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KPMG’s response to the CC’s Working Paper “Barriers to Entry: Reputation and Experience”

PART A: General Comments

- 1 This paper provides our response to the Competition Commission’s (CC’s) Working Paper on “Barriers to Entry: Reputation and Experience” (the “Working Paper”). We welcome the chance to comment on this Working Paper, and look forward to continuing to engage with the CC on this topic.

- 2 In our response to the CC’s working paper “Restrictions on entry and expansion”, we set out our views on the CC’s approach to assessing reputational and experience factors as barriers to entry. To summarise:
 - reputation is important in that it reflects previous investments and delivery of high quality audits;
 - investments in quality are not made for the purpose of raising barriers to entry, but in response to public expectation client demand and competition;
 - reputation reflects the underlying quality of audit firms;
 - mismatches between actual performance and reputation would be rapidly detected in an increasingly transparent regulated market cannot persist over time; and
 - it is important to take account of the role of independent quality reviews inspections in shaping reputation.

- 3 We also outlined why we do not think specific aspects of the so called ‘virtuous circle’, such as attracting talent and the alumni network, operate as barriers to entry.

- 4 Our views on a number of the specific aspects of the CC’s evidence and arguments are set out in detail below, however our general views can be summarised as follows:

The CC mischaracterises reputation and experience as barriers to entry

- 5 The CC continues to mischaracterise reputation and experience as barriers to entry. They are not. The standards of quality and the capabilities of audit firms servicing the FTSE350 represent the minimum requirements necessary in order to compete in a highly competitive market.

- 6 As we set out in our Main Submission, in response to the CC’s Issues Statement (“Main Submission”) and as Simon Collins reiterated at our Hearing with the CC on 3 October 2012 (“CC Hearing”), audit firms are under constant pressure to invest in enhancing their product as a result of client demand, regulatory expectations and competitive pressure¹. In this regard, we would like to again highlight the emphasis which we place on monitoring the quality of our audits. These take the form of internal quality controls, client satisfaction surveys and investments in staff training, all of which were outlined in detail in our response to the CC’s Market and Financial Questionnaire (“MFQ”)² and in our Main Submission³.

- 7 Thus, the investments which we make in delivering a quality product to our clients are the result of competitive processes. The CC itself has previously recognised this relationship⁴.

In any event, reputation and experience are not “barriers” to mid-tier firms competing

- 8 In our view mid-tier firms have a number of strategies available to them to expand in the FTSE350 audit market, such as:

¹ Paragraph 22 of our Main Submission and pages 3-4 of the CC Hearing Transcript.

² Section 61.7 of our MFQ response.

³ Section 5.1.7 of our Main Submission.

⁴ See paragraph 177 of the CC’s Working Paper “Nature and strength of competition in the supply of FTSE 350 audits”.

- Non-audit work: providing non-audit work to clients is a common and effective way for a new audit firm to familiarise itself with a client’s business, and also allows the client to judge the quality of the new audit firm’s work. As the CC has accepted, “*non-audit work can be used as a way of developing a professional relationship with a company and increasing the likelihood of being invited to tender for audit should the opportunity arise.*”⁵
 - Thought leadership: firms can make their offering more attractive by taking the initiative and engaging with, for example, a particular industry on issues which are affecting it. As the CC notes in its working paper “Firms’ stated competitive strategies”, thought leadership is an area of “active development” at mid tier firm Grant Thornton⁶.
 - Seconding employees overseas to build-up capabilities: where an audit firm perceives they have a weakness in a key jurisdiction or a certain sector, seconding senior staff from another member firm may be a way to redress this.
- 9 In addition, at the CC Hearing we outlined an example of a strategy which we believe a mid-tier firm could employ to build up the relevant experience and more effectively target FTSE350 clients, namely, directing efforts towards a simple UK-based business company located towards the bottom of the FTSE350, such as a supermarket chain⁷.
- 10 In addition, we note that PKF, which has successfully gained a reputation for thought leadership, in depth industry expertise and quality advisory work in the hotels sector, which has a significant international dimension⁸.
- 11 We consider the CC has not placed sufficient weight on the above evidence, which demonstrates that such strategies are available, and are being employed in the market.

⁵ Paragraph 22 of the CC’s Working Paper “Firms’ stated competitive strategies”.

⁶ The CC has also recognised that “*Some elements of thought leadership, such as technical and industry briefings, may be sent to company staff as a more passive way of developing the firm’s reputation with individuals who may have some influence in purchasing professional services.*” See Paragraph 44 of the CC’s Working Paper “Firms’ stated competitive strategies”.

⁷ Pages 23, 30 and 57 of the CC Hearing transcript.

⁸ This was recognised by the CC at paragraph 35 of its Working Paper “Firms stated competitive strategies”. We note that PKF has not yet begun providing auditing services to any companies in the hotel industry, although this may be due to PKF’s stated strategy of only concentrating on 1 or 2 tenders per year, as set out in paragraph 23 of that Working Paper.

