KPMG

KPMG response to the CC's Working Paper on "Characteristics of long audit tenure companies"

1 Executive summary

1.1.1 In this paper we set out our response to the Competition Commission's Working Paper "Characteristics of long audit tenure companies" (the "Working Paper"). We welcome the chance to comment on the Working Paper.

1.1.2 Given that we do not have access to the full dataset the CC has used in this Working Paper, nor the full econometric output, diagnostic tests and detailed results from robustness checks[1], we are not in a position to assess the robustness or reliability of the analysis undertaken by the CC. As a result, we are not in a position to comment on whether the CC's econometric model is well-specified.

1.1.3 As set out in our response to the CC's working paper on "Nature and strength of competition"[2], it is our firm view, based on our commercial experience, that companies have a strong bargaining position, and that this exerts strong competitive pressures on incumbent audit firms to maintain the competitiveness of their offering throughout the relationship.

1.1.4 In addition, audit firms make relationship-specific investments in quality and exploit the efficiencies that can result from an audit relationship in order to retain existing clients and to win new ones. Hence frequent tendering and switching would lead to an inefficient market outcome where the value of these significant investments would be lost. Such investments mean that audit firms have strong incentives to ensure that the relationship with any given audit client continues.

1.1.5 Indeed, in a setting where there is strong pressure on audit firms to provide a competitive quality and price in order to retain their clients, and where long term relationships can result from exploiting efficiencies through relationship-specific investments, the CC should be clear that long tenures are consistent with strong competition[3] and an efficient outcome. Hence, we question the ability of the CC to draw conclusions in relation to the effectiveness of competition from an analysis of switching rates and audit firm tenure.

1.1.6 Setting aside our misgivings about the relevance of this analysis overall, we also have concerns with the methodology the CC has used to analyse switching events. At a high level, it is unclear why the CC adopted a probit model as opposed to for example a duration model.

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[1] For example, the choice of this tenure window seems arbitrary and it is not clear why the CC restricted the analysis to a ten year period.
[2] Section 2.1 of our response to the CC working paper on "Nature and strength of competition".
[3] In this context any observed instances of switching are off-equilibrium outcomes.

1.1.7 Further, whether a company switches audit firm depends on the quality and price (both technical and service quality) it receives from its incumbent audit firm. The CC has completely neglected these two key factors in the analysis performed in the Working Paper. Instead, the CC has sought to analyse how factors such as the complexity of a company's business or its geographic spread impact on whether it has switched audit firm[4]. As a result, in our view the CC has not captured the factors leading to long audit tenures and the reasons why companies have or have not switched audit firm. Indeed, the CC itself notes that there are important unobserved factors relevant to whether a company switches audit firm which are not captured in its analysis, such as the quality of different engagement teams and the relationship a lead partner has with a company[5].

1.1.8 The CC's analysis has therefore identified relationships between certain observable company characteristics and incidences of switching, rather than identifying the underlying causes of switching events which could impact on the relationships the CC does observe, and as a result the CC's analysis is in our view flawed. The CC itself admits that *"[i]t is not immediately clear how [to interpret] evidence that suggests that companies that had an existing long relationship with their audit firm and/or companies that were audited by a Big 4 firm were less likely to switch audit firm"* [6] and that the extent of the predictive power of its model *"does appear limited"* [7]

1.1.9 In addition, we also want to reiterate our concerns regarding the CC's use of certain of the variables captured in the Public Dataset[8]. In particular, we do not believe that the variables the CC has used to capture risk and complexity adequately do so.

1.1.10 In the remainder of this response we will discuss our views on the CC Working Paper, namely that:

- switching is not per se indicative of competition in the market; and
- observed company characteristics are not meaningful indicators of companies' observed behaviour in relation to switching.

[4] Paragraph 12 and 13 of the Working Paper.
[5] Paragraph 5 and paragraph 42 of the Working Paper.
[6] Paragraph 4 of the Working Paper.
[7] Paragraph 10 of the Working Paper.
[8] Please see the email correspondence and letters (from Norton rose) to you on 4 April 2012, 27 April 2012, 19 June 2012 and 29 June 2012 in relation to the creation of the Public Dataset.

2 The competitive pressures faced by audit firms to retain audit clients

2.1 Our views on switching and competitive pressures

2.1.1 As we have stated in previous submissions[9] the number of companies switching audit firms is not informative of the competitive pressures on audit firms. This is also consistent with the CC's conclusions in previous inquiries, where it has found that even low rates of switching are consistent with competition functioning well[10]. An unduly narrow focus on the degree of actual switching or tendering will give a misleading picture of client or customer conduct and characteristics, and ultimately of the level of competition in the reference market[11].

