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30 October 2018

Dear Mr Hayter,

Response to the Competition and Markets Authority's Invitation to Comment

I am writing on behalf of KPMG LLP in response to the Competition and Markets Authority's ("**CMA**") Invitation to Comment ("**ITC**") on its market study into the statutory audit market (the "**Market Study**") issued on 9 October 2018. We are grateful for the opportunity to comment and have set out in the attachment our detailed responses to the questions raised in the **ITC** for your consideration.

Firstly I would emphasise that audit is core to our business and critical to our brand and what we do.

Auditing is a highly skilled activity that demands an increasing range of expert technical skills and deep sectoral market knowledge. This includes multi-disciplinary expertise in many areas including tax, cyber security, risk and regulation, technology, actuarial, valuation and cash flow and business model analysis. It also demands deep market knowledge across many sectors: for example financial services, pharmaceuticals, telecoms and energy. These skills need to be global and underpinned by consistent and high quality control standards and common technology platforms. Therefore global scale is critical in the conduct of high quality audits of complex or multinational organisations that demand deep skills such as global financial institutions.

Confidence and trust in the audit profession is critical to capital markets and to society more generally. We recognise that the audit profession is rightly under scrutiny, in particular as regards (a) audit quality, (b) actual or perceived conflicts, and (c) choice and concentration. We also recognise that the challenges facing the profession are real and require action. The purpose of audit needs to evolve and quality needs to be enhanced to meet the challenges of evolving markets and needs of stakeholders; potential conflicts need to be demonstrably managed more clearly and effectively; and the market needs to be accessible and attractive to firms capable of delivering high quality audits. We are determined to be at the forefront of the market and look forward to engaging constructively with the CMA to address these interrelated issues.

The way in which audits are delivered is the product of a range of interconnected factors, including the framework for corporate reporting (including international accounting standards), corporate governance (in particular, the critical importance of Audit Committees (“**ACs**”), including Audit Committee Chairs (“**ACCs**”) representing shareholders’ interests on the demand side), investor stewardship and regulation. Many listed companies, particularly those in the FTSE 350, operate on a global scale and require consistent global capability in audit. Measures that change the market for the better can only succeed if the whole corporate ecosystem and the interactions between these various elements are fully understood. We are also engaging with the Kingman review on a number of issues affecting audit and the regulation of corporate Britain more generally.

Comprehensive reform may well require consideration of aspects of corporate governance and the corporate reporting framework, stewardship and shareholder engagement and the audit framework (in particular, the so-called “expectation gap” to which the CMA refers) as well as aspects of the audit market. The recent discussions convened by the ICAEW have confirmed our view that there is no one “silver bullet” which could address all of the issues: a package of measures, carefully thought out in the context of the whole system of corporate governance of which audit is part, is likely to be required.

Given that the CMA’s remit under the Enterprise Act is primarily competition-focused, a main question in this Market Study is how far the challenges identified above arise from a lack of competition. We believe that competition within the audit sector is strong. The reforms relating to rotation and tendering introduced following the Competition Commission (“**CC**”) inquiry of 2013 and the subsequent EU level reforms have made competition more intense, as have the increasing capabilities and demands created by new and evolving tools and technologies. In the last five years about 75% of audits in the FTSE 350 have switched from the previous incumbent, demonstrating strong competitive forces and effective action by ACs and ACCs in determining whether, and if so when, it is appropriate to tender or switch auditor. By reference to most indicators, whether switching rates, pricing, investment in methods, tools and technologies or other innovations, the audit market is a competitive market.

We accept, however, that the concentration in the audit market for FTSE 350 companies, driven by actual or perceived differences in skills, capacity and coverage of different sized firms, is a matter of concern. We are fully ready to further explore practical solutions already considered in the ICAEW discussions referred to above.

In terms of any further measures to be considered from a competition perspective, we suggest that three particular aspects need to be borne in mind. First, the enhancement of audit quality should be the primary criterion; any reforms proposed from a competition perspective should be judged from their potential to protect and enhance audit quality and should not risk a deterioration in quality.

Secondly, the risks of unintended consequences must be evaluated. For example, measures that prevented audit firms from accessing or attracting the best talent, or discouraged investment or innovation, would be clearly counterproductive. Similarly, measures that hampered ACs in driving competitive tension in the market, or undermined the role of the AC in its governance role on behalf of shareholders, would risk reducing quality in the future.

Thirdly, any reforms of the market need to consider the drivers of the present state. The current market structure has been shaped by competitive market forces, in particular audit firms investing very considerably in the scale and techniques that are necessary to keep pace with the global reach of many companies and the sheer complexity of many modern businesses. Scale and scope economies, the ability to attract and retain talented individuals and investment incentives – especially in audit quality – could easily be lost by ill-considered reform, especially if the result were to hamper UK based firms internationally.

As set out in our responses to the CMA's questions in the attached document, our position on the three main issues of audit quality, conflicts, and choice and concentration, is in summary as follows.

As regards *audit quality*, conducting an audit is not a simple process, but a complex operation requiring multiple skills. It requires not only deep technical accounting experience and relevant sector expertise, but also knowledge of finance, business, technology and law. Above all, however, audits require sound and independent judgement, combined with the ability to probe, scrutinise and challenge.

We believe that the quality of audit in the UK, albeit difficult to define and measure, generally meets a high standard – with the challenge being one of consistency to ensure that this high standard is always achieved. Indeed, we believe that the UK audit profession and the qualifications which underpin it (principally the ICAEW's ACA and ICAS's CA qualifications) are highly respected across the world. We are committed to an ongoing programme to enhance audit quality, with the objective of surpassing the FRC target of 90% of audits of FTSE 350 companies requiring no more than limited improvements.

Moreover, recognising the challenges relating to both audit quality and to perceived and actual conflicts that the profession is facing (as described above), we are also significantly enhancing the governance of our audit practice and believe this is key to clearly fulfilling the public interest function of an audit business, while retaining all the benefits to audit quality that are derived from a multi-disciplinary firm. Measures include:

- All our Board and Executive Committee members having objectives relating to audit quality.

- A Board Committee focused exclusively on audit quality.
- Audit partners having objectives and responsibilities focused on audit quality.
- Segregation within our audit function will be introduced of audit staff and certain specialists undertaking audits of listed entities, with separate governance and performance management of that function to enhance transparency and performance.
- The inclusion of our view on the caution or optimism in key findings and judgements – which we call “graduated findings” and which we have promoted since 2014.

On *conflicts*, we strongly believe that the public interest in high quality audits is best served by an audit practice operating within a multi-disciplinary firm. Audits are complex and require both specialists’ skills and significant technology which only the scale and scope associated with a multi-disciplinary firm can provide, particularly internationally. Conflicts potentially arising from the provision of non-audit services to audit clients are currently managed through compliance with professional rules on auditor independence and the vigilance of ACs. However, to remove even the perception of a possible conflict, we are currently working towards discontinuing the provision of non-audit services (other than those closely related to the audit) to the FTSE 350 companies we audit, which would be most impactful if implemented within a regulatory framework.

On *choice and concentration*, the cross-profession discussions facilitated by the ICAEW have confirmed that various “solutions”, while addressing some stakeholder concerns, may exacerbate others, and that there is no simple answer or single measure that can easily be arrived at. Provided that the ultimate solutions do not jeopardise audit quality now or in the future, we are ready to build constructively on the ICAEW discussions, in conjunction with shareholders and regulators, in considering a combination of measures in relation to audits of FTSE 350 companies. Whilst recognising that there might be significant implementation challenges, these measures include:

- A market share limitation of some kind.
- Shared audits.
- Sharing of skills and resources.
- Removing barriers to mid-tier expansion/reducing financial disincentives.
- Measures to strengthen the demand side, including the transparency of the tendering process and the position of ACs.



The pros and cons of these various possibilities are discussed in our responses attached.

We look forward to engaging fully with the CMA in this important Market Study. Please do not hesitate to contact me if it would be helpful to discuss any of the comments in this letter or the attachment.