Reputation is an accurate reflection of underlying quality.

- 12 The CC states that if reputation is objectively justified then it is helpful to companies as it allows them to “*distinguish accurately between potential suppliers of audit services and select the most appropriate for their needs*”⁹. In our view an audit firm’s reputation is a reflection of its underlying quality. In our view quality is observable, and particularly so to audit clients, both Audit Committees (ACs) and management. While having a proven track record for delivering quality audits – that is, a good reputation – is very important, it does not guarantee an audit firm will be successful in winning a tender.
- 13 The above notwithstanding, the CC appears to suggest in its Working Paper that there may be a ‘gap’ or mismatch between the perceived and the actual quality of audit firms¹⁰. We are very concerned with this suggestion, for which the CC appears to have no material evidentiary base, and which appears not to be based on logic or economic theory. In particular, it is unclear on what basis the CC believes an audit firm could be successful (other than in the short term) in the market on the basis of reputation alone, without delivering high quality services to its clients. Such a suggestion is also contradicted by numerous other evidence which the CC has already recognised elsewhere¹¹. We therefore strongly reject the suggestion that audit firms’ reputations reflect anything other than their underlying quality and capabilities.
- 14 In addition, the CC has again failed to acknowledge the impact that independent regulators’ reports on quality have on reputation, ignoring not only our repeated submissions on this point¹², but also evidence from the CC-commissioned survey (“CC’s survey”) which finds that adverse regulatory findings are a factor in many

⁹ Paragraph 3.

¹⁰ See, for example, paragraph 76 of the Working Paper.

¹¹ For example, the most common principal factor which caused FTSE350 companies to switch auditor was ‘better quality of service in audit delivery’: slide 63 of the CC Survey.

¹² See, for example, Paragraphs 26.41-26.45 of our response to the MFQ and our response to the CC’s Working Paper “Firms’ stated competitive strategies”.

companies' choice of auditor¹³. The CC's failure to give weight to this evidence is curious given that these reports can be expected to provide an insight into the quality of audits delivered in the market; therefore are another reason why reputation and actual quality will remain aligned; and because, as independent reports, they can be expected to have a significant influence in shaping a firm's reputation¹⁴. Again, as indicated in Simon Collins's opening statement at the CC hearing, the UK has the most robust and transparent audit regulatory oversight in the world, the only country to produce firm-wide full public inspection reports annually and to provide individual audit reviews to the AC Chair (ACC) and audit firm concerned.

Clients do not generally 'rely' on reputation as a proxy for quality.

15 As the evidence demonstrates (and as the CC has previously recognised¹⁵), companies are sophisticated purchasers of audit who are able to judge technical quality and to observe quality, both ex ante (that is, during the process of choosing an auditor) and ex post (that is, when judging the quality of services being provided by their current auditor).

Judging quality ex ante

16 As to judging quality ex ante, while we agree that audit is an "experience good", there are many ways in which companies can assess the quality of prospective auditors, as the CC has recognised. We would also point out that this is a two-way street: just as audit firms are able to demonstrate quality to a client by providing a range of non-audit services, so too can companies choose to build up a relationship with an audit firm where it wishes to learn more about the quality of its offerings¹⁶.

¹³ Sides 33 to 38 of the CC Survey.

¹⁴ It is even more curious that the CC has chosen to ignore this evidence given that it considers information asymmetries mean that stakeholders may have difficulties observing quality.

¹⁵ See Paragraph 63 of the CC's "Framework for the CC's assessment and revised theories of harm" Working Paper.

¹⁶ See, for example, the ACC's view that using different firms for non-audit services is a way to "keep an eye" on other firms, at paragraph 57 of Case Study B.

- 17 Finally, in our experience, clients look for experience of working with FTSE350 companies and relevant industry experience not for “reputational effect”, but because such experience improves the quality of the audit. Such experience does not necessarily need to be audit-related, as noted by Simon Collins in the CC Hearing¹⁷.

Judging quality ex post

- 18 Once an audit firm has been appointed, clients assess quality based on the actual work done, rather than on the basis of reputation or experience. Our experience with clients, as we set out at the CC Hearing, is that they are not only able to perceive and judge quality, they will quickly tell us if we are not delivering it and, what’s more, they will talk among themselves¹⁸. As a result, underperformance is likely to be communicated to a wider audience than just the audit client. Thus poor performance will harm not only our relationship with an existing client, but also damage our chances of winning future mandates. Therefore, and as we have previously submitted, any alleged mismatch between quality and reputation would be corrected in the short to medium term¹⁹.
- 19 Our views on some of the specific aspects of the CC’s Working Paper are set out in the next part of this response.

¹⁷ See, for example, the comment at page 29, line 13 of the CC Hearing transcript.

