



KPMG Response to CC’s Working Paper “The framework for the CC’s assessment and revised theories of harm”

1 Introduction and summary

1.1.1 This note sets out KPMG’s response to the Competition Commission’s (CC’s) working paper “The framework for the CC’s assessment and revised theories of harm” (the “Working Paper”). We welcome the CC setting out the development in its thinking, and its narrowing of the scope of its inquiry into two theories of harm.

1.1.2 In our view the CC’s theory of harm that principal agent problems might cause a prevention, restriction or distortion of competition is not supported by the balance of evidence, largely because:

- Audit Committees (ACs)’ interests are aligned with those of shareholders and they exercise scrutiny over the audit firm;
- Finance Directors (FDs) and ACs are well-placed to judge technical quality and will switch audit firms on quality grounds. In addition, the importance of the reputation of audit firms plays a key role in ensuring quality;
- any information asymmetries that do exist do not dampen incentives to compete; and
- we question the CC’s assertion that in practice management’s objectives in relation to the audit are misaligned with those of shareholders.

1.1.3 In our view the CC’s theory of harm that customer conduct and barriers to entry might cause a prevention, restriction or distortion of competition is also not supported by the balance of evidence. In particular:

- we agree with the CC that audits are bespoke but disagree that this has adverse consequences on the ability of companies to compare prices;
- we disagree with the CC’s characterisation of certain costs as ‘switching costs’;
- we disagree with the assertion that there are material search costs in the supply of statutory audit services;
- we disagree that the background of FDs and Audit Committee Chairs (ACCs) might limit the pool of audit firms from which they choose; and
- we disagree with the CC’s discussion of barriers to entry.

1.1.4 In relation to the categories of detriment identified by the CC, we disagree that there is weak competition which:

- softens the incentives of audit firms to reduce fees leading to higher audit fees; and / or

- adversely affects the technical quality of audit reports, the accuracy of the audit opinion, the quality of services provided or the insights provided by the audit team in the process of conducting the audit.

1.1.5 In this response we begin by commenting on the CC's reference to, and apparent importance attached to, other stakeholders in the context of UK law.

1.1.6 We continue by setting out our comments on the CC's two remaining theories of harm. Finally, we set out our comments on the Working Paper's discussion of outcomes and detriments associated with any restriction or distortion of competition.

2 The CC's discussion of the demands of shareholders and "other stakeholders"

2.1.1 At various points in this Working Paper the CC refers to "other stakeholders" in terms of, for example, the extent of other stakeholders' influence over the selection of the auditor, and the extent to which the audit process and reports are satisfying the needs of such other stakeholders¹.

2.1.2 As we set out in our submission to the CC of 16 January 2012, we consider that the provision of audit services is an important part of the economy and the governance of corporate life². An effective assurance industry, of which statutory audit comprises an integral part, is important to the robust and efficient operation of financial markets.

2.1.3 The above notwithstanding, whilst third parties, and the market in general, may well derive benefit from the information provided by audits³, the auditor's duty is to prepare the audit report for the benefit of company and its shareholders only. In the UK, legislation makes it clear that in delivering a statutory audit service the auditor is required to address its report only to the members of the company and not more widely. We therefore do not believe that current legislation entitles other stakeholders to have their specific needs satisfied by the audit, or that "these wider benefits" are "reflected in

¹ The CC indicates that these may comprise, variously, lenders, employees, suppliers, customers and "other investors". Paragraphs 45, 46, 48, 49, 64, 65, 67, 69, 73, 81, 83(a) and 87 of the Working Paper.

² Paragraph 2 of KPMG's submission to the Competition Commission, 16 January 2012.

³ Paragraph 29 of the Working Paper.

the history of audit regulation in the UK"⁴. Such stakeholders play no role in either commissioning the service or paying for it.

2.1.4 Given that this reference is in relation to the supply of statutory audit services and that the scope of these is defined by legislation, there is clearly a disconnection between that subject matter and issues such as "whether other stakeholders have significantly less information available to them than the company and its shareholders to assess the technical quality of the audit"⁵, or any misalignment of the objectives of shareholders and other stakeholders.

2.1.5 We are also concerned that in paragraph 82, the CC apparently fundamentally misunderstands the output from the audit when it states it will consider the "potential for rivalry between audit firms to be able to bridge any such gap between the **financial information** stakeholders would like audits to provide and that which is currently being provided" (emphasis added). The purpose of a statutory audit is not to provide financial information (that is the responsibility of management and the AC in their roles as the agents of the shareholders), but to provide assurance over that information (including assurance over its completeness).

2.1.6 In our view the provision of high quality statutory audit services meets the requirements of shareholders and, in general terms, benefits other stakeholders (see paragraph 2.1.2 above). That said, there is a debate to be had in the wider context of the evolution of audit and assurance services about demands beyond the statutory scope (whether of audits as currently understood, rather than broader assurance products, or of the expectations of stakeholders other than shareholders). For present purposes, it may suffice to say that even if, and to the extent that, the demands of such other stakeholders are not being met, this is not a failure of competition, or of auditors failing to carry out their statutory duties, because auditors are not obliged to fulfil these demands. KPMG and audit profession more widely have engaged (and continue to do so) in dialogue about various aspects of these "scope" concerns.

⁴ Paragraph 30 of the Working Paper.

⁵ Paragraph 65b of the Working Paper.

