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Dear Mr Gadhia

Audit Market Investigation
KPMG Response to "Firms' Stated Competitive Strategies" Working Paper

Thank you for affording us the opportunity to comment on the Competition Commission's (CC's) "Firms' Stated Competitive Strategies" Working Paper (the "Working Paper") published on 12 September 2012 and the appendix on "Strategies of Individual Firms" published on 20 September 2012.

In our view, the Working Paper shows that the market for statutory audit services is highly competitive. In particular all the firms have very active strategies to both retain existing and attract new audit clients and devote considerable resources to implementing these strategies. We set out in the appendix a detailed response to the Working Paper's analysis, KPMG do not have any comments on the Commission's annex.

We trust that these comments and observations are useful in informing your consideration of the Working Paper. Do not hesitate to contact me if you have any queries or wish to pursue any of these points further.

Yours sincerely

David L Gardner
Director of Public Policy

Appendix 1

Unless otherwise stated, paragraph references are to paragraphs in the Working Paper.

WP paragraph	**KPMG comment**
5	This states that audit firms have increasingly focussed on developing industry sector teams to take ownership of clients and provide an integrated approach. For many years (certainly from the 1980's) KPMG has worked in a matrix fashion between functions, markets and geographies although the relative strength of each has changed over the years. Following the legislative and regulatory changes in 2002-2006, the function is now clearly more important internally than market sector, but we have continued to have cross-functional market and client teams. In relation to the last decade it is certainly wrong to characterise KPMG (we cannot speak for the other firms) as being "increasingly" focussed on industry sector teams.
8	*"A recurring theme in the submissions from the Big 4 is the persistent threat of an audit client going out to tender if fees are not reduced, but the frequency of this threat occurring and the likelihood of a client following through is not apparent"*. We would challenge the latter half of the sentence very strongly. Specifically, the CC's survey evidence shows that threats to tender are real and companies are well informed, for example (i) the large majority of companies have been approached formally or informally by another audit firm[1]; (ii) that switching does not have a significant impact on internal costs (and so these do not imply that switching is a less credible threat)[2]; (iii) the majority of companies review prices every year[3]. This is consistent with the survey result that for the large majority of those companies that have not tendered their audit in the last 5 years, this is because they are satisfied with the price and quality of their existing provider[4]. We also reiterate our response to question 91 of the Market and Financial Questionnaire (MFQ), where we discussed the threats to switch – we explained that there is a constant implicit threat to switch and also provided numerous examples of explicit threats. We discuss threats to switch and their implications for competition further in our response to the CC's working paper on "Evidence on switching costs (and implications for barriers to entry)".
8	We agree with the CC's statement that customers are well informed and, as we have argued elsewhere, this means they are well placed to judge audit quality and fees and possess substantial bargaining power.
9	We agree with the CC's statement that there is uncertainty over audit firms' abilities to implement fee increases. It is very difficult to implement fee increases because of intense competitive pressures throughout an engagement (not just during tender processes). The CC's analysis shows that FTSE350 audit fees have dropped by 5.2% in 2010 and 10.4% in 2011[5]. This highlights the ongoing downward pressure on fees.

[1] Section 2.6 of our response to the CC's working paper on "Survey Results".
[2] Paragraph 2.8.4 of our response to the CC's working paper on "Survey Results".
[3] Section 2.5 of our response to the CC's working paper on "Survey Results".
[4] Section 2.7 of our response to the CC's working paper on "Survey Results".
[5] Competition Commission Public Data Descriptive Statistics, Audit fee levels and changes.

