STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of hearing with KPMG held on 29 April 2013

Introduction

1. The balance of evidence in relation to choice, pricing, profitability and quality clearly showed the opposite to a number of important provisional findings made by the CC and undermined the basis for those adverse findings and its two principal theories of harm. Accordingly, KPMG believed that the CC's provisional findings should not be confirmed.

2. KPMG considered that competition was effective and the following CC evidence showed this. In KPMG's view: the CC concluded that audit firms had strong incentives to compete; the CC did not find evidence of excessive profits; the CC's evidence was that prices had been falling in real terms; the CC found that Finance Directors (FDs) and Audit Committee Chairs (ACCs) were experienced and qualified and that the vast majority of companies reviewed service, quality and price on a regular basis; the CC found that competition between audit firms was fierce and there was no evidence of anti-competitive behaviour; and the CC considered that audit firms had incentives to, and strived to maintain, quality and sought to compete on the basis of quality as well as price.

3. KPMG considered that the evidence also showed that FTSE 350 companies had an appropriate degree of choice. KPMG accepted that concentration in the reference market was relatively high but there was sufficient choice available to companies in the FTSE 350 for them to achieve competitive outcomes. Companies also looked to Mid Tier firms in about one-third of tenders. In KPMG's experience, competition among the Big 4 firms was very intense. The emergence of these leading firms was the result of a competitive process. The failure of Arthur Andersen showed the inherent level of risk in the market, which KPMG believed had been discounted by the CC. The larger firms had been successful because they had made investments in network expansion and the quality required to meet the requirements of international capital markets. Mid Tier firms had not made such investments and had not successfully focused their marketing efforts.

4. KPMG suggested that the comparatively low rate of switching in the reference market did not indicate that competition was not working well but it rather reflected high levels of service and client satisfaction. The plateauing of engagement profitability and falls in real prices demonstrated that low switching rates did not lead to exploitation by audit firms but rather that companies exercised bargaining power through benchmarking and the ever-present threat of switching.

5. KPMG also considered that the CC had not properly taken into account the impact of the Financial Reporting Council's (FRC's) adoption of mandatory tendering on a 'comply or explain' basis which was already having an impact on the market.

6. KPMG noted that the CC's findings stated concerns about quality were 'significant and widespread'. KPMG considered that the evidence indicated that audit quality was very high and had been improving over recent years, especially given the population of companies that were subject to Audit Quality and Review team (AQRT) reviews, which represented the most diverse, largest and complex audits. The number of audits found to require 'significant improvement' was less than 10 per cent of the total number of audits reviewed by the AQRT. Even in these cases, KPMG was not aware

of the AQRT having concluded any instances of an incorrect audit opinion being issued. KPMG considered that the CC had given insufficient recognition to the internal monitoring and training procedures implemented by audit firms, which played a significant role in enhancing audit quality and maintaining overall high standards in the reference market.

7. KPMG considered that none of the examples cited in Appendix 17 of the CC's provisional findings showed an explicit finding of an insufficient degree of professional scepticism. It said that if these were the most problematic examples found by the CC, KPMG could only assume that the others depicted relatively minor issues indeed.

8. Audit firms currently competed on the basis of process innovation and, to the extent that KPMG was able to meet additional shareholder demand within the recognized constraints within which it operated, it and other firms did so. KPMG considered that the CC dismissed process innovation out of hand, despite processes being an important determinant of the efficiency and quality of an audit. This was misguided as audit firms invested significantly to ensure that testing, reporting, audit methodologies, IT systems, service delivery and the scope of the audit product being provided were not only reflective of best practice but also designed to meet the companies' and shareholders' high expectations.

9. The CC was wrong to assert that there was unmet demand arising out of a problem with competition. The CC had not shown any link between the degree of competition and any unmet demand. Rather, because of the risks of free riding among shareholders, and statutory constraints on audit firms in meeting demand, this was a matter of governance and regulation over the definition of the products. The CC's approach also overlooked the fact that KPMG and other firms were actively engaged with the relevant regulators in seeking to determine and meet any significant unmet demand.

10. With respect to auditor independence, KPMG said, the evidence showed that, since the Cadbury Report and the challenges of the early 2000s, concerns in this regard had been effectively addressed through measures which had strengthened the extent of challenge by Audit Committees and, more generally, non-executive directors. The CC had identified a number of theoretical concerns regarding auditor independence but had failed to substantiate these concerns with sufficient evidence. In KPMG's view, this lack of evidence supported the conclusion that auditors did not have misaligned incentives and displayed sufficient independence when conducting their work. The CC's case studies suggested that independence and professional scepticism above all else were what clients demanded from their auditors and the available evidence pointed to the fact that this was what audit firms were delivering in practice.