- 2.1.7 As regards shareholder demand for audit services, the CC has recognised an apparent consensus that the incentives of managers and shareholders to commission audits are likely to be insufficient to ensure social demand for independently audited accounts is satisfied⁶. As a result, the requirements for audits and their exact scope need to be mandated by legislation and regulation.
- 2.1.8 As a consequence of the above, individual shareholders may be restricted in their ability to procure the desired services from auditors to satisfy any un-met demand. First, the issue of "free-riding" identified by the CC in its Working Paper⁷ may restrict shareholders' ability to bring about change at a company level. Furthermore, the need for audits (and assurance services in general) to comply with a clearly articulated standard also means that an extension of assurance services is only likely to take place at an industry level⁸.
- 2.1.9 As such, to the extent that there is shareholder demand which is not being met, this is, again, not a symptom of a lack of competition, but a consequence of the nature of the audit product.

3 Theory of Harm: "Principal agent issues"

3.1 General remarks

3.1.1 In this section we set out our views in relation to the CC's theory of harm that principal agent issues might prevent, restrict or distort competition. In particular, it is our view that:

- ACs' interests are aligned with those of shareholders and they exercise scrutiny over the audit firm;
- FDs and ACs are well-placed to judge technical quality and will switch audit firms on quality grounds. In addition, the importance of the reputation of audit firms plays a key role in ensuring quality;
- any information asymmetries that do exist do not dampen incentives to compete; and

⁶ Paragraph 21 of the Working Paper.

⁷ Paragraphs 25-26 of the Working Paper.

⁸ Paragraph 33 et seq. of the Working Paper.

- we question the CC's assertion that, in practice, management's objectives in relation to the audit are misaligned to those of shareholders.
- 3.1.2 The CC identifies a number of relationships affected by 'moral hazard' or 'adverse selection', stemming from principal agent problems in those relationships caused by asymmetric information and a misalignment of incentives. In particular the CC identifies potential principal agent problems in the relationship between shareholders and managers, shareholders and audit firms, and shareholders and ACs. While in theory this may be the case, whether these relationships are in practice characterised by principal agent problems and, particularly, how these are related to competition, again, requires a carefully considered and detailed analysis in order to be established.
- 3.1.3 The CC then attempts to describe a link between competition in the provision of statutory audit services and corporate governance more broadly, and suggests that the potential consequences of the principal agent problems associated with the corporate governance system could include a misallocation of resources and sub-optimal levels of investment across the UK economy as a whole⁹. In our view such a link, between competition in the provision of statutory audit services, and corporate governance and the alignment of capital in the economy, cannot be established without a detailed analysis of the broader regulatory framework in place in relation to corporate governance.
- 3.1.4 We are not in a position to comment at this stage on the merits and detail of the CC's assessment of the way in which competition in audit affects corporate governance issues. We anticipate doing so when the CC provides more detail on how it plans to conduct this analysis.
- 3.1.5 In the rest of this section we set out our views in more detail on this CC theory of harm.

3.2 *The role of the Audit Committee*

- 3.2.1 In this section we discuss the CC's suggestion that the AC may not properly protect the interests of shareholders. We argue that the AC's interests are aligned with those of shareholders and that ACs can and do exercise proper scrutiny of the audit firm.

⁹ Paragraph 14 of the Working Paper.

- 3.2.2 The CC recognises the role of the AC in protecting the interests of shareholders and ensuring that audits are conducted for shareholders' benefit¹⁰. However, the CC states that principal agent problems might arise between shareholders (principal) and ACs (agents) if shareholders face difficulties in monitoring the performance of the AC¹¹, unless the objectives of the shareholders and the members of the AC are sufficiently aligned¹². The CC states that it will investigate these issues under its "principal agent issues" theory of harm¹³.
- 3.2.3 Corporate governance and the role of ACs in the UK have undergone significant development over the last two decades. The CC's Law and Regulation Working Paper refers to the 2003 Smith report that codified the role of ACs, stating that ACs should be composed of at least 3 members, all of them independent non-executives. As independent non-executives, AC members have no incentive to act in any other way than in shareholders' interests, and there are strong incentives to fulfil this role well, due to their own reputations being at stake (as the CC itself acknowledges). This is also illustrated by the CC's case studies - for example, one ACC stated that the greatest incentive to complete his role in the audit diligently was that he was 'putting his reputation on the line'¹⁴.
- 3.2.4 Fundamentally, the role of the AC in relation to overseeing the auditor and the audit process is only one element of the role of independent non-executives (from which population AC members are drawn) in relation to the governance of a corporation and the protection of shareholder interests.
- 3.2.5 The obligations placed on ACs and the personal reputational damage that may ensue in the event that the job is not performed adequately provide AC members with a powerful incentive to act in the best interests of the shareholders. Those obligations are well codified and leave no uncertainty as to the time and effort required.

¹⁰ Paragraph 42 of the Working Paper.

¹¹ Paragraph 43 of the Working Paper.

¹² Paragraph 42 of the Working Paper.

¹³ Paragraph 83b) of the Working Paper.

¹⁴ Paragraph 48 of the CC's Company E case study. See also paragraph 44 of the CC's Company I case study.

- 3.2.6 Generally, whilst recognising that constant evolution is desirable and necessary in a volatile and dynamic environment, we believe that corporate governance in the UK works well and that this belief would be broadly accepted. To suggest that the AC's interests are not aligned with shareholders is therefore either to suggest that UK corporate governance is not effective or that the specific case of the oversight of the auditor and the audit process is an exception to this generally effective corporate governance environment.
- 3.2.7 The CC's own evidence gathered so far also shows that ACs act to protect shareholders' interests. The CC case studies contain strong evidence that ACCs act in line with shareholders' interests¹⁵ and exercise extensive scrutiny of the audit¹⁶. In addition, there is strong evidence in the case studies and CC-commissioned survey ("CC's survey") that ACs take their duties very seriously in recommending the appointment of the audit firm to shareholders and in the resolution of audit issues¹⁷.
- 3.2.8 The CC's survey shows that in judging audit quality ACCs focussed on those characteristics of a company's audit and audit firm that will be important to shareholders: over 90 per cent of ACCs stated that the ability to detect misstatements, audit firm independence and a high degree of challenge were all important¹⁸ when judging auditor quality.¹⁹ Similarly, the CC's survey showed that when (re)appointing a statutory audit firm, ACCs focussed on those characteristics of an audit firm that are likely to be important to shareholders: 97 and 85 per cent of ACCs stated that the experience and knowledge of the engagement partner and the experience and knowledge of the engagement team were important factors respectively when deciding