¹⁸ Page 51 of the CC Hearing transcript.

¹⁹ See paragraph 6.2.6 of our response to the CC’s Working Paper “Barriers to entry and expansion”.

PART B: Views on specific aspects of the CC's Working Paper

1 Introduction

1.1 At paragraph 1 the CC discusses the potential for reputational factors to limit the mid-tier's prospects of profitably entering the market. However, the CC overlooks the fact that a number of the mid-tier audit firms have already 'entered' and are competing for, and auditing, FTSE350 clients. This is different from a situation where, for example, a firm needs to make a substantial sunk cost to enter and therefore must weigh this against the chances of being unsuccessful and exiting. Specifically, the costs of tendering do not represent a hurdle, as the CC notes in its working paper "Nature and strength of competition in the supply of FTSE350 audits", where it finds that mid-tier audit firms stated that the costs of tenders or a lack of financial or personnel resources were not a barrier to tendering²⁰.

1.2 The CC further states that reputation may be "reinforced through strategic actions such as marketing and branding"²¹. For us the investments we make in developing and maintaining our capabilities, and the delivery of high quality services with integrity, are the two most important drivers of our brand. To the extent that we take "strategic" actions such as advertising and sponsorship, these are simply the promotion of the underlying quality which we deliver; they cannot preserve reputation, but are designed to raise awareness of it.

2 Experience and capability

2.1 Demand for experience and expertise in the large company audit market

2.1.1 At paragraph 12, the CC states that companies want their audit firms to have both relevant industry experience and experience of auditing in general. Experience and expertise in auditing large clients and clients in a particular sector ensure that the audit

²⁰ Paragraph 116 of the CC's working paper on "Nature and strength of competition in the supply of FTSE350 audits".

²¹ Paragraph 3 of the Working Paper.

firm is able to minimise the risk of an audit error and to enhance the quality of judgement and challenge, and is also more efficient with the delivery of the audit. Experience and expertise are therefore real quality differentials on which audit firms compete. Further, as with any other “experience good”, clients use indicators, such as the experience of the audit firm in a relevant industry, or the experience of an audit firm in dealing with large and complex companies, to judge, ex ante, the audit’s quality. Clients may also use reputation as an ex ante indicator of the quality of an audit firm or the individual partners. However, experience and reputation are just two of many factors companies can use to judge quality ex ante. Other attributes include technical expertise, good working relationships, independent reports on the audit firm’s quality and (in particular for companies with a significant overseas presence) a strong international network²².

2.1.2 Related to the above issue, at paragraph 15 the CC finds that the most frequently cited reason for losing a tender is lack of experience. Again, this is not specific to the audit industry, nor is it specific to competition between the largest four audit firms and those outside the largest four: when we lose tenders to our competitors an oft-cited reason is experience. However, as we set out above, and in the case studies we submitted as part of our Main Submission, there are strategies available to both the largest four audit firms and those outside the largest four alike to gain experience.

2.1.3 In addition, and as set out above, it is important to recognise that once an audit firm has been engaged, the client will not refer to the audit firm’s reputation and previous experience in order to assess quality. Rather, it will base its opinion directly on the quality of the audit services it receives. Thus, if an audit firm fails to deliver a high quality audit, this will have negative effects for its relationship with existing clients and prospects for winning new business, it could also affect the public inspection report on the firm. This demonstrates that reputation is not only built on a consistent history of high quality work, obtained through investment and effort, but it also drives incentives

²² See, for example, slide 56 of the CC survey.

to maintain that same quality level, since any small drop in quality could have serious effects on a large number of future clients.

2.2 Existing relationships with large companies

2.2.1 The CC considers whether having a pre-existing relationship via the supply of non-audit services is an advantage in the auditor selection process²³. We agree that having a pre-existing relationship with companies is an advantage, in that it allows auditors to demonstrate technical capability and develop a working relationship with a company. However, this strategy is open to all firms to exploit, and mid-tier firms have ample opportunity to, and do, demonstrate their capabilities to large firms by performing non-audit work.

2.3 Reputational effect of international networks

2.3.1 The CC discusses the size and quality of international networks, including the importance of international networks, to audit clients, and the role of reputation in the ability of networks to retain their member firms, in a separate working paper on “Barriers to entry: international networks”. As we set out in our response to that working Paper, our clients demand that we have the capability to provide complete coverage of their activities²⁴. We also know that if we do not respond to this demand, one of our competitors will. Thus, client demand and competition are the driving forces which have shaped the strength and depth of our international network and the networks of other firms. This is evidenced by the CC’s survey, which we discussed in our response to the CC’s working paper “Survey Results”²⁵.

2.3.2 As regards the specific issue of reputation raised in the Working Paper, it is not clear to us how the ‘reputational effect of international networks’ is a barrier to audit firms

²³ Paragraph 16 of the Working Paper.

