



KPMG response to the Competition Commission Working Paper “Competition Commission survey results”

1 Introduction and summary

- 1.1.1 This note sets out KPMG’s response to the Competition Commission’s (CC’s) Working Paper “Survey Results” (the “Working Paper”). The Working Paper sets out what the CC considers to be the key results from its customer survey (“the CC’s survey”) of FDs and ACCs from a range of FTSE350 and non-FTSE350 companies. We welcome the opportunity to comment on this Working Paper.
- 1.1.2 Overall, our view is that the survey results are consistent with evidence we have already submitted to the CC (in particular our submission in response to the CC’s Issues Statement (“Main Submission”).
- 1.1.3 In particular, the survey results show that:
- The largest four audit firms’ characteristics are driven by customer demands
 - ACCs are informed purchasers of audit services
 - The large majority of companies perform regular fee and quality reviews, outside of tenders
 - The large majority of companies are approached by audit firms, at least informally
 - Companies are generally satisfied with the quality of their audits and this explains why some have not switched in the last five years
 - Nevertheless, companies can and do switch if they are not satisfied
 - Clients of the largest four audit firms are no more likely to use their audit firm for non-audit services than clients of non Big 4 audit firms.
- 1.1.4 On the survey methodology, we agree with the CC’s conclusion in paragraph 7 of the Working Paper that the response rates in the survey are good. We also agree that the survey is broadly representative in relation to the audit fees, size and sector of

companies surveyed, as well as of the market shares of audit firms^{1,2}. We share the CC's view overall that this survey is likely to provide a robust basis from which the CC can draw conclusions for its analysis of competition in the market.

1.1.5 In the rest of the paper we comment on the key points from the survey in more detail.

2 Key messages from the CC's survey results

2.1.1 In this section we set out what we believe are the key messages that can be taken from the CC's survey in relation to its analysis of competition. In doing so, we also point out some additional results from the survey which in our view are also important.

2.2 *The largest four audit firms' characteristics are driven by customer demands*

2.2.1 The CC's survey finds that:

- The factors that FDs and ACCs look for when considering whether to appoint or reappoint an auditor are largely similar and for both groups the most important factors 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 expertise³;
- When asked why tender lists had primarily been limited to a certain group of firms, amongst FTSE350 companies FDs and ACCs most frequently mentioned: the specialist knowledge of the audit firm; the regional and geographic coverage of the audit firm; and, the size of the audit firm⁴; and,
- The most frequently cited reasons among both FDs and ACCs for FTSE350 companies for not considering audit firms outside of the largest four⁵ were: size and geographic coverage; sector knowledge and experience reputation and calibre / training of staff; and, size and complexity of the audit⁶.

2.2.2 Overall, the characteristics of audit firms that are important to companies when selecting their audit firm correspond to those characteristics of audit firms that we

¹ With the caveat of the over-representation of Deloitte which the CC recognises in paragraph 21 of the Working Paper.

² Paragraphs 11 – 23 of the Working Paper.

³ Table 11 and paragraph 35 of the Working Paper.

⁴ Paragraph 47 of the Working Paper.

⁵ This question was asked to those companies that said they would not consider audit firms outside of the largest four audit firms if their current audit firm was to cease trading.

⁶ Table 19 and paragraph 69 of the Working Paper.

highlighted as most important in our Main Submission⁷. The CC also noted these themes in its evidence in relation to the survey results in its working paper on the "Nature and strength of competition in the supply of FTSE 350 audits"⁸. The CC's survey results provide support for our views that that a client's characteristics, the complexity of its audit and its specific needs determine the capabilities required of audit firms to deliver a high quality audit.

2.2.3 FDs of companies audited by the largest four audit firms or FTSE100 companies are more likely to rate the consistency of worldwide delivery as an important factor in assessing the quality of an audit⁹. The CC also noted that those companies where a higher level of their audit fee was accounted for by non-UK activities were more likely to cite this factor as important (and this difference was statistically significant)¹⁰. This further supports the view we set out in our Main Submission that the development and maintenance of global audit firm networks operating to consistent standards are driven by client demands and is an important aspect of delivering a quality audit to global clients.

2.3 *Audit Clients are informed purchasers of audit services*

2.3.1 The CC's survey analyses the importance of various aspects of the audit product provided. The most frequently cited factors rated as very important and important to companies in assessing the quality of an audit were: the efficiency of the audit process, independence of an audit firm, ability to detect misstatements, high degree of challenge and reliability and usefulness of the audit report¹¹.