2.1.2 We believe, and described to the CC in our previous submissions[12], that it is important for the CC to recognise that any decision to switch audit firm is crucially dependent on the performance of the incumbent. The performance of the incumbent depends on the competitive pressures it faces and the competitive environment results in pressures exercised on the audit firm *throughout* the length of the relationship with a given audit client, which ensures the provision of high quality services at competitive prices[13].

2.1.3 Competition manifests itself through (re)negotiations, specific client targeting and formal tendering regardless of the existing tenure of the current audit firm. This is evidenced by the CC's finding that there was no real difference in benchmarking activity between long-and shorter-tenure companies[14]. We provided the CC with a summary of the extensive evidence of these competitive pressures in Annex 2 of our response to the CC's working paper on "Nature and strength of competition"[15].

2.1.4 As we set out in our main submission in response to the CC's Issues Statement ("Main Submission"), the competitive environment in the reference market cannot be expected to lead to frequent tendering and switching[16]. Indeed this would be an inefficient market outcome where the value of significant investments would be lost. Both audit firms and audit clients make significant investments in a relationship in order to exploit efficiencies and derive maximum value from it. Such investments mean that audit firms have strong incentives to ensure that the relationship with any

[9] Section 7 of our Main Submission.
[10] London Stock Exchange plc / Deutsche Börse AG and Euronext N.V merger inquiries.
[11] Paragraph 30 of our Main Submission.
[12] Paragraph 251 of our Main Submission.
[13] Paragraph 20 of our Main Submission.
[14] Paragraph 19 of the Working Paper. Also see paragraph 3 in Appendix C to the Working Paper.
[15] Also see our previous evidence of competitive pressures presented in section 7 of our Main Submission, and questions 87 and 91 of our response to the MFQ.
[16] Section 7 of our Main Submission.

given audit client continues. Hence, the result that many companies find that there may not be good reasons to switch is entirely consistent with the market being competitive.

2.1.5 At the same time it does not imply that companies would not tender their audit were the performance of their current audit firm to drop. The ability of audit clients to judge the quality of the incumbent audit firm ensures that the incumbent audit firm will be incentivised to provide a high quality and good value for money service in order to reduce the company's incentives to switch[17].

2.1.6 The CC's analysis has not taken into account the quality and value for money received by companies in its analysis of switching. Instead it has sought to analyse whether switching events are associated with observable company characteristics. Since the CC has not included the underlying drivers of switching (ie quality and price), the CC's analysis cannot identify the real causal drivers of switching and the relationships it does identify may be biased[18]. Although we previously identified some of the characteristics of audit firms that are likely to drive audit quality[19], these would not be fully determinative of the quality of an audit and in any case these are largely not observable. As a result, in our view any analysis of switching of the form used by the CC cannot determine the true causes of observed switching events. We discuss the relationships the CC has identified in relation to observable company characteristics further in section 3 below.

2.2 The CC's evidence on the drivers of switching

2.2.1 The CC's own evidence on the key drivers of companies switching audit firm shows that, consistent with the view we set out in section 2.1 above, companies switch audit firm when they are not satisfied with the quality and price they receive.

2.2.2 The CC noted that *"The CC survey found that among FTSE 350 companies that had not tendered in the last five years, 51 per cent gave as the reason for this that they received a good quality of service and 25 per cent because the audit fee was competitive. This leaves a set of companies which may not have tendered due to reasons other than the quality of the audit, for example high switching costs"*[20]. However we would also like to point out that a further 21 per cent of survey respondents noted that they were "Happy as things are", 15 per cent said "Partner rotation keeps things fresh", 7 per cent said that the "Incumbent understands business" and 8 per cent that the "Benchmarking suggest get

[17] Paragraph 251 of our Main Submission.
[18] Since these unobserved variables are likely to affect the switching decision of an audit client, we believe that the model estimated by the CC is likely to suffer omitted variable bias.
[19] Paragraph 178 of the Main Submission.
[20] Paragraph 2 of the Working Paper.

good value". These further survey results would not seem to be examples of concerns about switching costs. Whilst a possible reason for not switching, 16 per cent cited "Disruption/getting new auditors up to speed" and 13 per cent "Tendering costly and time consuming" we would also note that these two reasons are not mutually exclusive and may indeed be combined with the earlier reasons.

2.2.3 The CC's survey finds that the factors that FDs and ACCs take into account when deciding to reappoint an audit firm are driven by the quality of services that are provided by that audit firm[21]. Similarly, the CC finds that the most common reasons given by survey respondents for not changing audit firm were that they were already receiving good quality or value for money from their existing audit firm[22]. The survey results also show that those companies that switched in the last 5 years did so in relation to price and cost factors, as well as a number of quality factors[23].