²⁴ Cover letter of our response to the CC’s working paper “Barriers to entry: international networks” and Section 2.2, and notably 2.2.3, of our response to the CC’s Working Paper “Competition Commission survey results”.

²⁵ Paragraphs 2.2.1 and 2.2.3 of our response to the CC’s Working Paper “Survey Results”.

competing on the market²⁶. The CC points to evidence suggesting that the strength of a firm's international network is an important factor for some companies, particularly those with significant international operations. However, these characteristics can be observed by companies, and demonstrated by audit firms. There is therefore no sense in which the 'reputation of the international network' of an audit firm is different from the firm's actual international network. Thus it is not clear to us how reputation – as opposed to the observable qualities – of a firm's international network has any bearing whatsoever on the choice of auditor or ability of the mid tier to compete in this market. Furthermore, as the CC notes, there is evidence which shows that mid-tier firms also seek to exploit the reach of their international networks²⁷.

2.4 Demand for technical resource

2.4.1 As we have submitted elsewhere, and as the CC has recognised, technical skills are crucial to providing a high quality audit. However, as with international networks, the CC provides no evidence to support the contention that a reputation for high quality technical skills – as opposed to actual, observable high quality skills is different from reality – is a barrier to entry, or that there is a difference between reputation and reality. As we set out above, if there were a difference then reputation would soon be lost.

2.4.2 The CC refers to evidence showing that some companies require their auditors to have technical, sector-based skills. While this may be the case, we note that all firms are able to build up expertise by providing non-audit services to clients in specific sectors. For example, as noted above PKF has built up a capability in the hotel and hospitality sector²⁸ by providing non-audit services to clients. Similarly, we built up capability and

²⁶ The CC also appears to struggle with the concept itself: the word 'reputation' only used once (in the second line) and thereafter appears to have been substituted with 'strength' and 'coverage' i.e. factors relating to quality and capability.

²⁷ Paragraph 22 of the Working Paper.

²⁸ See the PKFHotels website http://www.pkfhotels.com/home/about_us/ demonstrating their experience and reputation

experience in the water industry through thought leadership and targeting clients, which eventually led to us winning the [REDACTED] audit in 2010²⁹.

2.5 Summary of evidence on experience and capability

2.5.1 As set out above, in our view reputation reflects the underlying quality of an audit firm. To the extent different audit firms are perceived differently, this represents actual differences in quality.

2.5.2 The CC finds that experience, pre-existing relationships and a strong international network are important to clients. We agree with this proposition, however we disagree that they act as material barriers to entry. Experience can be gained, and relationships formed, by providing non-audit services to clients and by auditing smaller companies in that sector and this strategy is open to all audit firms to exploit (and is). Similarly, international networks can be, and are, strengthened through organic growth. Indeed, the CC cites evidence that the mid-tier audit firms are continuing to expand their international networks at a faster rate than the largest four audit firms in its working paper “Barriers to entry: International Networks”³⁰.

2.5.3 All firms are also able to gain sector-specific experience, which the CC states may also be relevant to a company’s choice of auditor, by providing various services to companies within those sectors. [REDACTED].

3 Attracting talent and influence of alumni network

3.1 Attracting talent

3.1.1 While the evidence presented by the CC is that there is a mixed range of experiences with working with audit firms outside of the largest four, the weight of evidence as regards the largest four audit firms (here and elsewhere) illustrates that quality of staff is

²⁹ We set out in detail our strategy for winning the [REDACTED] audit mandate at Annex 2 of our Main Submission.

³⁰ Paragraph 100 of the CC’s working paper “Barriers to entry: international networks”.

consistently high³¹. This is, we believe, a reflection of not only of the quality people which we recruit, but also the quality of the training that we provide our staff which, in turn, is driven by client demand and intense competition.

3.1.2 Nevertheless, we do not believe that attracting talent is a barrier to competition. With investment in recruitment and training there is no reason why mid-tier audit firms cannot attract good people with the appropriate experience to deliver quality services. Further, to the extent that they already do have quality staff, if the problem is that companies are not aware of this, then the mid-tier audit firms have ample opportunity to address this by demonstrating their quality by, for example, providing general assurance services.

3.1.3 The CC notes in paragraph 33 of the Working Paper that firms mention their graduate employment credentials in tender documents. However neither the case studies nor the CC's survey indicate that this is an important factor for companies when choosing an audit firm. In our view this is not a barrier to competition.

3.2 *Alumni network*

3.2.1 The CC describes its findings of the number of FDs/CFOs and ACCs working in FTSE350 companies who previously worked at the largest four audit firms, and in audit firms outside of the largest four, but provides no evidence or views as to the 'influence' of this alumni network or how this might operate as a barrier to competition. Moreover, there is no evidence that the companies at which the alumni worked are more likely than those of the non-alumni to appoint the largest four audit firms as their auditors. As we have discussed in our submission in response to the CC's working paper on "Framework for the CC's assessment and revised theories of harm"³², there is no sense in which the status of many FDs and ACCs creates any kind of bias, and the CC has provided no evidence at all in support of any such hypothesis.

