Market Investigation into the provision of statutory audit services to large companies: KPMG UK Submission to the Competition Commission

Contents

Introduction and summary Page 3

KPMG UK’s position on the reference Page 3
KPMG UK’s view of the market and competition Page 3
KPMG UK’s view of the CC’s statement of issues Page 6

1. Introduction to KPMG Page 9

1.1 KPMG merger Page 9
1.2 KPMG International Page 9
1.3 KPMG Europe LLP Page 10
1.4 KPMG Europe LLP Governance Page 10
1.5 KPMG Limited Liability Partnership Page 10
1.6 KPMG in the UK Page 11

Part A: Background on the provision of audit services Page 12

2. Statutory and regulatory background Page 12

2.1 Introduction Page 12
2.2 Legal Requirements Page 13
2.3 The regulatory framework Page 14
2.4 The audit Page 17
2.5 Supply of non-audit services to audit clients: independence rules Page 19
2.6 Current proposals for change Page 21

3. Nature of services provided by audit firms Page 22

3.1 Introduction to statutory audit services Page 22
3.2 The stages in the delivery of an audit service Page 25

4. Audit clients Page 28

4.1 Characteristics of FTSE350 companies Page 28
4.2 Client demands for quality and value for money Page 34

5. Clients’ audit requirements and the implications for audit firms Page 37

5.1 Client requirements drive audit firm investment and organisation Page 37
5.2 Relationship-specific investments Page 42

Part B: Competition in the provision of audit services Page 44

6. Introduction to competition in the provision of audit services Page 44

7. Short term competition Page 45

7.1 Competition to gain new clients Page 46
7.2 Competition in retaining existing clients: renegotiation and bargaining Page 47
7.3 Conclusions on short term competition

8. Dynamic competition

8.1 The drivers of investment

8.2 Investment in quality that is not specific to a given client

8.3 The need to maintain a reputation for high quality services

8.4 Implications for market structure

8.5 Summary of dynamic competition

Part C: Addressing the CC’s theories of harm

9. Addressing theories of harm

9.1 High concentration and barriers to entry

9.2 Bundling

9.3 Customer conduct

9.4 Risk of regulatory failure

9.5 Tacit co-ordination

9.6 Information asymmetries

Part D: Market outcomes

10. Market outcomes

10.1 Suboptimal quality and levels of innovation

10.2 Higher price and cost

10.3 Less competition in non-auditing markets

Annex 1: Audit Committee Chairs and Financial Directors

Annex 2: Case Studies of KPMG’s statutory audit clients

Annex 3: High level comments on Oxera’s price concentration analysis

Annex 4: Pitch documents (see attachments)
Introduction and summary

KPMG UK’s Position on the Reference

1. This is the submission of KPMG UK. This investigation comes at an important time for the sector. There has been considerable debate about competition and quality in the provision of audit services. Whilst we did not invite this reference we look forward to engaging with the Competition Commission (CC) on the issues. It is incontrovertible that companies in the FTSE350 tend to select one of the four leading audit firm networks as their auditor. But as KPMG UK will demonstrate throughout this investigation this is the product of, and consistent with, very considerable and effective competition between those firms and between those firms and other players. Thus we already face significant competitive pressures and countervailing buyer power in relation to both quality of service and prices, and extensive regulatory oversight of technical quality.

2. The provision of audit services is an important part of the economy and the governance of corporate life. It should be the subject of healthy competition and appropriate regulatory scrutiny. It is our belief that these conditions are already in place and will continue to develop. Audit quality is generally very high and prices provide good value for money. Audit firms are innovative and responsive to client demands. There are few signs of client dissatisfaction, either from companies themselves or from investors.

KPMG UK’s view of the market and competition

Statutory audit services

3. The provision of statutory audit services is subject to extensive legislative and regulatory requirements to ensure the quality of the audit opinion that is provided and hence ultimately protect shareholders’ interests. These requirements cover the scope of audits; how they are conducted; what is required to be reported; the qualifications needed; and provisions to ensure the objectivity and independence of the auditor (including limitations on audit-related and other non-audit services an auditor may perform). The requirements are even more extensive in the case of audits of listed companies.

4. For listed companies, the audit committee is responsible for recommending the appointment of a statutory auditor, subject to approval by shareholders. The scope of the work and conduct of the audit are then overseen by the audit client’s audit committee. Audit clients have high expectations as to i) the quality of the audit work undertaken; and ii) the insights that the external auditor may be able to provide as a by-product of the extensive work undertaken at numerous of the audit client’s operating locations in order to deliver the audit opinion. Contrary to the views of the OFT, audit clients are well informed purchasers of these services.

Each client’s demand and requirements for statutory audit services are bespoke

5. A statutory audit of a large company is not a commodity. It is a complex, bespoke service, where high quality is paramount. The complexity of an audit primarily derives from the scale and complexity of companies, the industries in which they operate and their commercial arrangements; from the ad hoc requirements of individual clients; and from the regulatory frameworks that govern the process of delivering an audit. The consequences for both audit client and auditor of the publication of materially inaccurate financial statements and the issuance of an inappropriate audit opinion can be huge or even catastrophic.

6. The nature, size and complexity of a business influence the attributes that an audit client requires from its statutory audit provider. These requirements may include:

a) a global network;

b) high staff quality (in turn requiring the ability to recruit, develop and retain high quality candidates, at all levels);
c) extensive experience (of auditing large and complex businesses and/or of specific sectors);
d) specialist skills (e.g., actuarial expertise);
e) a “bench” of sufficient strength (i.e., the ability, at any given time on an engagement, to field an appropriate number of staff members with the right skill mix. For example, the ability to replace members of the team with other members of staff with equally appropriate skills, following the rotation of existing staff off the engagement, either as required by regulation or unexpectedly);
f) knowledge and understanding of a client’s business;
g) an appropriate working relationship with the client, at all levels of seniority;
h) consistent methodology and processes, supported by technology to maximise efficiency and quality; and
i) strong quality assurance processes.

7. These factors allow audit firms to develop a reputation for, and track record in, providing a high quality service.

The role of quality

8. Whilst not all of the above factors are easily measurable in quantitative terms, they are both discernible and differentiating. The extent to which an audit firm possesses and uses the capabilities set out in paragraph 6 determines the quality of the audit firm from the audit client’s perspective. As a result of the complex needs of large audit clients, and their demand for high quality, audit firms have had to invest (and keep investing) significantly to build and maintain these capabilities.

9. Some of the investments needed to develop these capabilities are of a general nature, or in other words are aimed at improving the quality of audit services across a number of clients (or even all clients). Others are relationship-specific, as they involve learning about a client’s business and its complexities; developing relationships with the key personnel at the client, at all levels of seniority; and providing specific staff members with expertise for that client’s needs.

10. Audit clients also invest in the relationship with their auditor. For an audit firm to develop client-specific knowledge, it has to learn from the client’s management about its structure, commercial arrangements, its reporting practices and requirements, and other aspects of the client’s business. This requires management time and effort. Audit clients (in particular their audit committees) also exert effort to monitor the quality of the auditor’s work.

11. Audit committees routinely review the effectiveness of the statutory audit services they receive. In this context, we have a comprehensive client feedback programme, which allows us to understand any clients’ concerns and act upon these as matters of priority. This also allows us to conclude that audit clients are certainly capable of judging the quality of the audit service they receive.

Competition in the provision of audit services

12. Audit firms compete in a number of ways. Ultimately their goal is to expand their client base for the provision of audit services and in order to do so they have to be competitive in a number of dimensions. At a high level, they have to be able to provide the highest quality of service to their clients while making sure their offer delivers value for money.

13. Some aspects of this competitive effort impact on audit firms’ competitiveness in the short-term. For example, certain aspects of quality and of the audit scope, as well as prices, can be adjusted in the short-term to compete for a given client’s audit. Other strategies have an effect in the medium-
to long-term. These include investments made to improve different aspects of quality or to increase efficiencies.

*Short-term competition*

14. Audit firms compete in the short-term to acquire new clients and to retain existing ones (we refer to this process as 'short-term competition'). This dimension of competition involves varying those competitive strategies that can be adjusted over this time horizon (such as price and some elements of quality).

15. As for the competition to win new clients, we identify target clients clearly, with specific plans aimed at winning their audits. More generally, audit firms tend to maintain contact with companies which are not audit clients to monitor potential dissatisfaction with the existing audit relationship or to identify opportunities to provide a higher quality / better value audit offering. Audit firms also make unsolicited approaches to such companies, in order to entice them to switch, even without a formal tender process being initiated by the company.

16. Once an audit firm wins a new client, it has to maintain a competitive offering in order to retain it. [redacted]

17. For any given company in the FTSE350 there will be a number of alternative providers able to offer audit services of very high quality at competitive prices. As stated in paragraph 10, audit clients also invest in the relationship with their audit firm. Switching to a new audit firm would mean that the customer would have to re-invest that time and resource into a new relationship.

18. Similarly, an audit firm is constantly aware of what it would lose if the relationship with a given audit client was terminated. This first entails losing the financial value of the audit itself. The audit firm would also lose the value of the relationship-specific investments. As audit firms put in more hours in the first years of an audit, becoming more efficient as the relationship continues, the return from these extra hours would be lost if the relationship was terminated. Moreover, losing an audit client might imply that the ability to realise some of the economies of scale and scope arising from auditing several large, complex businesses would be reduced. In addition, loss of an audit client of a certain size or complexity, or in a certain sector, represents a reduction in the experience base of an audit firm as well as potentially damaging the audit firm’s reputation for high quality, making it less attractive to certain clients. In this way the loss of an existing audit client might also reduce the ability of an audit firm to win work from other clients.

19. In summary, given the value of a client relationship to an audit firm and the scale of the relationship-specific investment undertaken by an audit firm both in winning the client in the first place and in ensuring a high quality product, audit firms have a strong incentive to ensure their existing audit clients do not switch away. In other words competitive pressure provides a constant incentive to deliver a quality service at a reasonable price.

20. This competitive environment cannot be expected to lead to frequent tendering and switching. Indeed this would be an inefficient market outcome where the value of significant investment would be lost, and then duplicated if a new audit firm were to take over. Rather, 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.

*Dynamic competition*

21. ‘Dynamic competition’ indicates the investment strategies that audit firms make in order to win new clients in the medium- to long-term.

22. Large audit firms are under constant pressure to invest due mainly to three factors. First, the level of audit quality required to be competitive in the marketplace calls for substantial investments over time. Failure to undertake these would come at the risk of an audit firm failing to meet the needs of its clients and letting its capabilities fall behind those of its competitors. Second, there is a need to
minimise the probability of audit failure. The probability of audit failure occurring is mitigated by an experienced and competent staff that complies with risk management processes. This needs to be achieved by: development of specialist and industry knowledge; the ability to recruit, develop and retain talented professional staff; the application of consistent methodology; and the presence of highly effective quality control systems, among other factors, all of which require substantial investment. Third, audit firms need to comply with increasingly tight and demanding regulations.

23. These investments are sunk costs (that is, they cannot be recouped) and are not relationship-specific or even, in all cases, sector-specific. In other words they improve the quality of the services offered across the whole of the client base.

24. These investments improve the performance of an audit firm in the medium- to long-term and generate economies of scale and scope. Audit firms that sufficiently invested in the areas that are valued by audit clients have realised benefits generated by the economies of scale and scope and have grown their market share.

25. These factors are the key drivers of audit market structure. Economic theory predicts that in a market where clients are particularly concerned with the quality of the service, and when quality is achieved through significant sunk cost investments, the resulting market structure cannot be a fragmented one. A competitive market outcome is likely to be one with few, high quality suppliers.

26. In summary, the observed level of market concentration is a result of market forces. It is an outcome of a competitive process where firms invest to improve quality, rather than an external market feature determining the extent of competition.

**KPMG UK’s view of the CC’s Statement of Issues**

27. Whilst recognising that the four largest audit firms have a significant share and that the incidence of switching may appear relatively low, we firmly believe that:

a) the reference market is characterised by effective competition;

b) the possible adverse outcomes identified in the Issues Statement are not present;

c) the CC’s theories of harm do not hold; and

d) there are no features leading to an adverse effect on competition (AEC).

28. Thus although it is true that the largest four firms collectively have a high share of the reference market:

a) we contest the CC’s approach to barriers to entry: the size, network reach and reputations of the largest four firms reflect the continuing competition to meet the needs of clients in the reference market. They are themselves market outcomes and should not be described as barriers to entry; and

b) we believe competition is sufficiently intense as to negate the suggestion that any of the largest four firms have market power.

29. Bundling of services rarely takes places and in any case does not create barriers to entry:

a) professional rules regulate multi-service provision to audit clients, and hence the scope for bundling to occur is limited;

b) non-audit markets are themselves competitive and so there are no adverse effects on competition in those markets by any (very limited) bundling that does occur; and
the limited bundling that does occur arises for very strong efficiency reasons, as the supply of integrated multi-national audit services to multi-national clients:

- occurs in a competitive market;
- is efficient; and
- is what clients want.

30. Audit clients are informed, expert purchasers of audit services who are aware of their options and of their ability to switch, or threaten to switch. Audit clients use this to obtain high-quality provision of services and value for money from their audit firms. An unduly narrow focus on the degree of actual switching or tendering will give a misleading picture of client or customer conduct, and ultimately on the level of competition in the reference market.

31. The regulatory regime is not dominated by the largest four firms and nor do we believe the relevant authorities “protect” the largest four firms. We believe the regulatory regimes are transparent, flexible and exposed to multiple influences.

32. The conditions for tacit coordination are not met. Audits are in practice bespoke and determined after private negotiation, so whilst fees are ultimately made public, the scope and hence the value of the audit is not. Consequently the supply of statutory audit services is not susceptible to coordination.

33. The CC’s discussion of information asymmetries and conflicts of interest in its Issues Statement gives insufficient weight to the following:

a) audit clients want high-quality audit services because of the investor pressures on company boards and audit committees to have excellent governance procedures;

b) those clients tend to be governed by teams of individuals who will individually and collectively have the skills and experience necessary to assess audit quality and compare audit providers; and

c) the consequences for audit providers of “getting it wrong” in any one audit are not confined to that audit but are systemic:
   - loss of that audit client; and
   - loss of reputation among clients in that sector and then more generally.

34. Consequently audit providers are incentivised to – and do – invest in systems designed to support the excellence and independence of their people. When paragraph 55 of the CC’s Issues Statement suggests that these incentives may be vitiated by “high barriers to entry and the market power of the four largest firms”, it fails to recognise that for any audit firm the threat of loss of reputation and business – and the existence of real alternatives for its audit clients – will drive the right incentives.

35. Furthermore we firmly believe that the possible adverse outcomes discussed in the Issues Statement are not present:

a) audit quality is generally very high. This is borne out by:
   - our own quality reviews;
   - client feedback; and
   - the generality of AIU reports into KPMG UK and other members of the largest four firms.
b) prices are not generally the subject of client dissatisfaction; they are reflective of competitive pressure; and they tend to reflect the complexity of service and high quality of delivery; and

c) competition in non-audit markets is not distorted by the provision of audit services due to the operation of independence rules and competitive forces in those markets.
1. Introduction to KPMG

KPMG dates from 1870 when William Barclay Peat formed an accounting firm in London. Peats grew rapidly up to the Second World War, largely through organic growth. This is in stark contrast to the pattern of growth since the Second World War, which has been a combination of organic growth with substantial merger and acquisition activity.

This pattern was not unique to KPMG and by the 1970s the term ‘Big Eight’ became common when describing the largest of the accounting firms in the UK. Peats itself undertook multiple ‘local’ mergers outside of London in the forty years after the Second World War which led it to become one of the ‘Big Eight’.

1.1 KPMG Merger

In August 1986 KPMG was formed through the merger of Peat Marwick Mitchell International and KMG (which was a network founded by its Dutch, German and UK firms in 1979). This was followed by further mergers between large audit firm networks: shortly afterwards Ernst & Whinney merged with Arthur Young to form Ernst & Young, and Deloitte, Haskins & Sells merged with Touche Ross to form Deloitte & Touche to create the ‘Big Six’. This became the ‘Big Five’ in 1998 when Price Waterhouse merged with Coopers & Lybrand to form PwC, and then the ‘Big Four’ with the collapse of Arthur Andersen in 2001. These mergers were driven by the need to better serve the needs of clients who required global reach to align with the internationalisation of their own operations and to achieve the scale necessary to invest in global audit methodologies and IT systems.

In the 1990s, the issue of liability became far more pronounced, with the increase in litigation against audit firms. In response, KPMG UK transferred its audit business of UK-listed companies to a separately incorporated company, KPMG Audit Plc, which commenced business at the beginning of 1996.

1.2 KPMG International

KPMG is a global network of professional firms providing Audit, Tax and Advisory services. It operates in 152 countries and has 145,000 people working in member firms around the world. The independent member firms of the KPMG network are affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity. Each member firm is legally distinct from KPMG International and from other member firms. KPMG International is a non-trading vehicle through which a global strategy and common values, methodologies and standards are promoted within the network. It also undertakes certain shared services. Under agreements with KPMG International, member firms are required to comply with policies governing how they operate and how they provide services to clients.

In the financial year 2010/11, total revenues of the KPMG International network totalled $22.7bn (€16.3bn, £14.2bn) of which $10.48bn was audit, $4.69bn tax and $7.54bn advisory revenues. More than half these revenues were in or attributable to the Europe, Middle East and Africa (EMA) region ($11.66bn) and, of this €4.59bn ($6.4bn) was in KPMG Europe LLP (KPMG ELLP, see paragraph 43).

1 In this submission, the term “KPMG” refers to the whole KPMG network of firms, the terms “KPMG UK” and “we” refers to KPMG LLP, the UK KPMG firm and its subsidiaries, and the term “KPMG International” refers to the KPMG International Co-operative, the central co-coordinating entity of the KPMG network. Where in this document views or opinions are attributed to KPMG or KPMG UK, these are the views or opinions that have been agreed by the working groups or other governance organs of KPMG and KPMG UK respectively whether or not they are held by any other individual member of the KPMG network.

2 The term "merger" is used here and subsequently in describing audit market consolidation, notwithstanding that the form differs to typical corporate structures given the nature of audit firm networks. Within any individual geography, the representative member firms of the relevant networks may or may not have amalgamated, and where such amalgamation took place the legal form of that may have differed by jurisdiction.

42. KPMG UK is the largest operating subsidiary of KPMG ELLP operating just in Great Britain. KPMG’s activities in Northern Ireland form part of KPMG Ireland and KPMG Channel Islands and KPMG Isle of Man are also separate member firms. KPMG UK has 11,200 people and in 2010/11 had annual revenues of £1.707bn ($2.7bn) and operates from 22 offices in England, Scotland and Wales.

1.3 KPMG Europe LLP

43. More recently, the EU Statutory Audit Directive 2006 permitted cross-European ownership of audit firms allowing the establishment of KPMG Europe LLP (KPMG ELLP) in October 2007, at first bringing together the UK and German Firms. Since then, many other KPMG national member firms have joined Europe LLP, totalling 18 member firms as of December 2010. KPMG ELLP itself is incorporated as a UK limited liability partnership under the Limited Liability Partnerships Act 2000. KPMG ELLP is wholly owned by its members (partners) all of whom work in KPMG firms in specific countries. For regulatory or other reasons KPMG ELLP is not the legal owner of all of the operating firms in certain jurisdictions. KPMG ELLP is a cross-border professional services group; delivering audit, tax and advisory services through its operating firms. KPMG ELLP brings the advantage of a strong European entity, market and functional leadership; investment in shared services to increase value to clients; mobility for professionals and, most importantly, a seamless service to clients. The driving force was to better serve our clients taking full advantage of the EEA single market and to provide better opportunities to our people.

44. KPMG ELLP now includes: UK, Germany, Switzerland, Spain, Belgium, the Netherlands, Luxembourg, the CIS, Turkey, Norway, Saudi Arabia, Jordan and Kuwait. Other European member firms are not part of KPMG ELLP but operate within the EMA region of the KPMG International network.