11. In KPMG's experience, audit judgement calls were difficult and finely balanced. There was always room for professional disagreement without opprobrium. KPMG's systems and internal processes were regarded by the AQRT as sound and, in its view, were well suited to protect its independence and professional scepticism.

12. The CC's criticism of audit firms' relationship with management as being too consensual was, according to KPMG, unfounded and misguided. It overlooked the importance of the effectiveness of this relationship in maximizing audit quality. KPMG said that the CC recognized that the quality of an audit was affected by the quality of internal reporting to senior management and that this in turn was best served by a reasonable balance of cooperation and scepticism. KPMG noted that the CC referred to this as the 'third limb' of audit quality, but considered that the CC failed to give this sufficient weight in its provisional findings. KPMG believed that the CC had got it wrong on the adverse outcomes it observed.

13. With respect to the CC's first theory of harm, KPMG said that the CC concluded that companies found it difficult to appraise competitors' offers in the absence of a tender. However, the CC's reasoning on this point was not supported by its own evidence, which suggested that ACCs, Audit Committees more generally and company management had the appropriate skills and resources to assess and compare the quality of audit firms other than the incumbent. KPMG considered that this was supported by submissions from clients, other reporting bodies and other audit firms. In its experience, individuals serving on FTSE 350 company Audit Committees were highly qualified, engaged and diligent in conducting their responsibilities and showed a real determination to achieve a thorough and rigorous audit.

14. KPMG considered that the CC's conclusion that switching may lead to a loss of efficiency, an increased risk to audit quality and the incurrence of significant costs by management, should be taken as recognition of the advantages to the client of the substantial investment made by the audit firm in the audit relationship. KPMG regarded these as reflective of, and benefits from, the competitive process rather than as barriers to entry.

15. KPMG believed that the CC's finding that companies had weak bargaining positions was seriously flawed. It said that the CC had found that: FDs and ACCs were informed buyers who had or could call upon the necessary resources to evaluate audit firms; audit firms had incentives to compete; and the exercise of buyer power was possible and happened. There was no evidence to support a conclusion that long tenure was inconsistent with companies exercising effective bargaining power over their incumbent auditor. It noted that the decline in real prices was also inconsistent with the exercise of incumbent market power. To the extent that audit was an experience good, the experience would be difficult to judge in advance, whether by tender or otherwise, so the CC's focus on tenders as the benchmark for competitive outcomes was flawed. Similarly, the evolving scope of audit would inevitably make precise estimation of costs difficult and the evolution of prices was therefore an inevitable part of the competitive process, whether that began with a tender or competitive benchmarking and discussion.

16. Regarding the CC's observations on the position of Mid Tier firms, KPMG saw no cogent evidence to support the CC's provisional finding that reputation and experience were barriers to entry. In its experience, Mid Tier firms were frequently asked to participate in tender events and companies were well equipped to assess quality both within and outside such tender events. KPMG said that the CC's discussion of barriers to switching suggested that these were variable, but also revealed customer confidence that they were manageable in practice.

17. In relation to the CC's second theory of harm, KPMG believed that the evidence in the round was that auditor, management and shareholder incentives were not misaligned and that auditors' professionalism, regulation and incentives, together with robust corporate governance processes, were effective in addressing any theoretical concerns. Further, the available evidence regarding audit quality, independence and unmet demand suggested that there was no such misalignment operating in practice in the reference market. In KPMG's experience, which it said was supported by the CC's own evidence, it was clear that company management and the Audit Committees expected and demanded thorough and independent audits. Quality and independence were key competitive drivers in the relevant market and directly impacted upon an audit firm's reputation and its competitive position. The threat to a firm's reputation, should there be a perceived systemic lapse in independence from audit clients, was so great as to make any such isolated benefit (from a loss of independence) worthless. These inconsistencies in the CC's own evidence base had the effect of undermining the CC's second theory of harm.

18. KPMG considered that the balance of evidence before the CC showed that competition was working well. It had serious concerns about the CC's inconsistent treatment of the evidence before it.