³¹ Paragraph 28 of the Working Paper.

³² Paragraph 4.5.3 of our response to the CC's Working Paper "Framework for the CC's assessment and revised theories of harm".

3.3 Summary of evidence on Attracting Talent

3.3.1 The CC finds there is a ‘common belief’ that staff at the largest four audit firms are of a higher quality than staff at audit firms outside of the largest four. We consider that this belief is based on a track record of consistently delivering quality products, and as we have set out above, there is no sense in which there is any ‘gap’ between actual and perceived quality, and no evidence to support any such assertion³³. None of the evidence cited in this section, however, suggests that attracting talent or alumni factors are a barrier to entry or competition³⁴.

4 Awareness of audit firms

4.1 General awareness and marketing

4.1.1 The CC presents no evidence to suggest that marketing (in the sense of advertising, sponsorship and so on) has any effect on reputation. In addition, there is nothing to suggest that mid-tier audit firms are unable to compete on this basis (if they have the requisite underlying quality). In any case these types of activities (as opposed to more focussed business development and targeting) represent a very small proportion of our revenues³⁵, which suggests that this spend is not a barrier to competition.

4.1.2 Evidence from the case studies which the CC cites in paragraphs 42 to 44 suggests that the lack of awareness of mid-tier audit firms is at least partly a function of the marketing efforts (including building relationships with companies) of these firms: case study interviewees received more marketing material and seminar/briefing invites from the largest four audit firms than the mid-tier, and this is supported by the survey

³³ A number of FDs and ACCs at FTSE100 companies trained with firms outside the largest four audit firms (including their predecessors), for example: John Manser (SAB Miller), John Coombe (HRG), Michael Hartnall (BAe), Peter Hooley (Cobham) and Steve Lucas (Compass). See also http://www.accountancymagazine.com/Accy_Mag/features/A_Audit%20Committee%20Chairmen.pdf.

³⁴ At Paragraph 41 of the Working Paper the CC states that the Survey interviewees generally had a much better awareness of the capabilities of the largest four audit firms, in part due to their experience working in the largest four audit firms. We explain why this is not a barrier to entry in the next section.

³⁵ The CC sets out its analysis of these costs in its putback on the working paper on “Economies of Scale in Operating Costs”. We will comment on those figures specifically in response to that putback.

evidence cited at paragraph 45, which shows that 77 per cent of FTSE350 companies had not been approached by an audit firm outside of the largest four.

- 4.1.3 Thus, it appears that the lack of awareness is due, at least in part, to the marketing efforts (or lack thereof) of audit firms outside of the largest four. We believe that this lack of awareness can therefore be overcome relatively easily, for example via an enhanced programme of sponsorship or thought leadership publications³⁶.

4.2 Knowledge of firms' international network

- 4.2.1 The case studies indicate that companies' concerns with mid tier firms' networks are that they are insufficient in reach and quality to undertake some international audits. We do not disagree: for the larger, multinational audits, we do not consider that the mid-tier audit firms have the reach or the depth to enable them to perform them to the necessary standard.

- 4.2.2 Nevertheless, as evidenced in the CC's working paper "Barriers to entry: International Networks", each of the mid-tier audit firms have extensive international networks which they are continuing to expand. As the CC indicated in its working paper "Barriers to entry: International Networks", the rate of expansion of the largest four audit firms' networks appears to be slowing as compared to the rate of expansion of the networks of the mid-tier³⁷, indicating that the differences in at least the network scope between the largest four audit firms and the mid-tier are decreasing.

- 4.2.3 The mid-tier audit firms also exploit their international networks as a selling point, where appropriate, when competing for audit work³⁸. To the extent that companies are unaware, or have misconceptions about, the strength of any of the mid tier's networks, this is again an issue which we believe can be relatively easily overcome.

³⁶ As noted by the CC at Paragraph 24 of the Working Paper.

³⁷ Paragraph 89 of that Working Paper.

³⁸ See paragraph 22 of the Working Paper.

4.2.4 As we set out in our response to the CC’s working paper “Barriers to entry: International Networks”, we consider the higher quality networks are a reflection of the time and investments that the largest audit firms have made, driven by client demand and competitive pressures.

4.3 *Summary of evidence of Awareness of audit firms*

4.3.1 As we set out above, to the extent that CFOs/FDs and ACCs do not have up to date knowledge of the mid-tier audit firms, this might reflect, at least in part, the efforts of the mid-tier in building capability and demonstrating this to prospective clients. We do not consider that lack of awareness represents a material barrier to entry, given that mid-tier audit firms have strategies available to them to build capability (including by expanding their international networks, which they are actively doing) and demonstrating their abilities to prospective clients.