1.4 KPMG ELLP Governance

45. A full description of the governance arrangements is provided in the KPMG ELLP Transparency Report.

46. KPMG UK operates under a structure headed by KPMG LLP (a UK Limited Liability Partnership, see paragraph 47) through a UK Board and UK Operating Team to deal with local statutory and operational matters. The UK Board consists of five members, the UK Senior Partner and the UK Chief Executive Officer and three additional members. More details are contained in the UK Transparency Report.

1.5 KPMG Limited Liability Partnership

47. KPMG LLP was established in 2002 following the LLP Act 2000 and Regulations 2001. LLPs bear some characteristics of both a company and an unincorporated business. KPMG LLP is registered with Companies House and an LLP structure (unlike a traditional partnership) limits the personal exposure of the partner to the fortunes of the business. This is particularly critical in a field with unlimited liability such as statutory audit. As noted above ELLP is also registered as a UK LLP.

5 Switzerland joined the ELLP in later 2007, Belgium (excluding the audit practice) and Spain joined as of October 2008, CIS (Russia, Ukraine, Kyrgyzstan, Kazakhstan, Armenia and Georgia), Turkey, The Netherlands (excluding KPMG Meijburg & Co.) and Luxembourg joined as of October 2009 and Norway and Saudi Arabia finally joined as of November 2010 ([http://www.kpmg.com/be/en/whoweare/pages/kpmg-ellp-history.aspx](http://www.kpmg.com/be/en/whoweare/pages/kpmg-ellp-history.aspx)).
8 Commonwealth of Independent States includes Russia, Ukraine, Armenia, Georgia, Kazakhstan, Kyrgyzstan and Azerbaijan.
9 Jordan joined KPMG ELLP in December 2011.
KPMG Audit Plc is registered as a public limited company (see paragraph 39 above) and is wholly owned by KPMG LLP.

1.6 KPMG in the UK

48. KPMG UK provides the full range of services provided by KPMG internationally, organised into the following five lines of business:

(i) Audit: audit, audit-related and assurance services;
(ii) Tax: taxation and people related (such as pensions) services;
(iii) Transaction and Restructuring (“T&R”): transaction services (such as due diligence and corporate advisory services) and restructuring (including liquidations and receiverships);
(iv) Risk Consulting: including advice on the management of fraud, IT and other business risks; and
(v) Management Consulting: including advice on business process and performance improvement.

49. The full range of services is available on our website.

50. In 2011 relevant metrics were:

Table 1. 2011 KPMG UK sales and contribution by function

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<th>Audit</th>
<th>Tax</th>
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Source: KPMG data

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Part A: Background on the provision of audit services

2. Statutory and regulatory background

Summary

This section sets out the regulatory framework and demonstrates how it ensures the necessary attributes required for the provision of audits (and market confidence); namely: independence, quality, scepticism, professional judgment and objectivity. The rules and standards are set either by elected governmental bodies or by regulatory bodies after public consultation. Accounting firms have advocated less, rather than more, regulatory complexity.

The section also discusses the regulation of non-audit services and the restrictions on a firm’s ability to, for example, tie or bundle the provision of these services to audit services, before briefly touching on the proposed regulatory changes being contemplated in Europe.

2.1 Introduction

51. The provision of statutory audit services is subject to extensive legislative and regulatory requirements. In our view these legislative and regulatory requirements have been progressively strengthened over the last 10 to 15 years, in particular following the Enron scandal in 2002 – 2003. This has meant that audit firms have to put in more effort not only to produce a high quality audit, but importantly to demonstrate to the regulator, in a transparent manner, that this has been achieved. Legislative and regulatory requirements include those relating to:

a) the scope of audits;

b) how they are conducted and what is required to be reported;

c) the qualifications required to conduct an audit; and

d) limitations on audit-related and non-audit services an audit firm may provide to its audit clients.

52. In relation to the audit of listed companies (and other Public Interest Entities13), higher standards are applied (either as a result of regulatory requirements or the voluntary application of standards / codes).

53. These requirements are designed to ensure that audits are carried out:

a) objectively;

b) exercising professional judgment and with professional scepticism;

c) by appropriately qualified persons; and

d) independently from the audited entity.

54. These themes run through all facets of the regulation of the audit profession in the UK, Europe, and elsewhere.

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13 Public interest entities means entities that are of significant public relevance because of the nature of their business, their size or their number of employees, in particular companies whose securities are admitted to trading on a regulated market, banks and other financial institutions and insurance undertakings.
This section sets out the relevant legal and regulatory frameworks, and the key bodies relevant to the supply of statutory audit services to large UK companies. It also outlines the regulatory framework surrounding the provision of audit-related and non-audit services by audit firms.

2.2 Legal requirements for an audit

The basic requirements for the scope, conduct and content of an audit of a company incorporated in a Member State of the European Union are set out in the 8th Company Law Directive¹⁴ ("the Directive") and in UK company law.¹⁵ The Directive sets out the legal framework, and requires Member States to put in place measures to ensure that statutory audits are carried out only by suitably qualified persons who are subject to a system of quality assurance and independent from the company being audited. It also requires the use of international standards on auditing (ISAs) adopted by the EC¹⁶.

In the UK, the Companies Act 2006¹⁷ requires an audit firm to:

a) make a report to the company’s members that must state clearly whether, in the auditor’s opinion, the financial statements give a “true and fair view” of the financial position of the company and have been prepared in accordance with the relevant reporting requirements¹⁸, the requirements of the Companies Act and the IAS Regulation¹⁹ (where applicable²⁰); and

b) report on the Director’s Report²¹ and, in relation to listed companies, the auditable part of the Remuneration Report²² and the Corporate Governance Statement (if such a separate statement is prepared)²³.

At the conclusion of the audit process, the audit firm is required to provide an opinion on the financial statements which is either (a) unqualified, (b) qualified or (c) unqualified, but with emphasis on certain matters to which the audit firm wishes to draw attention²⁴.

The audit opinion, by necessity, involves the exercise of considerable professional judgment by the auditor, based on the adequacy of the evidence required to support their opinion.

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¹⁴ 2006/43/EC.

¹⁵ The key provisions as they relate to large UK public companies are contained in Part 16 and Part 42 of the Companies Act 2006. Rules which govern the audit of UK-listed companies are also contained in the Financial Services and Markets Act 2000 ("FSMA") and the Financial Services Authority’s Listing Rules.

¹⁶ The EC has yet to officially adopt any international auditing standards and as such Member States are free to apply national auditing standards.

¹⁷ Section 495.

¹⁸ The report will identify the relevant financial reporting framework – Companies Act 2006, s495(2)(a).


²⁰ Under Article 4 of the IAS Regulation, consolidated group accounts of UK companies must be prepared in accordance with IFRS, as adopted by the EU, where their securities are admitted to trading on a regulated market in any EU member state.

²¹ Companies Act, s.496.

²² Companies Act, s.497.

²³ Companies Act, s.497A.

²⁴ Companies Act 2006, s495(4). See also Companies Act 2006 s498 for duties of auditor to, for example, state where adequate accounting records have not been kept or where the auditable part of the directors’ remuneration report is not in agreement with the accounting records and returns in his report.
2.3 The regulatory framework

2.3.1 Relevant regulatory bodies

Financial Reporting Council

60. The FRC is the UK’s key corporate governance and reporting regulator and, through various operating bodies, is responsible for setting and enforcing standards in the UK audit profession. The key FRC bodies in relation to audit and the audit profession are the Auditing Practice Board (APB) and the Professional Oversight Board (POB), which includes the Audit Inspection Unit (AIU).

61. The APB is responsible for setting UK national auditing standards and also the Ethical Standards (ESs) for auditors (see paragraph 66 below). The board of the APB is made up of members of the audit community, with 40 per cent being ‘responsible individuals’ (persons eligible for appointment as a company auditor). Any of the remaining 60 per cent who are accountants shall not be office holders of any accounting firm, nor involved in the governance of an accounting firm, nor a partner in a firm eligible to conduct audits.

62. The POB is responsible for the independent oversight of the regulation of the auditing profession, and the monitoring of the quality of audits of listed and large private UK companies (via the AIU). The AIU conducts extensive reviews of policies and procedures and samples of audits carried out by firms which audit major companies (both annually the largest four firms and slightly less frequently for other firms). It publishes reports on the outcomes of these reviews, both overall reports for the profession or sections thereof and for the nine largest audit firms in the UK separately.

Responsible Statutory Bodies (RSBs)

63. The European 8th Directive mandates the establishment of competent authorities in each Member State to regulate both audit firms and individual auditors. The key RSBs in the UK are the Institute of Chartered Accountants of England and Wales (ICAEW) and the Institute of Chartered Accountants of Scotland – the ICAEW being the RSB with whom the major UK audit firms are registered. The ICAEW, for example, has various roles – from granting professional qualifications, to producing guidance on technical and practice issues and personal development programmes. It has an important role in terms of audit quality assurance, with firms being monitored through an annual return and a review visit from the Quality Assurance Department, whereby a sample of audits outside the scope of the AIU is reviewed. RSBs also provide ethical guidance, for example via the ICAEW Code of Ethics (which effectively incorporates the APB’s ethical standards for auditors but is also of wider application for example to non-audit services and to members not in professional practice). This code is itself based on the IFAC Code of Ethics, since adherence to the latter is a condition of the ICAEW’s membership of IFAC.

Overseas regulatory authorities

64. A number of UK incorporated companies are listed in the US (often, but not necessarily, in conjunction with a UK listing) and hence are subject to the rules of the US Securities and Exchange Commission (SEC); in addition auditors of such companies must be registered with and subject to regulation and inspection by the US Public Company Accounting Oversight Board (PCAOB).

65. A listing of a company in another jurisdiction outside the European Union may also require the related audit firm to be registered with the relevant national authority; to date (apart from the US) this has given rise to little if any additional regulatory impact.
2.3.2 Standard setting

66. Standard setting affecting the provision of audit services to large listed entities in the UK falls essentially into the following categories:

a) accounting standards;
b) auditing standards; and
c) ethical standards.

67. The accounting standards which must be used by listed entities in preparing consolidated accounts are the International Financial Reporting Standards (IFRS), which are issued by the International Accounting Standards Board (IASB) and, after an endorsement process, adopted by the EU (see below at paragraph 72). Whilst there are a few listed entities which are not groups and hence can follow UK GAAP as set by the UK Accounting Standards Board (ASB), the ASB has a policy of aligning UK GAAP with IFRS wherever it makes sense to do so. In addition in its consultation on the future of UK GAAP the ASB is proposing that larger listed entities preparing individual accounts should also be obliged to follow IFRS.

68. Auditing standards and ethical standards are set by the UK Auditing Practices Board (APB), but their policy is to follow in large part the same standards issued by the International Auditing and Assurance Standards Board (IAASB) and International Ethics Standards Board for Accountants (IESBA). We have therefore also focussed on these international standards.

International standard-setting

69. The international bodies have gone through various reforms over the years, but one major push has been to diminish the influence of audit practitioners (including those from the largest four firms) and increase the “public interest” influence. This is particularly true for auditing and ethics after 2005 when the Public Interest Oversight Board was formed to oversee standard setting in these areas. The PIOB comprises 10 members largely with a regulatory background including for example Sir Bryan Nicholson from the UK who was formerly Chair of the FRC. In addition each of the IAASB and IESBA has a Consultative Advisory Group whose role includes input into the technical detail of standards; the IAASB CAG comprises 29 members including institutional investor groups and bodies such as the European Commission; the IESBA CAG has 19 members from similar backgrounds and includes the UK APB.

70. The IAASB comprises 18 members of which five (four of which are from the largest four firms) were until recently nominated by the Forum of Firms. In addition one other member is from a largest four firms firm. Auditing standards approved by the IAASB are considered in a public meeting following a formal open public consultation process.

71. The IESBA also comprises 18 members with five (of which four are members of the largest four firms) who were until recently nominated by the Forum of Firms. In addition another two members are from the largest four firms. Ethical standards approved by the IESBA are considered following a formal open public consultation process.

25 The Forum of Firms is an association (currently with 24 members) which is open to any international accounting networks or firms of any size which agree to meet the membership criteria being to: maintain quality control standards in accordance with the International Standard on Quality Control (ISQC 1) issued by the IAASB in addition to relevant national quality control standards; conduct, to the extent not prohibited by national regulation, regular globally coordinated internal quality assurance reviews; have policies and methodologies for the conduct of transnational audits that are based, to the extent practicable, on the International Standards on Auditing (ISAs) issued by the IAASB; and have policies and methodologies that conform to the IESBA Code of Ethics for Professional Accountants and national codes of ethics.
The IASB as constituted today has 15 members and contains no practising partners from the largest four firms and only three members who joined directly from one of the largest four firms; there are four other members who worked for one of the largest four firms’ networks at an earlier stage of their career. Members are appointed by the Trustees after an open process of advertising vacancies; the Trustees’ background is typically securities regulation or the accounting professional bodies. In addition there is a Monitoring Board which comprises public authorities. All standards approved by the IASB are considered in a public meeting, following a formal open public consultation process and the Board’s meetings are held in public. Furthermore IFRS must also be adopted for use in the EU. That process involves a technical assessment (again following public consultation) by the Technical Expert Group of EFRAG which meets in public and currently has 12 voting members of which five are or have recently been partners of one of the largest four firms. In addition the EC then has to propose adoption for formal approval both by Member States (in the Accounting Regulatory Committee) and the European Parliament.

Standard setting in the UK

The process for introducing new auditing and ethical standards and revising existing ones is an open and consultative process: proposals must be approved by the majority of APB members who are eligible to vote (ie not simply those present at the meeting to take the decision). Once approved, the APB will publicly consult on the proposed new/amended standard, seeking input from members of the audit profession. Consultation documents are typically not lengthy and the consultation period is normally quite long (six months), allowing ample time for interested parties to make submissions. Responses to the consultation drafts are published on the APB’s website and final standards similarly require approval of a majority of APB members.

Major amendments were recently made to international auditing standards to clarify them and make them more understandable. The project, entitled ‘Project Clarity’, commenced in 2004 and was led by the IAASB. These amendments were subsequently taken into account by the APB and in 2009 new International Standards for Auditors (UK & Ireland) (ISAs (UK&I)) were approved after a period of public consultation. These were widely accepted by members of the auditing industry, from the largest four firms to smaller auditing firms and industry and regulatory bodies.

The ISAs (UK&I) are a comprehensive set of standards with which auditors of UK companies must comply. They cover all aspects of the conduct of an audit from requirements for audit firm independence and objectivity, to the planning of an audit, the conduct of an audit and the review of audit quality. The key themes running through each and every ISA are independence, objectivity, scepticism and professional judgment, and each standard is designed to ensure that audits are conducted in a manner in which these are promoted.

Ethical Standards for Auditors are published by the APB and contain basic principles and essential procedures together with related guidance in the form of explanatory and other material. They cover the integrity, objectivity and independence of auditors and apply in the audit of financial statements.

Other Regulations

In addition, the audit of UK incorporated companies is governed by a number of other regulations. The key instruments are outlined below.

Audit Regulations
78. The Companies Act 2006 requires RSBs such as the ICAEW to develop and maintain rules and practices relating to matters such as eligibility and competence. The Audit Regulations prescribe requirements for qualifications needed to be an auditor, continued practice and conduct of audits, and require that registered auditors monitor how effectively they are complying with these regulations. The Companies Act 2006 provides that the rules relating to the conduct of audit work have to be written by an independent body, therefore chapter 3 of the Audit Regulations requires compliance with the auditing, quality control and ethical standards of the APB.

**Audit Firm Governance Code**

79. In January 2010 the FRC and ICAEW published the Audit Firm Governance Code (the Code), which applies to eight firms that audit more than 20 listed companies, and is intended to promote good governance. The FRC intended that the Code be used to enhance choice in the market for the audit of listed companies, and to reduce the risk of a firm leaving the large company audit sector due to a loss of public trust in it. The FRC has listed four intended roles for the Code:

a) enhance the stature of firms as highly visible exemplars of best practice governance;

b) enrich firms’ transparency reports;

c) encourage changes in governance which improve the way that firms are run; and

d) strengthen the regulatory regime by achieving transparent and effective governance without disproportionate regulation.

80. The Audit Firm Governance Code has been adopted by KPMG ELLP. In addition, audit firms who are members of the Forum of Firms have adopted the standards outlined above for their international work. KPMG member firms have also adopted these standards for domestic work to the extent they exceed local standards.

2.4 The audit

2.4.1 Who can audit

81. The Companies Act 2006 provides that an individual or firm is only eligible for appointment as a statutory auditor of a UK incorporated company if the individual or firm:

a) is a member of an RSB (see above at paragraph 63), and

b) is eligible for appointment under the rules of that body.

82. Auditors must hold a recognised professional qualification awarded by a Recognised Qualifying Body (RQB) – an audit qualification. Statutory auditors can only accept appointment as auditors in accordance with the rules of an RSB – such rules mean that in practice an individual cannot accept audit appointments unless the firm in which the individual works is also a registered auditor.

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27 For details see Companies Act 2006, Schedule 10.

28 Current version effective from 1 January 2012. These regulations apply to ICAEW, the Institute of Chartered Accountants in Ireland and the Institute of Chartered Accountants in Scotland.

29 Baker Tilley, BDO, Deloitte, Ernst & Young, Grant Thornton, KPMG, PKF and PricewaterhouseCoopers.


83. Regard must also be had to the engagement provisions in the Companies Act 2006\textsuperscript{32}, ESs and ISAs (UK&I). When considering an audit engagement, independence is a key consideration. This is enshrined in ES 3 (Revised), for example, which provides that when auditing listed companies no person shall act as an audit engagement partner for any one audit client for more than five years, and anyone who has held this role for five years cannot participate in the audit engagement for a further five years.

2.4.2 The conduct of an audit

84. The ISAs (UK&I) contain objectives, requirements and application material which are designed to assist the auditor in obtaining ‘reasonable assurance’ as to whether the financial statements as a whole are free from material misstatement, whether due to fraud or error.

85. ‘Reasonable assurance’ is obtained when the auditor has obtained sufficient appropriate audit evidence to reduce audit risk (that is, the risk that the auditor expresses an inappropriate opinion \textit{when} the financial statements are materially misstated) to an acceptably low level. The concept of ‘materiality’ is applied by the auditor in planning and performing the audit, and determining materiality involves the constant deployment of professional judgment\textsuperscript{33}.

86. To this end, the ISAs (UK&I) require auditors to exercise professional judgment and maintain professional scepticism at all times in the conduct of an audit\textsuperscript{34}.

2.4.3 The audit opinion

87. The audit process culminates in the audit engagement partner providing an ‘opinion’. An unqualified opinion is expressed when the auditor is able to conclude that the financial statements comply with the applicable financial reporting framework (including applicable law) and give a true and fair view of the financial position of the audited entity.

88. The vast majority of audit opinions given, in relation to all sizes of UK companies but particularly for listed companies, are unqualified. Nevertheless, there may be instances where the auditor feels they cannot provide an unqualified opinion. ISA (UK&I) 705 deals with ‘modifications’ to the opinion, defining a modified opinion as “a qualified opinion, an adverse opinion or a disclaimer of opinion”.

89. An auditor expresses a modified opinion where:

\begin{itemize}
  \item[a)] the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or
  \item[b)] the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.
\end{itemize}

90. The auditor then makes a judgment as to whether these misstatements are material and pervasive. The table below taken from ISA (UK&I) 705 illustrates how the auditor’s judgment about the nature of the matter gives rise to the modification, and the pervasiveness of its effects or possible effects on the financial statements, affects the type of opinion to be expressed:

\begin{table}[h]
\centering
\caption{Types of modified opinions}
\begin{tabular}{|l|l|}
\hline
\textbf{Type of Modified Opinion} & \textbf{Description} \\
\hline
Qualified Opinion & The auditor concludes that the financial statements are not free from material misstatement, but the misstatements are not pervasive. \\
\hline
Adverse Opinion & The auditor concludes that the financial statements are not free from material misstatement, and the misstatements are pervasive. \\
\hline
 Disclaimer of Opinion & The auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements are free from material misstatement. \\
\hline
\end{tabular}
\end{table}

\textsuperscript{32} See, for example, s. 489 on the appointment of auditors by the board of directors and s.1214 on the independence requirement.

