC's assessment and revised theories of harm', the fact that many FDs and AC members are alumni of the largest four audit firms in no way acts as a barrier to entry or expansion.

7 Regulatory barriers to entry

- 7.1.1 As set out in our response to the Law and Regulation Working Paper, we agree with the CC that the provision of statutory audit services is subject to an extensive legislative and regulatory framework.
- 7.1.2 Paragraph 53 the Working Paper lists a number of ways in which the regulatory framework may act to restrict entry or expansion and we discuss some of these in the next sub-sections.

7.2 Increasing complexity (and globalisation) of accounting standards

- 7.2.1 The CC states that it will consider whether accounting standards are more complex than necessary and whether this might "play into the hands of the larger firms and increase the barriers to entry for smaller firms"³⁵.
- 7.2.2 We recognise the concern which is often expressed by companies and investors in particular that accounting and reporting is overly complex. There have been significant changes to, and an increase in regulation, in particular since the collapse of Andersen in 2001, which we set out in our Main Submission³⁶ which have increased the level of detail and complexity. At the same time International

³³ Paragraph 50 of the Working Paper.

³⁴ Section 5.1.2 of the Main Submission.

³⁵ Paragraph 53a of the Working Paper.

³⁶ Section 2 of our Main Submission.

Accounting Standards in particular have become more aligned with equivalent US standards in an attempt to ensure international consistency. However, in part this reflects the increasing complexity of business and to an extent the demands from investors for more standardisation of accounting treatment (resulting in more prescriptive accounting standards) and greater transparency (which has resulted in more prescriptive and detailed disclosure requirements). A good example of this is the loan impairment model which is likely to move to an expected loss model in response to criticisms of the existing model which was discredited in the financial crisis.

- 7.2.3 Reducing complexity whilst ensuring standardisation (and therefore comparability) and transparency is, therefore, a key challenge for accounting standard setters. However, we do not believe that technical complexity is a barrier to entry or expansion for small firms. Understanding of the accounting requirements is a key component of the accountancy qualification of the various professional bodies (eg the ICAEW) and therefore all staff of any audit firm must demonstrate the necessary competence and knowledge of accounting complexity in order to qualify as an accountant. Notwithstanding this, we acknowledge that application of that knowledge in the practical environment of an audit is dependent on the judgement and skill of individuals – ie the quality of the people – particularly if an audit is to be delivered efficiently, and the capability of individual partners and staff therefore is more relevant to coping with the complexity of standards than the size of the firm.

7.3 *Limited ability of the auditor to differentiate itself in the audit report*

- 7.3.1 The CC states that it will consider whether:

"The binary nature of the audit opinion may give investors very limited ability to judge the quality of the audit process. This inability to measure quality may increase the importance of auditor reputation and thus favour incumbent firms"³⁷.

- 7.3.2 As set out in our response to the CC's Working Paper on "Law and Regulation" (in particular paragraphs 3.27 – 4.1) a statutory audit of a large company is a complex, bespoke service, driven by the scale and complexity of companies, the industries in which they operate and their commercial arrangements, culminating in an audit report that is not 'binary' but covers several issues (please see our response to paragraph 4.1 in our response to the CC's Working Paper on Law and Regulation). The latest FRC proposals in relation to Corporate Governance also require the AC to explain the

³⁷ Paragraph 53b of the Working Paper.

audit process in much more detail³⁸. In addition, there are further developments on the auditor reporting model launched by the IAASB and PCAOB.

7.3.3 Further, the nature of the audit opinion and what it covers as described above does not give recognition to the enormous task involved in formulating that opinion. During that process, FDs and ACCs are able to form a judgement on the technical quality of the audit. We set out our views on the ability of clients to judge quality in our response to the CC's Working Paper on "The framework for the CC's assessment and revised theories of harm"³⁹, as well as the role of ACs in protecting and acting according to shareholder interest. As we also noted in that response, the CC itself recognises the ability of FDs and ACCs to judge technical quality⁴⁰. As a result, we disagree with the CC's statement in the quote in paragraph 7.3.1 above that there is an "inability to measure quality". Many of the FDs and ACCs are exposed to audit firms other than their statutory auditor through non-audit work or positions they hold at other companies. This furthers their ability to make comparisons and judge auditor quality, as illustrated in some of the CC's case studies⁴¹.