5 Use of reputation as a proxy for quality

5.1 *Reputation*

5.1.1 In its opening paragraph to the Working Paper, the CC states that “reputation and experience may create an incumbency advantage for current suppliers and hinder entry to the market for the supply of statutory audit services to FTSE 350 companies”. It goes on to state that “the inability of Mid Tier firms to match the reputation of the incumbent firms appeared to be a key reason why their chances of winning tenders for FTSE 350 audits may be lower than necessary to make entry profitable”.

5.1.2 At paragraphs 11 to 48 of the Working Paper the CC outlines the factors that it considers affect reputation, and in paragraphs 50 to 53 it considers how companies view reputation and whether they consider it important in selecting an auditor.

- 5.1.3 The CC’s survey found that “reputation” was an important or very important factor in auditor selection for 84 per cent of FDs/CFOs and 82 per cent of ACCs³⁹. However another important factor is a company’s own prior experience of the firm, in other words: first-hand experience of an audit firm’s quality⁴⁰.
- 5.1.4 As the CC itself notes, of the companies which would not consider an audit firm outside the largest four firms, only 18 per cent cited ‘reputation’ as the reason. Therefore while companies feel that reputation is an important factor in auditor selection, it is not the reason why most companies choose the largest four audit firms over others. Instead we argue that they decide according to observable quality and their own experience using the largest four audit firms.
- 5.1.5 There is further evidence in the survey that is not cited by the CC. For example, of the companies which only invited the largest four audit firms to tender in the previous five years, only 11 per cent gave ‘wanted to use the Big 4’ as a reason⁴¹. This indicates that any prestige value that derives from “Big 4” status is not determinative in selecting an audit firm.
- 5.1.6 The CC presents no concrete evidence in this section to suggest why reputation is not supported by underlying quality. As we have previously argued⁴², and as the weight of evidence before the CC indicates⁴³, the reputation of the largest four audit firms is objectively justified and therefore helpful to companies as it allows them to “*distinguish*

³⁹ Paragraph 52 of the Working Paper.

⁴⁰ This is supported by the CC’s case study evidence, presented at paragraph 17(a) of the Working Paper, in which Company C’s process for evaluating tender documents reportedly included a review of the assignments conducted for the company by firms over the past two years.

⁴⁶ Slide 56 of the CC’s Survey Presentation. It cannot be implied from this result, however, that these 11 per cent were selecting auditors from the largest four audit firms based purely on reputation. Some respondents may, for example, have responded ‘wanted to use bBig 4’ because of the real quality differences between the largest four audit firms and other audit firms.

⁴² See, for example, section 6 of our response to the CC’s Working Paper “Restrictions on entry or expansion”.

⁴³ See for example, slide 60 of the CC Survey, which reports that ‘high quality service’ was the leading reason why companies had not switched auditor in the previous five years. This was an unprompted question, and this result clearly indicates that companies are able to perceive quality.

accurately between potential suppliers of audit services and select the most appropriate for their needs”⁴⁴. Importantly, there is nothing to suggest that the quality of the mid-tier audit firms is also not reflected in the reputations of each. BDO admits as much:

“[T]he mid tier firms all suffer from a lack of consistent quality within both their domestic and international audit practices. There is not the investment in knowledge or the strength in depth seen in the Big 4.”⁴⁵

5.1.7 To the extent that the mid-tier audit firms have a good reputation, there is no evidence that they are not able to exploit this to the same extent as the largest four audit firms.

5.2 *Academic literature*

5.2.1 We have previously set out our views on Professor Beattie’s literature review. We welcome the CC’s decision not to cite any of the, in our view, flawed findings of Professor Beattie’s review which specifically relate to reputation.

5.2.2 At paragraph 53, the CC outlines the findings of Professor Beattie’s literature review which deals with the effect of audit characteristics on the cost of capital. The results centre around the financial scandals of 2001/02, and are mixed as to the effect of these events on auditor reputation. We also note that the papers cited focus on the potential effect of reputation as perceived by the financial markets, rather than from the perspective of companies which would be more directly relevant.

5.2.3 In our view to the extent that these papers find that there are differences between perceived quality of audit firms, this is consistent with a competitive market where audit firms seek to improve quality and communicate that with the market.

6 **External pressures and subjective factors**

⁴⁴ Paragraph 3 of the Working Paper.