\textsuperscript{33} See ISA (UK&I) 320 on materiality in planning and performing an audit.

\textsuperscript{34} ISA (UK&I) 200 at 7.
<table>
<thead>
<tr>
<th>Nature of Matter Giving Rise to the Modification</th>
<th>Auditor’s Judgment about the Pervasiveness of the Effects or Possible Effects on the Financial Statements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial statements are materially misstated</td>
<td>Material but Not Pervasive</td>
</tr>
<tr>
<td>Inability to obtain sufficient appropriate audit evidence</td>
<td>Qualified opinion</td>
</tr>
<tr>
<td></td>
<td>Qualified opinion</td>
</tr>
</tbody>
</table>

91. In certain circumstances an auditor’s report includes an ‘emphasis of matter paragraph’ to highlight a matter affecting the financial statements that, in the auditor’s judgment, is fundamental to users’ understanding of the financial statements. This does not qualify the auditor’s opinion. 35

92. The provision of an audit opinion requires extensive knowledge of the company being audited, its unique circumstances and the industry and environment in which it operates. 36 Most importantly, it requires judgment and skill which can only be gained through many years of experience, and can only be properly exercised where the audit engagement partner has access to sufficient resources and technical support (in the UK as well as in the other key overseas locations in which the company operates), the likes of which only a limited number of firms possess.

### 2.4.4 Quality control

93. In addition to the external quality reviews by bodies such as the ICAEW and the AIU, as described above, ISQC (UK&I) 1 and ISA (UK&I) 220 require audit firms to establish quality control systems to ensure audit quality. These include systems to ensure that audits are conducted independently and ethically, audit staff are appropriately trained and equipped, and that any identified deficiencies with the firm’s processes are remedied. These systems are assessed annually by the AIU.

94. The various quality control measures taken within KPMG are described in section 5.1.7.

### 2.5 Supply of non-audit services to audit clients: independence principles

95. Aside from the statutory audit itself, audit firms frequently provide additional services to clients that, while not all required by law, are valued by clients, as discussed below. Audit-related services are permitted, because the risk to auditor independence is “clearly insignificant”. 37

96. The provision of an audit requires the auditor to remain independent from the audited entity, remain objective and exercise professional scepticism and judgment. Where an audit firm also provides non-audit services, this independence can be compromised and hence there are a number of restrictions which affect the market for such services.

97. Since the collapse of Enron and the associated collapse of Arthur Andersen in 2002, there has been increased scrutiny on audit firms providing non-audit services to clients, including in the UK (despite the Arthur Andersen collapse being unrelated to the operations or independence of its UK

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35 If the auditor considers it necessary to communicate a matter other than those that are presented or disclosed in the financial statements that, in the auditor’s judgment is relevant to users’ understanding of the audit, the auditor’s responsibility or the auditor’s report, the auditor does so in a paragraph in the auditor’s report with the heading “Other Matter”.

36 ISA (UK&I) 315, sets out requirements for identifying and assessing risks of material misstatements through understanding the entity and its environment.

37 ES 5 (Revised), para 54.
practice). In 2004 the APB published its Ethical Standards, with particular attention given to non-audit services.

98. These have been subject to periodic revision. For example, in 2009 the Treasury Select Committee called for a ban on the sale of all non-audit services by audit firms. There was widespread rejection of the idea by stakeholders, however, and the FRC/APB decided not to recommend such a ban after a public consultation. The APB Review recognised the efficiencies which can be generated for companies by having certain non-audit services provided by the audit firm, due to auditors already knowing the company well – resulting in cost, quality and consistency benefits, which in turn benefit shareholders. In addition, audit firms argued that providing non-audit services allowed them to obtain insights which were then useful in an audit context and aided them in recruiting more highly skilled individuals.

99. The APB concluded that the environment in which non-audit services are offered protects an auditor’s independence, and therefore that there should be no outright prohibition and no major change in the conceptual approach taken to the provision of non-audit services. However, the transparency and governance requirements in the APB Ethical Standards for Auditors were further strengthened as a result of the review to improve transparency and information flows, and amendments were made to clarify the non-audit provisions in the Ethical Standards. For example, a list of audit-related services was added.

100. In the context of the provision of non-audit services, the principal threats to auditor independence are:

a) self-interest – where substantial fees are generated from the provision of non-audit services, the level of fees may suggest a loss of independence;

b) self-review – where the results of a non-audit service provided by the audit firm are reflected in the financial statements;

c) management – where work is undertaken which is properly the responsibility of management, which may align the interests and views of the auditor and audited entity; and

d) advocacy – where the auditor undertakes work to support a position taken by the audited entity, which can align the interests of the auditor and audited entity.

101. In addition to the above, threats of familiarity and intimidation may also impact on auditor independence, although these are less relevant in the context of the provision of non-audit services.

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38 These have continued to evolve over time, and a number of updates have been issued since this time.
39 The Select Committee concluded “We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity.”
40 For consultation see: APB consultation paper, “Consultation on audit firms providing non-audit services to listed companies that they audit”, 6 October 2009; APB consultation paper, “The provision of non-audit services by auditors: feedback on previous consultation and Consultation paper on revised draft Ethical Standards for Auditors”, July 2010; and APB feedback paper, “The provision of non-audit services by auditors: feedback on July 2010 consultation”, December 2010.
41 This point has been made by audit firms, of all sizes, not just in relation to the APB/FRC enquiries but frequently in relation to the supply of non-audit services to audit clients.
42 Under ES 4 (Revised) the audit engagement partner shall ensure that audit fees are not influenced or determined by the provision of non-audit services to the audited entity. Where it is expected that the total fees for both audit and non-audit services receivable from a listed audited entity and its subsidiaries will regularly exceed 10 per cent of the annual fee income of the audit firm, the firm shall not act as auditor. Under ES 5, in relation to listed companies, where fees for non-audit are expected to be greater than those for non-audit services for a financial year, the audit engagement partner must provide details to the Ethics Partner.
There is an outright ban on the provision of some non-audit services where the risk to auditor independence cannot be reduced to acceptable levels. For example, internal audit services where it is reasonably foreseeable that reliance would be placed on these statements by the external auditor are prohibited, as are recruitment services in relation to key personnel.

For services which are not specifically prohibited, the APB has adopted a ‘risks and safeguards’ approach to ensuring that auditor independence is maintained. This recognizes that, in some circumstances, it will be possible to put in place safeguards to ensure that these risks are eliminated or reduced to an acceptable level. For example, it may be possible to eliminate risk where services are provided from a separate team from the audit engagement team. Where it is not possible to reduce risk to an acceptable level, the audit firm must either refuse the non-audit engagement or withdraw from the audit engagement.

It is important that not only actual threats to independence are avoided, but that the perception of threats to independence are avoided, as shown by the response to the recent APB consultation which called for improved transparency and information flows. Details of non-audit fees are also required to be disclosed in annual reports.

UK Audit firms can also be subject to the independence rules in other jurisdictions, which can further limit the extent to which they can provide non-audit services. For example, where a company has a US listing, its audit firm will need to comply with the (more stringent) requirements of the SEC’s and PCAOB’s requirements.

2.6 Current proposals for change

The European Commission has published proposals to reform the audit sector in response to the financial crisis, aimed at introducing even more stringent requirements on auditors, such as reinforcing independence and scepticism requirements, and enhancing international cooperation for the statutory audit of public-interest entities, such as banks, insurance companies and listed companies. Yet further regulation is being promoted as a way to enhance audit quality.

Specific proposals include: mandatory auditor rotation; a prohibition on auditors providing non-audit services to audit clients; increased publicity of information in audits; and large audit firms being required to create ‘pure’ audit firms, ie complete separation of audit from consultancy firms. It is unclear at this stage which, if any, of the proposals will finally be adopted and hence what impact they might have on the market for either audit or non-audit services.

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43 ES5, para. 63.
44 ES5, para. 117.
45 For example see APB, “Feedback on July 2010 Consultation paper on Revised Draft Ethical Standards for Auditors”, December 2010, section 3.
46 Companies (Disclosure of Auditor Remuneration and Liability Limitation Agreements) Regulations 2008 (as amended in 2011), which promote auditor accountability to shareholders and to the market, and also ensures a form of public review of the level of non-audit work done by audit firms for audit client.
3. Nature of services provided by audit firms

Summary

This section provides an overview of services provided by audit firms; namely, statutory audit services, audit-related services and other non-audit services. It outlines the limits on the provision of audit-related and non-audit services to audit clients, before describing the delivery of a statutory audit step by step.

108. This section sets out the dimensions of statutory audit services. In particular it describes what services and products a customer receives as part of its statutory audit, the process that is followed to deliver a statutory audit and the audit engagement team. Taken with the descriptions of clients in the reference market and what is needed to meet their requirements (developed in sections 4 and 5) this will demonstrate the drivers of audit complexity and the specialist skills required to perform complex audits.

3.1 Introduction to statutory audit, audit-related and other non-audit services

109. A statutory audit is the provision of an independent view on whether a company’s financial statements present a true and fair view of its financial position at a specified date and of its results and cash flows for the period ended on that date, in accordance with a specified accounting framework. This independent view on the company’s financial statements is addressed to and for the benefit of the shareholders as a body (as opposed to individually), and is delivered via the issuance of a public ‘audit opinion’. For listed companies in the UK, the audit firm is also required to report certain other matters (some on an exception basis) specified by company law, auditing standards or listing rules in the audit opinion.

110. This audit is in relation to the opinion on the entity’s stand alone (and, where applicable, consolidated) accounts. The audit firm is required to exercise judgment when determining the scope of work necessary in order to render the audit opinion. There are likely to be many considerations in defining the scope the audit firm judges necessary, and this will take account of the views of management and the audit committee to the extent they want to increase it.

111. For listed companies, the audit committee is responsible for recommending the appointment of a statutory auditor. If the company’s board does not accept the audit committee’s recommendation, it is required to include in the annual report, and in any papers recommending appointment or reappointment, a statement from the audit committee explaining its recommendation and should set out reasons why the board has taken a different position. This is subject to approval by shareholders. The scope of the work and conduct of the audit are then overseen by the audit client’s audit committee.

112. The delivery of the audit opinion requires a detailed understanding of a company’s business procedures. The statutory auditor will also often provide a report to management providing advice on a number of possible issues, using the experience it has gained in understanding the company’s processes and procedures as a result of conducting the audit work for the audit opinion.
3.1.1 Categorisation of services provided by an audit firm

113. Ethical Standards published by the APB categorise the services provided by an audit firm⁴⁷.  

a) Audit – work that is undertaken by the auditor to enable him or her to express an independent audit opinion on an entity’s financial statements⁴⁸;  

b) Non-audit services – services other than the audit of financial statements of the audited entity⁴⁹; and  

c) Audit-related services – a sub-set of non-audit services that are largely carried out by members of the audit engagement team and where the work involved is closely related to the work performed in the audit⁵⁰.

3.1.2 Audit services

114. In relation to audit services, ES 5 is explicit that this category does not include other work undertaken by the audit engagement team at the request of management or those charged with governance unless it is clear that the predominant rationale for the performance of the work is to enable a soundly based audit opinion on the financial statements to be expressed⁵¹.

115. Audit clients have high expectations as to i) the quality of the audit work undertaken; and ii) the insights that the external auditor may be able to provide as a by-product of the discharge of its duty to issue an opinion, as a result of the extensive work undertaken at numerous of the audit client’s operating locations.

116. In regard to ii), our ‘Audit Insights’ resource provides a basis for audit teams to deliver valuable insight to their client’s management and audit committee based on observations derived from fieldwork undertaken for the purpose of the audit. The resource enables audit teams to combine the depth of understanding generated by their audit with the breadth of expert knowledge that exists across KPMG. [redacted]

117. Elements of this reporting may be required by Auditing Standards (for example audit risk assessments) whilst other elements ([redacted]) would not be covered by a specific reporting requirement – these elements would only be used where the audit fieldwork had identified a specific issue that might be of interest to the client.

118. It is important to understand that this reporting is a by-product of the audit rather than a specific investigation of a particular subject. For example, the fact that the auditor may identify control issues, process inefficiencies or [redacted] would reflect simply those matters which the auditor had identified during its audit work. This may be significantly less extensive than those matters which might have been identified had the audit firm been commissioned to undertake a specific review of the controls, process efficiency [redacted] as an exercise separate to the audit.

3.1.3 Audit-related services

⁴⁷ APB Ethical Standard 5 (Revised) - Non-audit services provided to audited entities (published December 2011) (ES5).

⁴⁸ ES5, para 6.

⁴⁹ ES5, para 12.

⁵⁰ ES5, para 54.

⁵¹ ES5, para 9.
119. ES5 elaborates on audit-related services\(^\text{52}\) as:

- reporting required by law or regulation to be provided by the auditor;
- reviews of interim financial information;
- reporting on regulatory returns;
- reporting to a regulator on client assets;
- reporting on government grants;
- reporting on internal financial controls, when required by law or regulation; and
- extended audit work that is authorized by those charged with governance performed on financial information and/or financial controls where this work is integrated with the audit work and is performed on the same principle terms and conditions.

120. Many of the audit-related services, to the extent the services are required, would need to be provided by the external auditor under regulation. The requirement for certain of the above services to be performed will be known at the outset of any audit relationship based on the circumstances and practice of the audit client. For example, where a company has a US listing and is required to comply with the provisions of the US Sarbanes-Oxley Act, the auditor is required by the PCAOB’s auditing standards to issue an opinion thereon. Similarly certain regulatory reporting would be required from the auditor.

121. Other audit-related service would as a matter of practice almost always be provided by the external auditor (principally on the grounds of efficiency, given the overlap of activities with those of the statutory audit) wherever a client requires them. This would include for example reporting in relation to client assets and money for financial institutions subject to the relevant aspects of the UK’s Financial Services Authority requirements. Again, the requirement for certain of the above services to be performed will be known at the outset of any audit relationship based on the circumstances and practice of the audit client. For example, some audit-related services need to be undertaken by the external auditor if a client chooses to have such a service provided at all – for example a review of interim financial information. Whilst listed companies are required to publish such financial information, there is no requirement for this to be reviewed, although it is common practice for a review to be undertaken – in which case this review would be undertaken by the external auditor.

122. A slightly different scenario is relevant to extended audit work ((g) in the list in paragraph 119). In this case there would be no regulatory requirement for the external auditor to undertake this work, and whether it is most efficient for the external audit to provide them depends on the particular circumstances at a particular client. However, there are often clear cost advantages to them being provided by the audit firm, given the efficiency that the audit firm can offer by undertaking work in conjunction with its external audit work. Were the client, for example, to have these services provided independently (either in-house or through another external service provider), this could involve significant incremental costs (unnecessary duplication of work, travel and subsistence in visiting locations etc, especially given the geographic diversity of many large clients) which might be avoided through the use of the external audit firm.

123. In all of these cases, the recurring nature of the audit-related services and the integration of the underlying work with the work supporting the audit opinion, means that the fees in relation to such services may be negotiated in conjunction with the audit fee. For example an overall figure is often agreed for the totality of the work.

\(^{52}\) ES5, para 55.
124. The scope and fee of other audit-related services that are not necessarily recurring or predictable, such as reporting in relation to Prospectuses (for example in relation to IPOs or debt offerings) or government grants, would not be negotiated in conjunction with the scope and fee of the audit. Rather, fees in relation to any of this work would be the subject of a separate agreement from the audit fee and would not be conditional on the audit fee (or vice versa).

3.1.4 Other non-audit services

125. An illustration of other non-audit services (i.e., non-audit services that are not audit-related services) is also provided in the APB’s Ethical Standards:

a) other assurance services;
b) tax compliance services;
c) tax advisory services;
d) internal audit services;
e) services related to corporate finance transactions; and
f) other.

126. The scope and fee of other non-audit services are negotiated and contracted for entirely independently from the negotiation of the annual audit agreement. Indeed the Ethical Standards explicitly provide that the audit engagement partner shall ensure that audit fees are not influenced or determined by the provision of non-audit services.

3.2 The stages in the delivery of an audit service

127. A company’s annual statutory audit requires the same very broad stages each year in order to deliver the audit opinion. The main stages of an audit may be summarised as:

a) client/engagement acceptance and continuance;
b) planning and risk assessment;
c) testing; and

d) completion and reporting.

3.2.1 Client and engagement acceptance and continuance

128. This stage involves an assessment of the risk and value to the audit firm of association with the client (client acceptance) and undertaking the particular engagement (engagement acceptance). For a new client, this will require an assessment of the risk associated with accepting that client, its management and its shareholders (for example due to the client’s reputation, its industry or the jurisdiction(s) where it operates). In practice, client and engagement acceptance tend to occur simultaneously and engagement acceptance in the case of an audit would include, among other things:

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53 APB Ethical Standard 1 (Revised) - Integrity, objectivity and independence (published December 2011) (ES1), Appendix.
54 APB Ethical Standard 4 (Revised) – Fees, remuneration and evaluation policies, litigation, gifts and hospitality (published December 2010) (ES4), paragraph 7.
55 What follows is based on KPMG’s experience in performing statutory audits. KPMG assumes the process followed by other audit firms is similar.
consideration of whether the audit firm has sufficient skilled resource in the appropriate locations and whether that resource is available, in the light of other commitments;

b) factors which might limit the ability of the audit firm to be able to undertake the audit effectively; and

c) if applicable, whether there are any circumstances which might mean that the audit firm is not sufficiently independent from the audit client to comply with the APB’s Ethical Standards.

3.2.2 Planning and risk assessment

129. This stage involves the planning of the statutory audit work required in more detail, and identifying the risks involved in undertaking the audit. The audit firm will seek a more detailed understanding of the client’s business in order to conduct a risk assessment, put in place the audit strategy and approach, and ultimately create a detailed plan for the delivery of the work. These plans will include the involvement of specialists, other experts, internal audit teams and service organisations.

130. While relatively straightforward for simpler entities, particularly stand-alone entities, these steps can be highly complex for large diversified multinational groups. We discuss the drivers of audit complexity further in section 4.

3.2.3 Testing

131. At this stage the actual audit of the audit client’s accounts is conducted. It largely consists of “field work” performed at the client’s site or sites, and involves testing controls and examining individual items or transactions wherever there is a risk that the figures appearing in the financial statements could be materially misstated.

132. While on smaller audits it can be efficient to examine a relatively large proportion of items and transactions, this is not practicable for larger entities which will have many hundreds of thousands, or millions of transactions subject to audit. An examination only of individual items leaves the auditor with evidence only about the items that had been tested (and not those which had not been tested), and thereby does not provide enough information to allow the audit firm to reach an independent true and fair view. Instead, for large audit clients the bulk of the audit effort is directed towards identifying how the entity ensures that nothing can go materially wrong as a result of fraud or error. This is done by examining how the client checks and controls its financial affairs. For large companies testing therefore focuses on establishing that the entity’s systems and controls have functioned as intended throughout the period being audited, as well as performing a number of tests of individual, more significant items. As well as being a significant volume of work, this process involves a high degree of judgment (as to whether sufficient work has been done), which in turn requires experience and a thorough understanding of the client and its operating environment.

3.2.4 Completion and reporting

133. At the end of the testing stage, the audit firm checks that the assessments and judgments made at the beginning of that stage are still valid.

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56 In addition to consideration of non-audit services provided historically or underway, this would also involve consideration, among other things, of former audit firm staff employed by the audit client (or vice versa) and business relationships between the audit firm and the audit client.