2.2.4 In Appendix C to the Working Paper, the CC stated that *"As well as company characteristics, we considered company preferences in terms of what was important in the selection of an audit firm, market-testing activities, triggers of a tender and contact with audit firms. In the vast majority of cases we did not find significant differences between long- and shorter-tenure companies"*[24]. The survey results contain substantial evidence of the constraints on audit firms outside of formal tender processes, ie the large majority of FTSE 350 companies negotiated on the audit fee (93%), conducted a post-audit quality review (91%) and have informal contact with other firms (78%) every year[25].

2.2.5 This support our views as set out in section 2.1.2 above, that there are competitive pressures on the audit firm throughout the relationship with a given audit client regardless of the tenure of the audit relationship[26].

2.2.6 The link the CC draws between long-tenure companies and switching costs in paragraph 20 of Appendix C is unclear. This appear to correspond with our view that that even if longer audit tenures are efficient, companies are able to actively ensure that they receive competitive offerings from their audit firms throughout the duration of the relationship (see paragraph 2.1.3 above).

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[21] Table 11 and paragraph 35 of the Working Paper. The factors ACCs and FDs look for when considering whether to appoint or reappoint an auditor are: the experience and knowledge of the engagement partner; a good working relationship with the audit team; the reputation of the audit firm; the experience and knowledge of the engagement team; and, sector-specific experience or expertise

[22] Paragraph 2 of the Working Paper and slide 60 of the CC's survey presentation.

[23] As discussed in more detail in paragraph 4.3.8 of our response to the CC's Working Paper on 'The framework for the CC's assessment and revised theories of harm' and 2.7 of our response to the CC's Working Paper on 'Survey results'.

[24] Paragraph 3 of Appendix C to the Working Paper.

[25] Table 12 in the Working Paper.

[26] Also see section 2.5 of our response to the Competition Commission's (CC's) Working Paper "Survey Results" for evidence that the large majority of companies perform regular fee and quality reviews, outside of tenders.

3 Company characteristics considered by the CC

3.1.1 In paragraph 39, the CC sets out the company characteristics that it believes, all equal, will increase or decrease the observed probability that a company has not switched audit firm in the last ten years. We highlighted to the CC on several occasions our concerns and reservations regarding the use and significance of the variables captured in the Public Dataset[27].

3.1.2 As we set out in paragraph 2.1.5 above, although the CC finds evidence of correlation between company characteristics and incidence of switching (such as companies that had an existing long relationship were less likely to switch audit firm[28]), the results cannot be informative of any causal drivers of companies' likelihood of switching. Below we briefly set out our specific comments and concerns regarding some of the characteristics the CC has included as variables to explain the likelihood of a company switching.

3.2 Identity of the audit firm and the length of tenure of the incumbent audit firm

3.2.1 The CC finds that companies audited by one of the largest four audit firms are less likely to switch audit firm. Similarly, the longer a company's existing audit firm's tenure, the less likely it is to switch audit firm. The CC finds that both of these relationships are statistically significant.

3.2.2 However, the identity of the incumbent audit firm and the length of tenure of the existing audit firm are not independent of the quality and value for money of an audit a company receives. Instead, companies choose an audit firm according to observable quality and their own experience using the largest four audit firms[29]. Similarly, companies decide whether to reappoint an audit firm based on the quality and value for money of the audit services they receive.

3.2.3 Therefore, in observing that companies audited by one of the largest fours audit firms are less likely to switch audit firm, the CC should recognise that this is likely to be driven by the underlying quality and value for money of the audit services received, rather than by the identity of the audit firm per se or its previous length of tenure.

3.3 Company index status

[27] Please see the email correspondence and letters (from Norton rose) to you on 4 April 2012, 27 April 2012, 19 June 2012 and 29 June 2012 in relation to the creation of the Public Dataset.
[28] Paragraph 4 of the CC's working paper "Survey results".
[29] See our response to the CC's working paper on "Barriers to Entry: Reputation and Experience".

3.3.1 In our experience, movements and changes in a company's listing status in themselves are not drivers of a company's decision to switch audit firm. We believe that the evidence presented by the CC in this Working Paper, as well as the working paper "The life cycle of FTSE 350 companies" is consistent with there being no institutional bias or external pressure on companies to switch to the largest four audit firms on entering the FTSE 350[30]. This is consistent with our experience that competition is fierce to win new clients, regardless of the identity of the incumbent audit firm, or its index designation.

3.4 Risk and complexity

3.4.1 As set out in our Main Submission[31], and in our response to the Market and Financial Questionnaire (MFQ)[32] the complexity of an audit can be driven by an array of factors. The industry, business model, commercial arrangements, organisational structure and accounting practices of a company will all give rise to different levels of complexity. This may also be exacerbated by the stage of development of the markets in which a group operates and the sophistication, standardisation and centralisation of the organisation's transaction processing, IT and control systems.