¹⁵ For example, paragraph 56 of the CC's Company C case study; paragraph 59 of the CC's Company D case study; paragraph 48 of the CC's Company E case study; paragraph 48 of the CC's Company F case study; paragraph 96 of the CC's Company G case study; paragraph 61 of the CC's Company H case study.

¹⁶ For example, paragraph 59 of the CC's Company D case study; paragraph 52 of the CC's Company G case study; paragraphs 14 and 60 of the CC's Company H case study; paragraph 58 of the CC's Company C case study.

¹⁷ For example, paragraph 104 of the CC's Company G case study; paragraphs 14, 27 and 31 of the CC's Company H case study; paragraph 45 of the CC's Company J case study; paragraph 45 of the CC's Company I case study.

¹⁸ In the CC's survey presentation 'important' denotes responses that a factor was judged 'very important' and 'important' on a scale of 1 to 5.

¹⁹ CC commissioned survey, Slide 28.

whether to appoint or reappoint its statutory audit firm²⁰. In addition, 94 per cent of FTSE350 ACCs stated audit firm complacency might prompt them to seriously consider changing their company's statutory auditor²¹.

3.2.9 We therefore see no evidence in practice to support the CC's view that "time and resources available may limit what these individuals can achieve"²².

3.2.10 The latest proposals relating to the UK Corporate Governance Code from the FRC²³ would further enhance the role of ACs and importantly place reporting obligations on them that would further improve their transparency to shareholders, both in respect of their supervision of the production of financial information and the appointment and supervision of the statutory auditors. These proposals should be factored in to any analysis by the CC of this issue as they should significantly assist shareholders in monitoring the AC.

3.2.11 It is difficult to comment further on this issue without understanding how the CC intends to approach and analyse these issues.

3.3 *The ability to observe technical quality*

3.3.1 In this section we comment on the CC's discussion on the difficulties on the part of ACs and FDs in judging technical quality. The CC also suggests that a lack of ability to judge technical quality might mean that FDs and ACs have less incentive to switch audit firm on the basis of quality. In our view FDs and ACs are well placed to judge quality, and audit firms' reputations are also important in assuring technical quality.

3.3.2 The Working Paper states that an audit is an 'experience good'²⁴. This is true to some extent, and ACs and FDs base their decisions on expected quality prior to selecting an audit firm. They judge expected quality by looking at a number of observable

²⁰ CC commissioned survey, Slide 38.

²¹ CC's survey, slide 74.

²² Paragraph 83(b) of the Working paper.

²³ <http://www.frc.co.uk/Our-Work/Publications/Corporate-Governance/Consultation-Document-revisions-to-the-UK-Corporat/Appendices-to-Consultation-Document/Appendix-to-Consultation-Draft-Revised-UK.aspx>

²⁴ Paragraph 83d of the Working Paper.

characteristics of an audit firm, all of which are important factors in the resulting quality of an audit.

3.3.3 This is evidenced in the CC's survey, which shows the sorts of characteristics of an audit firm that FDs and ACCs in the FTSE350 look for in order to make their decisions to (re)appoint a statutory audit firm. In particular, the factors stated to be important in decisions to (re)appoint an audit firm were: the experience and knowledge of both the engagement partner and the engagement team (over 80 per cent of FDs and ACCs), a good working relationship (over 80 per cent of FDs and ACCs), the reputation of an audit firm (over 80 per cent of FDs and ACCs), sector-specific expertise (69 per cent and 74 per cent of FTSE350 FDs and ACCs respectively), strength of the international network (over 60 per cent of FDs and ACCs), expertise in audit-related services (59 and 67 per cent of FDs and ACCs respectively) and adverse comments from regulators (over 65 per cent of FDs and ACCs)²⁵. In summary, therefore the CC's survey shows that FDs and ACCs in FTSE350 companies focus on observable characteristics that are determinative of audit quality when appointing their audit firm (rather than other factors, like management preference for an auditor, which was not cited as important by the majority of ACCs or FDs). We consider these results to be broadly consistent with those aspects of audit quality that we emphasised in our Main Submission in response to the CC's Issues Statement ("Main Submission") and in our response to the Market and Financial Questionnaire ("MFQ")²⁶.

3.3.4 The CC then states that even after the event (of the audit firm's appointment and delivery of audit services) the AC, shareholders and other stakeholders may not have visibility on certain aspects of the product. The CC states that perceptions of the quality of the audit report and audited accounts will be based on variables that are observable such as the identity of the audit firm, rather than the underlying quality of the audit²⁷.

3.3.5 However, the CC appears to have greatly underestimated the ability of ACs (and FDs) to observe the quality of an audit, once the audit firm has been appointed and has started

²⁵ CC's survey, Slides 33, 35, 38 and 40.

²⁶ Paragraph 178 of our Main Submission and response to questions 94 and 26 of the MFQ.

²⁷ Paragraph 83c of the Working Paper.

to conduct the audit²⁸. We discussed the ability of FDs and ACs to judge audit quality in section 4.2 of our Main Submission.