Yours sincerely,

Bill Michael
Chairman and Senior Partner, KPMG LLP



Statutory Audit Market Study

Response to the Competition and Markets Authority Invitation to Comment

KPMG LLP

30 October 2018

This report contains 35 pages

Annexes contain 9 pages

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1 PART A: General

1.1 How well is the audit sector as a whole serving its stakeholders?

Despite some isolated (albeit high profile) events of corporate failure, and in some cases identified auditor failings, in KPMG's view the quality of auditing provided in the UK is generally high, with the key challenge being to ensure that high quality audits are delivered on every occasion. While KPMG acknowledges and is determined to face up to current concerns about audit quality and believes that "continuous improvement" will always be required, effective competition amongst audit firms is generally delivering a high level of investment and innovation and continuing efforts to satisfy the needs of stakeholders (and investors in particular).

KPMG notes that, in its 2013 report, the CC was satisfied that both management and auditors generally aim to perform their respective functions diligently and effectively. Similarly, as the CMA itself notes, the FRC has reported broad increases in quality. The overall proportion of a sample of audits deemed "good or only requiring limited improvements" via AQRs was 58% in 2012/13, rising to 77% in 2016/17.¹ Although recent AQRs affecting KPMG have been more critical,² the FRC itself noted in its AQR annual reports:

*"Changes to the proportion of audits falling within each category from year to year reflect a wide range of factors, which may include the size, complexity and risk of the individual audits selected for review and the scope of the individual reviews."*³

At the same time, KPMG is committed to addressing the FRC's comments on its audits as a matter of the highest priority. As a result, it has an ongoing programme of continuous improvement of audit quality and of investment to develop better approaches to audit work. A specific programme of transformation of the audit approach began in 2017 to ensure that all of our audits are delivered to the same standards as those which achieve the highest grade from the AQR (see Annex 1 for details on this work).

¹ Invitation to Comment, paragraph 2.13.

² KPMG believes an examination of audit quality in audit services as a whole necessarily needs to go beyond AQR scores. The AQR results do not in KPMG's view indicate a general lack of quality in audit services, much less one that is a result of a lack of competition. AQR scores are not based on a representative sample of audits, but instead focus on a small number of audits (around 5% of the relevant audits that fall into the FRC's scope), selected on the basis of a number of factors, including the assessed risk in relation to the entity and particular priority sectors the FRC wishes to focus on.

³ FRC, KPMG LLP/KPMG Audit PLC Audit Quality Inspection, June 2018, footnote 4.

1.2 How well does the audit framework support the interests of both direct shareholders and also wider stakeholders in the economy?

As the CMA notes, the audit framework is largely set at an international level and KPMG notes that the CMA is not intending to carry out a detailed assessment of the international standards and rules which set the audit framework.

The “audit framework” referenced by the CMA under Theme 1 in the ITC in fact comprises two aspects – namely the framework for audit itself, based on International Standards on Auditing (ISAs) and quality control standards (ISQC1) which define how an audit should be conducted; and the wider accounting framework in the form of International Financial Reporting Standards (IFRSs). It is the latter against which the auditor makes an assessment of the truth and fairness of the financial statements and in which the CMA expresses interest in views on how the *accounting* framework impacts on competition and outcomes in audit services. In relation to this accounting framework, KPMG notes that, while IFRSs are not immune from criticism, they are set after considerable (some would argue overlong) deliberation and consultation and have the merit of ensuring a largely consistent basis on which listed companies internationally⁴ prepare their accounts. They thereby better enable comparison of financial information across geographic boundaries.

In relation to the *audit* framework, the CMA references the “expectation gap” between what the public and financial statement users believe auditors are responsible for and what auditors’ actual duties are. We agree that such an expectation gap exists, for example as to the extent of auditors’ responsibilities in relation to a company’s viability, detection of fraud, identifying control and governance weaknesses, etc. In fact, auditors’ duties in these areas under ISAs are currently more limited. Corporate governance, proper management of risk, avoidance of fraud etc. are primarily the responsibility of the company’s Board and executive management. However, we support any debate which: (a) increases awareness of the current purpose and scope of audit; (b) identifies what shareholders and other stakeholders need from corporate reporting and assurance over reported information (the audit framework); and (c) indicates what needs to change across the ecosystem to meet these needs. It is only if these aspects are considered together rather than audit being considered in isolation that shareholder and other stakeholder needs will be met.

In this context, it is also important to recognise the “unseen” value that shareholders and broader stakeholders obtain from the work of auditors such as KPMG. This is not limited to the audit opinion as set out in the annual accounts. In fact, there is a huge amount of work performed by auditors which is largely behind the scenes and provides a crucial contribution towards better management, controls, financial

⁴ A notable exception to the application of IFRS is the US where public companies apply US Generally Accepted Accounting Principles (GAAP).

reporting and transparency across corporate Britain. Specific examples of activities by KPMG in its audit function include:

- Challenging and correcting accounting treatments and conclusions, resulting in often large, sometimes material, changes to the financial results, for example:
 - Highlighting management’s inappropriate assumptions about how to account for significant transactions, resulting sometimes in those transactions not proceeding.
 - Challenging management estimates and judgements, resulting in significant adjustments to the financial statements and changes in disclosures.
 - Critiquing companies’ approaches to unfamiliar accounting issues (perhaps due to a new standard or a new line of business), resulting in better accounting approaches being adopted.
- Insisting/encouraging disclosure on and explanations for business prospects and other features, resulting in more balanced disclosure in annual reports, for example:
 - Insisting on disclosure of significant drivers of financial results, going concern issues, regulatory investigations and tax disputes contrary to management and Board wishes.
- Challenging, supporting and providing insight to ACs and management in relation to sector issues, improvement of their teams and support for necessary internal changes, for example:
 - Providing feedback on the quality/performance of chief financial officers (“CFOs”) to ACs that has led to changes in personnel and stronger internal finance teams.

These examples illustrate how an auditor, even under the current framework, provides additional value to shareholders and broader stakeholders on a day-to-day basis, separate from the statutory audit report. KPMG considers that audit firms’ ability to make these sorts of changes would be heightened if additional channels of recourse to regulators were available to deal with significant differences of views between audit firms and ACs.

1.3 To what extent do the decisions made by ACs support high quality audits, whether through competition for audit engagements or otherwise?

As the CMA notes in its ITC, audit is a service for shareholders, but is commissioned by company management, as has always been the case under company law. KPMG does not, however, believe that what the CMA describes as a “principal-agent” problem adversely affects audit quality. The AC is a critical safeguard in aligning incentives and preserving audit quality. KPMG strongly believes that the current framework for ACs supports (and indeed requires) the provision of high quality audits. KPMG’s experience is that ACs are sophisticated purchasers of audit services that

closely scrutinise and challenge auditors' work, including consideration of any potential conflicts of interest. ACs pay close attention to audit firms' AQR quality scores and ask questions around firms' quality processes – particularly since the introduction of requirements for additional tendering. ACs' focus on quality is driven in part by the need for ACs to protect their personal and professional reputation, which relies on the robustness of the auditing and financial reporting carried out.

Alongside the AC's crucial role there is significant shareholder engagement in relation to audit:

- Shareholders vote on the appointment and remuneration of auditors; and
- KPMG receives input from shareholders on the issues that they consider relevant to audits in a particular sector, which is then built into our audit approach.

KPMG fosters the relationship with major shareholders of the companies it audits and engages in a number of outreach activities with them. KPMG has, for example, launched an initiative over the summer to collect feedback from large investors on the issues that matter to them when it comes to an audit. These examples point to the close attention that shareholders pay to the process of auditing a company's accounts.

KPMG is also aware of efforts made by ACs to obtain input from investors, for example from institutional investors at the start of audit tenders, or by including dialogue with the ACC as part of "investor days" which are sometimes attended by the auditor.

Furthermore, the multiple remedies introduced by the CC (including enhanced shareholder engagement and strengthening auditor accountability to the AC) have further strengthened the AC's role, as discussed below. KPMG is supportive of measures to further strengthen the role of the AC. This is discussed further in Part B. In addition, KPMG would welcome additional channels of recourse to regulators being made available to deal with significant differing views between audit firms and ACs.