57 In this context, misstatements or omissions are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

58 These will have been assessed throughout the audit as procedures are performed and evidence obtained; this is an opportunity to stand back and look at the whole audit.
134. In the case of a group audit, at this stage the final returns from the auditors of the different components of the group around the world are collected and reviewed in detail. In the case of significant subsidiaries, a senior member of the group audit engagement team will discuss the findings with the local audit teams. Depending on their significance, this might involve visiting the local teams and meetings with local management either at the end or during earlier phases of the audit.

135. The audit engagement team will then perform completion procedures, including an overall review of the financial statements. This will allow an overall evaluation, including an evaluation of significant findings and issues, which will be communicated with those charged with the client’s governance (in the case of listed companies, the audit committee).

136. Determining the significance of findings and issues demands a high degree of experience and skill, as the auditor wants to ensure that what is communicated within the entity is what is significant to the audit committee and (local and group) management and is at the appropriate level of detail.

3.2.5 Quality Review

137. For KPMG, in any engagement, the last stage consists of a thorough and well-documented review of the entire audit prior to the issuance of the audit opinion. All major audit firms are likely to include a quality review stage, though the details of this process will vary across companies. An Engagement Quality Control Reviewer (“EQCR”) is required to be appointed for the audits of all listed entities and of other engagements identified as of public interest; at KPMG they are also appointed for audits evaluated as high risk. The EQCR reviews:

a) selected audit documentation and client communications;

b) the appropriateness of the financial statements and related disclosures; and

c) the significant judgements the engagement team made and the conclusions it reached with respect to the audit.

138. EQCRs have appropriate experience and knowledge to perform an objective review of the decisions and judgements made by the audit team and engagement partner. They are experienced audit professionals who are independent of the engagement team and are required to be involved in crucial stages throughout the audit. They offer an objective review of the more critical and judgemental elements of the audit. The audit is completed only when the EQCR is satisfied that all significant questions raised have been resolved.

139. Once each of the above stages is completed, the audit engagement partner will issue an audit opinion.
4. Audit clients

**Section summary**

Large audit clients have different characteristics, but in general have a number of factors that lead their audit requirements to be more complex than smaller audit clients.

Large audit clients are sophisticated purchasers who place a high value on quality, and are well-equipped both to judge and, where necessary, procure an improvement in, the quality of the service they receive.

140. This section begins by setting out the characteristics of audit clients, focusing on FTSE350 companies. An understanding of these characteristics is important in order to understand the various dimensions of the quality of audit provision. Customers with different characteristics will ultimately require different characteristics of an audit firm in order for that firm to be able to deliver a high quality service, which we develop further in section 5. In the rest of this section we then set out how clients demand quality and are able to judge the quality of audit service they receive.

4.1 Characteristics of FTSE350 companies

141. Companies within the FTSE350 vary according to a number of different characteristics. In this section we present the parameters by which companies vary.

4.1.1 Company turnover

142. Companies within the FTSE350 vary substantially in terms of their size. We have collected information on the turnover of all FTSE350 companies, as presented in Figure 1 and Figure 2 for the FTSE100 and FTSE250 respectively.

*Figure 1. Distribution of FTSE100 companies according to annual turnover in most recently published annual report*
More than 60 per cent of FTSE100 companies have an average annual turnover of less than £10bn, with the smallest being £0.1bn. Around 25 per cent of FTSE100 companies have annual turnover between £10bn and £30bn according to their latest annual reports. There is a small number (six) of much larger companies in the FTSE100, with an annual turnover of more than £50bn.

On average, FTSE250 companies are smaller in terms of turnover than the FTSE100 (though the largest FTSE250 companies have a greater turnover than the smallest FTSE100 companies).59 The majority (72 per cent) of FTSE250 companies have an annual turnover of less than £1bn. A further 23 per cent have an annual turnover of between £1bn and £4bn. There are only seven FTSE250 clients with an annual turnover of greater than £7bn.

4.1.2 Company global footprint

Companies listed in the FTSE350 often have substantial operations outside of the UK. As noted by Lord Smith of Kelvin, in his submission to the House of Lords Inquiry: “A look at the FTSE100 shows that the vast majority of turnover, profits and assets come from outside the UK. This applies as much to oil, engineering and mining companies as to pharmaceutical, technology and financial services companies. These large, complex and global businesses need large, technically advanced, global auditors.”60

Figure 3 and Figure 4 show the distribution of companies listed in the FTSE100 and FTSE250 respectively according to the proportion of revenue that is earned from outside of the UK.61

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59 The indices are based on market capitalisation rather than turnover.

60 House of Lords, Auditors, Market Concentration and their Role – Written Evidence (page 248, evidence submitted by The Lord Smith of Kelvin).

61 For 12 FTSE100 clients and 18 FTSE250 clients we have only the percentage of revenue that is earned from outside the EU. However, this will represent an upper bound to the percentage of revenue that is earned outside the UK. We have therefore taken for these 12 and 18 clients respectively the percentage revenue earned outside the EU as the percentage revenue earned outside the UK, but note that this would tend to underestimate the proportion of non-UK revenue for these clients.
There is substantial variation across FTSE100 clients as to how much revenue is earned outside of the UK. However, the majority (51 per cent) of FTSE100 firms earn more than 70 per cent of their revenues from outside the UK, and a further 17 per cent of companies earn at least 50 per cent of their revenues from outside the UK. Similarly, there is a lot of variation across the FTSE250 in terms of how much revenue is earned outside the UK. 53 per cent of FTSE250 companies earn more than 50 per cent of their revenues from outside the UK, a smaller percentage than for the FTSE100, though still a majority. Moreover, even where companies generate turnover in the UK, if they process those transactions offshore the requisite audit effort may be outside the UK.
Those companies with substantial non-UK operations will require a statutory audit of the global group as a whole, and will require an audit firm that is able to efficiently provide statutory audit services across the company’s international operations. In general, clients will require an audit firm that has a network that matches its own key global operations, so that the statutory audit is provided efficiently across this global group. Different clients will have key subsidiaries or outsourced operations in different locations, and it is these different locations that a statutory audit supplier will need to be able to match to provide the statutory audit to that group efficiently.

In theory, the statutory audit of a group with several international subsidiaries might be provided through subcontracting independent local audit firms. However, in practice this would be highly inefficient, and could put the quality of the group audit at risk. When reporting on consolidated financial statements, the auditor has a responsibility, as defined in ISA 600, to oversee the local audits, and in doing so understand key local issues. Multi-national companies want their activities audited and reviewed on a consistent basis. This process would be more difficult if an independent local firm was used, as the expectations and standards used by the group auditor would have to be explained to the local firm. In addition many groups have interdependent operations across many countries, which means that activities accounted for in one subsidiary cannot easily be isolated from the rest of the group.

Of course, this is not true for all FTSE350 companies, as even some quite large companies will have largely UK operations. In addition, we note that some FTSE350 companies do not have a UK head office. Some others are not UK companies (though they are listed in the UK), and hence may not have a UK auditor.

4.1.3 Company sector

FTSE350 companies can be categorised according to their sector and there are different sector categorisations that might be used. Oxera’s price-concentration analysis, replicated by the OFT, used a certain set of industry classifications (we discuss this analysis further in section 9). However, some of these sector definitions are not particularly intuitive in terms of the companies within each sector being likely to share similar characteristics (for example, the chemicals industry is grouped with publishing). Instead, the analysis below uses those sector definitions as KPMG’s market analysis and monitoring, which are more relevant for the classification of companies according to the industry’s characteristics.62

Figure 5 and Figure 6 below show that there is substantial variation in the number of companies in each sector in both the FTSE100 and FTSE250.

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62 This is not to say these are the only or the best sector classifications for all purposes, rather we have used them because they make sense to KPMG’s business and because this sector classification was readily available at the time of this analysis.
The CC refers in its Issues Statement to the possibility that audit supply is particularly concentrated in certain sectors. This argument is discussed in section 9.1, but the analysis above...
shows that the number of listed companies within certain sectors is very small (eg automotive industries).

154. In many sectors there are particularly special or technical issues which may arise in relation to the auditing of the companies in question: the treatment of financial derivatives and other complex instruments in financial services; actuarial valuations in insurance; asset valuations in mining; and complex cross-supply arrangements in telecommunications are just four important examples.

4.1.4 Reporting complexity

155. Large groups may have many legal entities in a number of different countries. As discussed in section 2, auditing and accounting standards vary from country to country largely because of differing business practices, fiscal systems and company laws.

156. In many jurisdictions, a company’s management must produce local statutory accounts for each legal entity, complying with the local reporting requirements, under the appropriate accounting framework (local Generally Accepted Accounting Principles), and these will often be required to be audited.

157. In addition, the legal structure on which reporting to meet local requirements is based is unlikely to be the same as a group’s management structure for internal reporting purposes. This “disconnect” between legal structure and management or business organisation also means it is not simple to conceive of separate auditors for different geographic subsidiaries within a group. Local audit teams are therefore likely to have to undertake a separate audit of the reporting package for submission to the audit client and inclusion in its consolidated financial statements. Since, for UK-listed companies, IFRS is required, this reporting submission will either need to be in IFRS – ie different to local GAAP – or adjustments will need to be made on consolidation to convert the information under local GAAPs to IFRS. In addition, the reporting date (year end) may be different for local reporting purposes compared to the audit client’s year end date. Differing year ends may add further complexity to the local and group reporting process.

158. In addition, if a company is a joint venture, then the way in which the accounts are prepared and reported might be different in order to comply with the requirements of the other joint venture partner(s).

159. Therefore clients vary in the degree to which their audit involves the issuance of a large number of audit opinions – on individual management reporting packages and local statutory financial statements. In addition to the issuance of audit opinions, for certain clients local regulations may also require the auditor to report on a variety of other reports, for example in relation to client money, prudential returns, tax computations or other matters.

4.1.5 Operational complexity

160. The commercial arrangements and structuring of large companies may also create complexity which increases audit effort. Whilst this is not necessarily unique to large companies, the scale of the companies tend to exacerbate the complexity – and the larger companies in the FTSE indices will tend to be more operationally complex.

161. This complexity may be due to the nature of an audit client’s business or individual contracts. For organisations with large numbers of third party arrangements (whether alliances, purchase or supply contracts) which are not on standard terms, this will involve an analysis of each contract significant to the entities on which audit opinions are issued. This is necessary in order to understand the detailed rights and obligations, as well as understanding the appropriate accounting treatment.

162. Similarly group structures established for commercial purposes – for example financing, fiscal or commercial – may also create complexity even though these are often not visible in the consolidated accounts of the audit client. For example, where the audit client needs to finance an
overseas operation, this can involve funding via numerous entities in different jurisdictions (which may be specially created for the purpose) just for a single transaction, in order to ensure the most tax effective treatment of the arrangements. Alternatively the commercial arrangements may be complex; situations where the intellectual property, productive assets and marketing operations all reside within a single legal (or management reporting) entity are increasingly rare. For example, intellectual property may be owned in one jurisdiction; purchasing may be undertaken for multiple group entities in another jurisdiction; whilst management of sales and marketing may be undertaken at more than one level in a group. These kind of arrangements result in significant volumes of intra-group transactions which, whilst eliminated on consolidation, will be relevant for the underlying legal entities and, potentially, significant in the determination of tax liabilities.

4.1.6 Accounting complexity

163. Accounting complexity in part results from the mismatch between legal and management reporting structures described above. In addition, accounting standards themselves can be complex (IFRSs and interpretations now run to more than 2900 pages) and are constantly changing.

164. The nature of the audit client’s accounting systems and arrangements for transaction processing can also add to this complexity. These accounting systems may be diverse (ie legal or management reporting using systems which differ) which means that synergies between the documentation and testing of the systems can be limited.

165. More recently, large companies have been standardising and centralising transaction processing arrangements which provides, ultimately, the opportunity for more centralised and streamlined audit arrangements. However, this can still create complexity in the audit not only during the period of change (when the audit firm will need to assess the controls over the implementation of the arrangements), but also, and more importantly, on an ongoing basis. Whilst transactions may be processed in a particular location for multiple group entities (eg India) using a common system (eg SAP) and common processes, responsibility for accounting (ie the application of accounting standards) and for the accuracy of reporting may still lie with the relevant legal or management reporting entity. Particularly close co-ordination is therefore required between audit teams in different countries in order to ensure that the end-to-end transaction process is audited (ie nothing “falls between the gaps”) but that there is no duplication in audit effort. This is made more complex where jurisdictional legal and reporting requirements differ or have particular restrictions (for example as to the location of accounting records). In addition, centralised transaction processing centres may not only be offshore, but outsourced to a third party which adds separate issues for the audit engagement team to deal with before an audit opinion is issued.

4.2 Client Demands for quality and value for money

166. Paragraph 111 sets out that the audit committee is responsible for monitoring the auditor appointment. As such, the audit committee (led by the audit committee chair (ACC)), on behalf of the company and its shareholders, is the principal “client” to whom an audit firm is responsible for the audit. However, a company’s management (including the finance director (FD)) is also a highly relevant customer of certain aspects of the audit. At its most basic, the audit-related, added value services based on lessons learned or observation gleaned during the audit process will probably be of direct interest to a client’s management. In addition, management will be affected by the efficiency of the audit firm and the quality of the working relationship.

4.2.1 Clients are sophisticated purchasers

167. Audit clients in the reference market are sophisticated purchasers who are well-placed to judge the quality of the service they receive. The majority of ACCs and FDs at FTSE100 and FTSE250 companies have held the same roles previously and/or are professional accountants. The background of FDs and ACCs is informative of their ability to judge quality in a number of ways:
FDs and ACCs with financial or accounting qualifications will on average be better placed to judge the quality of the statutory audit services a company receives because they will understand the technical complexities of the audit, be better placed to question and query audit findings, and be better placed to judge the skills and qualifications of an audit team.

ACCs and FDs that hold or have held previous similar roles will on average be better placed to judge the quality of a statutory audit firm as they will have experience of making such judgments and will have observed the consequences of judgments they have made in the past. In addition, having more roles increases the number of contacts an ACC or FD has with other ACCs, FDs, or non-executive directors, through which an ACC or FD can gather intelligence on the performance of different audit firms.

Our analysis demonstrating the experience of FTSE FDs and ACCs is set out at Annex 1. It demonstrates that a substantial proportion of ACCs in both FTSE100 and FTSE250 companies have held previous ACC roles or other current relevant roles, and that the majority of ACCs in both the FTSE100 and FTSE250 are also qualified accountants or members of professional accountancy bodies. In addition, a substantial proportion of FDs in both the FTSE100 and FTSE250 have held previous FD roles and the majority of FDs in both the FTSE100 and FTSE250 are also qualified accountants and/ or members of professional accountancy bodies.

Although we do not have specific data, we understand that FDs and non-executive directors often sit on multiple boards, further increasing their ability to gather relevant information on different audit firms.

**4.2.2 Clients actively measure quality**

Not only are ACCs and FDs of large companies well-equipped to judge the quality of the service they receive, the evidence suggests that they use this experience to monitor the quality of their audit firm and compare it to others. This is borne out by the results of the most recent annual KPMG Audit Committee Institute survey of Audit Committee members, the results of which are discussed below.

The survey found that audit committees routinely review the effectiveness of the statutory audit they receive. In doing so, anecdotal evidence suggests that audit committees draw their conclusions based on their own experience and contact with their external audit providers, as well as the views of others. Many audit committees seek the views of a wide range of individuals such as the CEO, FD and the head of internal audit.

ACCs are now increasingly seeking to measure audit quality objectively: the survey found that 50 per cent of evaluation processes include clear performance objectives against which the external auditor’s performance is rigorously evaluated, and 41 per cent of companies share those performance conditions with the auditor in advance. The survey also demonstrated that the ability to evaluate the quality of the audit team as a whole is essential, and that audit committees want an insight into the quality of the staff below partner level. Audit committees do this by (for example)

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63 We have calculated the proportions out of 100 ACCs for the FTSE100 and 250 ACCs in the FTSE250, even though data was missing for a small number of ACCs in both indices (information for some ACCs (two in the FTSE100 and seven in the FTSE250) was not available).

64 The estimates presented in this Annex 2 are lower bounds to the true proportions of ACCs and FDs with previous similar roles or qualifications, since information was not available for some ACCs and FDs, yet proportions have been taken out of 100 and 250 FTSE100 and FTSE250 companies respectively.

65 Recognizing the challenges that audit committees face in meeting their demanding responsibilities, KPMG created the Audit Committee Institute (ACI) to serve as a resource for audit committee members and senior management. Our primary mission is to communicate with audit committee members to enhance their awareness of, commitment to, and ability to implement effective audit committee processes.

66 See 2010 ACI Survey of audit committee members (report submitted to the CC in KPMG’s response to the FDL, question B10).
meeting audit teams at different locations to canvass their views without the lead audit partner being present.

173. For some clients, benchmarking or other information is also available. KPMG often provides benchmarking information to assist clients in judging the quality (and value for money) of the statutory audit service they receive. [redacted]

174. Clients are also frequently approached by competitors, aiming to induce them to switch of audit firm (which we discuss further in section 7). Comparing these alternative offers with their own supplier allows clients to further judge the quality and value for money of their existing audit firm.

4.2.3 External measures of quality are available to clients

175. Aside from being able to draw on a wealth of skill and experience and their own activities to assess auditor quality, there are external and objective quality standards to assist clients in judging the quality of the audit they receive.

176. The AIU monitors the audit quality of a sample of statutory audits on an on-going basis. The AIU focuses on aspects such as whether there is sufficient audit evidence to back up the opinion, indications that there has been proper consultation prior to issuing the audit opinion, and that processes are properly documented.

177. Following the review of an individual audit, the relevant audit engagement partner receives a letter from the AIU reporting its findings and is expected to share it with the client. KPMG also sends ACCs the reports from the AIU. Our handbook for ACCs⁶⁷ contains information on how to evaluate an auditor’s quality, and this includes making sure that ACCs have received AIU reports.

4.2.4 Clients are able to address sub-optimal quality

Large audit clients demand high quality from their auditor and can and do exert pressure on their audit firm to address any perceived issues. This pressure is exerted through regular renegotiations, which we discuss further in section 7. Where an audit firm is not delivering an acceptable level of quality, large clients can and do replace their auditor with an alternative audit firm that provides the requested quality of service ([redacted]).

⁶⁷ http://www.kpmg.co.uk/aci/tk/index.cfm
5. Clients’ Audit requirements and the implications for audit firms

Section Summary

Auditing large companies is a very complex exercise requiring significant expertise, scale and geographic reach. A client’s characteristics determine the complexity of its audit. Variation in clients’ characteristics, and hence in the complexity of their audits, means that each company’s audit is bespoke.

A client’s characteristics and the complexity of its audit determine the capabilities required of audit firms to deliver a high quality audit. Large companies place high demands on audit firms to deliver a high quality audit, and this has driven investment by and growth of the four largest audit firms.

178. This section builds on the description of clients in the reference market and their demands for high quality audit services. It sets out how clients’ different characteristics influence the characteristics they require from their audit supplier. Put broadly, in our experience clients tend to look for certain qualities in audit firms:

a) a global network;

b) high staff quality (in turn requiring the ability to recruit, develop and retain high quality candidates, at all levels);

c) extensive experience (of auditing large and complex businesses and/or of specific sectors);

d) specialist skills (eg actuarial expertise);

e) a “bench” of sufficient strength (ie the ability, at any given time on an engagement to field an appropriate number of staff members with the right skills mix. For example, the ability to replace members of the team with other members of staff with equally appropriate skills, following the rotation of existing staff off the engagement either as required or unexpectedly);

f) knowledge and understanding of a client’s business;

g) an appropriate working relationship with the client, at all levels of seniority;

h) consistent methodology and processes, supported by technology to maximise efficiency and quality; and

i) strong quality assurance processes.

179. KPMG UK (and other audit firms) invests in developing these characteristics to meet client requirements and provide a high quality service. This investment is driven by the need to compete for new and existing audit clients, which we discuss further in section 7, and allows us to develop a reputation and track record in providing a high quality service.