- 3.3.6 In addition, the CC's case study evidence provide a number of illustrations that ACs are engaged with setting the scope for the audit, to ensure that the scope is sufficient to ensure a high quality audit, and that the ACC meets regularly with the audit firm and discusses contentious issues, as discussed in paragraph 3.2.7 above. The CC's case studies also provide further evidence of the qualifications and experience of ACCs, which allows them to better judge the quality of the audit they receive²⁹. Indeed the discussion in paragraph 83c of the Working Paper is in contradiction with the CC's own statement in paragraph 63 that "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 services"³⁰.
- 3.3.7 To the extent that there are any aspects of quality that an AC cannot observe, the reputation of an audit firm plays an important part in ensuring that an audit of high technical quality is delivered. As we set out in section 8 of our Main Submission, a reputation for technical audit quality is gained by investment in those characteristics that are important for the delivery of high technical quality, as well as experience on previous audits and systems that ensure that mistakes are not made. Reputation is extremely easy to lose, as discussed in section 7.2 and 8.3 of our Main Submission.
- 3.3.8 Indeed, the CC itself recognises this role of reputation in this Working Paper,³¹ as well as its Working Paper on 'Restrictions to entry and expansion'³².
- 3.3.9 In relation to the CC's theory of harm associated with barriers to entry and customer conduct, the CC suggests that difficulty in judging audit quality may also dampen

²⁸ Paragraph 83c of the Working Paper.

²⁹ For example, paragraph 47 of the CC's Company C case study; paragraphs 40 and 61 of the CC's Company D case study; paragraph 37 of the CC's Company E case study; paragraphs 35 and 36 of the CC's Company F case study; paragraphs 49 to 51 of the CC's Company G case study; paragraph 54 of the CC's Company H case study; paragraph 36 of the CC's Company I case study.

³⁰ Paragraph 63 of the Working Paper.

³¹ See paragraph 37 of the Working Paper.

³² Section 6.2 of our response to the CC's Working Paper on "Restrictions to entry and expansion".

incentives to switch audit firm³³. As we set out above, the assertion that quality is difficult to judge is inaccurate and hence we disagree with the suggestion that this might dampen incentives to switch audit firm.

3.4 *Incentives on FDs and ACCs to encourage competition*

3.4.1 In this section we comment on the CC's hypothesis that information asymmetries might dampen incentives on companies to switch audit firms. We disagree that any information incentives have any such effect and have seen no evidence of this being the case.

3.4.2 The Working Paper states that the CC will consider "the potential for information asymmetries in the technical quality of an audit to reduce the incentives of FDs and ACCs to negotiate a reduction in the audit fee (or to change auditor) given a perceived risk that this could send adverse market signals, ie that a lower fee is a reflection of lower technical quality"³⁴. The same point is made in relation to the principal agent theory of harm (paragraph 84c) and in relation to the CC's theory of harm on barriers to entry and customer conduct (paragraph 76d), which we discuss in more detail in the next section.

3.4.3 The evidence shows that FDs and ACCs are willing and able to switch if they perceive that their current audit firm is not providing good value for money. For example:

- As discussed in sections 4.2 and 7 of our Main Submission, audit clients are informed, expert purchasers of audit services who are aware of their options and of their ability to switch, or threaten to switch.
- The CC's survey shows that price was cited as a principal factor behind the decision to switch audit firm for the 24 per cent of FTSE350 companies that switched in the last five years³⁵. Further, 71 per cent of FTSE350 FDs and 54 per cent of FTSE350 ACCs stated that a substantial increase in audit fee would prompt them to seriously consider changing their statutory auditor³⁶. Finally, price was stated as important when appointing or reappointing an auditor by 56 per cent of

³³ Paragraph 76d of the Working Paper.

³⁴ Paragraph 66 of the Working Paper. A similar point is made in paragraph 84d and paragraph 76d.

³⁵ CC commissioned survey, Slide 63. Price was the joint third most commonly cited principal factor behind a decision to switch by FTSE350 companies that switched in the last five years.

³⁶ CC commissioned survey, Slide 68 and 74.

FTSE35- FDs and 36 per cent of FTSE350 ACCs. It was only deemed not important by 8 per cent and 13 per cent respectively³⁷.

3.4.4 As we stated in section 7 of our Main Submission, a lack of frequent switching of audit firm is fully consistent with companies achieving a competitive outcome through renegotiations and benchmarking. There is also extensive evidence in the CC's case studies of companies benchmarking their audit fees and reviewing the quality of the audit they receive³⁸. We discuss switching and tendering further in the context of the CC's other theory of harm (see section 4.3 below).

3.4.5 Finally, we note that the existence of competitive pressure in the supply of statutory audit services, and the competitive outcomes that are observed do not depend on ACs and FDs 'encouraging' competition, as the CC suggests³⁹. Rather, competitive pressures and outcomes are ensured by the existence of credible alternatives to any company's incumbent audit firm. These pressures ensure incumbent auditors keep their offers competitive, and incentivise audit firms to approach potential customers informally to offer them an alternative⁴⁰. The CC's survey shows that the large majority of FTSE350 companies had informal contact with other auditors outside of a tender process⁴¹ and the CC's case studies and survey also discuss the contact with other audit firms⁴².

3.5 Management and shareholder objectives

3.5.1 In this section we discuss the CC's suggestion that management incentives might be misaligned with those of shareholders, and that this might lead to a distortion of competition. In our view it is not clear that, in practice, any significant misalignment

³⁷ CC commissioned survey, Slide 34 and 39.

³⁸ For example, paragraph 25 of the CC's Company C case study; paragraph 61 of the CC's Company D case study; paragraph 60 of the CC's Company E case study; paragraph 24 of the CC's Company F case study; paragraphs 74 - 76 of the CC's Company G case study; paragraph 26 of the CC's Company I case study.