1.4 How has this changed following the Competition Commission's intervention?

The evidence available to KPMG (both empirically and anecdotally) indicates that, despite having had only three years in force, the CC remedies have generated significant changes in the operation of the audit market, with increases in both tendering of audit contracts and switching, and, as the CMA notes, the FRC has reported broad improvements in quality.

The CC's intervention has impacted on the role of ACs. Contrary to the CC's findings in 2013 that a sizeable minority of CFOs and ACCs at FTSE 350 companies considered that the CFO was the most influential in appointing the auditor, in KPMG's experience this is no longer the case – ACs/ACCs are consistently the most influential in such decisions across all large companies. This is a fundamental change since the 2013 inquiry.

The increased role of ACs and ACCs has driven an overall paradigm shift in the way audit decisions are made; whereas historically this used to be a relationship decision with a high degree of continuity and low switching, companies, led by their ACs, are now much more analytical about trying to find technical differentiation. ACs and ACCs have strong incentives to have as much choice as necessary to drive competitive outcomes.

One further aspect has been an increased focus on technological capabilities, which has accelerated audit firms' investments in technology. Large company tenders now commonly measure the relative technology strengths of tendering firms as a core part of the tender process and this has become an increasingly important competitive parameter. It is therefore crucial for firms to be at the forefront of innovation to be able even to compete for certain large audits.

Finally, a more direct engagement with ACCs has led to a decrease in the amount of non-audit services provided to audited companies as also discussed in Part B.

- 1.5 Is competition in the audit market working well? If not, what are the key aspects hindering it?**
- 1.6 In particular, how effective is competition between the Big Four and between other firms and the Big Four?**
- 1.7 How has this changed following the Competition Commission's intervention?**

Competition between audit firms (analogously with other markets) is a process of rivalry that drives incentives to provide high quality services at competitive prices, as well as incentives to invest and innovate. The intensity of rivalry in audit services is demonstrated by a range of indicators, both in terms of direct client-facing parameters such as price and quality initiatives, and in the upstream rivalry to attract the most talented employees (which has a pronounced and long-term effect on overall audit quality).

With regard to direct client-facing competition specifically, tender processes that drive competitive interactions are frequent and lead to frequent switching as demonstrated by the data above. Furthermore, the rate of tendering in audit services has increased substantially. Since 2013, on average 11% of FTSE 350 companies tendered their audit in any given year, against 3% that the CC had found in the previous inquiry. In 2016, as many as 21% of FTSE 350 companies tendered their audits.

KPMG's analysis of the [redacted] tenders it participated in across the FTSE 350 between 2013-2018 shows that a very high proportion of tenders resulted in a switch away from the incumbent ([redacted]), which is the equivalent of 75% across the period). Even excluding those tenders where the incumbent auditor did not bid (presumably due to rotation requirements), more than half of tenders (53%) resulted in a switch away from the incumbent. Moreover, the large majority (74%) of these tenders had at least three competing bidders. Across all FTSE 350 tenders, just over 16% saw competition from at least one mid-tier firm, rising to c.20% for the FTSE 250. Contrary to the perception that competition amongst auditors is more limited for larger FTSE companies, the

switching rate for tendered audits for FTSE 100 companies was 82% – slightly higher than the overall average for all FTSE 350 companies.

Moreover, since the 2013 CC inquiry:

- Tender processes have become more efficient and cheaper (for the company), so the likelihood of companies going out to tender is more significant. Tendering itself has become the norm and replacement of the incumbent auditors is very frequent, as already shown.
- Prices have remained strongly competitive with margins in audit under pressure (although this latter trend may not be wholly positive).
- Because of the increased sophistication of ACs, they have significant buyer power; they have a heightened ability to assess quality and to negotiate the best terms through processes other than formal tendering, which was an area in which the CC had previously observed somewhat less intense competition.
- Companies have become increasingly demanding in relation to the use of technology and demonstrating the ability to effectively process large amounts of data. As technology advances, KPMG expects that reliance will be less on quarterly and yearly reports but more on real time metrics, and that some players that are currently not active in this market, such as tech giants, may develop some solutions that are wholly different in nature but substitutable with the work provided by audit firms.

The rivalry between audit firms requires significant investment. This is not limited to the ongoing and fierce competition to attract talented audit professionals in the industry, but also includes significant levels of capital investment. To remain competitive, firms must have the best technology and related expertise and often have to make large time investments in the team itself to learn about the audited company to even be in contention to win the tender. This need for investment determines the current structure of audit services. It drives the multi-disciplinary nature of the firms as well as their scale. As businesses become larger, more complex and dynamic, audit firms need greater access to specialist resources and to make continued large-scale investment in technology and data analytics capabilities – both of which are facilitated by multi-disciplinary firms with the scale to invest appropriately. Indeed, KPMG’s international reach is critical to delivering complex global audits.

Given the level of investment required in audit services, the market dictates the level of concentration that is consistent with the delivery of the services to a high quality. In other words, the level of concentration in the market for the largest companies is itself the result of competition, as only a certain number of firms can build the scale to make the investments in training and technical capabilities required to compete. The fact that concentration goes hand in hand with intense competition is consistent with the findings of the CC, that noted that “*generally a FTSE 350 company and its incumbent*

auditor can expect strong competition for the audit engagement if the company were to decide to go to tender”.⁵ This remains even more the case today.

In view of the evidence, KPMG considers that competition in the audit sector is robust. The CMA itself has noted that:

“We have also seen greater rivalry in some sectors with more of the Big Four competing for clients in areas where they did not previously – for example in banking where all Big Four auditors now have FTSE 350 clients, compared to three previously. Other sectors which now seem to have more choice of auditors include food and drug retailers (in 2014, only PwC and Deloitte audited these, now all four do), construction and materials and healthcare equipment and services. These steps should be seen as significant progress towards a more competitive and inclusive audit market with wider choice and higher quality.”

As a further example, KPMG notes that Deloitte has been appointed as auditor for BP, and understands that this represents its entry into the provision of audit services for big oil & gas companies.

The evidence that competition is effective can be shown by figures relating to competitive interactions. As regards more specifically competition between the Big Four and mid-tier firms, the provision of audit services to FTSE 350 companies often requires scale, technical resources and investment, and global reach to maintain high across-the-board quality. Mid-tier firms have so far not been able to make the investments necessary and achieve the scale needed to be credible auditors to many of the larger companies, where the Big Four compete fiercely, as indicated above. There is scope for the mid-tier firms to expand, in relation for example to FTSE 250 companies, and there is no intrinsic reason why they should not do so, building up over time the capacity to challenge for the largest audits.

The overall picture is one of a competitive market, with ACs and ACCs driving the competitive tensions. KPMG is open to considering, in conjunction with shareholders, other stakeholders and regulators, measures which might reduce concentration in the market for large audits as discussed in Part B below.

1.8 What is the role for competition in the provision of audit services in delivering better outcomes (i.e. consistently higher quality audits)?

In addition to the points already made, there are two key areas where competition drives better outcomes, innovation and improved audit services.

Innovation

KPMG engages in significant investment to produce technological innovations that aim to increase audit quality, effectiveness and efficiency. Companies expect the use

⁵ CC, Final Report, paragraph 9.65.

of technology in their audits, and KPMG – just like other firms – has to respond and invest. The KPMG International network’s global development team has spent approximately [redacted] over the last three years on developing audit technology, in particular launching KPMG’s Clara platform, and plans to spend approximately [redacted] per year over the next three years [redacted]. KPMG in the UK is one of the largest contributors of this funding. This investment at the global level is on top of the significant investment made in technology development and maintenance at individual member firms – for example, KPMG in the UK spends approximately [redacted] per year specifically on audit technology development and maintenance to ensure, inter alia, that UK-specific requirements are addressed.

The tools developed through this investment in technology improve the quality of audits, at all stages of the audit process:

- [redacted]
- [redacted]
- Finally, in relation to the audit of significant accounting judgements, technology also allows for more robust scrutiny. For example, KPMG’s use of predictive and valuation analytics provides the audit team with the ability to analyse projections and sensitise assumptions, as well as using inputs from a number of data providers such as S&P. This provides greater capability to challenge management on key judgements (for example in relation to bad debt or impairments).

