

KPMG response to the Competition Commission Working Paper “Evidence of tacit coordination”

1 Introduction and summary

- 1.1.1 This paper provides our response to the CC’s Working Paper on “Evidence on tacit coordination” (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.
- 1.1.2 We agree with the CC’s conclusion that the pre-requisite conditions for tacit coordination are not present in the market for the audit of FTSE350 companies, and that (not surprisingly) there is no evidence of tacit coordination taking place. Nevertheless, we feel that the CC has mischaracterised some of the features of the market as being supportive of tacit behaviour when they are not, and has therefore over-stated the possibility of such behaviour. In addition, we also feel that the CC has under-stated the body of evidence which not only shows tacit coordination is not taking place, but clearly illustrates that there is fierce competition between audit firms for the audits of FTSE350 companies.
- 1.1.3 Our views on the specific aspects of the CC’s approach to assessing tacit coordination and its application to the audit of FTSE350 companies are set out below.

2 The CC’s approach

- 2.1.1 The Working Paper considers various factors which may be conducive to coordination in some markets, such as stability of market shares, stability of demand and price transparency¹. For the most part the CC finds that these facilitating factors are not present. In particular, it identifies a number of factors which would make coordinating on price difficult², and which would also undermine any market sharing strategy³.

¹ Paragraph 19 (a) to (f) of the Working Paper.

² Paragraphs 28 to 31 of the Working Paper. See also Paragraph 49 of the Issues Statement.

³ Paragraph 13 (a) to (f) and 27 of the Working Paper.

- 2.1.2 However, even if the factors identified in the Working Paper were present, our view is that they would still not be sufficient to facilitate tacit coordination in the audit market, and the CC does not place sufficient weight on the features of the audit market that make tacit coordination in audit particularly unrealistic.
- 2.1.3 We set out our views on the features of the audit market which make tacit coordination highly unlikely in our Main submission⁴, and the CC recognises a number of these at paragraph 14 of the Working Paper; namely, long client relationships, frequency and unpredictability of tenders, the fact that a refusal to tender would damage a firm’s reputation, and heavy investments in expertise giving rise to an incentive to realise economies of scale. In other Working Papers the CC has also found that audit firms seek to build up strong client relationships and make relationship-specific investments in potential clients⁵, and target clients across all industry sectors to broaden their practices and to expand the expertise of their people⁶.
- 2.1.4 It would therefore be extremely difficult for firms to reach any tacit agreement limiting their ability to pursue profitable engagements. Any such agreement on market allocation or allocation of clients would be inherently unstable in these circumstances. We set out the reasons for this in our Main Submission⁷, and in more detail in section 3 below.

3 Market conditions for tacit coordination

3.1 *Stability of demand*

- 3.1.1 At paragraphs 24 to 27 of the Working Paper, the CC explains that demand in the audit market is stable because FTSE 350 companies are required by law to obtain a statutory audit. While this may be true in a literal sense, we do not consider that this high-level view accurately reflects the fact that the nature and value of audit engagements are constantly changing.

⁴ Paragraphs 342 to 349.

⁵ See, for example, the CC’s Working Paper “Firms’ stated competitive strategies”, paragraph 18.

⁶ See, for example, the CC’s Working Paper “Firms stated competitive strategies”, paragraph 21.

⁷ Paragraph 345 et seq.

