



KPMG response to Competition Commission further remedy option for consultation

1 Overview

- 1.1 This paper sets out our response to the Competition Commission's ("CC") further proposed remedy option for consultation, namely that the Financial Reporting Council ("FRC") be given a secondary duty to promote competition between firms providing audits to FTSE350 companies. For the reasons given in our formal response to the CC's Provisional Findings Report ("Provisional Findings"), we do not accept that the Provisional Findings of an Adverse Effect on Competition (AEC) are well founded nor, therefore, that any remedies are justified. Our comments on this remedy option are subject to that general comment.
- 1.2 The CC has not set out in any detail what it envisages the FRC's duties and responsibilities to be as part of this proposed new remedy. It is therefore not clear to us what change or benefit this remedy option would bring to the supply of statutory audit services to FTSE350 companies. However, we do have some general concerns in relation to the effectiveness and proportionality of this remedy option, which we set out in the rest of this response.
- 1.3 The CC suggests that the FRC should consider how it might review and report on audits of large companies in a way which promoted competition. As a background to this, the CC notes that "[Audit Quality Review (AQR)] reports are not designed to enable companies or their shareholders to compare the performance of rival audit firms in carrying out audit services"¹. It also notes that "it was difficult to identify an objective external metric to allow reliable comparisons between audits and audit firms"². The CC considers that the proposed remedy may contribute to remedying the AEC it has provisionally identified by, amongst other things, increasing the transparency of AQR reports.

¹ Paragraph 16 of the CC's Notice of a Further Possible Remedy.

² Paragraph 11 of the CC's Notice of a Further Possible Remedy.

- 1.4 Our view is that the FRC’s role and AQR reports are already important in promoting competition, as we set out in our response to the Provisional Findings³. This is principally because they allow clients to gauge how their own auditors, and other auditors, are performing in the market in terms of the quality they are delivering. This (a) enhances companies’ ability to judge the quality of audit firms; and (b) provides an additional incentive on audit firms to ensure that they deliver audit quality to all clients. Both of these factors are amongst the features which underpin competition in audit quality.
- 1.5 In light of the above, a secondary duty to promote competition is in our view not necessary. Further, there are at least two broad reasons why it may in practice distort outcomes in the market in way that would create more harm than good.
- 1.6 First, it is unclear to us how transparency in reports could be increased in practice. To the extent that the CC envisages that the FRC might produce rankings or metrics, this presents some real and potentially significant dangers for outcomes in the market. One possible consequence is that it might encourage competition to focus on activities that lead to a better “score” in such metrics and divert effort away from the broader range activities that need to be performed in order to ensure that the audit needs of a particular company are fully met. In other words, given the bespoke nature of the audit product any metrics will be likely to introduce a degree of simplification with a great risk of distorting competitive efforts to produce a service that is less tailored to the needs of the company and its shareholders and ultimately less accurate.
- 1.7 Second, such a duty would not sit well alongside the FRC’s prudential duty. In particular, given the FRC’s primary duty to monitor and promote improvements in audit quality, it is unclear whether and to what extent the FRC would be in a position to comment on the “value for money” of different offers or on audit firms’ efficiency. For example if the CC envisages that the FRC produces AQR reports with some form of ranking of audit firms, we do not think that this could be done in a way that appropriately assesses audit firms’ quality as well as their efficiency and “value for money”. We provide further detailed comments in relation to AQR reports in the next section.

³ Paragraph 3.5.2.1 of our response to the Provisional Findings.

1.8 In our view, as we set out in our response to the CC's follow up questions from the Hearing on 29 April 2013, it is also important that any regulator with a duty to promote competition has the appropriate expertise to perform that function. This would require recruitment of staff with the appropriate skills and experience, and the CC needs to take into account the Net Present Value of these ongoing costs in assessing whether this remedy option would be proportionate. For example, the CC refers to the FCA⁴, which has a duty to promote competition. We note that the FCA, while it has not been given concurrent Competition Act 1998 powers, has other significant powers, including the power to receive super-complaints⁵, and is currently assembling a dedicated team with competition expertise to fulfil that duty⁶.