³⁹ Paragraph 84d of the Working Paper.

⁴⁰ See section 7 of our Main Submission, paragraphs 251 – 258

⁴¹ CC's survey, slide 46.

⁴² For example, paragraphs 30 – 31 of the CC's Company D case study; paragraph 48 of the CC's Company H case study; paragraph 28 of the CC's Company I case study; paragraph 77 of the CC's Company F case study; . In addition, the case studies provide further evidence that the mid-tier audit firms are not as active in approaching companies – for example, paragraph 32 of the CC's Company C case study; paragraph 56 of the CC's Company F case study.

between manager and shareholder objectives exists in relation to the audit a company receives.

- 3.5.2 The CC states that there is “the potential for a misalignment in the interests of those appointing the auditor (and managing the relationship) and those who use the output of the audit. For example for management, their working relationship with the auditor and the efficiency with which an audit is conducted will be important, whereas shareholders will be primarily concerned with the quality of the information provided by the audit outputs”⁴³.
- 3.5.3 The CC argues that any such misalignment might have implications for competition in the supply of audit services to FTSE350 companies, since if managers are influential in the decision to appoint an audit firm, audit firms might have an incentive to align with managers’ rather than shareholders’ interests⁴⁴.
- 3.5.4 We accept that there is in general the potential for misalignment between management and shareholder objectives; indeed this potential provides the underlying rationale for the statutory audit requirement. However, given that requirement, it is not clear from the evidence that any misalignment in the interests of managers and shareholders as regards the provision of that service exists in practice in this market, and in any case the UK corporate governance regime is designed to mitigate the risk of any such misalignment.
- 3.5.5 Firstly there is a need for managers to demonstrate that they are adhering to high standards of corporate governance and control. Secondly, as the CC acknowledges⁴⁵, for a large company the statutory auditor provides senior management with a useful independent perspective on more junior management and the reports they are making; this may be particularly valuable if there is a large span of control as exists in many multinational companies. While senior management may therefore care about quality of service, they also have incentives to ensure that technical quality is high. We set out in paragraph 3.3.3 above, the factors FDs ranked as important in deciding to (re)appoint an

⁴³ Paragraph 83d of the Working Paper.

⁴⁴ Paragraphs 39 and 84a – b of the Working Paper.

⁴⁵ Paragraphs 18-20 of the Working Paper.

audit firm, according to the CC's survey. Most of these factors are related closely to technical quality, such as experience of the lead partner and the engagement team, the international strength, sector-specific expertise, etc⁴⁶. Evidence from the Case Studies supports the assertion that management are also focused on the excellence and independence of the audit⁴⁷.

3.5.6 In addition, we disagree that any misalignment between management and shareholder interests would have the sort of implication for competition that the CC hypothesises. There exist a number of other factors that govern audit firms' incentives as well as any role of management in the context in which an audit firm is (re)appointed; for example the effect on reputation of adverse regulatory findings. This ensures that audit firms act in line with shareholders' interests to conduct an audit of high technical quality, regardless of any misalignment of incentives as out by the CC. In other words, the CC would need to show that this problem exists in reality and that it makes a difference to the level of competition.

3.5.7 In particular, ultimate responsibility for the selection (and recommendation to shareholders) of an audit firm rests with the AC, not management as implied by the CC in paragraph 81 of the Working Paper. In our experience, the overwhelming majority of companies take these responsibilities very seriously. As we set out in section 3.2 above, ACs' interests are aligned with those of shareholders since ACs are composed of independent non-executive directors. The evidence shows that ACs act to protect shareholders interests and exercise proper scrutiny over the (re)appointment of the audit firm.

4 Theory of Harm: "Customer Behaviour and market structure produce adverse outcomes"

4.1.1 In this section we set out our response to the CC's theory of harm that customer behaviour and market structure produce adverse outcomes. In particular:

- we agree with the CC that audits are bespoke but disagree that this has material adverse consequences on the ability of companies to compare prices;

⁴⁶ CC commissioned survey, Slide 35 and 36.

⁴⁷ See case studies D19-20, E5, F18 and 22, G22, H18, I17 and J16.

- we disagree with the CC's characterisation of certain costs as 'switching costs';
- we disagree with the assertion that there are material search costs in the supply of statutory audit services;
- we disagree that the background of FDs and ACCs might limit the pool of audit firms from which they choose; and
- we disagree with the CC's discussion of barriers to entry.

4.2 *Bespoke nature of the product*

4.2.1 The CC argues that each company's statutory audit is bespoke, due to the different characteristics of FTSE350 companies, including industrial sector, the structure of the organisation, the geographic interests of the company, and its financial structure⁴⁸. We agree that each company's statutory audit will be bespoke given this range of characteristics, and would add that a company's accounting procedures and complexity, as well as the need to employ specialist skills on its audit (for example actuarial skills or specialist tax advice), are also important drivers of the bespoke nature of a company's audit⁴⁹.

4.2.2 The CC goes on to argue that this bespoke nature of audits will make the comparison of audit fees by customers more difficult, as account needs to be taken of a wide range of factors that may explain differences in audit fees⁵⁰. Later, the CC also states that it will consider whether this means that it is more difficult for a customer to benchmark price and whether this will imply that incentives to switch on the basis of price are dampened⁵¹.

4.2.3 While we agree that audits are bespoke, we disagree that this means that it is difficult for a company to assess whether its fee level is competitive. In practice, a company's analysis of, and ultimately judgement about the competitiveness of its audit fee will be based on a range of information. This will include information about the fees paid by a range of other companies sharing some of the same characteristics.

⁴⁸ Paragraph 57 of the Working Paper.