5.1 Client requirements drive audit firm investments and organisation

180. This section discusses how those client requirements set out in paragraph 178 have led to audit firms investing in certain capabilities and characteristics, and have influenced the structure and organisation of audit firms.
5.1.1 The global operations of clients require an audit firm with global reach

181. Section 4 (paragraphs to 145 to 150) sets out the variation in FTSE350 clients in terms of the degree to which their operations involve overseas operations. It also shows how clients require an audit firm that has a network that matches their own, or in other words has local member firms in the locations key to the group audit. Of course, the larger the global network of an audit firm, the more attractive it will be to the widest number of companies listed in the FTSE350 with global operations. This has driven the development of our global network and the investments in developing this network and leveraging skills and experience across it in order to increase the efficiency of the provision of global group audits.68

182. Crucially, KPMG employs a global audit methodology across its local member firms; whereas local independent firms’ methodologies would not be entirely consistent with this global methodology. Subcontracting to a local independent audit firm would therefore require substantial checks to ensure this local firm’s quality, checking the methodology it uses, its compliance and independence procedures, its staff training and quality, etc. A failure in one of these factors on the part of a local independent audit firm could jeopardise the quality of the overall group audit and thereby the reputation of the firm contracted to do the group audit.

183. By contrast, when a group audit is provided by an integrated audit network, substantial procedures, experience and skills are leveraged across the network. Paragraph 182 notes the global audit methodology that is employed across our network. In addition, KPMG has quality and independence review procedures in place across our global networks (see paragraphs 204 to 208 below). The consistency of these procedures minimises the need for extra checks and controls on local audit teams, and thereby means that the global group audit of a UK-listed company with global subsidiaries is provided far more efficiently by an audit firm who is the member of a network with these global capabilities.

184. In relation to emerging markets, staff capability and technological development may impact the level of automation and sophistication of accounting and reporting functions with consequential implications for the audit approach. The audit firm will need to ensure that it covers and understands the impact of matters such as culture, tone from the top, talent and risk management. Issues such as fraud and compliance can also be more problematic in certain emerging markets, and as such local knowledge backed by an international approach is key.

5.1.2 Client requirements for high quality services drive investments in staff quality

185. The quality of staff is likely to be important to all clients, although the exact experience and capabilities of the staff that a client requires will to some extent depend on the size, complexity and sector of the client’s business. Higher quality staff members are better able to understand the various operational, reporting and accounting complexities of FTSE350 companies. This is crucial to the delivery of a high quality audit service in a number of ways:

a) staff quality is crucial to the ability of an auditor to pick up problems and address them during the audit process;

b) it means that the auditor requires less management time and involvement in order to get to grips with a large complex audit;

c) more generally it contributes to the efficiency of the audit;

68 [redacted].

69 [redacted].

70 [redacted].
it contributes to the quality of the relationship with clients, as higher quality staff will be better able to provide high quality insights into management processes, etc; and

c) finally, because staff have a high quality reputation to maintain, they are less likely to sacrifice this reputation by not reporting an important problem with the statutory accounts to the audit client’s management. In this way, staff quality also contributes to the independence of the audit firm and the shareholders’ confidence that any material problems will be reported.

Consequently we invest considerable time and expense in recruitment, training and the development of staff.

5.1.3 Clients’ requirements for high quality services drive investments “Bench Strength”

A high quality engagement team requires strength in depth and breadth of relevant expertise. In order to deal with the operational and reporting complexity of FTSE350 companies’ businesses (set out in paragraphs 155 to 162 above) audit firms require skills across a range of areas. For example, the audit of even mainstream corporate clients (quite apart from banks) may require support from professionals skilled in the treatment of financial hedging transactions, IT systems and so forth. Clients are aware of the need to test the quality of an audit firm’s strength in relevant specialisations.

Mandatory rotation requirements mean that members of staff with certain skills, knowledge or experience will periodically be rotated off an engagement. Other unforeseen circumstances may also imply that staff members with certain skills cease working in a given engagement. Clients will require that these staff members are replaced with others with similar qualities, such that the quality of the audit is maintained. Audit firms therefore invest in sufficient capacity and capabilities, such that they are able to deploy staff with appropriate skills and experience to any given engagement at any given time. In other words, audit firms invest in develop a “bench” of sufficient depth, as well as in the breadth of skills and expertise within the audit firm.

During a tender process or otherwise, audit clients may test the availability of credible alternative members of staff, in particular for key partners or staff with specialised skill sets, in order to assure themselves of a firm’s bench strength and hence of an audit firm’s ability to deliver quality.

5.1.4 Clients’ demands for quality, consistency and efficiency drive investment in technology and methodologies

Large audit clients look to their audit firms to provide the latest technologies in support of the audit process, as this will contribute to audit quality. Technology will increase the ability of audit firms to identify and address issues with financial information and reporting processes before the issuance of the audit opinion, as it helps individual auditors follow best practice and procedures. In addition, it increases the efficiency of the delivery of an audit, minimising management time involved in the delivery.

Technological innovations can allow a network to ensure that all member firms employ a consistent and efficient audit process and to better share best practice and knowledge across its operations and across its staff members.

KPMG dedicates significant resources to keeping standards and tools complete and up to date. Our global audit methodology, developed by the Global Services Centre (GSC), is based on the requirements of the ISAs. The methodology is set out in the KPMG Audit Manual (KAM) and includes additional requirements that go beyond the ISAs where KPMG believes these enhance the quality of our audits. The UK firm also adds local requirements and/ or guidance in KAM to comply with additional UK professional, legal or regulatory requirements.

[redacted].
193. KAM contains, among other things, procedures intended to identify and assess the risk of material misstatement and procedures to respond to those assessed risks. KPMG’s methodology encourages engagement teams to exercise professional scepticism in all aspects of planning and performing an audit. The methodology encourages use of specialists when appropriate and also requires use of certain specialists in the core audit engagement team when certain criteria are met. KAM also includes the implementation of quality control procedures at the engagement level.

194. KPMG’s audit methodology is supported by eAudIT, KPMG’s electronic audit tool, which provides auditors worldwide with the methodology, guidance, and industry knowledge needed to perform efficient, high-quality audits. eAudIT has been deployed to all audit professionals within KPMG. eAudIT’s activity-based workflow provides engagement teams with ready access to relevant information at the right time throughout the audit, thereby enhancing efficiency and delivering value to audit clients.

195. This knowledge comprises examples of industry audit procedures and other information (such as typical risks and accounting processes), that are then made available to all auditors through this electronic tool. In addition, industry overviews are available in eAudIT which provide general and business information in respect of particular industries as well as a summary of the industry knowledge. KPMG UK, along with other member firms, provides specialist input into the development of global industry knowledge, and deploys it via the use of eAudIT.

5.1.5 Clients appreciate sector-specific experience

196. A key part of audit quality and client demand is having a detailed understanding of the audit client’s business and industry. Firms in different sectors often have different requirements for the audit delivery, for example in terms of different regulations or reporting requirements, different requirements for specialist skills, different degrees of accounting and operational complexity, etc.

197. A key aspect of audit quality is whether the statutory auditor has the ability to anticipate where problems might lie and thereby the ability to identify potential misstatements in the financial statements prior to the issuance of an audit opinion. Different sectors often have different commercial risks, which flow from the nature of the products and the business models in that sector. Experience of these commercial risks and how to deal with them is crucial to the ability to anticipate likely problems as part of the statutory audit.

198. Some sector experience and knowledge can be gained from providing non-audit work to clients in particular industries. This experience is likely to be most relevant when an audit firm provides non-audit services that are closely related to statutory audit services, such as internal audit, assurance, or tax services.

199. We have procedures in place to assign both the statutory audit partners and professionals to a specific engagement by evaluating his or her skill sets, relevant professional and industry experience, and the nature of the assignment or engagement. Function heads are responsible for the process for allocating particular engagement partners to clients. Audit engagement partners are required to be satisfied that their engagement teams have appropriate competencies and capabilities to perform audit engagements in accordance with the KAM, professional standards and applicable legal and regulatory requirements. This may include involving KPMG’s local and global specialists.

200. In addition, KPMG’s eAudIT tool contains sector specific modules which aid the sharing of sector specific knowledge across staff and KPMG firms.

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72 Extractive industries, for example, are characterised by large capital projects. This involves its own particular set of commercial risks, and in addition, the accounting mechanisms and principles used to account for these capital projects. Alternatively, pharmaceutical firms often have complex licensing and contractual arrangements, which implies its own set of commercial risks and accounting principles. An audit firm will be able to provide a higher quality audit if it is able to anticipate these particular commercial risks, which it will be best placed to do if it has experience in the sector.
5.1.6 Client requirements for quality drive the development of appropriate working relationships

201. A good working relationship between a client and its statutory audit supplier is crucial to the delivery of a high quality audit. The relationship between the audit engagement partner and the FD and the ACC is a particularly important one. However an efficient working relationship between more junior audit staff and the more junior members of the audit firm is also key to the delivery of a high quality audit. A good working relationship at all levels is essential to the efficiency of the audit delivery, minimising management time required in assisting the audit firm, and ensuring that any problems are highlighted in an appropriate and timely manner.

202. As such, KPMG’s programme monitoring client feedback and demands (Client Insights) regularly monitors client relationships, illustrating the importance of this aspect of the engagement.

203. [redacted]

5.1.7 Client requirements for high quality services drive investment in quality control processes

204. KPMG International has a number of policies and procedures designed to achieve common quality control policy that applies to all member firms. These are designed to guide member firms in complying with relevant professional standards, regulatory and legal requirements, and in issuing reports that are appropriate in the circumstances. They also assist in maintaining KPMG’s reputation as a provider of consistently high quality services.

205. KPMG uses two formal internal inspection programmes conducted annually: the Quality Performance Review Program (QPR) and the Risk Compliance Program (RCP). Additionally all KPMG member firms are covered over a three-year period by cross-functional Global Compliance Reviews (GCRs) performed by reviewers in the Global Compliance Group who are external to the member firm. These programs are designed by KPMG International and participation in them is a condition of ongoing membership of the KPMG network.

Quality Performance Reviews (QPRs)

206. The QPR is the cornerstone of KPMG’s efforts to monitor engagement quality and one of the primary means of ensuring that member firms are collectively and consistently meeting both KPMG International’s requirements and applicable professional standards. The QPR assesses engagement-level performance in the audit, tax, and advisory functions and identifies opportunities to improve engagement quality. All audit engagement leaders are subject to selection for review at least once in a three-year cycle. The reviews are tailored to the relevant function, performed at a member firm level, generally overseen by a Lead Reviewer from outside of the member firm, and are monitored regionally and globally. Remedial action plans for all significant deficiencies noted are required at an engagement and operating firm level.

Risk Compliance Program (RCP)

207. The RCP is a member firm’s annual self-assessment program. The objectives of the RCP are to monitor, assess, and document firm-wide compliance with the system of quality control established through KPMG International's quality and risk management policies and applicable legal and regulatory requirements as they relate to the delivery of professional services. The programme is overseen and monitored regionally as well as globally.

Global Compliance Reviews (GCRs)

73 [redacted].
74 [redacted].
208. GCRs are performed by reviewers external to the member firm led by the Global Compliance Group and are carried out over a three-year cycle. These reviews focus on significant governance, risk management and independence and finance processes (including an assessment of the robustness of the firm’s RCP). In the event that a GCR identifies significant issues that require immediate or near-term attention, a follow-up review will be performed as appropriate.

5.2 Relationship-specific investments

209. The previous section set out the investments that audit firms KPMG make, which are relevant to a number of, or even all clients. By contrast, this section sets out the investments KPMG makes in providing a high quality audit for a specific client. The section then discusses the corresponding investments made by audit clients in ensuring that their audit firm provides a high quality service.

5.2.1 KPMG’s investments in specific relationships

210. Providing a high quality audit to an audit client requires relationship-specific investments in:

a) learning about the client’s business and its complexities;
b) developing relationships with the key personnel at the client, at all levels of seniority; and
c) providing specific staff members with expertise for that client’s needs.

211. A key part of audit quality and client demand is having a detailed understanding of the audit client’s business. Even within a sector, individual audit clients often have different requirements as a result of differences in geographic footprint, in company size, and in operational, accounting and reporting complexity. We provide services to a large number of FTSE350 companies that we do not audit in order to develop an understanding of these companies’ businesses. We also make other investments in developing knowledge and understanding of target clients’ businesses in order to be a more credible high quality alternative to these companies’ existing audit firms (this is discussed in more detail in section 7.1).

212. Audit partners and senior staff are subject to periodic rotation of their responsibilities for a specific audit client under applicable laws and regulations and independence rules. These limit the number of years that partners in certain roles may provide audit services to any audit client. Processes are however in place to ensure continuity and that learning is captured.

213. [redacted]75. [redacted]

5.2.2 Client investments in getting a high quality audit

214. As set out above, in order to obtain client specific knowledge, audit firms need to learn from the client’s management about its commercial arrangements, its reporting practices and requirements, its structure, its transactions-processing arrangements and so on. This requires significant management time and effort on the part of the audit client to ensure that the audit firm has the required degree of knowledge. In addition, time and effort is required in developing relationships with the audit firms, in particular for more complex organisational structures (for example global groups with a large number of subsidiaries). FTSE listed companies themselves would be best placed to provide the information to the CC on how much of this investment is required and what it involves.

215. These investments on the part of the audit client’s management and audit committees impact on the quality of the audit service that the audit client receives. Investing in developing the audit firm’s knowledge of the audit client’s business will ensure that the auditor is best placed to identify and address audit risks. In addition, it will minimise management time further down the line, by

75 [redacted].
ensuring that the learning takes place early on and the audit is delivered efficiently as soon as possible.

216. There are however certain investments that an audit firm can make in minimise the effort that an audit client needs to invest in order to develop the audit firm’s knowledge of the business and relationships with the management. This is discussed more in section 7.1, but this would include developing relationships with and providing non-audit services to non-statutory audit clients.
Part B: Competition in the provision of audit services

6. Introduction to competition for the provision of audit services

217. Having described the nature of audit services and the main characteristics of audit firms and audit clients, this section analyses the nature of competition in the supply of statutory audit services to large companies.

218. There are several dimensions of competition, which reflect the different variables that audit firms can flex in order to compete effectively. In this submission, these are grouped into ‘short-term competition’ and ‘dynamic competition’.

219. Short-term competition involves varying those competitive strategies that can be adjusted over this time horizon (such as some elements of quality, audit scope and price). Short-term competition materialises through the efforts firms exert to win new clients and to retain existing ones.

220. In relation to the competition to win new clients, audit firms track the occurrence of statutory audit tenders. They also monitor their own performance and that of competitors. There is also evidence that audit firms make unsolicited approaches to and develop relationships with rivals’ clients, in order to entice them to switch, even without the occurrence of a formal tender. We regularly do so.

221. Once an audit firm wins a new audit client, it has to maintain a competitive offering in order to retain it. Audit clients have annual reviews to decide whether to renew their audit contract. During these reviews, audit suppliers and their clients renegotiate the terms of the contracts (including fees and the scope of the audit). Large audit clients are sophisticated buyers and, through this bargaining process, exert competitive pressure on their audit suppliers, without the need to issue a competitive tender.

222. Given the scale of relationship-specific investments (see section 5.2) by audit firms and audit clients, both parties will have a strong incentive to ensure the relationship carries on. This competitive environment cannot be expected to lead to frequent tendering and switching. This would be an inefficient market outcome where the value of significant investment would be lost.

223. Dynamic competition relates to the competitive pressures that incentivise audit suppliers to make investments to win new clients in the medium-term to long-term.

224. Audit firms are under constant pressure to invest to ensure the consistent provision of high quality. Certain types of investment are not relationship-specific. These (sunk cost) investments improve the performance of an audit firm in the medium-term to long-term across a broad customer base and generate economies of scale and scope.

225. These factors are the key drivers of the audit market structure. Economic theory predicts that in a market where clients are particularly concerned with the quality of the service, and when quality is achieved through significant sunk cost investments, the resulting market structure cannot be a fragmented one. Instead, a competitive market outcome is likely to be one with few, high quality suppliers.

226. In summary, the level of market concentration is a result of market forces. It is an outcome of the competitive process, rather than a market feature determining the extent of competition.

227. Short-term competition and dynamic competition are discussed in more detail in section 7 and section 8, respectively.
7. Short-term Competition

Summary

Short term competition denotes competition between audit firms for specific clients. This manifests itself in [re]negotiations, specific client targeting and formal tendering. Negotiations between KPMG and clients are on-going, with clients often renegotiating contracts on better terms. This is driven, in part, by rival audit firms actively monitoring and targeting prospective audit clients, placing pressure on the incumbent.

Formal tenders are very competitive. However the rate of tendering is not indicative of the level of competition in this industry. This is because strong competitive tension is generated through the bargaining power of customers and the mere threat of tendering.

Both audit firms and audit clients make significant investments in a relationship, in order to derive maximum value from it. Such investments mean that frequent tendering and switching is inefficient, and that audit firms have strong incentives to ensure that the relationship with any given audit client continues.

228. This section describes how audit firms compete in the short term to retain existing audit clients and acquire new ones. This process is referred to as “short-term competition” to stress that this is only one part of the competitive process. This aspect of competition involves varying those competitive strategies that can be adjusted in the short term (such as some elements of quality, audit scope and price). Competition in the form of engaging in strategies that deliver their benefits in the medium- to long-term is discussed in the next section on “dynamic competition”.

229. Section 5.2 explained that the relationship between audit firms and their audit clients involves relationship-specific investment aimed at ensuring a high quality audit (as well as all the non-client-specific investments made in quality, set out in section 5.1). This investment provides an incentive to ensure that the supplier-customer relationship is a successful one over a period of time, so that the value of that investment is not lost. However this incentive does not provide protection for the audit firm against strong competitive pressures on both the quality and price of the services it offers. These pressures are exercised by audit clients through regular reviews and renegotiations and are stimulated and enhanced by the activity of other audit firms constantly investing in putting themselves forward as credible alternatives to the incumbent audit firm.

230. Given the value of an audit client relationship to an audit firm and the scale of the client-specific investment undertaken by a supplier both in winning the audit client in the first place and, further, in ensuring a high quality product, the audit firm will have a strong incentive to ensure the relationship carries on. In order to achieve this, audit firms will seek to constantly improve the value of their services to their customers and often to reduce their fees to ensure the continuance of the relationship.

231. This competitive environment cannot be expected to lead to frequent tendering and switching. This would be an inefficient market outcome where the value of significant investment would be lost. Rather the competitive environment results in pressures exercised on the audit firm throughout the length of the relationship with a given audit client. In addition, audit clients obtain information on the product offerings of audit firms other than their existing statutory audit provider in a variety of ways including benchmarking, developing relationships with other firms and other firms approaching customers to try to induce them to switch. Customers do not therefore rely on competitive tenders to gather information on alternatives available to them.
The rest of this section sets out first how audit firms in general, and KPMG UK specifically, seek to win new audit clients. It then describes, before concluding, how customers exercise competitive pressures on suppliers who seek to continue to provide audit services.

7.1 Competition to gain new clients

Our efforts to try and win new audit clients focus not only on tender events but also on developing capabilities and relationships with clients to try and induce a tender, and ultimately a switch.

Occasionally, a company’s circumstances change (for example as a result of a merger) or the incumbent audit firm’s service is seen as poor. Such circumstances as well as an audit client’s appetite for change (for example for governance concerns) may trigger a tender, but in any case in these circumstances the value of the relationship-specific investment is effectively reduced in the eyes of the audit client (either because it might not be relevant to the future audit if the audit client switches or because it is not seen as being good value given the quality delivered). In this case non-incumbent audit firms have an opportunity to put themselves forward as a better alternative. As a result, audit firms monitor closely these events and seek to make the most of these opportunities by investing time in developing a good proposition and by monitoring their competitors’ performance.