WP paragraph	**KPMG comment**
10	We will second staff in certain circumstances to support employees' career development. In particular, we undertake "out of the box" secondments for those on the leadership track. However, given independence standards, we would and could not second anyone to a position of management or responsibility or within the finance function at an audit client. For SEC clients there is a general prohibition on secondments. [✂]
12	*"Periodically the Big 4 attempt to enter the market for smaller companies, undertaking the work at close to cost price."* We have always audited a wide range of entities including smaller companies and we are not therefore 'seeking to enter' that 'market'. The CC's descriptive statistics on market shares shows that KPMG has a market share of between 22-29% in 2011 for all categories of companies within the dataset including "all other listed" and private companies[6]. Thus we are not entering the market as we operate throughout the market continuum for statutory audit. To a greater or lesser extent, the same appears to be the case with our competitors. KPMG also do not price by size of company, the main factors affecting price will be complexity, geography and seasonality.
12 - 13	The CC does not define "low-balling" but states that low-balling might occur because the largest four firms price lower ('close to cost'[7]) outside of their peak times in order to obtain some revenue for under-utilised staff. To the extent that the largest four firms offer prices that are close to cost (which may reflect seasonal pricing) this is to the benefit of customers. [✂] We fundamentally dispute that this is in any way strategic to block entry of smaller firms and we are not aware that the CC has received evidence that audit firms engage in this behaviour.
15	We reiterate that we do not pay our staff based on the size of audit clients, but based on geographical markets and the demand for labour in these markets. Our salaries are based on six geographical markets and have no reference to the size of clients on which the staff work. Whilst we understand that this assertion has been made by certain of our competitors, there is no evidence to support it.
17	The principal purpose of establishing our KPMG Resource Centre and KPMG Global Services Centre is to further improve our ability to deliver high quality service to our clients, and not simply to reduce cost. KRC and KGS provide our onshore professionals (in whatever country) with high quality, globally consistent support. KRC and KGS also substantially extends the effective KPMG working day. The scale and quality of KRC and KGS professionals enables high quality data analysis and other audit activities capable of being done remotely to be handled in an efficient and consistent high-quality manner. As a result, our onshore professionals (in whatever country) now focus more time on higher qualitative aspects of the audit.
18	The CC survey[8] showed that KPMG, along with the other larger firms, are highly active in approaching Audit Committee Chairs and Finance Directors.
20	Developing a reputation for quality and experience is not limited to a particular sector –

[6] Competition Commission Public Data Descriptive Statistics, Market Shares.
[7] Paragraph 12 of the Working Paper.
[8] Section 2.6 of our response to the CC's working paper on "Survey Results".

WP paragraph	KPMG comment
	reputation for delivery of quality audits, for large, complex clients is important regardless of sector. However, it is highly valuable to be able also to bring to bear extensive sector expertise.
21	*"Historically, being the auditor of a rival company has sometimes been an issue for clients"*. In our experience this is extremely rare and has only occurred in markets where there are a very limited number of dominant players, one example being Coca Cola and PepsiCo. The evidence the CC cites in support of this statement appears to be limited to one newspaper report on one US company. As a result the evidence the CC appears to have in support of this more general statement is weak.
21 a – d	We agree that these factors set out in this paragraph are likely to be important to clients. However, we would also reiterate comments from our response to the MFQ[9] that there are often insights that can be gained from similar sectors or just from other large, complex clients in general.
26	While we would not make a formal unsolicited written proposal, we make other informal approaches frequently, as shown by the very clear evidence on this in the CC's survey and the evidence in section 7 of our Main Submission in response to the CC's Issues Statement ("Main Submission"). In addition, in most case studies, ACCs and / or FDs reported informal approaches from one or more audit firms apart from the current auditor. These informal approaches make companies more aware of the alternatives that are on offer from other audit firms and exert important competitive pressure on the incumbent audit firm.
32	We very much agree with the statement in parenthesis that a key factor dealt with in fee negotiations are prospective audit fees offered by competitors. This is a key competitive constraint on an incumbent audit firm, and means that threats to switch are highly credible and treated as such by incumbent audit firms during renegotiations.
34	It would provide a better context to refer to the significant relative decline in the provision of non-audit services to audit clients. In 2001, revenues from FTSE350 non-audit services to audit clients were 1.65 times audit fees, whereas in 2011 they were just 0.47 times published audit fees, less than a third of "pre-Enron" levels[10].
40	The Working Paper suggests it is unclear whether recruiting school leavers is a way of reducing costs. KPMG's School Leavers' Programme ("SLP") (set out in paragraphs 26.10-26.14 of our response to the MFQ) provides a first class integrated training and degree programme for school leavers complementing our longstanding graduate recruitment programme. The SLP is about raising the bar on quality further, improving access to the profession and ensuring a broader mix of auditors. But there is no diminution in quality. Everyone completing the SLP will end up achieving both a full accountancy qualification and a degree. We are investing heavily in the programme, which is just entering its second year and supplements our longstanding graduate programme. [✂]. Competition for talent is fierce between the larger four firms and beyond.

[9] Response to Market and Financial Questionnaire, Q57
[10] Competition Commission, Public Data Descriptive Statistics, NAS ratios.

WP paragraph	**KPMG comment**
42-45	The focus of these paragraphs on reputation and brand is on marketing, sponsorship and thought leadership. However, these are not the key drivers of reputation or brand – rather, the key drivers of reputation are our investments in quality and continued delivery of a high quality product. Public inspection reports provide further evidence of our robust quality assurance processes, and a further way for Audit Committees and shareholders to judge quality We set out our thoughts on this in more detail in paragraphs 26.41-26.45 of our response to the MFQ.