KPMG response to the CC's Working Paper "Evidence on switching costs (and implications for barriers to entry)"

1 Summary and main conclusions

1.1 This paper provides our response to the CC's Working Paper on "Evidence on switching costs (and implications for barriers to entry)" (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.

1.2 Our own experience is consistent with several of the CC's conclusions in this Working Paper, which we therefore agree with, namely that:

- those companies that have switched have not found the process particularly burdensome or costly[1];
- individually any switching costs that do exist are not a barrier to entry[2]; and
- issues related to non-audit service provision are unlikely to be a major barrier to switching[3].

1.3 Whilst we recognise that there are a number of factors that might make frequent switching of audit firms inefficient, we do not see that these factors lead to certain of the conclusions the CC has drawn. In particular, we do not agree with the CC that:

- a perception of switching costs might be sufficient to deter tendering or switching[4]; nor
- collectively the switching costs that the CC identifies might constitute a barrier to entry or expansion[5].

1.4 We have set out in previous submissions[6] that there are benefits to a longer term relationship between the client and the audit firm and that therefore there are

[1] Paragraph 72 e) of the Working Paper.
[2] Paragraph 74 of the Working Paper.
[3] Paragraph 72 d) of the Working Paper.
[4] Paragraph 72 f) of the Working Paper.
[5] Paragraph 74 of the Working Paper.
[6] For example, paragraph 20 of our Main Submission.

inefficiencies associated with switching more frequently. In particular, the new audit firm must duplicate similar investments in understanding the client. However, we also believe that the evidence clearly shows that all audit firms are under competitive pressures, as there are no material switching costs for the client firm that would enable an incumbent to lower its competitive effort on any client.

1.5 As a result, in our view these factors do not have an adverse effect on the competitiveness of incumbent audit firms' offerings. Incumbent audit firms have to face the reality that their clients could switch to other firms and hence clients are able to exert effective competitive pressures and achieve competitive outcomes from negotiations with audit firms without switching or tendering.

1.6 Indeed, it is precisely because clients are able to achieve these competitive outcomes without switching and tendering that switching and tendering are not more frequent, as evidenced by the CC's survey results.

1.7 The CC also considers the implications of switching costs for the nature of competition within the market separately, in its Working Paper on "Nature and strength of competition"[7]. We will therefore comment further on the CC's analysis of switching costs in our response to the CC's Working Paper on "Nature and strength of competition".

1.8 In the rest of this response we set out our views on this Working Paper in more detail. We are disappointed that there is no evidence or arguments previously submitted by KPMG that have been referred to in this Working Paper. In the rest of this response we refer to some of our previous submissions on this topic, and explain again why we think our views are important for the CC's analysis and should be considered.

[7] Paragraph 5 of the Working Paper.

2 Disincentives to switch which arise only because clients receive high quality

2.1 The CC states that the risk of the audit opinion being incorrect in the early years of the audit can be seen as a cost associated with switching audit firm. We agree that the inherent risk of an audit error may be lower for an incumbent audit firm (compared to any other rival audit firm) to the extent that incumbency is associated with better knowledge of the company[8]. For this reason, as we have stated in previous submissions, frequent switching of audit firm is likely to be inefficient since it will lead to duplication of learning[9]. However, there are two further points to note.

2.2 First, any risk differential can be minimised by a (non incumbent) audit firm by deploying the necessary resources. Rival audit firms with the general skills and capabilities to audit large and complex clients also deploy additional resources to develop knowledge and skills specific to a new client. The costs of these resources are usually absorbed by the audit firm, rather than the client.

2.3 Secondly, the extent to which such differentials exist, they are a function of incumbent firms seeking to provide as good a service as possible in the face of competitive pressures. In this sense these differentials are also a result of competition in the market working well.

