

Initial views on the Competition Commission's investigation in the supply of audit services for large companies

Introduction

1. KPMG believes that a robust assessment of competition in any market can only be based on a thorough understanding of the product. In our view, the Office of Fair Trading (OFT) reference document¹ is based on a superficial understanding of the nature of audit services and of the customers of audit firms and, consequently, on an overly simplistic and erroneous analysis of competition for the supply of these services to large companies.
2. We have therefore set out KPMG's views on some of the key aspects of the nature of the products and of competition that we believe need to be taken into account as part of the Competition Commission's (CC's) competitive assessment. As part of these views we highlight what we consider are important shortcomings of the OFT's analysis and evidence base, to illustrate how a robust analysis of competition will need to move beyond the OFT's position.

The nature of the statutory audit product

3. In the audit industry, as with any other, the nature of the audit product determines the nature of competition for its supply and ultimately the industry structure. Although the OFT recognised to some degree the complexity of auditing a large company², it did not fully appreciate the dimensions of this complexity, and, crucially, its impact on the nature of competition.
4. Statutory audit is on the one hand very prescriptive; the current volumes of International Auditing Standards and International Financial Reporting Standards (the most relevant for large UK listed companies) run to 768 pages and 2900 pages respectively. On the other hand, these standards do not (and cannot) cover all the complexities of many large company audits, and therefore the audit of large companies still requires significant skill and judgement on the part of the audit team. The major audit networks invest a considerable amount in their methodologies, technology and training in order to ensure that judgements are applied as consistently as possible on an international basis. Whilst the audit networks establish processes (formal and informal) for consultation within the relevant firm, ultimately these judgements are exercised by the specific audit team and in particular the partners responsible for the relevant audit opinion.

¹ <http://www.offt.gov.uk/OFTwork/markets-work/references/statutory-audit/>

² Paragraph 4.20 of the OFT reference document.

5. The statutory audit of the largest companies in particular is often very complex. This is due to a range of factors including companies' extensive global operations, complex transactions, intricate accounting and tax structures and the increasing regulatory demands. It also needs to be appreciated that there is often more than one audit, in that a multinational group's subsidiaries will generally require local audits to local standards (including, for example, data maintenance practices, tax records and regulatory requirements) as well as forming an integral part of the group audit. In addition there is the need for detailed, industry-specific knowledge; this tends to be exacerbated for the largest companies who are often at the leading edge of developments in their industry. Audits also often need to include specialist expertise, such as actuarial, tax, technology, treasury and risk assurance specialists, as a result of increasingly detailed accounting regulations and volatile economic conditions. In KPMG's experience, the complexity of many large companies' statutory audits has increased substantially in recent years. One driver of this is the increasingly global nature of many large companies, exemplified by the extent to which FTSE100 companies' total audit fees are paid to non-UK firms.

6. As a result, the audit of large companies requires the combination of significant investment in methodologies and processes (including, for example, in technology), as well as in the network of audit firms (for example in order to ensure a consistent methodology across them); in attracting staff with the right skills and capabilities; and in maintaining and developing the skills of these staff. All of these investments ensure that individual auditors on any given large company audit are best placed to exercise the necessary skill, judgement and sector expertise, and use their experience of auditing other complex businesses. The quality of the audit service will depend crucially on how well the individual auditor is able to exercise this skill, judgement and experience, as well as on the reliable delivery of these services, drawing on all of the resources of the audit firm and the network as necessary. The nature of the product and the need for high quality on the part of the auditor impacts on the nature of competition, which we discuss in the next section.

7. KPMG would be happy to discuss these issues in more length by way of introduction for the CC, but the CC may prefer a neutral interlocutor. For this, we suggest that the CC might benefit from a learning session with the Institute of Chartered Accountants in England and Wales (ICAEW) and / or the Financial Reporting Council (FRC). This should provide some basic background on the nature of audit although it is difficult to convey the scale and complexity of the largest audits in a purely theoretical environment. We would also therefore welcome exploring the possibility of discussing in detail one or two of our larger multinational audits, subject of course to confidentiality requirements.