1.9 Finally, we note that the FRC's remit is far broader than regulating audits of FTSE350 companies. The CC has not found an AEC on any other market (and no evidence of anticompetitive behaviour in the reference market). Therefore it is not clear that giving the FRC a competition mandate, and therefore requiring it to procure competition expertise, in relation to just FTSE350 audits, would be a proportionate response even if the CC's provisional AEC finding were confirmed (which we would disagree with). Further, the CC will need to ensure that giving the FRC competition powers in relation to FTSE350 companies does not create a distortion on other markets. For example, if AQR reports present quality metrics or rankings for FTSE350 companies and these are used as a proxy for audit quality for all companies, this might lead companies outside the FTSE350 to choose an audit firm on which such reports are available.

⁴ Paragraph 19 of the CC's Notice of a Further Possible Remedy.

⁵ The FCA will be able to use its powers to promote effective competition, particularly making rules including its new "temporary product intervention rules".

⁶ The FCA has recruited Mary Starks (Senior Director) and Deb Jones (Director) from the OFT to manage this team.

2 Specific comments on the CC's suggestions in relation to AQR reports

2.1 In this section, we provide our detailed comments on the CC's suggestions in relation to AQR reports as part of this remedy option. The CC notes that:

"we provisionally found that the reports produced by the AQR team identified a range of issues (of varying degrees of gravity) regarding quality and a possible lack of auditor scepticism in the relevant market"⁷.

2.2 In our response to the Provisional Findings, we noted that far from suggesting an outcome that was consistent with an AEC, the generally high levels of quality found across FTSE350 companies' audits, and in the largest audit firms, suggests that competition is working well in delivering high quality outcomes for customers⁸. We have not seen any reliable evidence from the CC to suggest otherwise and the CC must address this in its Final Report.

2.3 Turning now to the CC's suggestions for how the AQR reports might be changed under this remedy option, the CC states that:

- AQR reports are useful in highlighting areas of quality that may need improvement⁹.
- Providing the FRC with a secondary duty to promote competition might increase transparency in AQR reports¹⁰.
- AQR reports are not designed to enable companies or their shareholders to compare the performance of rival audit firms in carrying out their duties, and providing the FRC with a secondary duty to promote competition might enable them to do so¹¹.

2.4 We take each of these points in turn. First, we agree with the CC that AQR reports are useful, as set out in paragraph 1.4 above, and that they contribute to the current competitiveness of the market.

2.5 In relation to transparency, we think the current reports already disclose a large amount of information and give substantial detail on the review. It is not clear how transparency

⁷ Paragraph 11 of the CC's Notice of a Possible Further Remedy.

⁸ Section 2.6 of our response to the Provisional Findings.

⁹ Paragraph 16 of the CC's Notice of a Possible Further Remedy.

¹⁰ Paragraph 18a of the CC's Notice of a Possible Further Remedy.

¹¹ Paragraphs 16 and 17 of the CC's Notice of a Possible Further Remedy.

and comparability in general could be increased without compromising the anonymity of the specific company whose audit is being discussed. The CC has not set out in any more detail in what way it considers these reports to be lacking transparency or how transparency might be increased.

2.6 In relation to comparability, we see several problems that may result from different ways in which the FRC might put into practice the CC’s generic suggestion.

2.7 First, as we explained in several submissions¹², audit is a complex and bespoke service. As such, a good assessment of what constitutes a high quality audit and good “value for money” will necessarily have to be specific to each company, given its particular characteristics and the characteristics of an audit firm and specific audit team. Companies can currently assess the quality and broader competitiveness of the services being provided to them by the incumbent audit firm using a combination of different sources of information¹³. These include AQR reports, approaches from competitors, evaluation of performance of alternative providers on non-audit services and the views and experience of ACs. This information currently provides companies with the ability to assess the competitiveness of incumbent auditors in a way that is meaningful to them given their specific needs. Each company might place a different weight on different aspects of service and seek additional information as required given their specific needs. It is not clear to us in what way AQR reports could be modified to capture information in a way that is relevant to all companies and yet enables comparability.