2.3.2 This confirms our views that ACCs and FDs are indeed focused on the most important aspects of quality as set out in our Main Submission¹². The CC finds similar results in

⁷ Section 5 and in particular paragraph 178 of our Main Submission.

⁸ Paragraphs 53, 54, 60 and 61 of the CC's "Nature of competition in the supply of FTSE 350 audits" working paper.

⁹ Slide 26 of the CC's survey presentation.

¹⁰ Paragraph 31 of the Working Paper.

¹¹ Table 9 and paragraph 30 a) and 30 b) in the Working Paper. Although there was a slight difference in the ranking of these factors as very important and important amongst FDs and ACCs respectively, these four factors ranked in the top four for both.

¹² Section 5.1 of our Main Submission.

its analysis of survey data in its working paper on the "Nature and strength of competition in the supply of FTSE 350 audits"¹³.

- 2.3.3 As noted in paragraph 2.3.1 above, FDs list a high degree of challenge as an important factor in assessing the quality of an audit. The CC suggests in its working paper on "The framework for the CC's assessment and revised theories of harm", that audit firms could have less incentive to challenge management during the audit process¹⁴. However, this evidence suggests that in practice audit firms will have no incentive not to provide a robust challenge to management¹⁵.
- 2.3.4 The survey also highlights ACCs as being most influential in selecting the auditor¹⁶. This provides further evidence that ACCs are effective agents for shareholders, as we discussed further in our response to the CC's working paper on "The framework for the CC's assessment and revised theories of harm"¹⁷.
- 2.3.5 The survey evidence also suggests that ACCs and FDs are well-equipped to judge these aspects of the audit product (ie the quality of the service they receive). The CC's survey results report that over 60 per cent of FDs/CFOs and ACCs previously worked for one of the four largest audit firms, and that nearly all ACCs surveyed sit on or chair another audit committee¹⁸.
- 2.3.6 The background and experience of FDs and ACCs is informative of their ability to judge the quality of an audit. The survey supports the evidence in our Main

¹³ Paragraphs 130-137 of the CC's "Nature of competition in the supply of FTSE 350 audits" working paper.

¹⁴ Paragraphs 39, 68 of the CC's "The framework for the CC's assessment and revised theories of harm" working paper.

¹⁵ We discussed issues around management and shareholder incentives more generally in our response to the CC's "The framework for the CC's assessment and revised theories of harm" working paper, Section 3.5.

¹⁶ Table 10 and paragraph 33 of the Working Paper.

¹⁷ Section 3.2 of our response to the CC's Working Paper on "The framework for the CC's assessment and revised theories of harm".

¹⁸ Paragraph 24 of the Working Paper.

Submission¹⁹, that audit clients are sophisticated purchasers who are focused on the key aspects of quality and well-placed to judge the quality of the service they receive.

2.4 *FDs and ACCs are not biased towards any particular audit firm, but rather judge audit firms on the basis of their quality*

2.4.1 As we set out in the previous section, ACCs judge the quality of a statutory audit provider according to a number of observable characteristics of an audit firm. In addition, we note that there is no evidence in the CC's survey that being alumni of the largest four firms is a driver of FDs' or ACCs' choices to use one of the largest four firms for audit, other than through their ability to judge quality.

2.4.2 As we set out in section 2.2 above, companies choose the largest four audit firms because of their particular characteristics, which are important to the delivery of high quality audits. It follows that within the CC's survey results 'Management preference for a specific auditor' was not seen as an important factor in the decision to appoint or reappoint an audit firm by either FDs or ACCs²⁰. Smaller companies are if anything more likely to consider this as important²¹.

2.5 *The large majority of companies perform regular fee and quality reviews, outside of tenders*

2.5.1 The evidence suggests that FDs/CFOs and ACCs use their experience (as discussed in section 2.3 above) to monitor the quality of their audit firm and compare it to others. The survey results also show that companies routinely review the effectiveness, price and quality of the statutory audit they receive through regular and extensive informal benchmarking activities:

- The large majority of FTSE350 companies negotiated on the audit fee (93%), conducted a post-audit quality review (91%) and have informal contact with other firms (78%) every year²²;

¹⁹ Paragraph 167-169 of our Main Submission.