3.4.2 Furthermore, some of the most significant determinants of complexity are either not publicly available and / or not measurable on a basis that enables effective comparison. Whilst not easily measurable or quantifiable, these factors are likely to be significant in determining the characteristics of audit clients and their required needs[33].

3.4.3 We now briefly set out our specific concerns regarding the three proxies for risk and complexity considered by the CC in the Working Paper[34].

3.4.4 As set out by the CC in the working paper "Econometric analysis of audit costs ", the information available regarding the number of countries requiring an audit is incomplete[35]. The CC therefore needs to be cautious when drawing any conclusions based on this information. Furthermore, the global presence of a company is likely to be more indicative of its scale than necessarily of its complexity.

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[30] Also see section 3 our response to the CC's working paper "The life cycle of FTSE 350 companies".
[31] Paragraph 5 and section 5 of our Main Submission.
[32] Response to question 86 of the MFQ.
[33] Please see the email correspondence and letters (from Norton rose) to you on 4 April 2012.
[34] Paragraph 39 of the Working Paper.
[35] Paragraph 52 in the CC working paper "Econometric analysis of audit costs".

3.4.5 We do not agree that the number of partners on the UK audit team can be used as measure of complexity within the context of this analysis. For example the number of UK partners involved in the audit of two clients of equal size, where one has all its operations overseas and the other all of its operations in the UK (but otherwise identical), will be higher in the latter case. So a client with one or two UK partners involved may nevertheless be complex where scale and / or complexity is outside the UK. [36]

3.4.6 In addition, the data captured in the Engagement Dataset captures all partners and staff that have charged hours to the engagement, regardless of how small a number of hours those partners and staff members have spent on an engagement. As we have previously explained[37], a number of partners (and other staff) may be involved in the audit process but only provide a small number of hours input to the audit as opposed to the audit engagement partner and key audit partners whose involvement will be much more substantial. Hence in this regard the dataset might overestimate the number of partners with a substantial involvement in the audit, and could result in misleading conclusions.

3.4.7 The measure for company risk captured by current assets/current liabilities as an indication of a company's short term liquidity is not a sufficient proxy for risk, which will be dependent on many factors (including, industry, management capability, quality of systems and processes, etc).

3.5 Merger activity

3.5.1 We do not have access to the Dialogic data that the CC has used to perform the analysis linked to merger activity[38]. It is not possible for us to comment on the robustness or reliability of the analysis undertaken by the CC and it is unclear what has been defined as "merger activity". The impact of deal activity on the likelihood of a company switching auditor can vary substantially depending on the type and scale of the Merger and Acquisition (M&A) activity undertaken by the company (ie whether it is due to and acquisition (ie a takeover) or 'merger of equals' in the pure sense of the term), and in our view this data will need to be used with caution.

3.5.2 In addition, we note that the CC is not considering as switches those instances where a newly merged company retained the incumbent audit firm of one of the parties to the merger[39]. However, in our view many of these instances should just as well be considered as a switch of audit firm, since the merged company has to make a genuine choice between the two different incumbent audit firms of

[36] See our response to the CC's working paper on "Engagement level profitability analysis" for a further description of this.
[37] See our cover letter to the Audit Data Request (ADR) on 27 February 2012.
[38] Also see our response to the CC's working paper "The life cycle of FTSE 350 companies".
[39] Paragraph 22 of the Working Paper.

the two merging parties (and, indeed, a conscious decision not to retain both incumbent firms in a joint audit arrangement).. By excluding these instances, the CC is underestimating the number of instances in which firms make a conscious choice and decide to use an alternative provider[40]. While, as discussed above we do not think that switches are informative of the degree of competition, this analysis could understate the degree to which switching takes place. .

3.5.3 A similar argument could be made that the number of switches should include the changes in auditor due to the demise of Arthur Andersen (or at least in those instances where the company selected an auditor other than Deloitte, which effectively acquired the Arthur Andersen business in the UK). This is because even though this was due to external factors, companies nevertheless made explicit decisions regarding the choice of auditor post Arthur Andersen.

3.5.4 The appropriate measure of switching will necessarily depend on what kind of behaviour is of interest. In both the case of mergers and the post Arthur Andersen switches, companies had to make conscious decisions as to who to appoint.

3.5.5 Ultimately, in our view, switching behaviour cannot provide a quantitative indication of the degree and extent of competition in the market, as competitive pressures are intense regardless of whether a company goes out to tender and ultimately chooses a different provider. As we explained above, the absence of switching (ie long term tenure) is more likely to arise as a result of intense competition and the incumbent accommodating its customers' requests.

[40] Also see our response to the CC's working paper on "Descriptive Statistics".