7.4 Partner rotation requirements

- 7.4.1 The CC states that it will consider whether requirements for partner rotation give rise to a barrier to entry⁴².
- 7.4.2 As set out in section 5.1.3 of our Main Submission, clients' requirements for high quality services drive investments in "Bench Strength". We do not agree that this is a barrier to entry, but instead in our view this is a result of audit firms investing in sufficient capacity and capabilities, such that they are able to deploy staff with appropriate skills and experience to any given engagement at any given time. In other words, audit firms invest in developing a "bench" of sufficient depth, as well as in the breadth of skills and expertise within the audit firm. This is one aspect of ensuring high quality audits, while also complying with the requirements for partner rotation.
- 7.4.3 The investments in bench strength are one example of investments that are made in order to provide high quality audits, as discussed in section 3.1.

³⁸ <http://www.frc.co.uk/Our-Work/Publications/Corporate-Governance/Consultation-Document-revisions-to-the-UK-Corporate-Appendices-to-Consultation-Document/Appendix-to-Consultation-Document-Draft-Revised-UK.aspx>

³⁹ Section 3.3 of our response to the CC's Working Paper on "The framework for the CC's assessment and revised theories of harm"

⁴⁰ Paragraph 63 of the CC's Working Paper on 'The framework for the CC's assessment and revised theories of harm'.

⁴¹ For example, paragraphs 30, 31 and 61 of the CC's Company D case study; paragraph 8 of the CC's Company F case study; and paragraph 28 of the CC's Company I case study.

⁴² Paragraph 53c of the Working Paper.

7.4.4 Partner rotation requirements are also there to serve a purpose for the benefit of shareholders – namely to ensure that management and audit partners do not develop too close a relationship.

7.5 Auditor liability

7.5.1 The CC states that it will consider whether audit firm liability acts as a barrier to entry and expansion. In particular, it notes that current regulations that allow firms to enter into agreements with clients to limit audit firm liability appear to be ineffective⁴³.

7.5.2 We acknowledge that the current arrangements in relation to the limitation of auditor liability may act as a barrier to entry and we have previously stated that we support “introducing appropriate limitation of liability to address the potential barrier to new entrants....”⁴⁴

7.6 Audit firm ownership

7.6.1 The CC refers to an Oxera report which suggested that the current rules on the ownership and management of audit firms might limit the ability of firms seeking to expand to raise capital and act as a barrier to expansion⁴⁵.

7.6.2 However, the CC also states that “audit firms, including non Big 4 firms, have not cited access to capital as a barrier to entry”⁴⁶. This statement is consistent with KPMG’s understanding and experience.

7.7 Rules on component auditors and joint audits

7.7.1 The CC states that joint audits or the reliance on the work of a component auditor from a different firm could be a way for mid-tier firms to gain experience and build reputation in the FTSE350 audit market⁴⁷.

7.7.2 In our response to questions 17 and 35 of the CC’s Market and Financial Questionnaire (“MFQ”), as well as in paragraph 149 of our Main Submission, we discussed the added complexity of overseeing local audits and using component auditors. If a component auditor does not meet the independence requirements that are relevant to the group audit, or the group audit engagement team has serious

⁴³ Paragraph 53d of the Working Paper.

⁴⁴ KPMG’s response to the European Commission’s Green Paper – *Audit Policy: Lessons from the Crisis*, 8 December 2010.

⁴⁵ Paragraph 53e of the Working Paper.

⁴⁶ Paragraph 53e of the Working Paper.

⁴⁷ Paragraph 53 f of the Working Paper.

concerns, the group audit engagement team cannot use the component auditor to obtain the necessary audit evidence, but must perform the work itself.