2.4 In summary, intense competition (whether during tender events or outside of them) leads to higher quality audits being provided by incumbent audit firms. If this translates to a differential between the quality of incumbents and competitors (and a difference in the actual or perceived risk of errors), this might reduce the incentive to switch – but this is a reflection of intense competition rather than a factor that gives rise to competition concerns. Therefore, the risk that changing audit firm will increase the

[8] For example, see section 7.2.1 of our Main Submission.
[9] Paragraph 274 of our Main Submission.

likelihood of an audit error does not allow incumbent audit firms to be less competitive to their existing customers[10].

2.5 Overall therefore, any perceived risk of this type cannot be seen as a switching cost in the sense that it might have the effect of increasing an audit firm's market power or allowing it to reduce the competitiveness of its offer[11].

2.6 In our view the CC's definition of switching costs as "any factor that discourages a company from considering switching auditors"[12], risks missing this crucial distinction.

3 Switching costs are not material

3.1 Overview remarks

3.1.1 In this section we set out our views on the other switching costs that the CC discusses in the Working Paper. We agree with the CC's conclusion that the evidence shows that those firms that have switched audit firm have not found the process particularly burdensome or the costs particularly high.

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[10] Some economic analysis finds that under some circumstances, switching costs may lead to an incumbent firm enjoying a greater degree of market power over its captive customers. In other words, the existence of material switching costs might in some circumstances allow an incumbent firm to be less competitive to relatively 'captive' customers, safe in the knowledge that it has some leeway before these customers will switch to alternative providers. Although it is also important to note that in these models anticipation of 'captive' customers generates fierce competition for new customers, for example in the form of low introductory prices, competing away any excess profits. We also note that the relationship between switching costs and market power is not straight forward. For example, see Cabral "Switching costs and equilibrium prices", Arie and Grieco (2011) and Duble et al (2009), as well as the CC's report on the proposed acquisition of the London Stock Exchange by Deutsche Börse AG or Euronext N.V (for example, paragraph 17).

[11] In previous responses to the CC (in our submission in response to the CC's Issues Statement (paragraph 334) and in other responses to CC papers and analysis, including KPMG's response to Professor Beattie's literature review (paragraph 66) and KPMG's response to the CC's Working Papers on "The framework for the CC's assessment and revised theories of harm" (section 4.3) and "Restrictions on entry and expansion" (section 4)) we have emphasised our view that it is incorrect to characterise the increased risk of an audit failure as a 'switching cost'. This view was motivated by the fact that this factor is not an exogenous one that allows incumbents to exploit market power, but rather is a reflection of the competitiveness of incumbent firms' offerings.

[12] Paragraph 7 of the Working Paper. This definition of switching costs is very broad. Such a broad definition of switching costs is valid only so long as the CC also makes clear that switching costs thus defined do not necessarily imply that competition is not working effectively.

3.1.2 More generally, for a switching cost to be relevant to the CC's assessment of competition in the supply of statutory audit services it must be material enough to allow incumbent audit firms to decrease the relative competitiveness of their offerings. In the context of the bargaining process that determines the price and scope of statutory audit services, this implies that switching costs must be material enough for an incumbent audit firm to discount or ignore threats from their customers (implicit or explicit) to switch supplier during these negotiations.

3.1.3 It is important to note that the observed rate of switching of audit supplier does not provide any evidence of the existence of material switching costs. Rather, the observed rate of switching is entirely consistent with there being minimal benefits to switching for the majority of companies, who achieve a competitive offering from their existing audit firm.

3.1.4 In our view the evidence set out in the Working Paper does not therefore show that there are material, relevant switching costs that dampen competitive pressures on incumbent audit firms. The CC therefore appears to have formed conclusions based on isolated or minority instance examples[13] rather than on the basis of the majority evidence which it presents in the Working Paper.

3.2 Management time required for switching is not a material deterrent to switching

3.2.1 The CC finds that the management time involved in switching audit firm (as part of the tender process and in order to educate a new audit firm) is a deterrent to switching[14]. However, in our view such a conclusion is unfounded on the basis of the evidence the CC has presented. Instead, the evidence shows that while management time is required for switching, this burden is not substantial and is not a deterrent to switching audit firm.