We also monitor tender activity. We track tenders as well as our performance and that of our rivals. We invest substantially in order to become a more credible alternative to audit clients of other audit firms. This investment includes learning about the business of target clients and developing the relationship with management. This activity might involve offering informal advice on financial reporting, perspectives on corporate governance, assurance and accounting standards, and other informal advice all aimed at demonstrating the credibility and knowledge of our firm and individual audit partners and staff.

Our pitches and proposals to potential audit clients emphasise the insights we have already gained into a client’s business, as without these insights there would be little or no chance of being viewed as a credible alternative supplier.

Generally speaking these investments in targeting clients are sunk costs, and ultimately give no return if the target client is not induced to switch its audit to KPMG. In addition to these sunk cost investments, we also provide non-audit services (including audit-related services) as another way to learn about clients’ businesses, and also to demonstrate KPMG’s high quality work and efficiency. KPMG often provides these services to non audit clients for this reason.

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76 [redacted].
77 [redacted].
78 [redacted].
79 [redacted].
80 [redacted].
81 Although in certain cases it might be possible to use these investments in learning about a client’s business model to sell some non-audit work to that client.
82 [redacted].
83 [redacted].
84 [redacted].
85 [redacted].
86 [redacted].
241. We have won audit clients thanks to such investments in relationships, including by competing to provide non-audit services that may contribute to providing the necessary sector expertise for a high quality audit.

242. Firms also make unsolicited approaches to rivals’ audit clients, in order to get them to switch. [redacted]87 [redacted]88.

243. All of this activity set out in paragraphs 233 to 242 is indicative of the efforts that audit firms put into generating new tender opportunities and being successful when they arise. [redacted]89. However, as discussed above this activity by audit firms to generate and win tender opportunities does not only create strong competition during the tender event. Crucially, it translates into strong competitive pressures felt by the incumbent audit firm in its regular negotiations with their clients throughout their relationship and separately from any tender events. We discuss this in the next section.

244. [redacted]

7.2 Competition in retaining existing clients: negotiations and bargaining

245. Audit contracts are annual. It is best practice for companies to undertake yearly reviews of their external auditors in accordance with the FRC’s Guidance for Audit Committees. 90 [redacted]91, [redacted].

246. [redacted]92.

247. During these reviews, audit firms and their audit clients negotiate the terms of the appointment, in other words these reviews correspond to a bargaining process between audit firms and their audit clients. Through this bargaining process audit clients exert competitive pressure on their audit firms, without the need to issue a competitive tender. The rest of this section sets out a framework through which the competitive pressures arising from these renegotiations can be assessed.

7.2.1 Negotiations between audit firms and their clients: a “bargaining framework”

248. The negotiations on price and scope of services that take place regularly during a supplier-client relationship need to be assessed in the appropriate context. As is the case for many business-to-business activities, what determines the price that is charged depends ultimately on the relative bargaining strength of the supplier and the customer. Evaluating competitive pressures that suppliers are under requires considering what would be the consequence, for each party, of not reaching an agreement. These consequences are referred to, in the economics literature that examines these scenarios, as “outside options”.

249. In any renegotiation, an audit firm and its audit client will each know what returns they will earn from continuing the relationship (even if these may not be measurable directly in financial terms). Similarly, an audit firm and its audit client will each have an outside option, which represents the best expected payoff they could hope to achieve if the relationship were to be terminated. The outside options, as well as the information available to the audit firm and its audit client, influence the relative bargaining strength of each party and hence the outcome of the renegotiation process.

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86 [redacted].
87 [redacted].
88 [redacted].
89 [redacted].
90 Financial Reporting Council Guidance on Audit Committees, December 2010, paras 4.20 and 4.23
91 [redacted].
92 [redacted].
In the rest of this section we present our assessment of the outside options to audit firms and their audit clients, and conclude that the relative bargaining power of audit clients is strong.

**Audit customers’ outside options**

An audit client’s outside option represents what it can expect to achieve were it to terminate a relationship with its audit firm and switch to an alternative provider. Section 7.1 set out the targeting by audit firms of rivals’ audit clients, including unsolicited approaches to these audit clients or the delivery of other services. This activity provides additional benchmarks that audit clients can use to evaluate the performance of the incumbent. 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 audit client’s incentives to switch.

These unsolicited approaches, and the broader targeting activities of audit firms, do not just provide a means of benchmarking the quality of the incumbent, but importantly also provide a clear indication of how competitive the customer’s outside options are. Audit clients are aware of these alternatives when renegotiating contracts.

Section 5.2 sets out the relationship-specific investments made by both audit firms and audit clients in order for the audit product to be of a high quality. Both audit clients and audit firms make investments, particularly at the start of a relationship, to ensure that the audit firm has a good knowledge of the business and its complexities, and has good working relationships with the audit client, at all levels of seniority. This indicates the investments made by both audit clients and audit firms in increasing the audit firm’s understanding of the audit client’s business, and hence improving the efficiency with which an audit firm is able to conduct the statutory audit.

Switching to a new audit firm would mean that the audit client would have to re-invest that time and resource in ensuring the new audit firm has the same knowledge of the business and good working relationships. In addition, while a new audit firm is going through this learning process, there is a greater chance that a mistake will be made in the statutory audit (with the resulting possibility of inaccurate financial information being published which would have significant reputational and/or financial implications for both the audit client and the audit supplier).

All other things being equal, the higher the value of this investment, the lower the value of the outside option available to an audit client from switching to a new supplier and ultimately the lower the audit client’s incentive to switch.

However, this does not imply that the lower incentive to switch arises from, or generates, reduced competitive pressures. An important aspect of how audit firms compete is the effort they put into ensuring that audit clients’ expectations are met or, even better, exceeded. In effect, this amounts to effort in ensuring the initial investment is valued highly by the audit client and hence putting the audit firm in a better competitive position.

All of these factors imply that audit clients have credible competitive outside options available to them, which drive their bargaining strength in the renegotiation process with their audit firm. Audit appointments are by law limited to one year, and so clients have the opportunity to re-evaluate their audit supply in light of its outside options regularly (ie they are not limited by any long term contracts).

**Audit firms’ outside options**

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93 The OFT’s reference noted (OFT, OFT1357MIR, paragraph 5.14) that there may be direct costs of switching, such as the management time involved in selecting a new auditor, the time required to bring the new auditor up to speed and the potentially higher risk of a new auditor making a mistake initially.
This section considers the consequences for an audit firm of losing an audit client. The immediate consequence of losing an audit client for an audit firm is to lose the value of the audit contract itself. In certain cases the individual contract value can be significant. For example, the global audit fees for KPMG UK’s ten largest audit clients are all in excess of £5mn per year.

However, the loss to an audit firm from the termination of an audit contract goes far beyond the loss of that contract value.

First, the audit firm would lose the value of the relationship-specific investments. There are also economies of scale and scope arising from the relationship-specific investments, whereby an audit firm becomes more efficient at, for example, auditing one large complex business if it has some ongoing experience of auditing another large complex business (this efficiency increases with the similarity between comparable organisations, for example in terms of industry, geography, etc). Losing an audit client might mean that the ability to realise some of these economies of scope will be reduced. This might be more significant if the audit client is particularly large or required the development and use of certain specialist skills.

Losing an audit client implies a reduction in the ability to win or retain other audit clients in the future. This is because of two factors. First, loss of an audit client of a certain size or complexity or in a certain sector represents a loss in the audit firm’s relevant experience base. The experience base of an audit firm (in terms of size of company audited, complexity or sector) is an important aspect of audit quality. It also provides a signal to shareholders that the audit firm is competent enough to pick up any errors, and minimises the time involved for management to help the audit firm learn about the business and its complexities. A reduction in the experience base of an audit firm thereby implies that the audit firm is less likely to be able to provide a high quality service to other new audit clients, and therefore the less attractive that audit firm becomes to potential new clients. In this way the loss of a current audit client decreases the probability of winning new audit clients.

Second, loss of an audit client might damage an audit firm’s reputation for quality. Any aspects of poor quality of service are likely to become common knowledge across company management, as finance directors, non-executives and audit committee chairs all sit on multiple boards, whereby issues around audit firms’ quality can be communicated (we discuss this issue further in the next section on “dynamic competition”).

As set out in section 4.1.3 the number of FTSE350 companies in certain sectors is very limited. Losing one audit client in a sector with only a small number of available companies implies that a key source of sector experience for the audit firm is lost. It is then much harder to compete for a new contract for companies in that sector should one arise. Finally, the same negative consequences for an audit firm losing a major audit client are mirrored in the advantages of another audit firm gaining that client. This magnifies the intensity of competition.

7.2.2 Evidence on the competitive constraint imposed by the bargaining process

The outcome of these bargaining interactions is that our audit clients are consistently able to exert a strong competitive constraint, without the need to go out to competitive tender. This section sets out the evidence on these competitive constraints and the outcome of bargaining processes between audit firms and their audit clients.

Buyers consistently place pressure on audit fees and we have to react to retain clients. [redacted] [redacted] [redacted] [redacted].

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94 [redacted].
95 [redacted].
96 [redacted].
This example shows how competitive pressures translate not only into lower prices and the need to maintain a high quality, but also in audit firms striving to become ever more efficient in the delivery of their products in order to maintain an acceptable level of return.

[redacted]⁹⁷; ⁹⁸; ⁹⁹; and ¹⁰⁰.

7.3 Conclusions on short-term competition

Short-term competition takes place both through the competition to acquire new audit clients and through the efforts to retain existing ones.

Competition to win new audit clients is evidenced by the efforts audit firms exert and the investments audit firms make to win audit clients from rival audit firms. This occurs both in the context of formal tendering processes and through unsolicited approaches to rivals’ audit clients.

Competition to retain an audit client materialises through the annual reviews that audit clients have in relation to their audit providers. These entail the renegotiation of the original terms of the audit contract and affect both the audit fee level and the scope of the audit.

These reviews involve a bargaining process between audit firms and their audit clients. What ultimately determine the price that is charged are the negotiating skills within the constraints of each party’s outside options.

In summary, given the scale of the relationship-specific investments undertaken both by the audit firm and the audit client, both parties will have a strong incentive to ensure the relationship continues. This cannot be expected to lead to frequent tendering and switching despite fierce competition driven by the wider costs of losing audit clients and the wider benefits of keeping them (economists call these externalities). Frequent switching would be an inefficient market outcome where the value of significant investment would be lost. Indeed in these circumstances switching and tendering rates would be an extremely poor indicator of competitive pressures.

⁹⁷ [redacted].
⁹⁸ [redacted].
⁹⁹ [redacted].
¹⁰⁰ [redacted].
8. Dynamic Competition

Summary

Providing a high quality audit to large companies is complex and requires continued investment and significant resources. These investments are driven by the audit clients’ requirements and by the audit firms’ need to ensure the delivery of a quality product to avoid losing market share to competitors. This implies that the natural market structure is one with relatively few firms providing a high quality service. However, this does not imply that the market is uncompetitive or not functioning efficiently; rather this market structure is the outcome of a highly competitive process, based on sunk cost investments.

275. This section discusses competition in the supply of statutory audit services to large companies in the medium-term to long-term. More precisely, it highlights the competitive pressures that incentivise audit firms to make investments in order to win new audit clients over that timeframe. Importantly, these competitive pressures give rise to the observed market structure in the supply of statutory audit services to large companies.

276. Section 8.1, explores the drivers of large audit firms’ investments; section 8.2 then discusses the nature of investments that are not firm-specific and how these result in economies of scale and scope; and section 8.3, discusses how investments are necessary to maintain the high quality of service provided and thus to sustain a reputation as a trusted supplier. Finally, section 8.4 sets out the implications of dynamic competition on market structure.

8.1 The drivers of investment

277. There are several reasons for audit firms to invest. In particular, there are three main drivers. First, the level of audit quality required to be competitive in the marketplace, discussed in sections 5 and 7, calls for substantial investments over time. As discussed in section 5, audit clients’ needs and expectations are growing and audit clients can judge the quality of service provided. In this context, a large audit firm strives to achieve market leadership and is under pressure to ensure that its capabilities do not slip behind those of its competitors. This requires ongoing investments, including those driven by the need to keep up with the latest technological developments, and make use of them to ensure audit quality is as high as it can be.

278. Second, the need to minimise the probability of major mistakes also requires investment. The probability of these mistakes occurring is mitigated by resource-intensive quality control systems, high quality training and the ability to recruit talented applicants, among other factors, all of which require substantial investment.

279. Third, audit firms need to comply with increasingly tight and demanding regulations and this requires substantial investments in professional development.

280. Most of these investments improve the competitive position of an audit firm across the whole client base.

8.2 Investment in quality that is not specific to an individual client

281. Section 5.1 reviewed the types of general (i.e., not relationship-specific) investments made by a large audit firm in order to meet customers’ requirements and thereby provide a high quality service. KPMG’s own experience identifies the following main areas of investment:
a) a global network, including a global methodology and an associated IT software for the application of a multinational audit with a consistent approach;

b) recruitment, retention and development of top quality staff, at junior and senior levels;

c) ability to devote sufficient high quality resources on new and existing projects at any time (“bench strength”);

d) technology and methodologies, with the development of tools like eAudit and KAM (which reinforce global consistency);

e) development of sector expertise, including marketing, technical material, thought leadership, etc; and

f) quality assurance processes and advanced conflicts and independence systems and controls, including state-of-the-art risk management and compliance frameworks.

282. These investments are not relationship-specific nor, necessarily, even sector- or audit-specific. In other words, they improve the quality of the services offered across the whole of the client base. These investments are driven by the need to provide a high quality service in an efficient way to clients, as well as in some cases by regulation.

283. These sunk cost investments lead to scale and scope economies which improve the performance of an audit firm in the medium-term to long-term. Economies of scale and scope imply that the same scope and quality of statutory audit output can be achieved with less input on behalf of the audit firm (such as the number of staff, the time required or other resources). This results in reduced costs for the audit firm, which in a competitive environment are passed on in the form of savings to customers. Equivalently, for a given level of resources employed on a given engagement, an audit firm that has invested effectively in the past will be able to offer a higher quality or wider scope than a firm that has not.

284. For example, an audit firm that invests in developing an electronic tool (be it an advanced technology or a specific methodology) that can be used in auditing a variety of companies will be able to deploy this tool across its client base and this will give rise to scale and scope economies as discussed above. This will in turn increase its ability and incentive to compete for a larger number of audits for a potentially diverse client base.

285. Learning-by-doing (for example when expertise in auditing a certain client is improved by the experience of having audited similar clients in the past) has similar characteristics. Audit firms have an incentive to compete aggressively for business that enhances their learning with a view to being more efficient and a higher quality provider for future audit clients. As a result, as discussed in section 7, audit firms have an incentive to compete for and retain audit clients for benefits that go beyond the fees they will earn from a particular engagement.

286. The need to invest and innovate is an important item for discussion at board level. [redacted] Similar investments in thought leadership and intellectual capital are made in other sectors, though this is often not specific to audit.

287. Audit firms that sufficiently invested in the areas that are valued by audit clients reaped the benefits generated by the economies of scale and scope and grew their market share. Deloitte is a good example of an audit firm with previously relatively low representation in the FTSE100 that grew in the medium term by investing and benefitting from scale and scope economies.

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102 [redacted].
103 Here we draw from Deloitte’s own account of its growth model (see Deloitte, Initial Submission to the Competition Commission, pages 5-6 and 15-16; available at http://www.competition-commission.org.uk/inquiries/ref2011/statutory_audit_services/initial_submissions.htm).
expansion was due to takeovers (including of Arthur Andersen’s after the Enron scandal), organic growth has also been a key driver for Deloitte’s success. This is evidenced by a sizeable increase in the number of FTSE100 clients audited: from 5 in 1995 to 17 in 2011 (excluding the five FTSE100 clients gained after the Arthur Andersen takeover). Deloitte’s experience shows that audit firms can successfully expand in the market provided they are willing to carry out the necessary investment.

8.3 The need to maintain a reputation for high quality of services

288. An important element of audit clients’ ability to evaluate the quality of an auditor is the performance of that auditor in the work they do for other clients. Good performance can be communicated easily in the market and so can poor performance. The latter is of particular importance in a context where auditors do not just need to satisfy their customers but also need to be seen by investors at large as reliable and high quality. In this context, the reputation of an audit firm for high quality services (particularly in relation to the quality of the audit opinion) is of particular importance.

289. An audit firm’s reputation is directly driven by the audit quality it provides to its clients. A track record of delivering high quality audit services and acting with integrity can only be built over time. However, like any reputation, it can be lost with just one significant mistake.

290. In this sense, reputation reflects past and current investments undertaken to develop the capabilities that large audit clients demand (which were discussed in detail in section 5.1) and ultimately the quality of the service provided. In addition, reputation reflects investments in quality control processes such as the time and expenditure devoted to compliance with ethics and independence rules. Setting up these quality control processes represents a costly investment for large audit firms, even before accounting for the implementation costs (ie the resources employed on performing the quality control on each project).

291. The speed with which reputation can be compromised is evidenced by the fate of Arthur Andersen. We are well aware of this risk and follows specific procedures to mitigate it [redacted].

292. Finally, a large audit firm’s reputation as a successful and trustworthy provider of high audit quality is instrumental in attracting high calibre staff members, both junior and senior. In turn, these talented individuals contribute to the consistent delivery of high quality audit services.

8.4 Implications for market structure

293. The nature of the costs that drive quality fall into two broad categories:

a) Variable costs: where quality is improved by using more inputs in the audit delivery, such as increasing the number of hours worked or the number of staff employed on an engagement; and

b) Sunk fixed costs: where quality is improved by sunk cost investments, which improve the quality of audit services on any engagement, irrespective of the resources (ie the variable inputs) employed on a given engagement.

294. In the case of audit, for example, quality can be enhanced either by committing additional hours of audit time (ie variable costs), or by developing the processes, range and depth of capabilities (whether intellectual, process-related or personal) that can be drawn on whenever necessary. The latter are the sunk cost investments discussed in this section (and further evidenced in section 5).

295. If quality is associated with variable costs, it would be unprofitable for high quality firms to try to undercut lower quality firms. A fragmented market structure can develop with multiple firms,
each of a different quality level catering for different customer preferences and willingness to pay for quality (e.g. restaurants).

296. However, when quality is associated with fixed sunk costs, high quality firms have an incentive to compete for market share. This is because high quality firms can sell at a premium over lower quality producers but still offer customers a better (quality-adjusted) deal. If customer differences in willingness to pay for quality are not too broad, lower quality products will not survive in a competitive market. Thus the natural market outcome is one with few, high quality suppliers. In other words, these investments are key drivers of market structure in the supply of statutory audit services to large companies.

8.5 Summary of dynamic competition

297. The level of market concentration is a result of market forces. It is an outcome of the competitive process rather than a feature of the market which itself shapes competition. The demand for quality audit services by customers drives the need for audit firms to maintain high quality services relative to competitors, as well as a reputation for high quality services. This in turn requires audit firms to conduct sunk cost investments to drive up quality and ensure that margin for errors are kept as low as possible. The incentives to compete in this type of investment, and the sunk nature of such investments, result in a market structure where a high level of quality for large and complex businesses cannot be provided by a large number of firms.

298. This does not rule out the possibility for market leaders to be challenged by an aggressive investor in quality. The ability to engage in this investment and to reap benefits is there for companies to exploit.

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105 See Shaked and Sutton (1983) for the theoretical underpinnings of this argument.
Part C: Addressing the CC’s Theories of Harm

9. Addressing theories of harm

Section summary

This section will demonstrate that the CC’s theories of harm do not hold and that they do not identify features that give rise to adverse effects in the supply of statutory audit services to large companies.

299. Part A of this submission described the nature of audit services and the characteristics of suppliers and customers of these services as well as the regulatory context for their provision. Part B described how competition for these services takes place over a range of parameters both in the short and medium to long term.

300. This section addresses in turn each of the theories of harm set out by the CC in its Issue Statement, by drawing on the material presented in the previous two parts of this submission.