- 3.1.2 While the CC accepts that the FTSE350 does not actually represent a fixed pool of clients⁸, the CC fails to acknowledge that the movement of companies in and out of this grouping undermines not just the incentives but also the ability of firms to coordinate on the basis of sector or identity of client. If firms cannot reliably predict the identity of available clients then they cannot feasibly reach consensus on allocation of clients or sectors, tacitly or otherwise.
- 3.1.3 The difficulty in coordinating in this fashion is further compounded by uncertainties related around the scope of audit services, and the nature of the audit relationship. The overall scope of a client’s demand, beyond the statutory audit, is often determined after the engagement has been secured, and the incoming auditor will not necessarily have full visibility of the range of audit related or assurance services that a company may demand at the outset of a relationship. These demands also vary (sometimes significantly) over time, for example due to transactional activity increasing the scope of the audit. Thus even incumbent auditors will not know with 100% certainty the ‘value’ of its own clients from year to year.
- 3.1.4 There is also great uncertainty about the length, and therefore the value, of a given audit relationship⁹. Commercial failure or merger activity are only two of the reasons a company may change auditor, and the company’s auditor has no way to control or predict these occurrences. This significantly undermines the incentives and ability of firms to reach consensus.
- 3.1.5 Audit engagements are also likely to be valued differently by different audit firms, and securing a particular client may be worth more to one firm than another. For example, the audit of a company in a given industrial sector may be worth more to an audit firm which does not have a client in this sector than one which does.
- 3.1.6 Finally, the CC considers that firms are able to monitor each others’ behaviour because the identity of companies that require a statutory audit, and the identity of their auditor, is publicly available information. However, it is inaccurate to say that “competition

⁸ Paragraph 24 of the Working Paper.

⁹ Paragraph 345 of our Main Submission. See also paragraphs 344 to 349 of our Main Submission for a detailed discussion of the unpredictability of demand in the audit market.

between firms largely takes the form of competition for engagements”¹⁰. As set out in detail at section 7.2 of our Main Submission, and borne out by the CC’s own survey and case study evidence, renegotiation plays a critical role in the dynamic between auditor and client, and has a significant impact on the resulting price. Firms renegotiate with clients each year in the knowledge that clients can and do credibly threaten to tender the audit, giving clients considerable buyer bargaining power. Competition therefore occurs even when competitors do not interact directly in a tender, and there is no mechanism to monitor tacit coordination in the renegotiation context.

- 3.1.7 The above factors would make any attempt to tacitly coordinate inherently unstable, not just “more difficult to sustain”¹¹, as firms would be forced to reach consensus repeatedly as companies enter and exit, on the basis of changing and unpredictable variables such as the length and value of engagements. Stability of overall market demand for audit services alone is therefore not conducive to tacit coordination in this context.

3.2 Price transparency

- 3.2.1 As the CC describes in its Working Paper, audit fees are published and companies can and do use reference companies in their industry to benchmark their audit fees¹². While we agree that prices are therefore sufficiently transparent to facilitate active competition¹³, competitors do not have enough visibility of the service provided post-engagement to monitor compliance with any tacit agreement, for the reasons outlined in the previous section.

3.3 Barriers to entry

- 3.3.1 We disagree with the CC’s finding that barriers to entry and growth in the supply of audit services to FTSE350 companies are high. As we have previously explained¹⁴, it is our view that the CC mischaracterises as barriers to entry what should more properly be

¹⁰ Paragraph 26 of the Working Paper.

¹¹ Paragraph 27 of the Working Paper.

¹² Paragraph 30 of the Working Paper.

¹³ See section 4.2.2 of our Main Submission.

¹⁴ See paragraph 302 of our Main Submission and our Response to CC’s Working Paper “Restrictions on entry or expansion”.

described as investments in quality. These arise out of competitive pressures in the market to provide a high quality service, and do not prevent mid-tier firms from posing a competitive challenge in most individual client situations¹⁵. Such competitive pressures render any attempts to coordinate behaviour externally unstable.

- 3.3.2 In addition, these investments further undermine the incentive to coordinate because, having made such investments in people, training and the quality of their audit service, firms are incentivised to compete aggressively for clients, and to seek engagements across the full range of sectors in order to realise economies of scale and scope. The presence of increasing returns to scale and scope in the audit industry is discussed further at sections 8 and 9.1 of our Main Submission.

3.4 *Switching costs*

- 3.4.1 At paragraph 34 the CC states its initial view “that there are substantial costs to a company associated with switching auditor”. We disagree with this view. As set out in our response to the CC’s Working Paper “Evidence of Switching costs (and implications for barriers to entry)”, and as acknowledged by the CC in that Working Paper, companies that have switched auditors have not found the process particularly burdensome¹⁶. There is no evidence to support a conclusion that a ‘perception’ of high switching costs deters companies from tendering or switching when they are dissatisfied with their current supplier on either quality or price grounds.