[13] Such as isolated statements from the CC's case study, which in some instances highlight costs associated with switching but which do not show that this has an impact on the competitive pressures on an incumbent firm.
[14] Paragraph 72(a) of the Working Paper.

3.2.2 The case study evidence set out by the CC in this Working Paper shows that several companies found the management time and costs associated with switching were modest[15]. Overall, the case study evidence does not suggest that the management time involved would put companies off switching audit firm were their incumbent to cease to meet its needs[16].

3.2.3 The CC cites results from its customer survey ("CC's survey") that around 25 per cent of the FTSE 350 companies surveyed 'mentioned' the disruption and costs involved in tendering the audits and changing audit firms as a reason for not having tendered their audit in the last five years[17]. Put another way, 75 per cent of FTSE 350 companies did not mention disruption or costs as reasons for not switching. The survey does not (and cannot) say if the same answer would be given by each firm every year, but it seems more likely that companies' views will change over time. If so, the CC's survey suggests that fewer than 25 per cent of FTSE 350 companies would find disruption a reason for not switching over a 5 or 10 year period. Indeed, over 80 per cent of survey respondents did not mention 'disruption/ getting auditor up to speed' as a reason for not tendering their audit in the last five years.

3.2.4 Furthermore, for this evidence to be meaningful it needs to be viewed in the context of the potential benefits from switching. If companies are already getting a good value and high quality service from their existing audit firm, then the existence of small management costs associated with switching might put companies off running a tender – but this does not imply that companies would be put off by these small costs if their service was to fail to meet these high standards.

[15] Paragraph 10 a), f), g) and h) of the Working Paper.
[16] This is explicitly stated by some companies (paragraphs 10 i) and l) of the Working Paper). In addition, the Working Paper refers to the view of the ACC of Company D, for example, who states that there is management time involved, but elsewhere in the case study this ACC states that there is a policy to informally retender every 4 to 5 years (paragraph 60), showing that management time is not a barrier to tendering.
[17] Paragraph 11 of the Working Paper.

3.2.5 Indeed, the CC fails to mention at this paragraph that more 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[18]. The survey results also show that when companies are dissatisfied with the price or quality of their existing audit firm, they can tender their audit and if necessary switch audit firm – those companies that switched in the last 5 years did so in relation to price and cost factors, as well as a number of other quality factors[19].

3.2.6 The CC's survey also shows that switching audit firm has a minimal impact on internal costs (which were defined as management or staff costs, or other operational costs) – over half of the FTSE350 respondents that had switched in the last five years stated that switching audit firm had no material impact on internal costs, and a further nine per cent did not know the impact the switch had on these costs[20], indicating that they must be immaterial. Fierce competition means that the audit firms must absorb most of the switching costs themselves.

3.2.7 Overall therefore, the evidence suggests that management time and related costs are not material. As a result evidence shows that the management costs associated with switching do not in any way imply that competitive pressures on audit firms during negotiations are reduced. In part, this is because all audit firms seek to minimise the management time required for new customers to start using them as their supplier of statutory audit services, which we discuss further in section 3.6 below.

3.3 'Timing issues' are not substantial and are short term in nature

3.3.1 The Working Paper states that there are only certain times of the year when a large company can consider tendering and switching, and sets out case study evidence that illustrate the timing issues companies will have to take into account in considering when

[18] Paragraph 39 of the Working Paper and slide 60 of the CC's survey presentation.
[19] 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'.
[20] CC commissioned survey, Slide 67.

to tender or switch audit firm[21]. We would not dispute that there are only certain periods in the financial year when a company could issue and complete a tender in order to give the newly appointed audit firm sufficient time to complete their work on the audit for the next financial year. Indeed, this is an unavoidable fact of the annual cycle of preparation of accounts. The case study evidence cited by the CC shows that companies work within this constraint effectively, planning the tender process for the most convenient time in the financial year[22].

3.3.2 In addition, we also recognise that during certain other times switching may be more difficult as a result of other activities the company is taking at that point in time (for example, restructuring or acquisition / disposal activities)[23]. However, these circumstances are relatively rare and furthermore are short-term in nature. Therefore, in no sense do these timing issues prevent companies from switching audit firm in the longer term once the particular short term circumstances are resolved.