In the previous inquiry, the CC was concerned that there was insufficient innovation in relation to the audit product supplied. The significant technological innovation that has occurred since the CC’s report set out above directly improves the quality of the audit product provided, and is not limited to simply enhancing efficiency of delivery. The tools also allow for the more efficient use of staff time – to focus more on complex areas of accounting judgements.

Better services to stakeholders

In addition, there has been significant innovation in the nature of the audit report provided by KPMG. In its 2013 report, the CC talked about an “unmet demand”. While the CC recognised KPMG’s “extended audit”, it noted that shareholders may want additional information regarding the audit of companies, but which is not included in the audit report, indicating that auditors were not competing to provide shareholders with the information they demand. KPMG has further developed the depth and nature of the commentary it provides in audit reports, representing a significant innovation. The key development is the inclusion of our view on the caution or optimism in key findings and judgements – which we call “graduated findings” and which KPMG has promoted since 2014. More detail on the nature of graduated findings is set out in Annex 2. KPMG has also introduced other innovations into audit reports such as providing better insights into risk through inclusion of “risk maps” (see for instance the audit report on Rolls-Royce Holdings PLC’s 2017 financial statements).

In KPMG's view, this is an area where regulators, including the CMA, must play a more proactive role, given the need for these changes to occur on an industry-wide level for them to be effective and consistent across the market. KPMG believes that the convergence of audit services towards an audit product that fully meets the needs of investors and the expectations of the public could be significantly accelerated by regulatory intervention.

1.9 In practice, how much choice do large companies and public interest entities have in the appointment of an external auditor?

1.10 What are the key factors limiting choice between auditors?

As reported above, the majority of companies tendering for an audit have at least three bidders. This rivalry drives audit quality and the incentive to invest in the ways set out above. In this sense, it can clearly be said that large companies as a group have sufficient choice to drive very strong competition in audit services.

KPMG believes that the vast majority of public interest entities and other large companies do currently have the choice of multiple high quality offerings. However, the nature of the demand means that for many companies only the Big Four are considered as being able to offer the quality, resources and investment necessary to compete effectively. This is a direct result of the fact that audit firms compete aggressively to develop better quality audit offerings. KPMG's observations are that ACs, particularly of FTSE 350 firms, continue to prefer Big Four audit firms over others based on a perceived higher quality of service provision and the statistics cited by the CMA's ITC appear to confirm this. This does not reflect a reduction in choice – quite the opposite, it reflects the deliberate decision by the procuring companies to exercise their ability to choose in a discriminating way.

On occasion, companies may choose not to involve one or more firms in a competitive tender process due to their desire to use or continue to use such a firm or firms to provide services which would not be considered compatible with auditor independence requirements. However, KPMG's data provided to the CMA, indicates that, as far as KPMG is concerned, this has only affected KPMG's decision to bid for a limited proportion of overall tenders amongst FTSE 350 companies (around [redacted]).⁶ Moreover, this is something that ACs and audit firms are in a position to fully control and manage, particularly through a planned tender cycle.

1.11 What are the main barriers to entry and expansion for non-Big Four audit firms?

While mid-tier firms have more opportunity to tender than previously, they may face experience and reputational hurdles. Regulatory and liability costs associated with large complex audits have also been cited as a barrier to entry or expansion for smaller audit firms. As the CMA itself notes, the large auditors in the UK are part of

⁶ In the data provided by KPMG to the CMA in the CMA's request "File E" on 23 October 2018, in [redacted] tenders among FTSE 350 companies of which KPMG is aware did KPMG not bid because of its provision of non-audit services.

similarly branded international networks of audit firms, experienced at working together using a common audit methodology and quality control processes to provide a seamless audit across borders, so a company may only need to appoint one auditor for its global business. The mid-tier audit firms' international networks are not as comprehensive, particularly in terms of scale, as those of the Big Four⁷ and alliances and mergers (which help deal with problems of scale, investment and capability) are not as commonly seen in audit services as in other areas such as banking and insurance.

The CC in 2013 considered that, given strategic investments to build reputation and to target appropriate FTSE 350 companies, there was no reason why mid-tier firms could not expand their provision of audit services on an incremental basis. KPMG believes this is still the case. As is evident from the statistics outlined above, many more tendering opportunities are now available in the audit market and increased levels of switching are occurring. This should remove one of the barriers to expansion cited by the CC in the last review, and strengthen its view that incremental expansion by mid-tier firms could occur, particularly in the FTSE 250.

As stated in Part B, KPMG would be willing to participate in any industry-wide discussion regarding practical measures that could be taken to help reduce any barriers to expansion in a way that maintained a level playing field in audit services, maintained choices driven by quality and did not limit incentives to compete (including through investment in technology and talent) to improve quality in audit services.

1.12 Is there a significant risk that the audit market is not resilient? If so, why?

Some commentators have argued that there is a risk which sees the Big Four firms as "too big to fail". The main theory seems to be that regulatory and market instruments to punish sub-standard audit quality are blunted, given that severe sanctions might result in market exit. Hence it is suggested that the firms involved have reduced incentives to avoid conduct or risks that might otherwise lead to market exit, which in turn has a detrimental effect on: (a) audit quality; (b) the reliability of auditors' work in predicting collapse; and (c) prices and innovation. We believe that this theory is unfounded.

The CC found no evidence of this risk in its 2013 inquiry, and the introduction of the suite of remedies since then has further strengthened both competition and regulatory powers. The FRC's recent criticisms of the Big Four, and KPMG's comprehensive response to the issues outlined above, show that it remains an effective regulator,

⁷ Based on the evidence from the CC inquiry, BDO and GT are present in 76% of the markets in which the Big Four are present, and furthermore the member firms of the Big Four were on average larger, their networks included fewer small member firms – and the CC recognised that the smaller networks potentially had less capacity to resource engagement teams for large subsidiaries at short notice. (Paragraphs 86-95, Appendix 9.1, CC, Final Report).

even before the potential changes that could result from the Kingman review currently in progress.⁸

In any case, the failure of an audit firm is not the most direct way in which the threat of “failure” drives incentives to maintain audit quality. Audits are led by individual partners, and those partners can “fail” if they are seen not to have demonstrated the right degree of professional scepticism or judgement, or executed their responsibilities as required by professional standards. As well as an individual’s professional reputation, sanctions of UK audit partners can be applied by the ICAEW⁹ and the FRC.¹⁰ In addition, during a tender process, companies will almost always require information on the record of the proposed senior team in relation to KPMG’s quality review process.¹¹ This leads to any partner with a poor inspection result not being included in tender documents and, as a result, to significant damage to their career. Similarly, these results are shared with clients during the course of an audit and, again, any poor inspection result (unless adequately explained and remediated) would most likely lead to a client demanding that the partner no longer work on their audit.

It is this personal aspect, together with the competitive demands for the highest quality, which maintain market discipline and incentivise individual partners (as well as the firm as a whole) to strive for quality. This factor is heightened by the increasing body of evidence (which the CMA itself observes) suggesting mid-tier audit firms are making incremental gains in expanding their auditing capabilities into those areas which were traditionally dominated by the Big Four. If the largest four audit firms failed to invest in quality, or to increase audit fees by a not insignificant amount, the mid-tier firms would increasingly be able to exploit this, particularly given the increased sophistication of ACs.

1.13 What is the appropriate balance between regulation and competition in this market?

As the CMA notes in its ITC, the publication of independently audited company accounts has an economic value beyond the private benefits to the shareholders and the management of a company. As a public good provided by the private sector, both sector-specific regulation and market competition are critical to developing properly functioning audit markets which support the interests of both direct shareholders and wider stakeholders in the economy.

It is clear, in particular, that certain aspects of public dissatisfaction with audit services at the moment (such as the so called “expectation gap”) cannot be addressed by competition alone, as discussed above. There remain questions about the specific role of audit within the financial reporting ecosystem, as well as the regulatory

⁸ KPMG is happy to provide the CMA with a copy of its submissions to the Kingman inquiry if the CMA has not already been provided with a copy of these.

⁹ Such as the loss of accounting licence.

¹⁰ Often financial, but also as illustrated with the BHS audit partner from PwC, the effective disbarment from the profession.