Competition in Quality

8. Value for money and the audit fee are important aspects of competition in the supply of audit services. However, it follows from the points in 4 to 8 above that audit firms also compete to provide a high quality service, a crucial aspect of competition that was not fully taken into account in the OFT's analysis.

9. KPMG makes substantial ongoing investments both in the UK and (through KPMG International and its network member firms) internationally to ensure the quality of the audit services it provides. These investments fall into two broad categories: those that are relationship-specific and those that are not. Those investments in quality that are not specific to any one particular client are crucial to maintain capacity in core skills and in a range of industries, as well as to ensure a detailed understanding of national regulations and the application of consistently high standards in the audit of UK-based companies and groups. This will drive the delivery of a high quality statutory audit service in the face of the increasing complexity of audit and accounting requirements across KPMG's clients. In addition to these investments, KPMG also seeks to further improve the quality of the audit by drawing on specialist skills from outside the core audit team (as discussed in paragraph 6).

10. Relationship-specific investments are made in order to understand the specifics of a particular client's audit needs and the complexities of its business. These are key to ensuring that each client's business is audited reliably and efficiently. These investments are made by both the audit firm and the company being audited. An auditor requires a deep understanding of the business he or she is auditing, for example the business' (global) structure, the structure of its accounting units and how transactions are processed in this complex environment, and the audit firm invests time and resources in achieving this understanding. A significant part of this investment takes the form of learning by doing, whereby an auditor working repeatedly on the same company audit learns more detail about the client (its business, its processes and importantly its people), resulting in fewer mistakes and a higher quality audit. This in-depth understanding is maintained even in the face of mandatory rotation of partners, by ensuring that the overall team retains the cumulative learning and experience. Audited companies make investments of time and resources in helping their audit supplier understand their business and companies (and in particular audit committees) also invest time and resources in ensuring the auditors' work is of high quality. In addition, there are important investments on both sides in establishing and maintaining good professional working relationships at all levels.

11. All of these relationship-specific investments have an ongoing element, but there is inevitably a substantial upfront investment required for a new customer and developing the auditor relationship. As the relationship continues and improves, fewer investments in learning about the business will be required, and the company's and in particular the audit committee's trust in and value of the auditor's reporting increases.
12. Both categories of investment in quality are also important to maintain KPMG's brand value and to prevent this value being destroyed by failure to deliver a quality service. A broad range of investments are made, particularly in quality control, that are important for maintaining that brand and guarding against damage to KPMG's reputation. We believe that it will be important for the CC to understand the nature of these investments and the incentives to engage in them that are created by competition in the market.

Customer switching and the efficient relationship for the delivery of audit services

13. The OFT characterised long-term relationships between audit firms and their clients as arising from “switching costs”³. This is in our view incorrect. The switching cost literature, upon which the OFT's analysis appears to be loosely based, is characterised by exogenous switching costs which are unrelated to the nature and quality of the product provided. A key driver of whether customers are likely to switch is related to efficiency and quality considerations in the delivery of the audit which could not be captured in the simplistic setting of “switching costs”. It is also, in our view, not something that would be helpfully described as a “feature” of the market. Rather it is the result of competitive forces and customer requirements, in other words: a market outcome.
14. For example, there are important reasons why it may not be efficient for a large company to switch auditor frequently. Some of these reasons stem from the relationship-specific investments in quality made by both audit firms and their customers (as set out in paragraph 11). In many markets, the need to provide an efficient service can lead to long term relationships between firms whose products or services are highly bespoke and require dedicated and relationship-specific investment. Whether a relationship between an audit firm and a large company is long or short term itself has no bearing on whether there are adverse effects on competition in this industry. Rather, the assessment of competition should be driven by an assessment of the efficiency of that relationship.

³ Paragraphs 5.14 – 5.17 of the OFT reference document.

15. In the audit sector, we believe the CC should consider whether frequent switching would be inefficient and in particular we suggest it consider three potential reasons why low switching rates may be entirely consistent with effective competition. First, frequent switching would imply that the value of relationship-specific investments would be lost, and hence that both audit firms and their customers would have insufficient incentives to put in the efficient levels of investment. Second, there would need to be duplicate investments made by the new audit firm. And third, the quality of the audit will fall following a switch of supplier, as the new auditor will not have made the same investments in understanding the business.
16. The OFT recognised⁴ that high switching rates may not be efficient in the large firm audit market where there are costs of switching for both suppliers and customers. However, in our view it is important to incorporate the reasons for and benefits of long term commercial relationships into the CC's analysis.

