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KPMG response to the Competition Commission Working Paper "The life cycle of FTSE 350 companies"

1 Introduction

1.1 This paper sets out our response to the Competition Commission's (CC's) Working Paper "The life cycle of FTSE 350 companies" (the "Working Paper").

1.2 This Working Paper has found no evidence of a causal relationship between changes of index designation and switching. Indeed, 61 per cent of switches did *not* coincide with a change of index designation in the year before or the year of a change of index[1] In other words, there is no evidence to support the suggestion that there is institutional bias or external pressure on firms to switch to the largest four audit firms on entering the FTSE 350.

1.3 We welcome the CC's conclusion that the largest four audit firms target each other's clients just as much as those of the mid-tier in advance of FTSE 350 listing[2]. This is consistent with our experience that targeting of potential clients is not biased towards the clients of mid-tier firms in order to create a strategic barrier to entry.

1.4 However, as we have stated in previous submissions[3], the number of companies switching between audit firms is not informative of the competitive pressures on audit firms. Audit firms face intense competitive pressure to retain their existing clients, stemming from the credible threat to switch to other firms, as supported by the fact that some FTSE350 companies have done just that[4].

1.5 In the following sections we set out our comments in more detail.

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[1] Paragraph 21 of the Working Paper.
[2] Paragraph 23 of the Working Paper.
[3] For example, see paragraph 274 of our main submission in response to the CC's Issues Statement.
[4] See Table 4 of the Working Paper.

2 Strength of competition

2.1 We agree with the CC's conclusion that there is no evidence that the largest four audit firms target mid-tier firms' clients in advance of FTSE 350 listing any more than they target the clients of other of the largest four audit firms[5]. This goes against any suggestion that the largest four audit firms aggressively target mid-tier firms' clients in order to create a strategic barrier to entry[6].

2.2 The strength of competition is further evidenced in the Working Paper by the fact that there is switching from the largest four audit firms to mid-tier firms by companies in the FTSE 250, in the Other Listed designations and in the case of private companies. This shows that the mid-tier firms can and do compete for such clients (though the competitive pressure on incumbent audit firms goes far beyond instances of companies switching audit firm).

2.3 As set out in previous submissions[7], competition is fierce to win new clients, regardless of the identity of the incumbent audit firm, and by the same token competitive pressure to retain audit clients is intense.

3 No evidence of institutional bias in switching audit firm prior to listing and entering the FTSE 350

3.1 This Working Paper finds no suggestion there is any institutional bias or external pressure on companies to switch to the largest four audit firms on entering the FTSE 350[8]. In particular, as the CC notes, more companies switched audit firm around the time of moving out of the FTSE 350 index or delisting compared with companies moving into the FTSE 350 or listing[9].

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[5] See Annex 2 of our response to the CC's "Nature and strength of competition in the supply of statutory audits" Working Paper, in which we provide details of the targeting programmes which we currently have in place.
[6] This suggestion was put forward by the CC at Paragraph 34 of the CC's Working Paper "Restrictions on entry or expansion".
[7] For example, see sections 7 and 8 of our Main Submission; paragraph 1.8 and Annex 2 of our response to the CC's working paper "Nature and strength of competition in the supply of statutory audits" and paragraph 3.4.5 of our response to the CC's working paper.
[8] These claims have been made, for example, by Mazars in their response to the CC's Working Paper "Restrictions on entry or expansion".
[9] Paragraph 4 of the Working Paper.

3.2 In addition, a significant majority of switches (61% as calculated by the CC) did not coincide with a change in index designation in the year before or the year of a change of index[10].

3.3 In relation to the methodology, we would note that the CC has considered only simple correlations, which cannot be informative of causal relationships. For example, we note that the CC states that it considers the number of switches that have occurred around the time a company has moved between index designations in order to "attempt to estimate the proportion of switches that could be *driven by* movement between index designations" (emphasis added)[11]. We do not consider this a correct interpretation of the coincidences of switches and changes in index designation. Switches that coincide with movements in index designation could be a result of features that are correlated with the change in index designation, though not "driven by" (or a result of) the movement[12]. The CC includes no other variables in its analysis to explore the relationship between the variables it explores in this paper, nor any statistical causality tests. Similarly, the CC's analysis is based on simple comparisons, with no testing of the statistical significance of any of the results.

3.4 In addition, the sample of firms investigated in this Working Paper only captures those firms which have recently been listed on the FTSE 350. As we have set out in our response to the CC's "Market Definition" Working Paper, there is no clear dividing line between the characteristics of different audit clients[13]. Instead, there are a number of factors that affect the characteristics of a company's audit, which vary continuously. There is therefore no discontinuity in audit clients' characteristics (or in their needs or demands) at any particular point.

4 Merger activity and switching audit firm

4.1 It is not possible for us to comment on the robustness or reliability of the analysis undertaken by the CC on merger activity and switching audit firm as we do not have access to the Dialogic data that the CC has used.

[10] Paragraph 21 of the Working Paper.
[11] Paragraph 19 of the Working Paper.
[12] Paragraph 19 of the Working Paper.
[13] Paragraph 1.1.3 of our response to the CC's Working Paper "Market Definition".

4.2 Nevertheless, we note that the CC has found that 20 per cent of switches occurred in the same year as a company undertook some deal activity and 33 per cent of switches occurred when there was merger activity in either the year before, the year of, or the year after the switch[14]. We believe that these figures support our previous argument, that undertaking merger activity does not prevent companies from switching audit firm if they are not happy with the quality of the audit they receive[15].

[14] Paragraph 27 of the Working Paper.
[15] Paragraph 3.3.2 of our response to the CC's Working Paper "Evidence on switching costs (and implications for barriers to entry)".