¹¹ A process which is mandated and monitored by the FRC.



Statutory Audit Market Study

Response to the Competition and Markets Authority Invitation to Comment

KPMG LLP

30 October 2018

approach to improve audit quality. The wider Kingman review of the FRC being conducted is therefore timely.

However, competition remains both a necessary and a significant driver of continuous improvement. Only competition can create incentives to invest in audit quality and capabilities, through creating the opportunity for audit firms to reap the rewards of that investment through success in the competitive process. Competition has been, and continues to be, intense in the audit sector and this is reflected in quality standards which are generally high, the attraction of talented staff to top auditing firms, price competition and investment in innovative new service delivery models. KPMG wholly embraces this competition – just as it also wholly embraces the role of regulators like the FRC and therefore looks forward to actively engaging with each of the CMA, the Kingman review and the FRC to strike an appropriate balance between competition and regulation.

2 PART B: Potential measures

As noted at the outset, KPMG recognises that the current scrutiny and criticism of the audit profession is linked to a certain loss of trust amongst some stakeholders and, society in general, in business, corporate governance, financial reporting and even free market capitalism more broadly. The audit profession faces profound challenges around audit quality, conflict management, concentration and choice that need to be addressed. KPMG is committed to engaging constructively with the CMA and stakeholders to find proportionate solutions.

However, if trust is to be maintained in the long-term, the central objective of any change must be the enhancement of audit quality and any measure(s) proposed must be carefully reviewed and evaluated with regard to whether it will genuinely achieve that objective, without causing unintended (and potentially counterproductive) effects.

In the following sections KPMG provides its view of each of the potential measures being considered. KPMG is willing to engage in more detail about any of the below.

2.1 Restrictions on audit firms providing non-audit services

Perceived conflicts of interest are at the centre of much of the current criticism of the audit profession. In the ITC, the CMA states that one way of promoting more effective competition among the Big Four would be to restrict audit firms from providing non-audit services to at least some companies. It outlined three potential variations of this measure:

- a) greater partial, or complete, restrictions on audit firms providing non-audit services to companies they audit;
- b) prohibit audit firms from providing non-audit services not only to companies they audit, but also to any other large company or PIE; or
- c) split the UK arms of major accounting firms into audit-only and non-audit services practices.

Section 2.1.1 considers the CMA's option (a), in response to its specific questions on this potential measure. Section 2.1.2 then discusses options (b) and (c) as set out by the CMA and explains why multi-disciplinary firms need to be preserved for the sake of audit quality.

2.1.1 **Measures restricting the provision of non-audit services¹² by audit firms to the companies they audit**

The CMA has suggested greater partial, or complete, restrictions on audit firms providing non-audit services to their audited companies in order to limit potential conflicts.

In certain jurisdictions it is required by law that specific services should be undertaken by the statutory auditor (although for most UK-based groups these would be unlikely to be significant in the context of the group as a whole). In addition, certain services which are not “audits”, and therefore are “non-audit services”, are however typically undertaken by, and logically should be undertaken by, the auditor (“**Audit-Related Services**”). These include: half-year (or interim) reviews for public companies; certain regulatory reporting (primarily for companies in the financial services sector); and public reporting engagements relating to securities offerings or transactions. Were any restrictions to be introduced over and above those currently in force, it is crucial that auditors can continue providing required services and other services closely related to audit which remain in the public interest for the auditor to perform. In addition, shareholders to private companies, particularly owner-managed businesses, look to their auditor to provide a “one-stop shop” and this is of significant value to the UK economy. KPMG is therefore in favour of retaining the ability of the owners of such businesses to choose and engage their auditor to provide a broader range of non-audit services as currently allowed under the FRC’s Ethical Standard.

Further restrictions on non-audit services which might be provided

KPMG considers that its current systems to comply with the restrictions in the FRC’s Ethical Standard are robust and, as KPMG submitted in the CC’s last investigation, the provision of non-audit services to audited companies can lead to important efficiencies, thanks to economies of scope and direct savings for the audited entity which benefits from continuity and consistency. There may be further efficiencies that are enjoyed by audited companies from the provision of non-audit services by their auditor, which is likely to vary across companies. Any consideration of whether it is appropriate for an auditor to provide non-audit services to the companies it audits needs to recognise these potential benefits to those companies and take into account relevant views. In its last inquiry in 2013, the CC did not make a recommendation of further restrictions in relation to the provision of non-audited services.

Whilst the rules and systems relating to the provision of non-audit services to an audited entity are extensive and complex, a perception of conflicts remain. While further enhanced governance is likely to address this perception to a degree, KPMG recognises that restricting the provision of non-audit services may be desirable. This could address significant public perception of auditors’ judgement being impaired by the nature of non-audit work or the financial benefits derived therefrom. We believe that any such restriction should be limited to FTSE 350 audited companies since these

¹² Question 18 of the Invitation to Comment.

companies tend to be at the level where the public interest – through dispersion of shareholdings and impact on the economy – is greatest.

The direction of travel with regards to non-audit services to audited companies across the profession has been clear for a number of years. As the table below shows, the proportion of non-audit fees to audit fees provided by companies' statutory audit firm has fallen significantly in the last seven years (also bearing in mind that non-audit fees include Audit Related Services).

Non-audit fees as a % of audit fee		
	2010	2017
FTSE 100	54.0%	40.1%
FTSE 101-200	80.0%	49.5%
FTSE 201-350	88.0%	60.1%

Source: Grant Thornton Corporate Governance review 2013 and 2017

Note: Excludes Investment Trusts – 2017 sample includes 305 companies

This is a result of both increasing regulatory restrictions, as well as changing attitudes of (particularly large) companies where ACs are increasingly limiting both the amount and range of non-audit services provided by the company's statutory auditor (beyond just prohibited services). Indeed, some companies already require a successful tenderer to cease supplying non-audit services.

As a result, and also conscious of the broader perception issue surrounding potential conflicts, KPMG is currently working towards discontinuing the provision of non-audit services to the FTSE 350 companies it audits, which would be most impactful if implemented within a regulatory framework. However, it is important to recognise that, given the need for the provision of Audit-Related Services, it is highly likely that companies will always report the provision of some "non-audit" services.

To strike a cautionary note, the CC noted in 2013 that a statutory restriction on non-audit services may further reduce choice, either because certain firms are automatically excluded from a tender process due to a desire on the part of the company to be able to continue to use the services of the relevant firm which would be prohibited for an auditor, or that some firms may be disinclined to participate in audit tender processes due to the incentives to continue to provide non-audit services. These factors led the CC not to recommend any further restrictions (beyond those adopted in its remedies order).

In KPMG's experience, ACs are generally able to manage this issue by retaining flexibility and choice over when to tender and which audit firms to involve. For a restriction on the provision of non-audit services by the statutory auditor of FTSE 350

companies to be practical, and not to lead to a loss of choice for ACs, it is important that at least a degree of flexibility is retained.

2.1.2 Other non-audit prohibitions and separate ownership¹³

The CMA invites comments on two further potential options: (b) prohibiting audit firms from providing non-audit services not only to their audit clients, but also to any other large company or PIE; and (c) splitting the UK arms of major accounting firms into audit-only and non-audit services practices.

Options (b) and (c) are, in practice, likely to be equivalent in terms of adverse market impact, albeit (c) would result in significantly greater disruption and cost. Sustaining a non-audit practice that is not able to serve larger companies would not be feasible. As a result, the discussion in this section in relation to the separate ownership of audit and non-audit services practices covers both options (b) and (c) of the CMA's potential measures.

As foreshadowed by the CMA,¹⁴ in KPMG's view, separate ownership of audit and non-audit services practices would entail significant costs and would in particular be very difficult to implement from an international perspective. Most significantly, such a measure would create a very serious, and potentially unsurmountable, risk to audit quality (including maintaining independence) and, as a result, KPMG does not believe that this is an appropriate approach to solving any issues in the market.

KPMG firmly believes in the merit of the multi-disciplinary model for audit firms as being essential for audit quality, in particular for the audits of larger companies. Audit practices as part of multi-disciplinary firms of this nature and scale have evolved, as a result of market forces, to provide the best quality audits to large companies.