2.8 We see a risk that this could encourage a set of ‘KPIs’ for audit firms, published by the AQR. This might in turn lead audit firms to focus on these metrics to the detriment of tailoring their service to the needs of individual companies and their shareholders. Moreover, this may limit incentives for audit firms to innovate if these innovations are not captured by such metrics.

2.9 These effects would be exacerbated if companies felt that they had to be seen to use audit firms with the best scores in such FRC metrics to ensure confidence from investors. Ultimately, this risks stifling innovation and distorting competitive efforts to

¹² For example, see paragraphs 5 and 6 of our submission in response to the CC’s Issues Statement.

¹³ Paragraph 3.5.2.1 of our response to the Provisional Findings.

produce a service that is less tailored to the needs of the client and ultimately less accurate.

- 2.10 We see a further risk that the AQRRT reports will substitute the much more considered judgement of the AC and ACC in particular. The experience and in-depth analysis that the AC conducts when selecting and reviewing an audit firm are important in ensuring that companies get the best and most competitive audit service possible. There is a risk that simplistic metrics and other comparators (for example rankings) may be seen as substitutes for the role of ACs and hence to some degree reduce the responsibility on the AC to perform its important role.
- 2.11 Finally, we note that the CC states that this remedy option is more likely to lead a company to switch audit firms, thereby increasing rivalry¹⁴. First, the CC has not explained, nor provided evidence to support its view that the remedy would lead to greater switching. Moreover, as we set out in our response to the Provisional Findings¹⁵, switching rates are not per se informative of the degree of rivalry in a market, and so in our view this statement is flawed. The CC has not addressed this point to date, nor has it explained why in this market an increased rate of switching would generate more competitive outcomes. We believe that, for the CC to be able to support its AEC finding and justify remedies (including this one) it must do so in its Final Report.

3 Conclusions

- 3.1 We set out in the previous two sections why we do not think that this remedy will be effective and why we believe that, depending on how it is implemented, it might involve significant economic costs. These would include direct costs, for example costs of recruiting appropriately skilled staff, as well as potentially far greater costs associated with the risks of stifling innovation and distorting outcomes in the audit industry.
- 3.2 To conclude, we provide our summary views in relation to the two questions the CC posed as part of this consultation:

a) whether giving the FRC a secondary duty to promote competition between audit firms will assist in comparisons across audit firms: In our view, it will be

¹⁴ Paragraph 18 of the CC's consultation document on the further proposed remedy.

¹⁵ Section 2.2 of our response to the Provisional Findings.

important to articulate clearly how this might be done in practice. There are significant risks with trying to increase comparability (as set out in the previous two sections). To the extent that some aspects of comparability can be improved, we do not think this will help much compared to the already good sources of information. A comparison needs to be based on the particular understanding of a company's business. This is best done by an AC which has the right experience and can observe other audit firms' more closely (for example, through ongoing contact with other audit firms including their provision of non-audit services to the company) and by using a range of information. AQRT reports cannot substitute for that company-specific information.

b) whether giving the FRC a secondary duty to promote competition between audit firms will assist shareholders to influence the audit firm appointment decisions of companies in which they hold shares: In our view, providing the FRC with a secondary duty to promote competition cannot increase shareholder engagement in any helpful way. The audit appointment needs to be based on an assessment tailored to the needs of the particular company, and this is best done by ACs. By using AQRT reports in isolation to form a view about auditor appointment, shareholders could put pressure on companies to appoint an audit firm that scores well 'across the board' without properly taking into account the particular needs of the company and its shareholders. This could result in distorting outcomes in the market to the detriment of companies in the ways set out above.