9.1 “The audit market is highly concentrated and there are high barriers to entry with the result that the four largest firms have market power”

301. At paragraphs 25-32 of its Issues Statement, the CC listed the following potential barriers to entry (and expansion) in the supply of statutory audit services to large companies:

a) the size and reputation of established audit firms;

b) sunk costs and economies of scale and scope associated with the statutory audit of large companies, eg an extensive and integrated international network and the ability to provide additional audit-related services;

c) the specific knowledge required to operate in the market;

d) costs of attracting and retaining staff;

e) the costs of raising capital for mid-tier audit firms; and

f) covenants and conflicts of interest that restrict auditor choice in certain circumstances.

302. Many of these features referred to as potential “barriers to entry and expansion” by the CC are the result of investments in quality made by the audit firms, which are driven by the competitive environment in which these firms compete.

303. The reputation of established audit firms is a result of the quality of statutory audit services demonstrated over many years, which they are able to provide as a result of the investments in quality we discussed in sections 5 and 8. The CC considered this possibility at paragraph 31 of its Issues Statement, suggesting that reputation may not be an exogenous feature of the market, but “may be due to the investment that the four largest firms have made in building expertise, quality of service and reliability, through years of competition.” As explained in this submission, we agree with this view of reputation; that it is an endogenous feature of the market, which is driven by customer needs and the demand for high quality statutory audit services.
304. Similarly, competition drives audit firms to make sunk cost investments (including those identified in points a) and b) in paragraph 301 above) in order to improve quality which in turn generate scale and scope economies. Economies of scale and scope are also endogenous features of the market, driven by clients’ demands, and make large audit firms more efficient and effective. We agree with the CC where it states in paragraph 32 of its Issues Statement that “the presence of economies of scale and scope could give efficiency advantages to larger firms and could explain a high level of concentration in the market.”

305. Reputation and economies of scale and scope are therefore a result of competition driving investments in quality. As such they should not be viewed as exogenous market features but rather outcomes of a competitive process.

306. The CC should be cautious in placing any weight on standard measures of concentration in this industry. Concentration measures (including the Herfindahl-Hirschman Index (HHI)) ignore concentration on the buyers’ side of the market. In industries such as statutory audit services where the number of customers is relatively small, this implies that measures of supplier concentration are likely to be biased upwards.

307. This is particularly true if concentration within a sector is considered, as the CC does in paragraph 30 of its Issues Statement. If, for example, in a certain sector there are only two large companies (and each is charged the same audit fee), then even if each of these companies’ statutory audit services are supplied by different audit firms, by definition the market share of each audit firm providing services to clients in that sector will be 50 per cent. As a result, any measure of concentration will be relatively high. This is however a function of the concentration on the buyers’ side, which imposes a lower bound to measures of supply-side concentration in the audit market (measured at sector level).

308. More generally, given how competitive pressures are exercised in this industry (that is, by large sophisticated and well informed clients through a process of bargaining) it is inappropriate to consider measures of supplier concentration to be informative of the degree of market power enjoyed by suppliers. Rather the bargaining position of buyers and suppliers should be considered. As discussed in section 7, this essentially involves considering the credibility of a threat to switch. In this context it is important to consider three points in particular. First the set of firms a customer may credibly threaten to switch to may be broader than implied by sales figures for given categories of customers. Second, a client may only need one credible alternative to provide an effective competitive constraint to its supplier of audit services. Third, clients’ bargaining position is further strengthened by the fact that to lose an audit client represents for an audit firm a very significant loss (which may be greater than that suggested by the proportion of the audit firm’s revenue represented by the lost audit client). In this context, concentration measures are unlikely to provide any meaningful guidance as to actual competitive pressures.

309. The CC considers other alleged barriers to entry and expansion which might be more reasonably treated as exogenous. In relation to the costs of raising capital as a potential barrier to expansion, we note that Aviva and others have submitted to the CC that capital requirements do not pose a material constraint. This is further evidenced by the expansion by Deloitte (which we summarised in paragraph 287): audit firms that effectively invest in quality, across its different facets, are able to grow and win significant shares of large firm audits. Moreover, investment is often about time and effort rather than large capital outlays.

310. In relation to the possibility of restrictive covenants’ in banks lending agreements, whilst we have not undertaken any survey of our own client base or more widely, we are not aware that boilerplate contractual terms which require a company to employ one of the largest four firms audit firm are significant considerations in the selection of the external audit firm.

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106 See, for example, paragraph 25 of the CC’s Issues Statement.

107 See paragraph 1.17 of Aviva’s written evidence from Iain Richards, submitted to the CC.
In summary, high concentration and barriers to entry are not features of the market that give rise to an adverse effect on competition. Rather, the size and reputation of successful audit firms are the endogenous outcome of medium-term to long-term investments that underpin competition in quality, which is demanded by audit clients (and regulators).

9.2 “The four largest firms could bundle together services in order to create barriers to entry in the market for statutory audit and in related markets”

At paragraph 33 of its Issues Statement, the CC notes that audit firms offer a number of “audit-related services”, such as advice on regulatory compliance and assurance reviews of internal controls and processes. It also points out that many audit firms (“particularly the four largest firms”) provide a range of non-audit services (such as tax advice, transaction services and corporate finance).

The CC notes a potential theory of harm that the bundling of audit services together with audit-related and/or non-audit services may create barriers to entry and expansion in these markets. The CC states that it will first investigate the extent to which firms have market power in these markets. Second, it will analyse whether market power in audit services facilitates the provision of non-audit services; and vice versa, whether market power in non-audit services facilitates the provision of audit services.

The CC also notes that bundling may not have any adverse effects on competition but rather that “it may be that any bundling of services reflects the wish of the customers, and it may be that any discounts for joint supply, as opposed to separate supply, of the different services reflect auditors’ cost savings (ie economies of scope).”

For convenience, we will adopt the same definitions of pure bundling, mixed bundling and tying as the CC’s (paragraph 34 of the CC’s Issues Statement). Further, pure bundling and tying can either be technical or contractual:

a) In the case of technical tying (or technical pure bundling) the two goods or services that are sold together cannot be separated by the customer.

b) Under contractual tying (or contractual pure bundling) the two goods remain physically distinct, they are simply sold together (and the customer agrees to buy them together from the same supplier).

Economic theory and competition practice underlie the potential for efficiency reasons behind bundling and indicate that for bundling to lead to anti-competitive effects, certain conditions have to be satisfied. Important conditions include the following. First, for an individual firm to adversely affect competition with a bundling strategy, it has to face little competition in the market where it sells the products that other products are “tied to” (the “tying market”). In other words, it has to enjoy significant market power. Second, adverse effects are more likely to arise for technical tying. Third, there needs to be high complementarity between the services that are offered as a bundle for clients to have a strong incentive to use them in combination and for competitors to need to offer it as well.

We discuss next our approach to providing services and argue that no conditions exist to indicate that any bundling may lead to anti-competitive effects. On the contrary there are strong efficiency reasons for some products to be provided in combination.

9.2.1. KPMG’s approach to the provision of audit, audit-related services and non-audit services

We set out the services we offer in section 3.1, grouping them in three categories:

a) statutory audit;

b) audit related services; and
c) other non-audit services, such as tax advice and advisory services more broadly.

319. First, as discussed in section 2.5, we note that professional standards limit the scope for an audit firm to provide non-audit services to its audit clients, and in particular prohibit any audit staff being remunerated for selling non-audit services to those audit clients on whose audit they work (see footnote 42).

320. Second, as we explained in section 3.1, many of the audit-related services (to the extent they are required by an audit client) are generally provided by the same firm in charge of the statutory audit. This mainly occurs due to regulatory requirements or on the grounds of efficiency, given the large overlap of activities with those of the statutory audit.

321. In effect the overlap between audit related services such as those listed in section 3.1 (some of which are mandated by regulation) and the work required for a statutory audit implies that the former hardly constitute distinct, stand-alone services from the statutory audit.

9.2.2. Efficiencies arising from the joint provision of audit work and audit-related services

322. In the case of non-audit services, where their provision to audit clients is permitted by regulation, it is done so in markets that are characterised by a multitude of options for audit clients and where those clients regularly source their services from multiple suppliers. We are not aware of services that could be described as being supplied under technical tying in these markets. These factors undermine the idea that audit clients see a high degree of complementarity between these services and that audit firms are required to offer a bundle in order to compete.

323. There are, however, substantial efficiencies in having the same supplier providing both the statutory audit and audit related services, as well as, in some cases, for audit and non-audit services.108

324. First, there are economies of scope in providing audit-related services to the same audit client. The existing auditor will need less briefing time and will already have built an intimate knowledge of the client’s business and its industry, also in light of relationship-specific investments. Moreover, in providing audit-related services, an audit firm will be able to draw seamlessly from its own work performed in the context of the statutory audit. More generally, the sector expertise achieved through audit work can also improve the quality of non-audit services.

325. Second, there are direct savings from the audit client’s perspective too, including the possibility of one-stop shopping; continuity and consistency in the services provided by an auditor they trust; and very little managerial time needed to brief the adviser.

326. In summary, audit and audit-related services are often provided together because it is inherently efficient to do so.

9.2.3. Market power in non-audit services and barriers to entry in the UK audit market

327. The CC also raised the potential concern that firms may use their market power in the markets for audit-related and other non-audit services to raise entry barriers in the UK audit market, via the use of bundling or tying (paragraph 35 of the CC’s Issues Statement). In our view, this potential theory of harm is completely unfounded.

328. First, professional standards constrain the extent to which large audit firms can provide many of these non-audit services to an audit client (see section 2.5).

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108 For example, in performing acquisition due diligence the audit firm would obtain significant information on the business, accounting practices and financial processes of the target entity which would be contribute significantly to the audit firm’s knowledge when auditing that business subsequent to completion of the acquisition.
Second, FTSE companies tend to use their acquisition of non-audit services as a mechanism to assess accounting firms other than their auditors. This alternative sourcing also avoids dependence and helps improve buyers’ bargaining position. Audit committees at some clients are particularly keen on buying from a variety of providers to avoid perceptions of undue reliance on their audit firm.

Third, while a full analysis of the markets for other non-audit services is beyond the scope of this submission, we argue that the set of large players that are active in the provision of some or all services which constitute other non-audit services such as tax advice, corporate finance, transaction services and other areas of consulting is much larger than that of large audit firms. These players include large investment banks (as well as the investment banking arms of universal banks), actuaries, legal firms, global management consulting firms as well as boutique advisory firms with particular specialisms.\(^{109}\)

For these reasons in our view there is no basis for the assumption that an audit firm, such as KPMG, could raise barriers to entry in the UK audit market by exploiting its “market power” in these other markets.

9.2.4. Conclusion

To the extent that audit firms sell audit-related or other non-audit services to audit clients, this does not amount to bundling, and there are good efficiency reasons for this joint provision. Furthermore, the conditions for bundling and/or trying to be anti-competitive, even if such practices did occur, are not satisfied.

9.3 “Customer conduct limits competition, in particular by tendering infrequently”

The CC noted that companies incur significant costs when switching auditor. It listed the following main categories of switching costs:

a) management and audit committee time required to select a new auditor;

b) the time required to familiarise the new auditor with the company;

c) the risk of a new auditor making mistakes initially; and

d) forgoing other advantages of long-term personal relationships (including confidence in the auditor’s ability).

However, it is incorrect to apply the standard economic “switching cost” framework to these sorts of costs. Rather, costs such as those set out in a) to d) above are the result of losing the benefits from relationship-specific investments made with the incumbent auditor, and having to make these again with a new auditor. These investments are discussed in section 5.2. As a result of these investments it would be inefficient for there to be frequent switching of statutory audit supplier, as this would imply frequent duplication of these investments. As with the barriers to entry discussed in section 9.1, the rates of switching observed in this market are driven not by exogenous factors (such as customer conduct) but rather by competitive forces that determine the investments made in quality, in this case specific to an individual client relationship.

By the same argument, it is the nature of the product (including the relationship with an audit firm) that determines the frequency of the tendering.

Section 7 sets out the impact of these investments on the bargaining process between audit firms and their clients. It showed how the substantial costs to an audit firm from having an audit client

\(^{109}\) Moreover, in recent years, KPMG UK’s experience is that large companies in particular have been retaining the services of external procurement companies in the procurement of other non-audit services. This intervention has added further competitive tension in the bidding process and negotiation of commercial terms for this type of work.
switch away imply that the audit client is able to impose strong competitive constraints on its audit supplier through renegotiations, and thereby without issuing a new competitive tender. Moreover, companies are able to learn much about alternative options without issuing a tender, as other audit firms make approaches and court clients to win business, involving substantial and ongoing investment (again see section 7). The CC also recognised the competitive pressure that the threat of tendering alone may exert on audit firms (paragraph 40 of the CC’s Issues Statement). Finally, when tenders do take place, competition is fierce, as the prize for winning can be substantial (see section 7.1). This is also recognised by the CC (paragraph 41 of the CC’s Issues Statement).

337. Finally, our experience is that customer conduct is, in fact, a major driver of competition. As discussed in detail in sections 7.2 and 7.3, [redacted] audit clients are able to effectively negotiate fee reductions from their existing auditor through negotiation, even where they indicate a preference not to switch provider.

9.4 “Specific features of the market may make it particularly prone to risks of regulatory failures which could lead to a reduction or distortion of competition in the market”

338. The CC’s theory of harm comprises three parts. First, it argues that large audit firms have excessive influence on the regulators (and could for instance lobby for increasing regulatory standards that only they can meet). Second, the regulators’ fear that a large audit firm may fail might induce the regulator to favour these firms in order to try to prevent that occurrence. Third, the existing level of regulation may be sub-optimal: over-regulation could create barriers to entry, while under-regulation may result in low-quality service.

339. Regulatory intervention is intended in this industry to ensure consistent high quality audit in order to minimise the incidence of the issuance by audit firms of inappropriate audit opinions and thereby undermine investor confidence in corporate reporting and, ultimately, financial stability.

340. The main objection to this theory of harm is that KPMG and the other large audit firms have not driven the development of the regulatory framework (discussed in section 2).

341. Regulatory processes are open and transparent and the influence of the audit firms and indeed the audit profession is explicitly constrained by the structures which are designed to ensure that public interest considerations are paramount. It is not therefore clear how the arguments made by the CC constitute a competition issue.

9.5 “Tacit coordination between the four largest firms results in less competition in certain sectors”

342. At paragraphs 46-47 of its Issues Statement, the CC suggested that certain of the conditions for tacit coordination are likely to be satisfied, namely:

a) high concentration;

b) significant barriers to entry;

c) limited competitive constraint by mid-tier firms;

d) price transparency;

e) existence of switching costs;

f) stable demand due to statutory requirement for an audit;

g) stable market shares; and
h) similar business models and cost structures across large audit firms due to audit and accounting standards and other regulatory requirements.

343. As the CC suggests (paragraph 49 of the CC’s Issues Statement), coordination around prices is highly unlikely in the supply of statutory audit services. Even if the audit fee is disclosed, public sources do not include sufficient information on the detail of the work to be undertaken and the locations to be covered in order to issue an audit opinion, so the fee alone is not informative to competitors. This is particularly the case for larger and more complex clients, for which the variables which define the detailed activities required to deliver an audit are more diverse and significant.

344. Instead, the CC notes that tacit coordination might be centred on coordination on customer identity or sectors. However, it is difficult to see how audit firms have the right incentives to sustain tacit coordination. For coordination to be sustainable, audit firms would have to forego the opportunity to compete for a given customer’s audit with a view to being rewarded at some point in the future for a contract to be won on the basis of a less competitive tender. For such behaviour to be internally sustainable audit firms would have to be confident that they know which future customers are allocated to them and be comfortable that the increased profits due to less than effective competition in the future more than compensate for the foregone opportunity to gain a new client in the present tender round110.

345. A few key facts about competition in audit are enough to show how such an occurrence is entirely unrealistic. First, there is great uncertainty about the length, and therefore the value of audit relationships. They may be terminated not only because of poor performance, but as discussed, also for external reasons, such as mergers and other changes at the client (such as its success or failure in the market) that are entirely outside the control of audit firms. Several clients have switched audit firm as a result of mergers and acquisitions, such as Taylor Wimpey’s switch to Deloitte following the merger of Taylor Woodrow with George Wimpey in 2007, ITV’s switch to KPMG as sole auditor following the merger of Granada and Carlton Communications in 2004, and International Consolidated Airlines Group’s switch to E&Y as the sole group auditor following BA’s merger with Iberia.

346. This is confirmed by the way in which audit firms go about competing for business. Section 7.1 gave many examples, not only of very aggressive competition during tenders, but, importantly, outside tender events. Audit firms continuously seek to win new audit clients by putting themselves forward and trying to win the confidence of companies that are not currently audit clients. [redacted] This describes the opposite of a market where coordination takes place.

347. Audit relationships are also likely to be valued differently by different firms depending on the benefits that auditing a given audit client is likely to bring in terms of learning by doing, reputation and other factors. These differences in valuation override any similarity between audit firms, of the form noted in paragraph 342 h). These factors are not only different between firms but extremely hard to evaluate. Moreover, the audits of large companies come up for tender at an unpredictable rate. This in itself renders impossible any attempt to tacitly identify any coordinated behaviour as well as to trade off current profits against future ones. In practice we and our competitors compete for audit engagements whether invited or not [redacted].

348. Secondly any punishment of a deviation from a tacit agreement, for the same reasons, would be very uncertain in its timing and effect.

349. In other words, far from being provided in a stable market, audit services are constantly evolving due to changing regulatory requirements and best practice, audit firms’ investments in quality improvements and new capabilities as well as companies’ evolving audit needs.

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110 Even taking into account the ability for audit firms to sell non-audit work to those companies for which they do not provide statutory audit services, it is hard to see how firms would have an incentive to sacrifice a new opportunity. [redacted] In any event, the unpredictable nature of contracts for all of these services (audit and non-audit) means that incentives to tacitly coordinate are not satisfied.
9.6 “Information asymmetries and conflicts of interest adversely affect audit quality and allow the four largest firms to maintain market power”

350. In its Issues Statement the CC sets out two aspects in relation to information asymmetries, which are discussed here in turn.

351. First, the CC suggests that there may be an information asymmetry within the audit client itself, between shareholders on one hand and the board of directors on the other: directors may have different incentives from those of the shareholders. We note that a market failure of this type may be solved through the appointment of trusted, independent auditors.

352. Second, there is an information asymmetry between the audit client (comprising shareholders, audit committee and finance directors) on one hand and audit firms on the other. The CC states that an informational asymmetry may arise from the fact that the quality of an audit may not be properly assessed even after the service is delivered. The CC then states that, as a result of this difficulty in assessing audit quality, finance directors may opt for one of the four largest firms due to their reputation.

353. We do not believe that audit quality is difficult to assess, although some aspects of quality can be difficult to quantify or observe directly. Other parts of this submission state that there are many ways in which organisations can and do assess the quality of their auditors or otherwise benchmark their performance (see for example, section 4.2 and paragraphs 251 to 253). Moreover, there are independent external review processes conducted by bodies such as the AIU, which provide companies with useful reference points. In some cases, clients may also rely on a firm’s reputation. However, as explained above, reputation is the product of consistently good performance and hence an efficient signal to market of consistent high quality.
Part D: Market Outcomes

10. Market outcomes

Section Summary

This section demonstrates that the possible adverse outcomes discussed in the Issues Statement are not present. Audit quality is generally very high, which is borne out by KPMG’s own quality reviews, client feedback and the generality of AIU reports into audit firms.

Prices are not generally the subject of client dissatisfaction; they are reflective of competitive pressure; and they tend to reflect the complexity of service and high quality of delivery.

Competition in non-audit markets is not distorted by the provision of audit services due to the operation of independence rules and competitive forces in those markets.

354. The CC’s Issues Statement stated that adverse effects might arise through any or all of:
   a) suboptimal quality and levels of innovation;
   b) higher prices and costs; and
   c) less competition in non-auditing markets.