There are two broad reasons why separation of the UK arms of major accounting firms into audit-only practices would pose a significant risk to audit quality.

First, KPMG and other big audit firms have a number of non-audit practice areas that closely support and enhance the provision of audit services, and the scale of the business overall supports crucial investment in audit technology: only a multi-disciplinary firm can provide the specialist skills needed to provide a robust and high quality audit for (increasingly) large and complex companies in a range of sectors. In KPMG's experience, there are a number of areas of expertise in a multi-disciplinary firm that are needed to deliver quality audits, including IT specialists, actuaries, tax experts, forensic accountants, experts in financial instrument valuation, business specialists, data scientists, engineers, cyber experts and macro-economists. The input from specialists in an audit for a large multinational company is considerable and can represent 20% of the hours spent on the audit. These specialists generally spend only a relatively small proportion of their time working on audit engagements, and so retaining these in an audit-only firm would imply significantly increased costs

¹³ Question 16 of the Invitation to Comment.

¹⁴ Invitation to Comment, para 4.10.

for companies in relation to their audit provision.¹⁵ More fundamentally, KPMG would not expect it to be feasible to retain most of these specialists with the right skills, at any cost, in an audit-only firm. Such specialists do not enter their profession in order to work solely on audit engagements and audit work is unlikely to be as attractive (interesting, challenging and varied) compared to the range of work they could experience at non-audit firms, especially in the area of technology where the very best talent is highly mobile, moving to wherever is most “exciting”. Maintaining specialist skills would be very challenging in an audit-only firm. Indeed, this expertise, itself honed from a variety of work, greatly benefits audit quality. Further, a multi-disciplinary model allows firms to offer top recruits the opportunity to see and experience interaction with specialists in the audit and thereby allows them to learn more. It also gives them other career opportunities while remaining at the same firm, thus helping KPMG to recruit and retain top talent.

Sourcing such expertise from outside the audit-only firm would also be challenging. Within a multi-disciplinary firm, these experts working on individual audit engagements maintain personal independence requirements, just like any member of staff or partner in the audit profession. If these experts were sourced from another firm, these independence requirements would likely not be satisfied, and it is unclear that any process could be put in place to maintain the personal independence of staff working on audit engagements from third party firms, quite apart from the inefficiencies inherent in having engagements with multiple parties to complete the audit.

Second, an international multi-disciplinary firm provides the scale to invest in IT, technology infrastructure and innovation in order to meet companies’ increasingly significant demands in relation to the use of technology on audit engagements (see Part A for the figures on global investment). Moreover, there are a number of further challenges associated with a separation into audit and non-audit firms:

- Unless mandated internationally, this would leave UK audit firms without international networks to service global audits which would not meet the needs of many stakeholders.
- An audit-only firm may, in fact, reduce the actual or perceived independence of auditors, as it would create smaller, standalone audit practices which would be fully reliant on audited companies for their fee income and may be more financially dependent on their larger clients.
- Small audit-only firms are unlikely to be able to attract sufficient capital to sustain the risks of public liabilities or to develop increasingly challenging modern technology, quite apart from the difficulty of attracting talented staff as already mentioned. Consequently, audit-only firms would be less resilient.
- Separation of multi-disciplinary firms into audit and non-audit firms would also fundamentally undermine the economics of the firm. It would require

¹⁵ As the CMA notes, this might be even more challenging for mid-tier firms of a smaller scale than the Big Four, Invitation to Comment, para 4.10(d).

significant investment to maintain quality standards and to respond to audited firms' increasing complexity and technology-driven business models (and it is not clear that this investment would be justified, particularly in view of the loss of scale). With regard to the impact on the non-audit part of the firm, the loss of the core audit business would produce a very different business model and likely make investment in non-audit services more challenging.

Overall, KPMG's view is that splitting the UK arms of major accounting firms into audit-only and non-audit services practices would create untenable risks to audit quality, and very significant practical challenges. Any benefits in relation to conflicts can be achieved through enhanced governance, alongside the reduction in non-audit service provision to audit clients that has occurred in recent years and which KPMG continues to work towards.

2.2 Market share caps¹⁶

The CMA suggests that the aim of introducing market share caps would be, over time, to increase the ability of smaller audit firms to compete for larger audits and increase their market shares, thus reducing market concentration.

KPMG recognises a concern that some shareholders and other stakeholders would welcome greater choice when selecting an auditor and believes that the option is worthy of further active consideration. There are, however, significant potential challenges both immediately and in the longer term associated with this measure which would need to be resolved if the CMA were to consider recommending some form of market share cap; for example:

- restricting ACs' choice of auditor;
- adverse audit quality outcomes;
- loss of scale economies;
- softening competition among the Big Four firms, without empowering the mid-tier; and
- challenges in practical implementation.

Restricting ACs' choice of auditor

A direct consequence of imposing formal market share caps is that this would restrict ACs' choice of auditor, when the market share cap for a particular audit firm (or audit firms) has been reached. In some cases, ACs might in practice be "forced" to appoint a particular audit firm even when they would not have chosen this option due to concerns over quality. While to some extent such choice is restricted in the case of mandatory rotation, a market share cap would likely represent a significantly greater restriction on the AC's choice. Experience at KPMG and our understanding of views from investors suggest that this is likely to be a significant issue for companies,

¹⁶ This section provides responses to Questions 19 – 22 of the Invitation to Comment.

especially for ACs and boards who are expected to take responsibility for the auditor appointment decision.

This would undermine the accountability of the AC and appears to sit uncomfortably alongside the increased focus on shareholder engagement and strengthening of ACs (something which the CC also sought to strengthen further) and which is discussed further below.

Adverse audit quality outcomes

Imposing strict market share caps could lead to lower quality audits. In particular, a weakening of the ability of the AC to choose an audit firm on the basis of quality (discussed above) and competence in a specific industry sector is likely to reduce the drive for quality through competition.

Furthermore, there is a risk that, in order to comply with their caps, the Big Four firms choose not to participate in tenders for the least favourable or more risky audits (as would be a rational commercial decision). This could mean either significant price increases or that a higher proportion of these types of audit are left to the smaller audit firms who may have less experience of such audits and therefore increases the risk of a reduction in quality, to the detriment of consumers overall.

Loss of scale economies

A reduction in scale due to the market share caps for the Big Four firms might have a further impact on quality and on prices going forward. A loss of scale would impact KPMG's ability to spread fixed costs and could lead to higher audit fees. It might also reduce the ability to undertake the same level of investment in KPMG's audit practice, which would have consequences for both efficiency and quality of audits.

In addition, caps may result in a potential loss of expertise in particularly specialised industries if an auditor is restricted from competing for audit clients in such industries. Over time, this could reduce the quality each firm is able to provide.

Softening competition among the Big Four firms, without empowering the mid-tier

Depending on how a market share cap measure is implemented, such a measure could blunt incentives between audit firms to compete, leading to an overall weakening of competition and could result in audit fees increasing. This might arise if the caps imply that audit firms do not compete for new tenders once their caps are reached or are under less competitive pressure on their existing audits if competitors have reached their cap. A cap that applies to the Big Four in total, rather than a cap for each individual firm, may preserve some degree of competition between them, but this may exacerbate practical challenges of monitoring and enforcement (discussed further below).

A downside to the proposed measure, which decreases its effectiveness were it to be introduced on its own, is that it does not directly enhance the skills or capabilities of

the smaller firms. Such benefits would instead theoretically develop over time as the smaller firms gain experience of auditing larger companies themselves. But there is no guarantee – or even a realistic assumption – that over time smaller audit firms could gradually build up capacity and quantity.

Challenges in practical implementation

KPMG is open to engaging on some measure with regards to market share limitation. If pursued, key questions to be addressed would include the metric on which market share should be calculated and the population of companies to which the measure should apply.

KPMG believes that, if introduced, a cap could only plausibly be based on numbers of audited companies in the requisite population rather than revenues, market capitalisations or other metrics. This would be on the grounds of simplicity, as monitoring and maintaining market share caps according to other metrics would be extremely complex, especially since these will change frequently over time, not just when companies switch audit firm.