19. With respect to the CC's proposed remedies, given that KPMG disagreed with the CC's provisional adverse effect on competition (AEC) finding, in its view no measures were required or justified on competition grounds in the present circumstances.

20. It was particularly important for the CC to consider the likely developments that might arise from the changes already coming out of the FRC and wider industry developments. In its view, they made the gap between the outcomes that the CC wanted and those to be expected vanishingly small.

21. KPMG completely rejected the need or desirability for mandatory rotation. Such a measure was likely to impose substantial costs on both companies and auditors, result in less choice and increase the chance of audit mistakes. Such outcomes would be very detrimental to the state of competition in the audit market. KPMG considered that its views were reflected in the majority of submissions received by the CC as part of its consultation process.

22. KPMG considered that mandatory rotation would result in one major competitor, quite often a credible and very strong competitor, being excluded from the tender. It noted that in an extensive study reporting to the US Senate, the Government Accountability Office (GAO) concluded that almost all of the largest public accounting firms and Fortune 1000 publicly traded companies believed that the costs of mandatory audit firm rotation were likely to exceed the benefits. In subsequent public statements, the GAO had explicitly rejected mandatory rotation as an effective solution. Further, as the CC set out in its provisional findings, switching auditor increased the risk of a potential fall in audit quality and might result in a loss of efficiency as the new auditor got up to speed.

23. KPMG considered that there were sound theoretical models which showed that accounting information quality was inversely related to the cost of capital. Even a very small change in the cost of capital for UK companies would generate highly significant economic costs. If these costs were to be incurred by companies and audit firms alike on a far more frequent basis, the CC must conduct a comprehensive assessment and cost-benefit analysis before such a remedy was considered. To date, KPMG was not aware of any such analysis being undertaken. If it were, it believed it would prove the lack of proportionality of this remedy.

24. The very idea of excluding an effective competitor from the tender process, thereby denying a client's free choice and restricting competitive activity, seemed completely inconsistent with a positive competitive outcome and offered nothing in the way of substantiated benefits.

25. In relation to mandatory tendering, KPMG considered that, given that this had just been introduced on a 'comply or explain' basis in the UK, it did not consider it necessary or appropriate for additional measures to be introduced before existing reforms had been given sufficient time to take effect. It was a virtual certainty that the new 'comply or explain' measures would result in more tendering, thus addressing the CC's core concern. The FRC reforms were effective and should be given time to take effect. This was supported by the majority of submissions received by the CC as part of its consultation process.

26. There were a number of costs associated with mandatory tendering with no 'comply or explain' provision that had not been taken into account. These included a potential

reduction in competition as companies would be less receptive to the approaches of competing audit firms outside of the fixed tender period. Mandatory tendering also assumed that all FTSE 350 companies could be treated the same regardless of their size or complexity, when in fact the size and complexity of a company had an important bearing on the appropriate timescale for a tender. The lack of a ‘comply or explain’ provision implied that individual circumstances, such as a change in company leadership, market activity or a critical business or financial situation, should be overlooked in order to comply with a rigid timetable. Such a lack of flexibility and choice seemed, to KPMG, to be inconsistent with a well-functioning and competitive market.

27. Based on the FRC’s comprehensive analysis, tendering every ten years on a ‘comply or explain’ basis was likely to be an effective solution and should be given time to take effect. Conversely, any fixed period was likely to create problems for some companies. Any time period shorter than ten years was likely to be inappropriate for a substantial number of FTSE 350 companies and might encourage greater explanation than compliance. Further, KPMG considered that the CC should recognize the possibility that audit quality could decline in circumstances where the most senior individuals in the profession were diverted from audit work to participate in more frequent tender processes.

28. A ‘comply or explain’ provision had the effect of maintaining the competitive pressure on the incumbent that might be reduced under tendering on a mandatory basis. It also afforded companies an appropriate degree of flexibility in meeting their obligations during intense periods of corporate stress or financial difficulty. Unlike with mandatory tendering, Audit Committees would remain incentivized to engage fully with their responsibilities, the quality of tenders was unlikely to fall and the negotiating position of companies would be maintained. In essence, further reforms at this stage to make tendering mandatory or to occur on a basis more frequent than every ten years raised a number of substantial costs for companies and audit firms alike with little benefit in circumstances where ‘comply or explain’ had proven to be effective in other areas of corporate governance in the UK.