⁴⁹ As we also set out in section 5 of our Main Submission.

⁵⁰ Paragraph 58 of the Working Paper.

⁵¹ Paragraph 76a of the Working Paper.

4.2.4 KPMG often facilitates this benchmarking exercise by providing more detailed information on the fees charged for other companies, as also set out in section 4.2.2 of our Main Submission. As discussed in paragraph 3.4.4 above the CC case studies contain several examples of companies benchmarking their audit fees.

4.2.5 In addition, as we discussed in section 7 of our Main Submission, audit firms approach potential audit clients to inform them about their offer and encourage them to switch. As set out on slides 81 – 82 of the CC's survey presentation, 71 per cent of FTSE350 FDs and 46 per cent of FTSE350 ACCs have been either formally or informally approached by an audit firm to audit their company in the last five years⁵². These approaches are another way through which companies obtain important information that allows them to benchmark their current audit firm, and ultimately negotiate a competitive offer.

4.3 *The CC's discussion of switching costs*

4.3.1 The CC suggests that switching costs are substantial and that this will restrict competition. We disagree with the CC's characterisation of these costs. In this section we set out briefly why in our view the CC's approach is inaccurate. We also discuss the role of switching costs in section 4 of our response to the CC's Working Paper on 'Restrictions to entry and expansion'.

4.3.2 The CC suggests that switching costs are substantial (in particular, management time, educating the new audit firm and increased chance of an audit failure following a switch) in comparison to the potential gains from switching⁵³. The CC also suggests that switching costs are higher because each firm's audit is bespoke⁵⁴.

4.3.3 We note that some of the aspects of the process of switching audit firm that the CC characterises as "switching costs" are considered immaterial by customers in their responses to the CC survey (see below paragraph 4.3.7). As to the increased chance of audit failure following a switch, we consider that the CC uses the wrong framework to analysing it, by characterising it as 'switching costs'.

⁵² CC commissioned survey, Slide 81.

⁵³ Paragraph 76b of the Working Paper.

⁵⁴ Paragraph 60 of the Working Paper.

- 4.3.4 We discussed this in our Main Submission in section 7, addressing a similar treatment of switching costs in the CC's Issues Statement. In particular, the increased probability of an audit failure, unlike other aspects of the process of switching audit firm, should really be seen as a quality differential between competitors. Some aspects of the process of switching audit firm (for example, management time associated with conducting a tender), could be seen as independent of the output of competing audit firms, and hence may well be characterised as a "cost" that needs to be incurred (we discuss these types of costs further in paragraph 4.3.7 below). However, whether or not the customer considers that there will be an increase in the risk of audit failure following a switch depends critically on that customer's evaluation of the quality of the incumbent auditor's team relative to what competitors can put forward.
- 4.3.5 An incumbent audit firm is always looking to demonstrate to the customer that the risk of audit failure is minimal, while competitors strive to demonstrate that a switch would not lead to any additional risks. In fact, in some cases, if a customer believes that the incumbent's team is not up to the job, that customer may switch because it perceives that doing so would actually *reduce* the risk of audit failure. This, of course drives powerful incentives for audit firms to put forward individuals that are of high professional quality and make investments to improve the overall quality of their product.
- 4.3.6 To characterise any such differentials in the risk of audit failure as a "cost" misses the fact that any such perceived risks are nothing other than the customers' evaluation of the outcomes of a competitive process, that in turn drive strong incentives for audit firms to compete by improving the quality of their staff and processes.
- 4.3.7 Furthermore, as mentioned above, the CC's customer survey suggests that other costs associated with a change in audit firm (which might be more reasonably characterised as 'genuine' switching costs, such as management time, as noted in paragraph 4.3.4 above) are not substantial. Over half of the FTSE350 respondents that had switched in the last five years stated in the CC's survey that switching audit firm had no material impact on internal costs⁵⁵, with a further nine per cent not knowing the impact the

⁵⁵ Which were defined as management or staff costs, or other operational costs.

switch has had on these costs⁵⁶. This also suggests that the majority of relationship-specific investments are made by audit firms rather than companies themselves.

4.3.8 More generally, the existence of relationship-specific investments does not imply that switching is not a credible threat, if companies are dissatisfied with the technical quality, the quality of service or the price of an audit they receive. The CC's customer survey showed that companies which have switched did so in relation to price and cost factors, as well as a number of other quality factors. For FTSE350 companies, other factors relating to quality that were the principal factors behind companies' decisions to switch in the last five years included: switching to obtain a better quality of service in the delivery of an audit (33 per cent of companies that responded), moving to an audit firm with good / better sector experience (23 per cent of companies), changing audit firm to keep things fresh / avoid complacency / have a policy to switch regularly (27 per cent of companies), switching to an audit firm with more professional / better customer service (21 per cent of companies) and switching to improve the "international scope / quality of the audit (12 per cent)⁵⁷. These responses are consistent with there being no aspects inherent to the process of switching, independent of the quality of audit firms, which would prevent any company from switching if it thought it could get a better service (or a more cost effective one) elsewhere. Whether or not some aspects of the switching process could be genuinely characterised as costs, these do not in any way diminish the credibility of the threat of a customer switching, which is the main driver of competitive constraints on an incumbent audit firm.

4.3.9 The CC also notes that at certain times switching may be impossible if other activities take precedence, or corporate reasons require a stable audit function, citing examples such as when a company is involved in refinancing, restructuring or a major acquisition. We recognise that there might be certain unusual circumstances when a company is more reluctant to consider switching audit firm, for a certain short period of time. This reluctance is driven by the inefficiency of undertaking relationship-specific investments to get a new audit firm up to speed, during a period where there are other upheavals in the business. We see no clear evidence that any reluctance to switch would result out of

⁵⁶ CC commissioned survey, Slide 67.