3.3.3 However, the restrictions above are simply not relevant in practical terms unless they were to act as a continuous barrier (ie allowing no time during the year in which a tender process might be conducted). The decision to tender the audit is not one in which the idea and decision is made overnight, but rather is likely to have arisen as a result of a number of factors over time. It follows that companies have plenty of time, in the context of considering the need to tender the audit and the decision to do so, to schedule the tender process to fit in with other demands on the company.

3.3.4 As a result, there is no sense in which these timing issues would enable an incumbent audit firm to reduce the competitiveness of its offering (for example increase prices or reduce the quality of the audit), since if it did so companies would switch audit firm once those short term constraints on tendering and switching were relaxed. We would

[21] Paragraph 19 of the Working Paper.
[22] Paragraphs 19 a) – d) of the Working Paper.
[23] Paragraph 24 of the Working Paper.

not consider a threat to switch any less credible because it may only be implemented at certain times in the year.

3.3.5 Indeed, the Working Paper refers to the results from the CC's survey that only around 10 per cent of customers that had not switched in the last five years mentioned the 'timing not being right' as a reason behind this decision[24]. This is fully consistent with these timing issues being immaterial and short term in nature.

3.3.6 The Working Paper also states that at certain times companies may be discouraged from switching due to reputation concerns[25]. We note that the CC has presented only a very few examples of where companies stated that this might be the case and has not presented concrete evidence of this having been an issue or that it is an issue for more than a handful of companies. In our experience this is not an issue that will prevent companies from switching, or credibly threaten to do so, and we have seen no evidence to suggest otherwise.

3.4 The possibility of a change in accounting treatment is not a barrier to switching

3.4.1 The CC considers whether there is evidence that a new audit firm might take an alternative view of a company's accounting treatment to the previous auditor, and whether this might be a cost that management and / or the company factor in when considering switching audit firm[26].

3.4.2 However, the evidence cited by the CC in this section does not appear to offer any support to this hypothesis[27].

3.4.3 In our view there is no incentive for companies not to switch audit firm because of concerns about a change in the approach to accounting practices. Indeed, the fresh pair

[24] Paragraph 30 of the Working Paper.
[25] Paragraphs 27 to 29 of the Working Paper.
[26] Paragraph 48 of the Working Paper.
[27] Paragraph 49 refers to a quote from the CC's Company I case study, which does not appear to directly relate to the CC's hypothesis. Paragraph 50 refers to a different set of circumstances, when a company switched following a disagreement over an accounting treatment.

of eyes that a new audit firm can bring is often a key benefit from switching audit firm. This is supported by the results of the CC's survey, which showed that 27 per cent of FTSE 350 companies that switched in the last five years did so because 'reviewing keeps things fresh/ avoids complacency/ policy to switch regularly'[28].

3.4.4 In particular, the AC has no incentive to ensure that the same view on accounting treatment is given by a new audit firm. Indeed, in our experience ACs are keen to hear about alternative views and approaches and this fresh perspective is seen as one of the benefits of the rotation of the lead audit engagement partner in the incumbent audit firm. We discussed the role of the AC in further detail in our response to the CC's Working Paper on "The framework for the CC's assessment and revised theories of harm"[29].

3.4.5 We therefore strongly question the CC's statement in paragraph 7 of the Working Paper that the desire to avoid a change in accounting treatment is one of the 'main switching costs' companies face, as it appears to be completely unsupported by any evidence and in clear contradiction of our experience of the role of the AC.

3.5 Rules on the provision of non-audit services do not prevent companies from switching

3.5.1 The CC finds that issues related to "the loss of provision of non-audit services (by a new auditor)... seem unlikely to be a major barrier to switching"[30]. We agree with the CC's conclusion.