- 3.4.2 We agree with the CC’s conclusion that firms consistently put in place initiatives to smooth the transition and manage these costs. [§<]

3.5 *Business models*

- 3.5.1 The CC states that the proportion of Big 4 firms’ revenue generated from statutory audit varies between 17.7 and 25.5 per cent¹⁷. We disagree with the implication that the almost 8 per cent difference between the largest and the smallest is not significant. On

¹⁵ See paragraph 2.1.6 of our Response to CC’s Working Paper “Market Definition” for our view that if the audit firms currently providing services to the FTSE 350 listed companies were to worsen their offer by some relatively small amount they would lose business to other audit firms not providing statutory audit services to this group of companies.

¹⁶ See, for example, Paragraph 3.1.1 of our response to that Working Paper; Paragraph 72(e) of that Working Paper.

the contrary, this is evidence that the Big 4 place a different emphasis on the role of their audit business within the firm structure, which would undermine any attempt to align their incentives.

3.5.2 The CC employs a similarly broad-brush approach in its treatment of business strategies. In paragraph 44 of the Working Paper, the CC asserts that the Big 4 firms have similar business strategies. However the similarities listed are those which we would use to describe a strategy of fierce competition. The CC appears to be saying, for example, that the uniform strategy of “targeting particular and existing clients, including organizing meetings with key staff of the company to discuss their proposed approach to the audit engagement” is a sign that the firms could be coordinating their activities. This is a somewhat counter intuitive view that turns the competition analysis completely on its head; it amounts to an assertion that extensive and active competition between audit firms somehow facilitates tacit coordination.

3.5.3 Finally, the CC states at paragraph 45 that the firms are “moving towards network structures”, conceding that these structures are in a state of flux and that there remain significant differences between them. This is not conducive to tacit coordination, with firms pro-actively pursuing expansion strategies and investing in innovative services to differentiate their offerings rather than make the firms more similar.

4 Evidence of tacit coordination

4.1.1 The CC examines two main types of evidence: market share information and documentary evidence. It finds that market shares have not been stable, all Big 4 firms have audited firms across all industry sectors (with one exception), and market shares have generally not been stable within industry sectors. The CC finds no documentary evidence whatsoever indicating tacit coordination is occurring.

4.1.2 We therefore agree that the evidence does not support finding of tacit coordination. On the contrary, it demonstrates the exact opposite: vigorous competition for audit clients. This is clearly evidenced in the internal documents we have provided to the CC, together with numerous examples of intense rivalry between firms both during, and

¹⁷ Paragraph 44 of the Working Paper.

outside of, tender situations¹⁸. The CC’s own analysis of tender documents has also confirmed this¹⁹. We believe the CC has therefore under-stated the strength of the evidence militating against a conclusion that tacit coordination is occurring (or is even possible).

- 4.1.3 We note that the CC refers to investments which it claims audit firms make in reputation. At paragraph 53 the CC states that “the Big 4 firms invest heavily in attributes that underlie reputation and strategies aimed at building relationships with potential FTSE 350 audit clients”. KPMG does not invest in reputation. Reputation is a by-product of the investments which KPMG makes in providing a quality service to its clients. Branding these investments as “attributes which underlie reputation” therefore mischaracterises the purpose for which they are made. We cover this point in more detail in our forthcoming response to the CC’s Working Paper “Barriers to entry: reputation and experience”.

5 Conclusion

- 5.1.1 The CC concludes that “many of the market conditions conducive to tacit collusion... appear to be satisfied”. We disagree. Many of the factors conducive to tacit coordination are not satisfied, for the reasons set out above. Moreover, there is overwhelming evidence which indicates there is fierce competition between firms.

¹⁸ See sections 7 and 8 of our Main Submission.

¹⁹ See the CC’s Working Paper “Evidence relating to the Selection Process: Tendering, Annual Renegotiations and Switching”.