⁵⁷ CC commissioned survey, Slide 63.

a concern that it would signal that a company is troubled or its financial statements are not reliable, and query the evidence base for such an assertion. However, regardless of whether or not this is the case in practice, we would question whether such instances are likely to have any substantial impact on the functioning of competition overall since at most they suggest a relatively limited delay in the time of a switching decision.

4.3.10 We discuss the CC's approach to switching costs more broadly in the response to the CC's Working Paper on Restrictions to entry and expansion.

4.4 *The CC's discussion of search costs*

4.4.1 The CC also states that it will consider whether search costs might make it less likely that a FTSE350 audit engagement will be tendered or that a FTSE350 company will switch audit firm⁵⁸. We disagree with the CC's suggestion that there might be material search costs in this industry and have seen no evidence suggesting that there are search costs of any significance.

4.4.2 Costly search is not required for a company to be aware of its outside options (in terms of both the price of alternatives or quality indicators such as sector expertise), and to develop enough knowledge of its outside options to evaluate them. Audit firms are accredited and well known, and there exists a wealth of public information about their offerings. It is also the case that AC members will often sit on more than one board and will therefore probably have direct current knowledge of alternative suppliers of audit services, aside from any direct experience they may have from previous roles. In addition, and importantly, companies receive numerous approaches from other audit firms, who make efforts to inform companies of the alternative services they can offer as part of the audit in order to encourage them to switch. These approaches serve to increase the awareness of companies of their outside options (as discussed further in paragraph 3.4.5 above and paragraph 4.5.3 below).

4.5 *The background of FDs and ACCs*

4.5.1 The CC states that in considering the potential for adverse effects on competition it will investigate whether "the Big 4 background of ACCs and CFOs may limit the population

⁵⁸ Paragraph 76 of the Working Paper.

of auditors they perceive to be able to deliver appropriate quality of audit and reputation of audit"⁵⁹. We strongly disagree with this assertion, as set out in the rest of this section.

4.5.2 The Working Paper does not set out in any more detail why the CC thinks that the Big 4 background of an FD or ACC might in principle limit the population of audit firms from which FDs and ACCs choose. In any case, we strongly disagree with the suggestion that the background of the FDs and ACCs at any of the largest four audit firms has any negative impact on competition. Rather, the background of FDs and ACCs at the largest four audit firms means that they are better able to judge the technical quality of audits, as we set out in section 4.2 and Annex 1 of our Main Submission. This means that they are better able to select an audit firm that delivers a high quality technical audit.

4.5.3 Any suggestion that FDs or ACCs select an audit firm from the largest four audit firms because they are somehow 'biased' towards their old firm (or the largest four firms in general) is without any merit and we have seen no evidence to suggest this may be the case. In fact, the CC's survey shows the opposite: only one per cent of FTSE350 FDs and no ACCs stated that staff at the company having links to the largest four audit firms would have an impact in their choice to consider only the largest four audit firms⁶⁰. To the extent that FDs or ACCs are more likely to appoint one of the largest four audit firms, this is a reflection of genuine differences in the ability of the largest four audit firms to deliver technical quality. The capabilities of the largest four audit firms were discussed in further detail in section 5 of our Main Submission, and the CC's case studies provide further support, as discussed in paragraph 3.3.6 above.

4.5.4 In addition, the largest four audit firms compete intensely to provide audit services to FTSE350 companies, as we discussed in section 7 and 8 of our Main Submission. This is supported by the CC's own survey evidence which shows that the FDs and ACCs of FTSE350 companies are regularly approached by the largest four firms. Of the 71 per cent of FDs who had been approached by an audit firm offering a change of audit, all had been approached by one or more of the largest four audit firms⁶¹. 46 per cent of

⁵⁹ Paragraph 76e of the Working Paper.

⁶⁰ CC commissioned survey, Slide 85.

⁶¹ CC commissioned survey slide 82.

ACCs had been approached in the survey, with only three per cent of these not being approached by the largest four audit firms⁶².

4.5.5 In addition to differences in the technical ability to conduct a high quality audit, another reason the mid-tier audit firms might be less successful in being invited to tender for or in winning FTSE350 companies' audits, is that they do not make the same effort and investments in approaching these companies and demonstrating their capabilities. This is evidenced in the CC survey when asking FTSE350 FDs and ACCs which audit firms had approached them formally or informally (see paragraph 3.4.5 above). When audit firms take a decision to invest, this can lead to them gaining substantial market share, as the case of Deloitte demonstrates⁶³.

4.6 *The CC's discussion of 'barriers to entry'*

4.6.1 We reserve our main response to the CC's approach to barriers to entry for our response to the CC's Working Paper on "Restrictions to entry and expansion". In this section we make two brief remarks. First we comment on the CC's failure to adequately describe the role of endogenous investment and dynamic competition in the supply of audit services. Second we comment on the CC's discussion of reputation in this Working Paper.

4.6.2 The CC's view of barriers to entry in this Working Paper in our view arises from a misinterpretation of the role and nature of dynamic competition in the supply of statutory audit services.

4.6.1 As we stated in our Main Submission (paragraphs 21-24), 'dynamic competition' indicates the investment strategies that audit firms make in order to win new clients in the medium- to long-term and leading 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."

⁶² CC commissioned survey, Slide 81 and 82.

⁶³ See Deloitte submission to the CC in response to the CC's Issues Statement.

"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."⁶⁴

4.6.2 The CC's Working Paper fails to consider this aspect of dynamic competition in its framework for the analysis of the supply of audit services, which we discuss in more detail in our response to the CC's Working Paper on the Restrictions to entry and expansion.