- 7.7.3 In our view, joint audits are highly inefficient. For example, if the purpose of joint audits is, as the CC suggests to allow mid-tier firms to gain experience this implies that mid-tier firms will not have the necessary experience when they work on the joint audit. This will necessitate the other audit firm replicating the work of any mid-tier party to a joint audit to ensure it is of adequate quality. This will lead to substantial duplication of effort and inefficiencies as well as increasing the chance of error.
- 7.7.4 The inefficiency of joint audits was recognised by HM's Government's response to the House of Lords' Economic Affairs Committee report, which stated that "The Government shares the Committee's scepticism of mandatory joint audits. The experience of the UK is that joint audits used to more common, but companies moved away from them because they found the single auditor model more efficient and effective"⁴⁸.

7.8 *Independence rules on client size*

- 7.8.1 We agree with the CC's preliminary analysis that the regulations in relation to auditor independence are, in practice, unlikely to affect the ability of the non-Big-4 to audit FTSE350 companies.

7.9 *Other independence requirements, eg banking relationships*

- 7.9.1 The CC states that it will consider whether other independence requirements could reduce the ability of an audit firm to tender for certain audits or introduce substantial costs in doing so⁴⁹.
- 7.9.2 As noted in our response to question 54 of the MFQ, in the case of certain business or commercial relationships, it could take more time to discontinue the arrangements than to tender for the audit. However, that we believe that many such arrangements that we have at present would not represent a barrier to our appointment as auditor of almost any large company – there are at most a few isolated examples where we may not wish to pitch for an audit opportunity at a large company.

7.10 *Requirements for audit committee to approve change of auditor*

- 7.10.1 The CC notes that:

*"Some commentators have suggested that the conservative nature of the audit committee acts as a further barrier to mid-tier firms winning FTSE350 audits"*⁵⁰.

⁴⁸ Government Response to Report on Auditors: Market concentration and their role dated 19 May 2011 and published by Authority of the House of Lords, 16 June 2011.

⁴⁹ Paragraph 53 h of the Working Paper.

7.10.2 We disagree with the views of these commentators and set out our views and evidence on the role of ACCs, who act in line with shareholders' interests, in our response to the CC's working paper on 'The framework for the CC's assessment and revised theories of harm'.

7.11 *Restriction of choice by regulations concerning the provision of non-audit services*

7.11.1 The CC refers to an issue raised by the OFT, namely that choice may be restricted by regulations concerning the ability of firms to supply certain non-audit services to audit clients, such that a significant proportion of FTSE350 companies find that one or more of the largest four audit firms are conflicted out⁵¹.

7.11.2 As explained in our response to question 54 in our response to the MFQ, in the case of non-audit services, most of the work that we provide to non audit clients would either be permissible for delivery to audit clients or are non-recurring, project-based, services which are undertaken over a relatively short time period (for example, tax advice, transaction-related services and many advisory projects). Potential exceptions to the short term nature of the work might include recurring engagements, for example the provision of outsourced internal audit services.

7.11.3 As we set out in detail in our response to question 9 of the Additional Information Request, as well as paragraphs 54.3-54.7 of our response to the MFQ, in general the historical or expected provision of non-audit services would not preclude or prevent us from participating in an audit tender process where we are invited to tender by a client. We have not identified any exceptions to this in recent years.

7.12 *Clauses in loan agreements*

We recognise the concern that "standard" clauses in loan documents mandating the use of one of the largest four audit firms might restrict the choice available to a company. We are not aware of this being a significant determinant in the choice of audit firm for large UK corporates, but would nevertheless support the removal of any such clauses if they were deemed to adversely affect competition. At the same time, however, we would recognise that institutions lending to companies may have particular requirements and their genuine commercial needs and ability to negotiate with borrowers for a specific audit firm should be recognised.

⁵⁰ Paragraph 53i of the Working Paper.

⁵¹ Paragraph 53j of the Working Paper.