²⁰ Slide 34 and 39 of the CC's survey presentation.

²¹ Smaller companies (with less than 1000 employees) within the FTSE350 are more likely than larger companies (more than 1000 employees) within the FTSE350 to rate management preference as important (and this is statistically significant). Similarly, smaller companies in the non-FTSE350 are more likely to rate management preference as important than larger companies in the non-FTSE350.

²² Table 12 in the Working Paper.

- FTSE350 companies were more likely to do all of these things more regularly than non-FTSE350 companies²³; and,
- Formal benchmarking takes place less frequently on average, although again FTSE350 companies are more likely to do this, and to do this more frequently, than non-FTSE350 companies.

2.5.2 The survey results contain substantive evidence of the constraints on audit firms outside of formal tender processes. We also emphasised this in our Main Submission as a more relevant indicator of competition than tendering or switching rates²⁴.

2.5.3 This also substantiates the informal survey of our audit partners conducted in May 2011²⁵. That survey also found that the large majority of companies had procedures in place to review fees formally with their auditors²⁶. During these reviews, audit firms and their audit clients renegotiate the terms of the audit (including fees and the scope). Through these reviews customers exert competitive pressure on their audit firms, without the need to issue a competitive tender.

2.5.4 The survey evidence also shows that FTSE350 companies (which are more likely to be audited by the four largest audit firms) were more likely to conduct these reviews more regularly²⁷. This is evidence of the strong bargaining position of these companies as set out in our Main Submission²⁸.

2.5.5 In our view this survey evidence shows that a formal presentation or formal comparisons are not required to ensure the effective review of the statutory audit services companies receive. The CC's survey results show that companies can make use of several informal processes to review the audit services they receive (also see section 2.5 below)²⁹. The results set out in the Working Paper on the smaller proportion of firms

²³ *Ibid.*

²⁴ Section 7 of our Main Submission

²⁵ Paragraph 16 of our Main Submission

²⁶ Where these reviews go beyond the minimum that is recommended by the Financial Reporting Council (FRC)

²⁷ Slide 16 of the CC's survey presentation

²⁸ Section 7.2 of our Main Submission

²⁹ Paragraph 40 of the Working Paper.

conducting formal reviews³⁰ are therefore in our view not relevant when viewed in isolation from the evidence on common informal reviews.

2.6 *The large majority of companies are approached by other audit firms*

2.6.1 In addition to the range of formal and informal activities companies undertake to evaluate audit firms (as discussed in section 2.5 above), audit clients obtain information on the product offerings of audit firms other than their existing statutory audit provider in a variety of ways. These include developing relationships with other firms and other firms approaching them to try to induce them to switch. The survey evidence shows that the large majority of FDs at both FTSE350 and non-FTSE350 companies have been approached informally by another audit firm offering to audit their company (a smaller proportion had been approached formally)³¹.

2.6.2 Unsolicited approaches, and the broader targeting activities of audit firms, provide companies with additional means of evaluating the quality of the incumbent auditor. Audit clients are aware of these alternatives when renegotiating contracts³².

2.6.3 For FTSE350 companies the large majority of approaches have been by the four largest audit firms. There appears to be a correlation in the survey results between those audit firms that approach more companies outside of a tender, and those that are more frequently invited to tender. As noted in paragraph 61 of the Working Paper, mid-tier firms are less likely to approach companies outside of tenders, which might be one further reason why they are less likely to be invited to tender^{33, 34}. BDO and Grant Thornton are more likely than the other mid-tier firms (and less likely than the four largest firms) to have approached a company outside of a formal tender, and are also

³⁰ Paragraph 39 of the Working Paper.

³¹ Paragraphs 59-61 of the Working Paper.

³² Section 7.2 of our Main Submission

³³ Paragraph 46 of the Working Paper, Grant Thornton and BDO are less likely to be invited to tender than all of the four largest audit firms, and the rest of the mid-tier firms are even less likely.

³⁴ Paragraph 47 of the Working Paper lists further reasons to why tender lists had been limited to certain firms. Also see paragraph 2.2.1 above.

more likely than the other mid-tier firms (and less likely than the four largest firms) to have been invited to tender^{35, 36}.