3.5.2 The CC cites only one example of an audit firm deciding not to tender for an audit due to non-audit work. Whilst we identified in our response to the CC's Market and Financial Questionnaire ("MFQ") one or two FTSE100 clients where arrangements might be more complicated[31], we are not aware of any FTSE350 company where we believe we would be conflicted from undertaking the audit as a result of the provision of

[28] CC's survey presentation, slide 63.
[29] 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".
[30] Paragraph 72 d) of the Working Paper.
[31] [✂]

non-audit services given a reasonably short period of notice. The balance of evidence therefore appears to provide very strong evidence that this is not in any sense prevent switching.

3.5.3 We would also point out that in some instances the ability to purchase a greater number / variety of non-audit services from the previous audit firm might be a further benefit associated with switching.

3.6 Audit firms seek to minimise switching costs for companies

3.6.1 The CC concludes that "audit firms go to considerable efforts to ease the process [of switching audit firm] and to manage the risks involved"[32].

3.6.2 We agree with the CC's conclusion. The CC has not referred in this Working Paper to the evidence we provided in our Main Submission on the efforts audit firms go to learn prospective clients' businesses in order to become a more credible alternative provider (including by providing non-audit services)[33], which further ease the process of switching.

3.6.3 Our pitch and proposal documents refer to the insights we have already gained about a prospective client at the point of an audit tender, in an effort to illustrate the minimal management time that would be involved in getting KPMG 'up to speed' with that potential client's business)[34]. [✂]. This is a necessary part of presenting a competitive offering to clients during pitches.

3.6.4 We expect our competitors, including mid-tier audit firms to offer the similar levels of diligent planning and project management to ease any transition to their services. This is something we are aware of as making switching easier for clients, and therefore increasing clients' bargaining position, in tenders or in annual renegotiations.

[32] Paragraph 72 e) of the Working Paper.
[33] Section 7.1 of our Main Submission.
[34] KPMG's proposal documents, submitted in response to the CC's tender information data request.

3.6.5 Audit firms will also often organise a handover phase with the previous audit firm, in order to smooth the transition further (and legislation already requires predecessors to provide certain information to successor audit firms in any event).

3.7 The CC refers to its own data analysis in relation to increased time costs in the early years of audits. The CC has not here referred to the evidence we set out in our Main Submission[35], but this also supports these findings. Specifically, our initial analysis of the hours worked per year on six new audit clients that KPMG won since 2003 found that for each client, the number of hours worked for the delivery of the statutory audit [✂]

There is no evidence for a 'perception' of switching costs being a barrier to switching

3.8 As set out in the previous section, we agree with the CC's conclusion that those customers that have switched have not found the process particularly burdensome or the costs particularly high. However, the CC goes on to state that:

"the perception that switching causes upheaval is widespread, and appears sufficient to deter tendering, particularly when management is preoccupied with other concerns".

3.9 Taking these conclusions together, the CC appears to be finding that although in reality switching costs are not material, there is a perception that they are higher than they are in reality and that this perception will deter companies from tendering and switching. However, we have seen no evidence, and in our view the CC provides no evidence in this Working Paper, to suggest that perceptions of switching costs are any different from reality. In particular, it is not clear that there have been any significant number of instances where, in practice, the perception has resulted in a tender being deferred. Audit firms cannot rely on customers being incorrect or irrational and for this reason

[35] Paragraph 213 of our Main Submission .

consider a threat any less credible[36]. Even if some customers were irrational or incorrect in perceiving the size of switching costs, this cannot be characterised as a switching cost.

3.10 As we set out in the previous section, there are no material switching costs in relation to the supply of statutory audit services that allow incumbent audit firms to relax the competitiveness of their offerings.

3.11 The CC also states that if the largest four audit firms are better able than mid-tier audit firms to signal their ability to manage a transition to a new audit firm[37]. It is important to note that any signal of quality can only be credible if based on fact. In other words, an audit firm can only signal its ability to manage transition because that ability really does exist – any failure to live up to the high standards promised in proposal documents would soon become public knowledge and damage the reputation for of the offending audit firm.

[36] For example, we discussed implicit and explicit threats to switch in our response to question 91 of the MFQ.
[37] Paragraph 75a) of the Working Paper.