Whilst there is an argument that any cap should be limited to the FTSE 350, as this group of companies has the greatest impact on market perception, KPMG also recognises that the market for the audits of smaller listed companies would arguably be where non-Big Four firms might be best placed to take on audit mandates in the short-term and thereby build credibility amongst ACs as to their capability to deliver quality audits. Careful consideration would therefore be required in defining the subject population. A phasing in of any such cap would also be important.

More generally, the design of any system of caps would need to, *inter alia*:

- Define who would monitor compliance with the caps and how this could be achieved effectively without unduly interfering with the functioning of the market or imposing disproportionate burdens on market participants.
- Determine how to sanction non-compliance.
- Address how audit firms with shares currently in excess of the capped level might identify which audits to surrender and the consequences for the restrictions in choice that this would mean for the relevant AC and the company's shareholders.
- Define the level of any market share cap, recognising that this level may depend on the population of audits (e.g. FTSE 350) subject to the cap and taking account of the fact that capacity outside the Big Four audit firms would be limited at the outset and be built over time.
- Determine how changes in the relevant population (e.g. constituents of the FTSE 350 index) would be addressed.
- Avoid the risk that a firm without the requisite capability and capacity might take an audit for which it was ill-suited or under-resourced.

- Determine whether any caps should be defined as a temporary measure pending a reduction in the level of concentration in the requisite market.

In implementing any such arrangements, the potential adverse outcomes as well as the implementation challenges outlined above would need to be addressed. KPMG would welcome the opportunity to discuss how this could be achieved effectively and proportionately.

2.3 Joint or shared audits¹⁷

Joint or shared audits have been suggested as a measure that would directly reduce market concentration and increase competition from non-Big Four firms.

In the ITC,¹⁸ the CMA has outlined three possible variations of joint or shared audit for consideration, as follows:

- a) a mandatory joint audit that requires two audit firms to sign off on the accounts of their audit client. Responsibility for the audit opinion, and audit liability, would rest with both auditors;
- a) a shared audit where one audit firm (the statutory auditor) takes overall control, responsibility and liability for the audit. Another audit firm would support the statutory auditor on certain aspects of the audit; and
- b) a peer review, where an independent audit firm (not the company's statutory auditor) reviews the audit file and assesses the accuracy of the audit opinion before it is signed off by the statutory auditor.

The CMA has suggested that some form of the measures set out above may be a way to ensure greater market access for non-Big Four firms. In addition, the CMA suggests that a joint audit might directly increase quality if it implies greater scrutiny of the audited company's accounts.

Such a measure is likely to most directly address the issue of the presence of mid-tier firms if the second firm is a non-Big Four firm, as only then will mid-tier audit firms be able to increase their presence both in the short-term and over time as their skills and experience are developed. Furthermore, having a non-Big Four firm as the second auditor might increase the diversity of scrutiny on larger firms' accounts.

However, KPMG considers that, if the CMA were minded to pursue such a measure, there are a number of challenges that need to be considered and addressed, including:

- potential implications for audit quality;
- additional costs to companies;
- liability issues; and

¹⁷ This section addresses Question 23 of the Invitation to Comment.

¹⁸ Invitation to Comment, 9 October 2018, paragraph 4.18.

- implementation challenges.

KPMG is not in principle opposed to exploring possibilities in relation to some form of shared (or peer reviews), rather than joint, audits. Overall, KPMG notes that the challenges set out below are likely to be significantly more manageable in relation to option (c); and even some version of option (b), if applied on a practical basis; and might avoid some challenges in comparison with the full joint audit described under the CMA's option (a).

Potential implications for audit quality

In KPMG's view, the focus should be on whether there is a form of this measure that can impact meaningfully on the ability of smaller firms to participate, while not sacrificing audit quality.

It is argued that joint audits could in theory improve audit quality, given that they involve two auditors scrutinising the company's accounts. However, the risk of this arrangement is that it could mean that both firms only have partial oversight, or automatically rely on each other's review, which could lead to issues being missed. KPMG is aware of examples of notable failures of joint audits, such as the Bank of Credit and Commerce International and Parmalat, where market commentators have suggested that the use of joint audits contributed to fraud remaining undetected.¹⁹ In both cases, the losses involved were in the hundreds of millions of dollars.²⁰ KPMG notes that a peer review system (option (c)) is unlikely to create a significant risk in this regard, as the measure would simply introduce a further pair of eyes, rather than implying any division of work. If the object is to further develop the capabilities of mid-tier firms, a peer review system could also be introduced outside the context of a formal joint or shared audit.

Additional costs to customers

In terms of other costs for companies and shareholders, the involvement of two firms in an audit would inevitably lead to some degree of duplication, particularly under option (a) which would require both auditors to sign the audit report and under current requirements assume full liability for it. Such duplication leads to inefficiency and to increased costs for companies due to higher audit fees.

Liability issues

From the perspective of audit firms, a major concern is the question of the allocation and extent of liability under a joint or shared audit model. Whilst this might be alleviated to an extent (for example by making clear in the audit report the work undertaken by the second auditor), relying on another firm's work and assuming

¹⁹ <https://www.accountancyage.com/aa/news/1809014/joint-audits-increase-fraud-big-four-partner>.

²⁰ <https://www.ft.com/content/c275dc7c-cd3a-11dd-9905-000077b07658>.

liability for that may not be acceptable to some firms in some scenarios. To do so would be unjust and create wrong incentives.

Implementation challenges

In addition to the risks outlined above, there would be significant practical implications.

- As indicated for market share caps, there may be a short-term capacity problem if the mid-tier firms were not able to take on the joint/shared auditor role without some years of preparation, so any measure would likely need to be phased in over time.
- Whether joint/shared audits would be needed across all companies, or whether the skills of the mid-tier could be enhanced by having them participate in a smaller number of such audits.
- There would be significant transitional costs, to help implement the measure, supporting smaller firms to transition, establishing protocols and ways of working. A framework would be needed to govern the principles of joint/shared audit and to determine liability, as well as to provide guidance on co-operation between firms. An area of difficulty would be to manage complications arising due to conflicts between the audit rules in other jurisdictions that may conflict with the principles of joint/shared audit.

In addition, KPMG notes that in 2013 the CC concluded that the potential benefits of joint or shared audit (i.e. lowering barriers to entry, expansion and selection) did not justify the potential costs of such a remedy. The CC stated that it “*placed considerable weight on the views of investors who were almost universally opposed to such a remedy on the grounds of additional costs and risks to audit quality*”.²¹ It is not clear to KPMG that investor sentiment has changed.

2.4 Direct support by the Big Four and/or professional bodies to the mid-tier

As indicated above, a key reason for the limited presence of mid-tier audit firms amongst the FTSE 350 is the gap in the depth of skills and resources on a global scale between them and the Big Four. Broadly speaking, KPMG is supportive of measures to address such concerns, provided that this can be done in a way which preserves the incentives on all audit firms to invest and compete on audit quality and innovation.

The CMA suggests that this measure could include the sharing of technology and skills with the mid-tier audit firms on the part of the Big Four.

Technology and related knowhow is commonly viewed as an indicator of quality in the audit market and therefore closely related to a firm’s competitiveness. In order to level

²¹ Paragraph 17.101, CC Final Report.

the playing field on technology, potential ways of designing this measure (subject to the concerns highlighted below) could be:

- for the Big Four to license audit software to smaller audit firms (either market wide or bilaterally) to the extent that firms were able to do so under any relevant licence arrangements;
- to develop a single technology platform between the Big Four and smaller firms, for all participating firms to use, enabled by a joint investment fund (along the lines of that proposed by the American Institute of CPAs, to create technology platforms); or
- for firms to build a managed service platform which could supply certain training or advice to all market participants.

In terms of sharing other skills that go to the quality of the audit services, this measure could cover skills such as specialist expertise, more training and development, and access to training on technology. For instance, it could:

- enable smaller firms to procure specialist resources from the Big Four firms;
- facilitate bilateral arrangements for training and development; or
- provide access to training on the Big Four firms' technology.

The implementation of this type of measure may require a third party to facilitate a marketplace for these resources through which smaller firms could purchase the resources they require.