29. With respect to the remainder of the measures which the CC had proposed, KPMG was very willing to engage with the CC on any measures that enhanced audit quality, notwithstanding that it did not consider them to be necessary on competition grounds as the available evidence did not suggest that there was an AEC in the reference market. However, unlike mandatory tendering and rotation, KPMG saw potential for these remedies to increase audit quality without distorting the market and accordingly would be receptive to further consideration by the CC of these options.

Provisional findings

30. KPMG said that the first-year costs to audit firms in a new engagement would be higher and these were not built into the first-year fee. In addition, in certain instances the new client might receive a discount on the previous year’s audit fee as an incentive to switch, which might, for example, cover the costs incurred by the company in relation to the higher first-year costs of an audit.

31. The CC noted that from its engagement with a number of FDs and ACCs during the course of the inquiry, having held in the region of 50 meetings, companies were not aware that they were offered a first-year discount as an incentive to switch. Accordingly the CC noted that this did not appear to indicate that a discount was offered as an incentive to switch.

32. KPMG noted that audit firms will put together a combination of price and services that aimed to make it attractive for companies to change audit firm. It noted that audit firms may not pinpoint exactly which elements of their overall offer comprised a discount that was aimed at making it easier to switch. However, KPMG noted that nonetheless audit firms' offers were put together to try to encourage companies to switch. Whether or not companies recognized particular components of the fee as a discount did not matter for outcomes to be competitive.

33. In deciding at what level to price in the first year, KPMG said that that would depend on its knowledge of the market, and how much information it received from management or could obtain from the public domain to make an assessment based on that. In a case where it was particularly strong in a sector, it might not offer any discount. Where it wanted to break into a sector, it may propose a lower fee. A company would choose a preferred firm based on its service provision and quality and then have a commercial negotiation around price with the firm.

34. KPMG said that companies would be quite aware that additional costs were going to be incurred by both the audit firm and the company and that companies expected to see a reduction from the previous year's fee. KPMG was surprised if companies were saying that they were not seeing a pricing tension. KPMG accepted that it might be a terminology issue, with companies not thinking of an initial fee reduction as a 'discount' but understanding that there were extra costs in the first year that the audit firm would not be seeking to bill. KPMG said that the terminology of 'discounts' would not normally be used.

35. KPMG noted that, typically, the fee that was charged would not decrease after the first year notwithstanding that costs would most likely reduce. KPMG would rarely talk about the underlying costs of providing the audit with the client. However, companies might ask for details of anticipated hours and underlying rates. It would sometimes be asked to give an indication of fees in subsequent years and KPMG would provide its expectations on how costs were likely to progress. KPMG also noted that typically, in KPMG's experience, audit firms were asked to quote for a fixed fee for a number of years.

36. The CC was surprised that expert purchasers were not having conversations around costs in order to challenge fees, as costs for the firm started to decrease, and that they did not seem to understand that they were being offered a discount to cover their own incremental transition costs. KPMG said that it was important to recognize that these purchasers had a number of reference points: fees they had been incurring historically; comparable fees from a tender process; and other experience. As a result, they would regard it as obvious that firms were absorbing incremental first-year costs and, if they could, would look to fix fees for three years.

37. KPMG noted that companies challenged fees year on year, not just in tender situations. KPMG was sometimes requested to provide an understanding of what might happen to costs if future expected changes took place in a business, such as acquisitions or changes in the business's processes.

38. The CC noted that a situation where there was very little understanding on the customers' part of what the costs were, and how the price quoted related to costs and was broken down, gave the appearance that the price for an audit was not connected to costs. KPMG disagreed that purchasers could not be expert because they did not have full information about costs. It noted that whilst the expert buyer may not have knowledge of costs, they did have knowledge of the competitive price and of the quality. The CC had not set out a rationale or basis in economic theory for knowledge of costs to be required to support a competitive outcome. In any case, in some cases

clients did require a breakdown of anticipated hours and sometimes underlying rates as well, which would give them that visibility.

39. KPMG said that upward movements in price after year one, absent any scope change, would be explained by finding that company systems and processes were not as strong as expected or that there were changes in the way that companies managed their business. In relation to the CC's observation that in the round, there was almost an expected upward movement in the price after year one, KPMG noted that it was quite difficult to generalize as to the reasons for any upward movement in fees. KPMG thought that the most common reason for upward movements in audit fees was companies changing all the time, through acquisitions, disposals, shared service centres, joint ventures etc. Common practice was that clients generally expected some form of commitment, if not obligation, for a fixed fee, subject to certain items such as foreign exchange, scope changes etc.