355. This section addresses each of these potential adverse effects in turn and shows that none of these arise in the supply of statutory audit services to large companies.

10.1 Suboptimal audit quality and levels of innovation

356. Typically, there may be concerns about the possibility that firms with market power cannot only increase prices above competitive levels but also lower quality below what a competitive market outcome would generate. The CC has suggested, however, that one potential adverse effect on competition (AEC) could be that quality levels in the UK audit market are “sub-optimal”; either by being excessively low or excessively high. For simplicity, we do not discriminate between quality and innovation, as the economic arguments behind them would be very similar. Moreover, in the audit market, it would be difficult to draw a precise boundary between these two aspects of competition.
This section demonstrates that the quality of audit is high. It considers two important sources of information on audit quality: the AIU’s annual reviews and KPMG’s own QPR framework. It then refers to some evidence from clients.

**Recent AIU Report results**

As outlined at paragraph 62, above, the AIU undertakes annual reviews of a selection of audits conducted by the largest four audit firms each year.

The AIU’s 2010/11 of 14 of KPMG UK’s audits found general satisfaction with the basis on which significant audit judgments were made. In particular, the report found that:

- **a)** KPMG UK places considerable emphasis on its overall systems of quality control; and
- **b)** KPMG UK has appropriate policies and procedures in place for its size and the nature of its client base in the relevant areas, which are subject to review.

Nevertheless, the AIU identified certain areas where improvements were required. The AIU’s key messages were:

- **a)** to ensure that audit teams apply appropriate professional scepticism to information prepared by the audited entity’s staff that is significant to material amounts included in the financial statements (such as provisions or recognised revenue) and test its reliability;
- **b)** to consider the need for further action to improve the overall consistency of work performed on key judgement areas;
- **c)** to ensure that the improvements made to the partner appraisal system are also applied to audit managers, particularly in relation to selling non-audit services to entities which are audited by the firm;
- **d)** to readdress as a priority KPMG UK’s recurring findings in relation to substantive analytical review where there are implications for the sufficiency of substantive testing and as a result the overall audit evidence obtained; and
- **e)** to monitor more rigorously the application of finalisation policies and file assembly procedures.

The results from the investigations over the last three years are presented below.
The findings of the AIU process are taken very seriously by KPMG UK’s leadership including KPMG UK’s Head of Audit. Formal commitments are made via a detailed action plan (included in the AIU’s private report) to address the issues raised. The main thrust involves leadership messages and regular alerts; changes to systems/procedures; updated training and enhanced personal development.

The key findings concern audit documentation limitations. In certain cases there have been noted deficiencies in respect of evidence of the audit engagement partner’s direction, co-ordination and supervision of the engagement.

As can be seen from the results of recent AIU reports, KPMG UK’s audits are of a very good standard and no material issues have been raised. On the other hand, there is room for improvement, and we are committed to making these improvements.

**KPMG’s QPR process**

Over the course of the last year, KPMG has further strengthened the Global Audit QPR programme noted in section 5, with the aim of making the reviews undertaken as part of this programme closer in robustness to those undertaken by external audit regulators. Accordingly, in 2011 KPMG International changed the grading system that member firms use in the QPR to make it more akin to the grades and definitions used by many external audit regulators around the world in their reviews. All engagements are awarded one of three grades, namely “satisfactory, performance improvement necessary, and unsatisfactory”:

a) a “satisfactory” grading requires both (i) the audit work performed, the evidence obtained and the audit documentation produced to all comply with KPMG’s internal policy, applicable auditing standards and legal and regulatory requirements and (ii) key judgements concerning significant matters in the audit and the audit opinion itself were appropriate;

b) a “performance improvement necessary” grading is attributed where the auditor's report is generally supported by the work performed and the auditor's report is appropriate. However, improvements are necessary in one or more significant areas including with respect to the documentation of the work performed; and

c) an “unsatisfactory” grading is attributed where the engagement was not performed in accordance with the firm’s policy and professional standards in significant areas; in particular
there are significant deficiencies in the financial statements themselves, the audit work paper documentation or the actual work undertaken.

367. In the 2011 QPR, 88.2 per cent of audit engagements reviewed were graded as “satisfactory”, 10.9 per cent were graded as “performance improvement necessary” and 0.9 per cent were graded as “unsatisfactory”. Whilst it is not possible to provide direct comparative scores for the 2010 programme (due to the change in the engagement grading system described above), we believe that other indicators from the 2011 programme suggest an improvement in the quality of engagements reviewed in 2011 over 2010. [redacted].

368. In terms of remedial actions all audit engagement partners receiving a “performance improvement necessary” grading are subject to a review in the following year and all audit engagement partners receiving an “unsatisfactory” rating or a “performance improvement necessary” rating on a Public Interest Entity audit will be subject to a review of another of their engagements in the current year. In addition, the ratings from the annual QPR exercise are included in the annual quality and risk metrics issued for all engagement leaders for all functions (which are relevant for performance evaluation and compensation above).

369. Audit engagement partners are notified if (i) any subsidiary in their respective cross-border and/ or global audit accounts was subject to review and received a less than satisfactory rating; and (ii) if a subsidiary of their global account is audited by a KPMG member firm where more pervasive quality concerns have been identified during the Global Audit QPR.

370. Similar to the AIU results, the level of audit quality observed by KPMG’s QPR system indicates that there is room for improvement in audit quality, indicating that levels of quality, despite being a central aspect of the provision of audit services, cannot be characterised as “excessively high”.

Views of customers

371. Evidence from customers during the House of Lords Select Committee inquiry attested to high levels of quality in the provision of audit services, arising from competition between audit firms:

a) the Chairman of the Hundred Group\textsuperscript{112} stated that this group is “content in general terms with the service provided and the competition that we observe in the market today”. This witness added that “audit firms know that we have a choice and that very often is all you need to keep their pricing and the quality of their service honest”;\textsuperscript{113},

b) commenting on the delivery of the audit opinion, the Chief Finance Officer of Pearson and member of the Hundred Group stated: “Could we get it cheaper? Possibly, but there’s also an issue about quality. We want to make absolutely certain that we are getting the best advice”;\textsuperscript{114} and

c) commenting on the value-added services, provided to an auditor using insights picked up during the course of conducting work for the audit opinion, the Chairman of the Hundred Group noted that these services add “a lot of value to the audit committee and provides a lot of perspective, context, even assurance for the non-executive directors, which you wouldn’t get from an insurance policy but you can get from your auditors”;\textsuperscript{115}

372. The level of quality in the UK market therefore cannot be characterised “suboptimal”, and hence this cannot be a source of adverse effects to customers.

\textsuperscript{112} The group of Finance Directors of FTSE 100 companies.
\textsuperscript{113} House of Lords Select Committee on Economic Affairs, “Auditors: Market concentration and their role”, page 11.
\textsuperscript{114} House of Lords Select Committee on Economic Affairs, “Auditors: Market concentration and their role”, page 262.
\textsuperscript{115} House of Lords Select Committee on Economic Affairs, “Auditors: Market concentration and their role”, page 262.
10.2 Higher price and cost

373. Section 7 discussed the nature and the extent of short-term competition (including price competition). This included evidence that KPMG feels pressure on prices both when it tries to win new audit clients and in the context of the renegotiation processes with its existing audit clients. [redacted].

374. The evidence from the chair of the Hundred Group (see paragraph 372 a)) also notes that this group of finance directors are content that competition keeps prices low.

375. In any event, in our experience it is clear that clients are able to negotiate lower prices from their audit firm through negotiation and/or the threat of switching to another audit firm. [redacted] Thus, where audit clients consider audit fees are too high, they are perfectly capable of negotiating them down.

376. The CC postulates that the market might tolerate inefficient cost levels (see paragraph 20 of the CC’s Issues Statement). As a series of partnerships KPMG is managed by partners who are also its owners. Consequently not only do they need to respond to competitive pressures, but they also stand to benefit directly from the eradication of inefficiency. An example of the efforts made by to lower costs is the considerable investment we are making in setting up low cost delivery centres in India.

377. The CC, in its Issues Statement, also referred to research by Oxera that found that auditors with high market shares could charge higher audit fees; and that an increase in market concentration was associated with an increase in audit prices. In referring the UK audit market to the CC, the OFT stated:

“The OFT’s consultation document noted the results of our econometric analysis of whether audit fees and market concentration were interrelated. The results stated were that there was some evidence, in line with the Oxera Report, that auditors with higher shares of supply (in a given sector and year) can charge higher audit fees and that an increase in concentration in the provision of audit services (in a given sector and year) is associated with an increase in the level of audit fees, when holding other relevant factors constant.” 117

378. We consider that the above analysis is seriously flawed and should be given no weight in the CC’s inquiry. A comprehensive critique of the OFT’s analysis is not provided here. Rather, in Annex 3 we make four observations to demonstrate that it is not possible to draw a robust conclusion of any significant link between market structure and audit fees, based on the OFT’s analysis. The CC also noted in its Issues Statement that this analysis was subject to criticism.

10.3 Less competition in non-auditing markets

379. As regards an AEC in the audit sector leading to less competition in non-audit markets, the CC raises two points in its Issues Statement.

380. First, referring to the Oxera (2006) report, the CC suggested that auditor independence rules may impose limitations on a firm’s choice of suppliers for accounting advice on transactions. [redacted] Oxera constructed a potential scenario of a transaction where the buyer is audited by one of the four largest firms, another of the four largest firms is acting for the seller and the two remaining four largest firms are acting for competing buyers. In this example, Oxera concluded, in absence of appropriate Chinese wall arrangements, the buyer is left without an accounting adviser for the transaction.

116 [redacted].

117 OFT, OFT1357MIR, para. 5.60

118 Oxera (2006), pp86-87
381. This scenario is however at odds with our experience in the market for statutory audit services to large companies. Moreover, Chinese wall arrangements are common in the industry, thus mitigating the potential effects of conflicts of interest. Finally, as Oxera itself noted, the independence rules do not prevent all types of advice on transactions by an audit client’s auditors and the joint provision of these services is often customer-driven [redacted] and efficient (see section 9.2).

382. Second, the CC hypothesised that an audit firm’s knowledge of its audit clients may confer it an advantage over competitors in the provision of other professional services.

383. As explained in section 9.2 in the context of “bundling”, the markets for non-audit services such as management consulting and M&A advice feature major global players, including global consulting firms and investment banks. Large audit firms feel strong competitive pressure from such companies in those markets. It is therefore hard to see how any behaviour in the audit market can lead to consequential effects in those separate markets.

384. Where one does observe the joint provision of audit and audit-related services, this is due to synergies and complementarities between these services, discussed in sections 3.1 and 9.2. To the extent that an audit firm has an advantage in also providing audit-related services to the same client, this will result in a more efficient outcome and a lower cost to the audit client.
Annex 1: Audit Committee Chairs and Financial Directors

This analysis investigates the backgrounds of ACCs and FDs, since this is informative of their ability to judge quality, in two ways:

a) ACCs and FDs with financial or accounting qualifications will on average be better placed to judge the quality of the statutory audit services a company receives because they will understand the technical complexities of the audit, be better placed to question and query audit findings, and be better placed to judge the skills and qualifications of an audit team.

b) ACCs and FDs that hold or have held previous similar roles will on average be better placed to judge the quality of a statutory audit firm as they will have experience of making such judgments and will have observed the consequences of judgments they have made in the past. In addition, having more roles increases the number of contacts an ACC or FD has with other ACCs, FDs, or non-executive directors, through which an ACC or FD can gather intelligence on the performance of different audit firms.

This analysis investigates the profiles of ACCs and FDs in FTSE350 companies (using the FTSE350 list of companies as of the third quarter of 2011). It considers three criteria for both ACCs and FDs:

a) The number of years ACCs and FDs have held their positions;

b) Previous ACC/FD roles held by the current ACCs/FDs; and

c) ACC/FD qualifications and membership of a professional body (eg ICAEW, ICAS, CIMA).

We have gathered the information for points a)-c) above for the ACCs and FDs of the FTSE350 from three primary sources: annual reports, company websites and business databases, including Reuters and Bloomberg. The companies were all present in the FTSE350 as of the third quarter of 2011.

The ACC dataset is comprised of ACCs for all of the FTSE100 companies and from 243 of the FTSE250 companies. For the FD analysis, we used a dataset of 99 FDs from the FTSE100 companies and 207 FDs from FTSE250 companies. The information was not available for all ACCs/FDs and therefore the figures presented in the rest of this annex should be treated as lower bounds to the true figures.

The number of years for which ACCs and FDs have held their positions

The average number of years ACCs had held their position within the FTSE100 companies is 5.6 years (see Figure 9 below). This figure is slightly lower for the ACCs within the FTSE250 companies, at 4.8 years.

FDs have been in their roles slightly longer than ACCs on average. For the FTSE100, FDs have been in their position for an average of 6.7 years, and 6.1 years for the FDs of the FTSE250 companies.

Both ACCs and FDs have considerable experience.

119 Many investment firms have directors without listing the specific roles they hold; these make up the majority of the missing data.
Figure 8. Average years in role for ACCs and FDs

Source: KPMG analysis of company Annual Reports, company websites and business databases (including Reuters and Bloomberg)

Note: These figures are lower bounds. Data was not available for all companies.

Previous ACC/FD roles held by the current ACCs/FDs

77 of the ACCs of the FTSE100 companies and 157 of the ACCs of the FTSE250 companies have had at least one other previous or current ACC or audit committee member role.

Similarly, 68 of FDs for the FTSE100 companies and 146 of FDs for the FTSE250 companies have had at least one previous FD role.

Figure 10 and Figure 11 below represent the number of previous and/or current roles held by the current ACCs/FDs in listed and private organisations, as well as the lower bound for the average number of previous and/or current roles.

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120 For example, an FD may have held that position at a previous company or an audit committee chair may sit on the board of various other audit committees.
Figure 9. FTSE100 Previous or other current roles

Source: KPMG analysis of company Annual Reports, company websites and business databases (including Reuters and Bloomberg)

Note: These figures are lower bounds. Data was not available for all companies.

Figure 10. FTSE250 Previous or other current roles

Source: Company Annual Reports, Company websites and business databases (including Reuters and Bloomberg)

Note: These figures are lower bounds. Data was not available for all companies.

ACC/FD qualifications and/or membership of a professional body (eg ICA, CIMA)

For the companies for which information was available, 52 ACCs and 55 FDs from the FTSE100 companies are qualified in accountancy and/or are members of professional bodies. From the
FTSE250 database, 152 ACCs and 134 FDs are qualified in accountancy and/or members of professional bodies.

The table below represents a lower bound for the percentage of the ACCs/FDs who are qualified in accountancy and/or are members of professional bodies.

**Figure 11. Accountancy qualifications and membership of professional body membership**

![Bar chart showing the percentage of ACCs and FDs qualified in accountancy and membership of professional bodies for FTSE100 and FTSE250.]

**Source:** KPMG analysis of company Annual Reports, Company websites and business databases (including Reuters and Bloomberg)

**Note:** These figures are lower bounds. Data was not available for all companies.
Annex 3: High-level comments on Oxera’s Price Concentration Analysis

Oxera conducted a price-concentration analysis, which found a relationship between levels of concentration in the supply of statutory audit services and the fees that audit firms are able to charge. This annex provides four high-level criticisms of Oxera’s price concentration analysis, which was replicated by the OFT. These demonstrate that it is not possible to draw a robust conclusion on any significant link between market structure and audit fees, based on the OFT’s analysis.

First, it is widely recognised that, in an analysis such as the one performed by the OFT and Oxera, it is essential to account for the potential joint determination of prices and market structure. However, we cannot rule out that auditors with high shares of supply (in a given industry sector and year) charge higher fees because they offer a higher quality product. The existing analysis fails to take into account that market structure is determined endogenously through a competitive process (as discussed in section 8.4). Put simply, the demand for high quality audit requires significant investment by audit providers. Audit clients’ demand for higher quality audits has driven an increase in concentration. The OFT appeared to recognise this potential problem with its analysis and noted:

“However we cannot rule out that auditors with high shares of supply (in a given industry sector and year) charge higher fees because they offer a higher quality product.”

Second, in attempting to model how audit fees are determined, it is essential to capture costs, since these are a key determinant of price. The OFT’s analysis uses turnover and international turnover as proxies for the complexity, and therefore cost, of providing an audit. However, the cost of providing an audit is dependent on client specific circumstances and is likely to change over time in a way that is not necessarily related to turnover.

As explained in section 4.1, the audit scope is dependent on a number of client-specific factors, which are not necessarily related to turnover. Failure to take into account the cost of provision will result in flawed analysis, because one cannot be confident that the identified relationship between audit fee and concentration would still hold if costs were controlled for properly.

Third, the concentration measure at industry level may be biased as a result of concentration of the buyers’ side, as we discussed in section 9.1.

Fourth, as the OFT recognises, the data it uses are potentially vitiated by significant error, due to errors in recording audit fees. Specifically the data on the audit fee level are frequently recorded incorrectly in the database the OFT relied upon. One problem from inaccurately measured data is that there may be spurious outliers that drive the results. In order to assess the potential impact of such outliers on the analysis, the OFT used three separate methods of identifying and dealing with outliers in its analysis:


124 OFT, OFT1357/MIR, footnote 100.

125 In addition, we note that the OFT’s use of share of audit fees as a measure of market share will lead to spurious correlation or bias. An increase (or reduction) in the scope of an audit increases (decreases) the cost of completing an audit. In turn, the audit fee will increase (decrease). Since the measure of market share used by the OFT is share of total audit fee, the increase (decrease) in scope also increases (decreases) the market share of the client’s auditor. Therefore the OFT’s analysis is biased to find a positive relationship between market share and audit fee even where no relationship exists otherwise. The affect on HHI is less clear since an increase in the market share of any single auditor can either increase or reduce the HHI. Nevertheless, it is not possible to be confident that the analysis is unbiased in that regard.
a) to remove observations of the very largest and smallest audit fees from the data\textsuperscript{126};

b) to remove observations where audit fees increased by at least £2m and by more than 50 per cent compared to the previous year; or

c) to remove observations for which the audit fee had increased by more than 50 per cent compared to the previous year.

We agree that it is necessary to deal with outliers, however, the first method identified by the OFT would not identify only outliers and would instead potentially remove valid observations. This method would not identify as outliers observations for which there is a significant change in the audit fee, but the fee remained within range of fees recorded by most companies in the FTSE350\textsuperscript{127}.

The OFT’s second and third methods of identifying outliers arguably in principle perform better at singling out audit fees recorded in error, since they identify large (and therefore unexpected) changes to audit fees relative to a company’s previous audit fee.

When the OFT repeats its analysis excluding observations using either the second or third approach to eliminate outliers, it does not identify any statistically significant link between market concentration, market share and the level of the audit fee. This suggests that outliers are responsible for the OFT’s main findings.

Even if those outliers are not necessarily errors, and the change in audit fee is correctly recorded, the change in fee is not consistent with audit companies persistently increasing audit fees in response to increased market concentration. Rather, the one-off changes in audit fees excluded by the OFT could be more accurately attributed to one-off changes in the scope of the audit; and if scope and cost were properly controlled for, the erroneous link between audit fees and market structure would no longer be found.

To conclude, so far there has been no robust econometric analysis establishing a statistically significant relationship between market structure and audit fees.

\textsuperscript{126} Technically, the OFT removed observations where the audit fee is at least two inter-quartile ranges below the lower quartile or above the upper quartile of all audit fees.

\textsuperscript{127} To illustrate this consider a hypothetical example in which most audit fees in the sample are between £1m and £10m. OFT’s first method would exclude from its analysis all observations for firms with an audit fee of less than £1m or more than £10m. Moreover, it would not exclude from the analysis an observation for a firm whose audit fee was £1m in year one, £8m in year two then £1m in all other years. In such an example it would seem natural to consider the £8m observation as an error, whereas the very smallest and largest audit fees need not be errors.