4.6.3 The CC recognises the key role of reputation:

"a reputation acquired by audit firms for sound judgement in the application of accounting standards will be a key factor in the value of the audit output within the company (including its shareholders) and to the wider market value of audited financial statements"⁶⁵.

4.6.4 We welcome this recognition of the important role of reputation as a reflection of quality. We add that the reputation of the largest audit firms is developed through investment in quality and quality assurance. We discuss the role of reputation further in paragraph 3.3.7 above, as well as in our response to the CC's Working Paper on "Restrictions to entry and expansion".

4.6.5 Elsewhere, however, the CC argues that the "reputational benefits to the audit profession as a whole created by the professional standards and behaviour of auditors have characteristics of a public good"⁶⁶. We disagree with this characterisation, since, as set out in section 5 of our Main Submission, if an audit firm were to fail to invest in its capabilities or to ensure its independence, then its reputation would seriously be at risk and the fact that other audit firms have invested in their capabilities and quality assurance would not change that.

⁶⁴ Paragraph 22 of KPMG's Main Submission.

⁶⁵ Paragraph 37 of the Working Paper.

⁶⁶ Paragraph 41 of the Working Paper.

5 Detriments and outcomes

5.1.1 The CC states that it will consider the impact of weak competition on a number of aspects of a FTSE350 audit. In this section we set out our views on the categories of detriment that the CC has identified.

5.2 Fees

5.2.1 The CC states that it will investigate whether weak competition could soften the incentives of audit firms to reduce fees, leading to higher audit fees⁶⁷.

5.2.2 As set out in section 7 of our Main Submission, buyers consistently place pressure on audit fees and audit firms have to react to these pressures in order to retain clients. We discussed evidence on how we have sought efficiency gains in response to these pressures illustrated in detail by internal documents and client negotiations, in paragraphs 266 – 269 of our Main Submission.

5.2.3 In Annex 2 of our Main Submission, we also set out two case studies ([§] and [§]) that illustrate the bargaining process and the constraints that are thereby placed on audit firms.

5.3 Quality

5.3.1 The CC states that it thinks that weak competition might adversely affect the technical quality of audit reports and the accuracy of the audit opinion, the quality of the services provided and the insights provided by the audit team in the process of conducting the statutory audit.

5.3.2 We set out evidence in our Main Submission that KPMG invests in developing the characteristics demanded by our clients (set out in paragraph 178 of our Main Submission) to meet certain capabilities and qualities to allow us to develop a reputation and track record in providing a high quality technical service and reports. This investment is driven by the need to compete for new and existing audit clients, as discussed in section 7 of our Main Submission. Moreover the scope and quality of the audit service tends to be evaluated and discussed with clients annually after each audit

⁶⁷ Paragraph 86 of the Working Paper.

and ahead of the next one in a process of continuing improvement, This is not consistent with a market that does not reflect competition on the dimension of quality.

5.3.3 As described in section 4.3 above, if our clients are dissatisfied with the technical quality, the quality of service or the price of an audit they receive they will, and do consider switching.

5.4 *The demands of shareholders and other stakeholders*

5.4.1 The CC states that it will investigate whether the audit process and reports are satisfying the demands of shareholders and other stakeholders and, if not, how competition might contribute to bridging these gaps.

5.4.2 As we explain in paragraph 2.1.6, above, we believe that the provision of high quality audit services currently meets the needs of shareholders, who are the only class of person to which auditors owe a duty. Any focus on the demands of other stakeholders is, therefore, inappropriate. In any event, KPMG (and other audit firms) are in constant contact with the investor community, and we (KPMG) are not aware of any unmet demand among this group of stakeholders⁶⁸. The CC itself also recognizes that there are other means via which financial markets are provided with the information they need.⁶⁹

5.5 *Investments in marketing and other efforts to win new clients*

5.5.1 The CC states that it considers that:

*"high audit fees would have the potential to create incentives for firms to make excessive investments in marketing and other activities in order to win FTSE350 audit clients. Such activities might be aimed at establishing reputation or building relationships with potential clients. We consider that such activity could weaken competition by raising barriers to entry"*⁷⁰.

5.5.2 The CC has not spelled out which elements of our activities it considers to be excessive. As a general point however, we disagree with this characterisation of the efforts audit

⁶⁸ For example, the ICAEW runs an Audit Quality Forum with stakeholders in which we participate, the ICAS has had a number of initiatives focussed on the scope of audit and PRG also has an on-going dialogue with investors and other stakeholders.

⁶⁹ Paragraph 87 of the Working Paper.

⁷⁰ Paragraph 90 of the Working Paper.

firms make to win FTSE350 clients and we discuss our views in more detail in our response to the CC's working paper on "Restrictions to entry and expansion". As we set out in our Main Submission⁷¹, and as illustrated in the CC's customer survey, audit firms make frequent approaches to FTSE350 companies to inform them about their offering and encourage them to switch (see paragraph 4.5.4 above).

5.5.3 These approaches, far from signalling a weakening of competition by raising a barrier to entry, are an important part of the competitive process, as it allows FTSE350 companies to gain a greater understanding of the outside options available to them (also see section 7.2.1 of our Main Submission). By allowing audit firms to learn about the nature of the business of certain FTSE350 companies, it also means that rival audit firms become more credible alternatives to the incumbent audit firm.

5.5.4 There is nothing to stop mid-tier audit firms making these investments to become more credible alternatives for FTSE350 companies. However, as the CC's survey shows, mid-tier audit firms do not make the same investment in approaching FTSE350 companies to encourage them to switch (see section 4.5.4 above).

⁷¹ Section 7 of our Main Submission.