⁴⁵ Paragraph 26 of the Appendix to the CC’s Working Paper “Firms’ stated competitive strategies”. The paragraph continues: “*However, BDO considered that it was able to compete with its own strong central technical accounting team. BDO considered that GT was the only other non Big 4 firm which did not suffer from a lack of consistency in audit quality both in the UK and internationally.*”

6.1 Use of largest four audit firms is the accepted norm

6.1.1 The CC cites examples from the case studies and evidence from the survey to show that use of the largest four audit firms by FTSE350 companies is the ‘accepted norm’. However, no evidence is presented to suggest that this norm is not reflective of the underlying quality and capabilities of the largest four audit firms vis-à-vis the mid-tier audit firms. As set out above, we consider that the reputation of audit firms is an accurate reflection of the underlying quality of their product offerings.

6.2 Companies’ views of investors’ expectations

6.2.1 The CC reports that just over half of companies would be likely to “seriously consider” switching if pressured by shareholders, bankers, lawyers or analysts. However, the CC provides no evidence of any actual pressure to switch being applied. Indeed, the notes to slide 63 of the CC’s survey reveal that none of the companies surveyed which had recently switched had been subject to such pressure⁴⁶.

6.3 Investors’ views

6.3.1 The CC spoke with two investors who both said they would include the largest six audit firms in the list of firms they would want to see on the accounts⁴⁷. BlackRock did not believe resistance to audit firms outside of the largest four stemmed from investor pressure, but rather board reluctance⁴⁸. As such, the CC presents no evidence of actual pressure on companies from either investors or other third parties to use the largest four audit firms only. Similarly, as set out in the CC commissioned research paper “Report on Auditor Clauses in Loan Agreements”, no evidence of financial institutions insisting

⁴⁶ These notes state: “More than half of FD/ CFOs and ACCs stated that ‘pressure from shareholders, bankers, lawyers or analysts’ would be a likely trigger that would make their company consider switching auditor (question C6) – however, this theme did not emerge as reason for recent switches at question C1. The responses to question C1 that could not be coded to any of categories shown in this slide were examined further to see if companies were subject to such pressure – no such responses were found”.

⁴⁷ Paragraph 65 of the Working Paper.

⁴⁸ Paragraph 66 of the Working Paper.

on, or enforcing, so-called “Big 4 only” clauses in loan contracts been received by the CC⁴⁹.

6.3.2 There is therefore no clear evidence to indicate that investors put pressure on companies to use the largest four audit firms. This suggests that third party ‘pressure’ is either not a barrier, or a barrier which can be readily overcome.

6.4 *Oxera’s investor survey on behalf of BDO/Grant Thornton*

6.4.1 We object to the Oxera report being presented, and relied on, as ‘evidence’ in the Working Paper. It is not evidence; it is a report which was prepared, and paid, for by two mid-tier firms. It has the status of a submission (and appears as such on the CC’s website). We therefore contend that the CC cannot rely on this report in the same manner as it relies on the objective evidence it has before it. If the CC wishes to rely on the findings of this report, then the main parties should be given access to the underlying data to allow them to scrutinise the methodology used, just as they have access to the underlying CC survey data.

6.4.2 In any event the report finds that most investors surveyed would have no concerns with the larger mid-tier firms auditing FTSE350 companies. Furthermore, investors do not perceive there to be a genuine capability gap between the mid tier and the largest four audit firms, except for the largest FTSE100 companies, specialist and multinational companies, which still leaves a significant portion of the FTSE350 open to the mid-tier audit firms.

6.5 *Cardiff Business School*

6.5.1 We note that the statements at paragraph 69 of the Working Paper rely on evidence from the United States that is nearly 10 years old. Cardiff Business School itself recognises that these papers are severely limited in its acknowledgement of the ‘noisy’

⁴⁹ As the report notes at paragraph 6: “...there has been a lack of reliable evidence on the nature of the clauses, on how often they occur and on the conditions under which they are most likely to appear.”

measure of the cost of debt used in one of the papers. As such, the evidence presented here is not reliable, robust or relevant.

6.6 Summary of evidence on Reputation

6.6.1 At paragraph 71 the CC states that FTSE350 companies see ‘risks’ in switching to mid-tier audit firms. As we have previously submitted, however, we do not see that there are material risks to companies switching in and of itself⁵⁰. To the extent there are risks associated with switching to mid-tier audit firms specifically, in our view these are associated with the risk of an audit which is of an inferior quality.

6.6.2 Further, the case study and evidence indicates that while investors may prefer the largest four audit firms (although Oxera’s study casts doubt on this), there are few or no examples of investors actually exerting pressure on companies to switch auditor.

7 Initial views on reputation as a barrier to entry

7.1 We disagree that there are characteristics of the audit product which make proving audit quality difficult. As the CC has acknowledged elsewhere, clients are well-resourced, sophisticated buyers⁵¹, and are therefore able to judge the quality of the audit services offered by competing firms. Further, they have strategies for getting to know a potential auditor better (and vice versa), as we have outlined above.