Market structure and barriers to entry

17. The OFT's analysis emphasises the degree of concentration in the supply of audit services to large companies and identifies this as a feature that might prevent, restrict or distort competition⁵. This analysis does not however capture the endogenous nature of market structure – in other words how market structure is determined by the nature of the product and of competition, rather than being a factor that simply affects competition.
18. There are aspects of the cost incurred by providers of audit services that give rise to economies of scale and scope. For example, KPMG has made upfront fixed cost investments in technology processes to support its staff in auditing ever more complex businesses. Furthermore, the OFT recognises that several of the barriers to entry and expansion that it refers to arise as a result of customer preferences⁶. However, the OFT's analysis fails to recognise the impact of these factors on economies of scale and scope and on quality differentiation, and therefore on market structure.
19. Rather than treating the market structure of the audit industry as exogenous, as the OFT did, the CC will in our view need to conduct a dynamic analysis of competition in order to understand why industry structure has developed in the way that it has and the implications on outcomes for

⁴Paragraph 5.22 of the OFT reference document

⁵ Paragraphs 5.49 – 5.65 of the OFT reference document.

⁶ See the OFT's discussion of the importance of an extensive, integrated international network, of greater experience of auditing large and complex business, of relevant sector experience and of the enhanced familiarity with latest developments in complex regulatory accounting (paragraph 5.34 of the OFT reference document).

customers. This will in turn have important implications for the appropriate indicators of competition in this industry as set out in the final section of this submission.

Indicators of competitive constraints

20. The OFT inferred from low rates of tendering and switching⁷ that competition does not work well in the audit industry⁸. However, competition in this industry, as in other professional services industries differs from, for example, competition in the supply of consumable goods. As such, rates of tendering and switching are poor indicators of the level of competitive constraint.
21. As set out above and as recognised by the OFT⁹, in industries characterised by such relationship-specific investments, we would not expect to see frequent customer switching. This is not indicative of a failure of competition – rather the level of switching arises because audit firms are incentivised to make and maintain relationship-specific investments in order to meet customer needs and to respond to the competitive pressures in the industry.
22. These competitive pressures are not captured by the rate of tendering, as large companies are able to put their audit suppliers under constant competitive pressure without the need for issuing a formal tender. The OFT argued that a company may not be able to properly assess the competitiveness, indicators of relative quality and the suitability of audit services being offered without inviting other firms to participate in a competitive tendering process, and in doing so creating a credible threat to switch¹⁰. The OFT's argument relies on two broad assumptions: that companies are unable to assess the quality of audit services without a competitive tender process, and that companies do not have a credible threat to switch without a competitive tender process. KPMG has seen no evidence to suggest these assumptions are likely to be true and furthermore has provided evidence of the opposite being true (see paragraph 25).
23. Instead, companies are well-placed to judge the quality of the audit services they receive, whether or not a competitive tender is issued. KPMG believes it would be useful for the CC to engage with Audit Committee chairs, which the OFT failed adequately to do, in order to properly understand the level of their expertise in discerning the quality of audit services.

⁷ Paragraphs 5.18 – 5.21 of the OFT reference document.

⁸ Paragraphs 5.22 and 5.24 of the OFT reference document.

⁹ Paragraph 5.22 of the OFT reference document.

¹⁰ Paragraph 5.26 of the OFT reference document.

24. KPMG's own experience is that large companies tend to have processes in place to regularly review their audit supplier. Evidence we provided to the OFT in response to the consultation document showed that around half of KPMG's FTSE100 clients had conducted extensive reviews which went well beyond regulatory requirements. We are also aware that audit suppliers make informal approaches to companies as part of these review processes. These review processes and any resulting renegotiations are conducted under the shadow of a credible threat to switch supplier. In our view, therefore, the CC should look for a broader range of indicators of competitive constraints and move beyond the OFT's superficial focus on rates of tendering and switching.