Dear Mr Wood

Audit Market Investigation
KPMG letter on responses to the Competition Commission’s Provisional Decision on Remedies

This letter sets out KPMG’s views on the responses the Competition Commission (“CC”) has received to its Provisional Decision on Remedies. In particular we highlight the weight of investor concerns with the CC’s mandatory tendering remedy as set out in its Provisional Decision on Remedies (Remedy 1), as well as concerns from a number of parties over the impact of that remedy on the quality of audit and of audit tenders. In light of this evidence we submit that the Commission should drop Remedy 1 from its proposals.

The majority of responses from investors received by the CC are against the CC’s proposed remedy of mandatory tendering every five years. Specifically, in response to the CC’s Remedies Notice, the following investors were against the CC’s tendering remedy, accounting for a large proportion of FTSE350 shareholders:

- the Investment Management Association, which we estimate accounts for approximately 45 per cent of FTSE350 shareholdings (which includes the 24 per cent accounted for by the Association of British Insurers). It stated that “whilst a minority of investors supports tendering every five or seven years, for the majority this is too frequent. The latter support the Financial Reporting Council’s measures such that FTSE 350 companies tender the audit at least every ten years. In general tendering should be on a comply or explain basis and something that audit committees decide in consultation with shareholders. To mandate it disenfranchises both”;

- Black Rock Investment Management, which we estimate accounts for five per cent of FTSE350 shareholdings;

- Standard Life Investment, which we estimate accounts for two per cent of FTSE350 shareholdings; and

- Hermes, which we estimate accounts for approximately half a per cent of FTSE350 shareholdings.

In addition to those groups listed above, almost all of the other investor groups that responded to the CC’s Remedies Notice, the views of which were summarised by the CC in the appendices to
the Provisional Decision on Remedies, were not in favour of mandatory tendering every five years. We estimate that these investor groups represent a further approximately two to three per cent of the FTSE350 shareholdings (not including the shareholdings of the unnamed investors). In addition, the National Association of Pension Funds, which we estimate represents approximately 15 per cent of the FTSE350 shareholdings, also expressed concerns in relation to the CC’s proposed remedy of mandating tendering every five years (although in favour of mandatory tendering every seven years).

The only shareholder groups that have expressed full support for the CC’s proposed remedy represent a very small proportion of FTSE350 shareholdings. Specifically: the coalition of six investors and a local authority pension fund which we estimate accounts for approximately two per cent of FTSE350 shareholdings; the UK Individual Shareholders’ Society, for which we cannot obtain complete information but the impact on FTSE350 shareholders we expect to be minimal; and the Pensions and Investments Research Consultants which is not an investor in its own right.

In addition, responses from investors, Audit Committee Chairs (“ACCs”), regulators and companies express concern that the CC’s mandatory tendering remedy will lead to reductions in audit and/or tender quality. A large number of respondents, including ACCs, companies, the Bank of England’s Prudential Regulation Authority and the FRC, noted that the resource constraints faced by companies and audit firms and the distraction of increased tenders pose a risk to audit quality. In addition, respondents stated that insofar as the CC’s proposed remedy will lead to increased switching which would not otherwise have been in the interest of shareholders, this will have a negative impact on audit quality.

For example, Standard Life Investment stated that:

“We think that the pressures of increased tenders on the resources of audit firms significantly heighten the risk of audit failure.”

1 As we set out in paragraph 3.4.8 of our response to the CC’s Provisional Decision on Remedies. In particular, see the responses from Baillie Gifford, Royal London Asset Management, Newton Investment Management and several unnamed investors.

2 Paragraph 3.4.9 of our response to the CC’s Provisional Decision on Remedies.


5 Page 3 of Standard Life Investment’s response to the Provisional Decision on Remedies.
Similarly, Steve Barber, ACC for Next Plc noted that:

“[Mandatory tendering] would almost certainly push up the cost of audits and would divert huge amounts of time from more productive efforts. It would not increase audit quality”

Furthermore, the Bank of England’s Prudential Regulation Authority stated that:

“it is of fundamental importance to our supervision of firms and to financial stability generally that the financial statements of the firms we supervise are the subject of high quality audits. ... However a tendering process every five years would in our view put audit quality amongst the larger firms that we supervise at risk.”

In addition, 20 respondents (excluding the largest four audit firms which also made similar points) believed there was a risk that, at the CC’s proposed frequency, the tender process is likely to become a compliance exercise as opposed to the “structured and thorough” process that the CC has observed under the current regime. For example, John Ormerod, ACC for ITV Plc, stated that:

“a mandatory tender process will be ineffective since there could be no real intention to change. This will result in a process that would solely exist to show a Company had complied with regulation and in the worse case scenario, by moving audit firm resources from focused tendering, counter the aims of promoting real market competition.”

As stated above, in the light of this evidence, we submit that the Commission should drop Remedy 1 from its proposals.

Yours sincerely

David L Gardner

David L Gardner
Director of Public Policy

---

6 The Bank of England’s Prudential Regulation Authority’s response to the Provisional Decision on Remedies.
7 Companies and Investors: BT Group, Glaxosmithkline, ITV, Johnson Matthey, Marks & Spencer, Hermes, Icap. ACCs: David Challen, Jeff Hewitt, Michael Wareing, Nick Land, Peter Hooley, Simon Laffin. Regulatory, Government and Professional bodies: The 100 Group, CPAB, CBI, FRC, GC100, ICAEW. Audit firms (excl. Big 4): Grant Thornton.
8 Paragraph 84 of the CC’s working paper “Nature and Strength of Competition”.