7.2 We disagree with the CC’s initial views stated in Paragraph 73. As set out above, we do not consider that quality is difficult to observe for audit clients, and, although it is an “experience good”, audit firms have ways in which they can demonstrate the quality of their products to prospective clients. Reputation is only one factor among a number in the decision to appoint an auditor, and, we would argue, is not a factor at all for clients in relation to their existing auditor, because they are able to readily observe the quality

⁵⁰ See for example our response to the CC’s Working Paper “Evidence on switching costs (and implications for barriers to entry)”.

⁵¹ See paragraph 63 of the CC’s Working Paper “Framework for the CC’s assessment and revised theories of harm”..

of audits. As such, we do not consider it is “hard” for new entrants to demonstrate that they can supply the requisite quality. We would also reiterate the point that the purpose of an audit is to provide assurance to shareholders, not stakeholders, as the CC notes in paragraph 73⁵².

7.3 At paragraph 74 the CC states that companies respond to lack of information by selecting audit firms based on proxy measures such as relationships, familiarity and market norms. The evidence suggests, however, that companies select audit firms based largely on what they actually observe as the quality of audit firms, rather than using any proxy measures. As evidenced by the CC’s Case Studies and by the CC’s survey, reputation is just one factor, and there is no evidence that it is decisive. Further, the fact that many ACCs/FDs are alumni of the largest four audit firms, as noted by the CC, may be relevant in this regard because those individuals are likely to know what a high quality audit looks like, thereby obviating the need to us proxies.

7.4 In paragraph 75 the CC states that the need for reputation has the effect of favouring the large, incumbent audit firms in selection decisions. Then, in paragraph 76 the CC hypothesises that reputation may over time depart from reality⁵³. As we set out above and in our response to the CC’s “Restrictions on entry and expansion” Working Paper, however, reputation cannot depart from actual quality for any significant length of time⁵⁴. There is no evidence that reputation does not reflect actual quality differentials. These actual quality differentials mean that those firms with higher quality offerings have a reputation that reflects this, and are of course more likely to be favoured by customers. But that does not imply that there is any way in which auditor selection decisions are based on anything other than objective differences in quality. The role of independent quality reviews, we believe, plays a significant role in this, and we are surprised that the CC has again chosen to ignore this.

⁵² See section 2 of our response to the CC’s Working Paper “Framework for the CC’s assessment and revised theories of harm”.

⁵³ Paragraph 76 of the Working Paper.

⁵⁴ Paragraph 6.2.6 of our response to the CC’s Working Paper “Restrictions on entry and expansion”.

- 7.5 The CC’s implicit statement that mid-tier audit firms’ quality may match or exceed that of the largest four audit firms⁵⁵ is unsupported by evidence. In addition, the CC’s statement that it might be hard for a new entrant to establish a reputation and to expand into the FTSE350 even if their quality was the same is incorrect, as we have discussed throughout this response. Similarly, the explicit statement of ‘when’ the mid-tier audit firms match the largest four audit firms capabilities at paragraph 79 is again not supported by evidence.
- 7.6 Contrary to the assertion at paragraph 78, firms do not invest in building reputation, rather they invest directly in quality. The CC appears not to have placed any weight on the large number of our submissions that set out the numerous factors which we believe give rise to our reputation, such as investing in high quality staff, specialist skills and quality assurance⁵⁶. As we have emphasised in previous submissions⁵⁷, reputation also depends crucially on actually delivering high quality.
- 7.7 Relationship-building is a separate concept which relates to the strategy of trying to agitate for a tender, communicating what an audit firm can offer, and trying to get companies to switch auditor, i.e. competing for new clients. It should be noted, however, that those actions will only ever work because we have invested in developing a quality product which makes us a credible alternative for clients. For example, as outlined above we engage in extensive efforts to ensure we maintain a high quality audit and a high quality level of service to our clients through client satisfaction surveys and internal quality audit and a high quality control reviews. This is a function not only of our clients’ demands, but also competitive pressure from other firms⁵⁸. As a result we have a (deserved) reputation for quality.

⁵⁵ Paragraph 77 of the Working Paper.

⁵⁶ See paragraph 178(a) to (i) of our Main Submission for the list of qualities that clients look for in audit firms.

⁵⁷ For example, paragraph 291 of our Main Submission.

⁵⁸ Indeed, the CC recognised that such efforts to retain firms may be as a result of competitive pressures at paragraph 177 of its Working Paper “Nature and strength of competition in the supply of FTSE 350 audits”.

7.8 Further, marketing and relationship-building efforts directed at FTSE350 firms are not audit-specific costs if the strategy is to win non-audit work initially (which is a common strategy).

7.9 Finally, we disagree that companies make decisions based solely on proxy factors for quality. A company may inform their auditor selection decision by investigating expected quality, which is driven by observable factors such as the extent of the international network, the information they have about partners' experience and sector expertise. On the other hand they also rely on their own first-hand experience of that audit firm's quality, not just from previous audits but also from non-audit engagements.