40. KPMG tried to manage its variability on margins by [✂].

41. With respect to AQRT reports, in a competitive market, KPMG would become concerned even with a low level of reports that indicated some failure to apply sufficient professional scepticism. It met and sought guidance from the AQRT to understand if there were any trends of this nature. What it tended to find through the AQRT was some sloppiness in documenting evidence. KPMG emphasized that a distinction must be drawn between inadequate documentation and insufficient professional scepticism. If subsequently KPMG found that such issues, that may not have been evidenced properly, had nevertheless been thoroughly looked at, then it would not be so concerned as if there was an actual finding of a failure of professional judgement or scepticism.

42. KPMG did not think any firm would willingly trade a 'significant improvement required' AQRT review in return for a higher return. In relation to the CC's suggestion that a failure to document evidence was equivalent to a failure to be sufficiently sceptical because the sceptical mind would document things fully, KPMG did not think this suggestion was correct. KPMG was concerned by any failure properly to document findings, and it had working paper disciplines that were very important. It noted that it would, however, be even more concerned if there was persistent or systemic failure to document evidence across audits. What would concern KPMG most would be any observation, from the AQRT or otherwise, that there was any slip in scepticism, consultation or formation of judgement, though it had not seen any examples of this having occurred in the CC's provisional findings. KPMG did not think it could be inferred from one instance of insufficient documentation that sufficient scepticism had not been exercised.

Mandatory tendering

43. KPMG did not think there was a need for a backstop in terms of setting a limit on the number of times a company could 'explain' in a 'comply and explain' regime. It considered that it should be up to the company and the Audit Committee to decide when would be the right time to tender, and 'comply or explain' made the thought process of the Audit Committee far more transparent. Businesses should not be forced to tender if they did not think it was appropriate to do so, noting that the explanations would need to be provided to shareholders. So long as shareholders accepted the explanations, then companies should be allowed to explain, potentially, indefinitely. KPMG explained that 'comply or explain' worked really well in UK corporate governance generally and KPMG had found that most companies had ended up complying in most instances rather than explaining over a protracted period. KPMG saw no reason why this would not apply in relation to tendering.

44. KPMG considered that sufficient explanations may include: major transformational acquisitions or disposals; some form of major expansion or large-scale organic growth; major changes in the finance function; and departure of the FD. The departure of the FD may be a good reason because the Audit committee was likely to look to the FD for assurance around processes, controls, reports and accounts. The Audit Committee was likely to feel quite uncomfortable if both the FD and an auditor were trying to become familiar with all these issues at the same time.

45. KPMG considered that there were risks of having 'mandatory tender with exception' rather than 'comply or explain', with a fairly well-defined list of exceptions. The defined exceptions may become the norm, so if companies could apply one of them, they would not bother considering a tender. This was not something the FRC was hoping to encourage through its 'comply or explain' regime. KPMG also thought a regime where specific exceptions required the approval of the regulator would start putting regulators in the shoes of the Audit Committee, which should be the best informed about whether it was appropriate for the company to tender or not. Further, KPMG suggested that over time the reasons why companies may need to explain rather than comply would change.

46. KPMG did not believe it was possible to stipulate mandatory tendering periods based on different components on the reference market. For any prescribed period for any constituent part of the index there were bound to be some companies for which this time period was inappropriate. As a result, its view was that companies should be given the flexibility to decide when to tender on the basis of when it was right for them, and a 'comply or explain' regime provided this.

47. Pragmatically, KPMG considered that ten years sounded like the right timescale for companies to consider tendering of the audit contract, noting that there was nothing stopping companies considering it sooner. KPMG noted that the FRC had been clear that it wanted companies to continue to consider annually if their audit contract should be tendered. It was helpful that the ten-year period aligned with two partner rotation periods, although KPMG noted that this did not neatly correlate with the partner rotation period internationally, which was every seven years. KPMG noted that its audit engagement partners felt like they were judged every year in any event. There was a risk that introducing a period for tendering would dilute this annual scrutiny because companies may lapse into scrutinizing their audit contract only at tender points. This may be more the case where a company was satisfied with its auditor.