2.7 *Companies are generally satisfied with their audits and this explains why most have not switched in the last five years*

2.7.1 When asked why they have not considered tendering their audit service provider in the last five years, FTSE350 companies responded that this is because they either 'Receive high quality services' (51%), 'Receive good value for money' (25%) or are 'Happy the way things are' (21%)³⁷.

2.7.1 As set out in the previous sections, audit clients are informed, expert purchasers of audit services who are well-equipped to judge the audit services they receive (see section 2.4), and regularly review or receive information that informs their choices (see section 2.5 and 2.6). The survey results therefore demonstrate that most companies are satisfied with the services they receive from their current auditor whose existing offer is competitive.

2.8 *Nevertheless, companies can and do switch if they are not satisfied*

2.8.1 As set out in sections 2.5 and 2.6 above, and as further explained in our Main Submission³⁸, audit firms face competitive pressures, through frequent negotiations, throughout the length of the relationship with a given audit client, regardless of whether or not a company conducts a formal tender process. However, companies can and do switch audit firm if they are not able to achieve a competitive offer from their audit firm through these negotiations.

2.8.2 The most common reasons cited by companies for switching to their current audit firm (across all companies) were price and quality of service in delivery of the audit^{39, 40}. This

³⁵ Slides 54 and 82 of the CC's survey presentation.

³⁶ We note that the CC draws finds similar results to the above in paragraphs 155-156 of the "Nature of competition in the supply of FTSE 350 audits" working paper.

³⁷ Slide 60 of the CC's survey presentation.

³⁸ Section 7 of our Main Submission.

³⁹ Slide 63 of the CC's survey presentation.

is consistent with the market functioning well, whereby if a company is not satisfied with its existing audit firm, it looks to switch.

2.8.3 The survey evidence further supports the reasons for switching (provided in paragraph 2.8.2 above) by noting that 75 per cent of companies stated that switching audit firm resulted in lower fees and/or improvements in quality⁴¹.

2.8.4 The majority of FTSE350 and non-FTSE350 companies stated that there was no material impact on internal costs from switching audit firm⁴². We explore this further in section 3 of our response to the CC's working paper "Evidence on switching costs (and implications for barriers to entry)".

2.8.5 This evidence clearly shows that companies can and do switch if their incumbent audit firm's offer is not competitive. We discuss switching costs in more detail in our response to the CC's working paper on "Evidence on switching costs (and implications for barriers to entry)".

2.9 *Clients of the largest four audit firms are no more likely to use their audit firm for non-audit services*

2.9.1 As noted in paragraph 26 of the Working Paper, over 90 per cent of companies also receive non-audit services from their current auditor. This is the case for companies audited by the largest four audit firms and for companies audited by other audit firms⁴³.

2.9.2 The CC's survey does not provide any evidence that the largest four audit firms are more likely than mid-tier audit firms to sell non-audit services to their audit clients. Instead, there is some evidence in the survey that non-audit services are likely to be, if anything, more important for mid-tier than four largest audit firms⁴⁴.

⁴⁰ The CC also noted this in paragraphs 110 and 134 of the CC's "Nature and strength of competition in the supply of FTSE 350 audits" working paper.

⁴¹ Paragraph 109 of the CC's "Nature and strength of competition in the supply of FTSE350 audits" Working Paper.

⁴² Slide 67 of the CC's survey presentation.

⁴³ The difference between the proportion of companies that receive non-audit services from their current audit firm and are audited by the largest four audit firms is not statistically significant from those audited by other audit firms.

⁴⁴ Slide 34, CC's survey presentation.

2.9.3 It should also be noted that overall, expertise in non-audit services is not considered important in the decision of whether or not to appoint an audit firm, by either FDs or ACCs⁴⁵. Against this backdrop, FTSE350 FDs are actually less likely to rank non-audit expertise as important than non-FTSE350 FDs (8 per cent and 17 per cent of FTSE350 and non-FTSE350 companies respectively ranked this as important or very important, and this difference is statistically significant⁴⁶). Similarly, FDs at smaller companies (with less than 1000 employees) are also less likely to rank non-audit expertise as important⁴⁷.

2.9.4 Overall therefore the survey provides no evidence that the non-audit services offered by the largest four audit firms are important in companies' decisions over which audit firms to appoint as their statutory auditors.

⁴⁵ Slides 34 and 39, CC's survey presentation.

⁴⁶ Slide 34, CC's survey presentation.

⁴⁷ *Ibid.*