48. KPMG also considered that in a regime where regulations defined the period at which companies should go out to tender, tendering in advance of such periods was more likely to send adverse signals to investors, which might impose costs on companies. This was because if the expectation in the marketplace was that tendering, for good governance reasons, ought to take place every 'X' years, then tendering earlier must suggest that there were other factors behind the decision to tender, such as something wrong with the performance of the audit or a disagreement with the auditor. KPMG considered that this perception might remain even if 'X' was meant to represent a maximum period, or explanations were provided by the company for the decision to tender earlier. KPMG considered that this was not the case at the moment, since tender periods were not mandatorily defined, and announcing tenders could be assumed as being driven by good governance.

49. The major determinant in how much resource KPMG devoted to any specific tender was how much it valued the potential new relationship. However, how much the company defined the tender process also had a big effect. Some companies had long elaborate processes, allowing for many meetings with many different people; others had much shorter, tighter, defined processes, although this might be accompanied by

a longer process pre-tender where the company sought to get to know the various audit firms. For example, KPMG was in a tender process for one company, [✂], which was testing various firms by commissioning some paid non-audit services from it. This had required KPMG to second employees into the company. Whilst undertaking this work, KPMG had meetings and discussions in relation to the audit, some of which were formal, others more informal, including with the ACC, other non-executive directors, the FD and the company's internal audit team. Once the company had made its assessment of each of the firms, its intention was to have a short tender process, which may only be with two firms out of those that it was assessing.

50. KPMG said that processes also varied depending on the nature of the company. KPMG provided the example of [✂], whose audit was out for tender at the moment in which there were a relatively small number of key people to get to know. Conversely, [✂], whose audit was also out to tender at the moment, required flying people all around the world to key parts of the group. KPMG believed that it had to be the choice of the Audit Committee to set up a tender process in the way that it considered allowed it to make the best choice of auditor. However, KPMG occasionally tried to do more than the process specified to try and ensure that it won the audit, but this was generally limited by the rules of the tender. KPMG noted that it had not changed the way in which it approached FTSE 350 tenders as a result of current tender activity following the recent FRC changes. However, it said that if tender activity increased, to say 70 tenders per year, then it would have to consider which tenders it went for and from which it refrained on resource grounds.

51. KPMG did not think it was possible to specify generic minimal requirements for all audit tenders. It noted that the FRC was planning to publish shortly information on effective audit tendering in the form of some case studies, which it thought might be helpful. KPMG considered that Audit Committees should determine what was required from an audit tender process. KPMG understood that for Audit Committees to have the best chance of getting the best result, they needed to ensure that all those tendering had sufficient knowledge of their organization and their requirements and that they had sufficient visibility of the tendering firms. What this entailed in terms of a tender process varied from company to company. KPMG predicted that with more frequent tendering it would be under pressure to 'industrialize' some parts of its tender processes . However, it considered that it was difficult for it to industrialize the majority of parts. The information it provided to a mining company, including the key individuals that would be involved in the audit, around the world, would be very different from the information it provided to a bank. KPMG did not think that, if companies tendered more frequently, they would streamline their processes nor allow audit firms to 'industrialize' more of their tender responses—because companies needed very specific information and companies were changing all the time, and relevant issues that would need to be considered by those tendering would be very different from tender to tender.

52. KPMG rejected the need or desirability for open-book tendering. In particular, KPMG considered that open-book tendering would result in less investment by audit firms in innovation or efficiencies around those areas that were revealed in an open book and it could also reveal competitively sensitive information to audit firms on what their rivals were doing. KPMG considered that company information in terms of an audit tender such as the legal structure of the company, the current fees, the scale of the business and the judgements a company itself reached could be shared. However, sharing audit firm information which would include how the audit was actually conducted, and the auditor's views on the company's judgements and the areas of risk in the audit, would be proprietary to the audit firm and could not be shared. KPMG considered that whilst information it shared as an outgoing auditor with a new incoming

auditor would include certain competitively sensitive information, the incoming audit firm would not be able to take advantage of that knowledge in competing for the specific audit, and so there was a difference between this situation and that of an open-book tender.

Mandatory rotation

53. KPMG rejected the need or desirability for mandatory rotation. Such a measure was likely to impose substantial costs on both companies and auditors, result in less choice and increase audit risk.

54. KPMG did not think there was a need to specify a backstop period after which there should be an enforced rotation of audit firm. There was no reliable evidence to suggest that independence or quality reduced with longer audit tenures. If there were any perceptions that an auditor's independence was in question because of the length of tenure, then investors would act to enforce a change. KPMG did not think it would bid any differently, or with extra vigour, if it were aware that the incumbent was being forced to step down.

Expanded remit and/or frequency of AQRT reviews

55. KPMG considered that the objective of the current AQRT reports was to raise the overall quality of audits across the industry, and they did this in two ways. The first was assessing the quality of audit firms in terms of a firm's performance of audits; its processes and controls; tone at the top; how it trained its people; and how it rewarded people for positive outcomes. Secondly, they made an assessment of a number of individual audits to back that up by looking at a firm's audit process on a more in-depth, job-by-job, basis. KPMG considered that the current AQRT reports were used by companies' Audit Committees to assess the competence of auditors.

56. [✂]. KPMG said that having been reviewed by both the AQRT and the Public Company Accounting Oversight Board earlier in the year, both had come up with similar points.

57. KPMG considered that the FRC process could be more streamlined, conducted in a shorter period of time. Its process also currently did not capture a company's point of view on the audit, including the extent to which the company felt challenged.

58. KPMG did not think the FRC was currently configured to take on a secondary duty to promote competition, nor that this would be an appropriate role for the FRC. Further, there would be substantial costs associated with expanding the FRC's role.

Prohibition of Big-4-only clauses in loan documentation

59. KPMG was comfortable with the prohibition of Big-4-only clauses to be extended to other forms of capital raising. However, it noted that two parties should not be constrained from agreeing an auditor as part of a negotiated process.

Strengthening the accountability of the external auditor to the Audit Committee

60. KPMG considered that Audit Committees were in general very effective and even more so for those Audit Committees of companies higher up the FTSE index. What the best Audit Committees did which others did not included deep diving into certain

areas, including meeting different teams such as finance, assurance, and supply chain, to understand what they were doing. They grilled members of management in various areas. This questioning was done with KPMG present, which was then asked for its views. KPMG considered that Audit Committee best practice did spread and that it had taken a role in spreading best practice.

61. KPMG indicated that its relationship with the ACC and possibly other members of the Audit Committee was quite extensive, including formal meetings and not infrequent contact outside such meetings as circumstances required, as issues emerged. However, KPMG had received indications that Audit Committees had not had substantive direct interaction with investors, so if investors did have specific concerns, they were not channelled through the Audit Committee to decide what to do with them. KPMG noted that traditionally there had been very little appetite on the part of investors to interact with Audit Committees more, although there now seemed to be a slow movement in that direction from investors. KPMG considered that over the last 20 years, Audit Committees had much greater visibility of the financial processes, controls and judgements than used to be the case.

62. KPMG agreed that there was a desire for issues to be resolved before they went to a higher level but noted that there was a requirement to report all issues that had been resolved to the Audit Committee. However, it was important to understand that in the most complex companies there were lots of items that would be resolved at a lower level and not everything would be visible to the Audit Committee. For the most significant issues, the ACC was likely to be aware of the issues that were being discussed between the auditor and the FD.

Enhanced shareholder–auditor engagement

63. KPMG did not support the suggestion that after a tender, Audit Committees should provide an option of two auditors, denoting their preference, to shareholders for a vote.

64. KPMG considered that it would be very difficult for Audit Committees to convey sufficient detail of the analysis it had done to enable investors to make an informed decision. If investors voted against the Audit Committee's choice, that would be tantamount to a vote of no confidence in the non-executives, with the position of the ACC becoming untenable. KPMG also considered that it would incentivize firms to spend a lot more money on promoting the firm to investors in order to encourage investors to vote for them. KPMG would prefer investors to be involved at an earlier stage, although it accepted that it would be a challenge to engage with all shareholders rather than a subset.

65. With respect to encouraging more investor engagement, KPMG preferred the FRC proposals of encouraging companies to present more in their annual reports to set out what their Audit Committees had done in the year. It would then be for investors to use this information and initiate a dialogue with the Audit Committee in the same way they did with the remuneration report.

66. KPMG considered that institutional investors no longer attended AGMs because they interacted with management in different ways. KPMG was aware of some examples where Chairmen had offered to make an ACC available to investors but there did not seem to be any appetite. An alternative might be to have the ACC attend some investor briefings.

Non-audit services

67. KPMG said that ACCs always made it very clear to it if they expected it to tender or not. This was the case irrespective of if there were potentially more lucrative non-audit services which it as a firm may prefer to engage with the company for. KPMG's approach had been to always try and win an audit tender.