One risk is that this remedy could reduce market participants' incentives to invest and compete, thus weakening the competitive dynamics in audit services. The importance of technology to the quality of audit and the Big Four's investment in these capabilities is discussed in Part A of this response. Furthermore, these investments are driven by incentives created through competition – investing successfully allows an audit firm to be more competitive. Any measures to share technology should be implemented in such a way that these incentives are preserved and in no way blunted.

Any licensing arrangements would therefore need to be established on fair commercial terms in order to preserve the incentive to innovate, as the firms will know that they can rely on audit revenue and licensing revenues to recoup their investment in technology.

Similar reasoning would apply to the provision of training and the sharing of staff, all of which would have to be provided under fair commercial terms which reflected the investment made by the Big Four in the acquisition of that knowhow.

An additional concern is that this type of measure could impact the audit labour market, particularly as regards the sharing of skills. Given the already relatively tight labour market in relation to audit, in KPMG's experience, staff delivering audits are already relatively stretched. The requirement to divert resource from current audits to

support other firms, for example through training, would present challenges, given the heavy existing workload and existing shortages of skilled staff.

It is important that the way any measure to provide support is designed does not lead to any issues with regard to independence, conflicts and choice available to ACs. Similarly, there could be liability considerations which would need to be clarified.

In addition:

- Any licensing arrangements may be complicated where the IP for such technology is held by the global firms or other member firms of a global network.
- The lead-in times and financing arrangements for a new audit technology platform could be lengthy and complicated, particularly if it involved a global network agreement.
- On the sharing of staff, there may not be sufficient specialist skilled resource in audit services to be available to support smaller firms' audits.

2.5 Reducing the barriers for senior staff to switch between audit firms

The CMA has proposed a measure to reduce the barriers for senior staff to switch between audit firms. KPMG is not clear that the current situation requires such intervention. Other than existing notice periods, it is unclear what barriers to switching exist in practice, and whether notice periods even present a barrier to switching.

To address any perceived concern, however, in the future KPMG will consider removing the existing restrictions which we have in place for audit partners leaving to join non-Big Four audit networks. Any proposed measure would need to be structured in the same manner, to avoid the risk that Big Four staff switch among the Big Four only rather than moving to the smaller firms, thus rendering the measure ineffective.

2.6 Changes to the restrictions on the ownership of audit firms

The CMA has suggested that current restrictions requiring most voting rights in audit firms to be held by qualified auditors could be relaxed. The CMA considers that this would have the effect of broadening the owners (in terms of equity holders) of audit firms, and thus allow a channel for the mid-tiers to attract more capital. This capital could then, according to the CMA, be invested to build the audit capacity of the mid-tier firms, so that they could be better placed to take on audits of larger, listed companies.

The UK is not the only territory to place restrictions on ownership of audit firms at present; the EU, the USA and Japan have similar measures in place. Such regulations resulted from concerns about ethics, including independence, audit quality, and

competence. Such concerns are considered to be addressed by ownership restrictions because:

- they ensure the owners of audit firms have a shared public interest mandate, arising from their membership of professional bodies or other licensing conditions;
- qualified auditor owners effectively invest their professional reputations and future career prospects in their firms, giving them a greater incentive to ensure audit quality; non-professional equity investors' losses are limited to the amount of capital invested – they have less to lose;
- the drive to generate return on investment may encourage decisions that have a short-term economic benefit but a long-term negative effect on audit quality; and
- the presence of non-auditor owners increases the likelihood of conflicts of interest with potential audit clients.

KPMG considers that audit quality and independence are the paramount concerns of an audit firm and any proposal to remove ownership restrictions should be preceded by research into whether existing restrictions do have a protective effect on these factors, whether removing the restrictions would have any negative effects and whether there are any effective safeguards that could be put in place to prevent those negative effects.

Unless this proposal were embraced by securities regulators, legislators and professional bodies outside the UK, audit firms taking advantage of the removal of ownership restrictions might find themselves blocked from auditing UK companies with securities listed outside the UK, and the potential increase in conflicts of interest might have the unintended consequence of reducing competition rather than increasing it.

KPMG therefore considers that the complexities in setting up such a system, including the necessary legislation and the potential international ramifications, would likely outweigh any benefits of the measure.

2.7 Break-up of the Big Four into smaller audit firms

A measure that has been widely heralded in the press as a potential “solution” to the perceived issues facing the audit sector is the break-up of the Big Four firms. The ITC suggests that this could entail forcibly splitting the audit practices of the Big Four in the UK into separate businesses, with each of the new independent businesses being then able to provide both audit and non-audit services. However, KPMG agrees with the CMA that the design and implementation of such a measure would present “significant and potentially insurmountable challenges” and it strongly believes that this course of action would be severely detrimental to the overall audit profession and

manifestly disproportionate. We believe there is a consensus among demand side stakeholders that this would not be an appropriate option.

The biggest risk of imposing such a radical measure is the adverse impact it could have on audit quality. As discussed in detail above, KPMG firmly believes there are clear benefits to audit quality and to the capital markets from audit firms having the scale to invest in developing technology and specialist capabilities which are required to audit the increasingly large and complex companies and to ensure audit services are of the highest quality and accuracy. Scale is also required to meet the costs associated with operating in a highly regulated environment. Simply breaking up current firms would result in firms lacking the scale, scope and financial sustainability to audit the largest and most complex companies, thus representing a step backwards in the quality and offering of the audit profession which would be to the detriment of all stakeholders and the wider public interest.

Another key downside to such a break-up measure relates to the international dimension of audit firms, given that the CMA (or any other UK or national body acting unilaterally) could not mandate the break-up of each member firm in the relevant networks globally. In practice, therefore, at least half of the newly created firms would not have access to an international network once they were separated from the previously consolidated firm. This is because affiliating more than one of these separated businesses to the same international network would be complex to implement and would undermine the intended separation. The international reach of the large audit firms is critical to delivering complex global audits and is often a prerequisite to tendering for large international companies. Therefore, the new firms without an international network would immediately be placed at a competitive disadvantage. KPMG submits that this would undermine the effectiveness of this measure and could compound the perceived issues surrounding competition and choice in the audit services market.

A further practical challenge to contend with would be how to determine which audited companies are retained by each of the newly separated firms (and, indeed, whether those audited companies would choose to remain with the relevant firm post separation rather than seek a new auditor firm through the tender process). By forcibly splitting up the firms and dividing the existing audit between the entities, ACs' ability to select an auditor with the skills and resources required would be removed completely. This undermines the accountability of ACs and the importance of quality driving competition. In addition, this drastic intervention in the normal functioning of the market would cause significant disruption and costs for companies as they transition to the new auditor or, as a result of the break-up, decide to tender earlier than planned. Such reasons may go some way to explaining what we perceive to be strong opposition from investors and audited companies toward this measure.

2.8 Improving transparency around tendering process

KPMG recognises that measures to improve transparency around the tendering process might increase confidence amongst shareholders and other stakeholders

who have concerns that ACs' incentives in the tender process might be misaligned with those of shareholders, or other similar concerns.

KPMG would support greater transparency around the tendering process providing that there were adequate protections in place in respect of commercially sensitive information, the publication of which might undermine either the audited entity or the audit firms' competitive advantage/position.

Publishing data on tenders and the tender process as suggested in the ITC could contribute towards building public trust in the audit selection process and more widely in the profession. It may also increase competition if it encourages or better enables firms to participate in tenders.

KPMG considers that the specifically proposed measures relating to publication of tender information could form part of a broader measure whereby a body/regulator has oversight of audit tendering processes in the market, which could bolster shareholder and public trust in the competitive process. The scope of the regulator's remit would need to be carefully considered but could potentially extend to conducting ex-post reviews of the tendering process of specific audits.

However, it is not clear how blind tenders (as mentioned in the ITC) would be practicable since it implies that knowledge of the audit firm and the relevant partners would not be available to those making the selection decision and/or that these identities might be kept secret throughout correspondence, tender documents and meetings (including, most importantly, the final presentations which are typically an important component of audit selection processes). Achieving this would almost certainly remove the ability of the AC (or other selecting body) to make an informed assessment of which firm is able to offer the best quality audit.

We would, however, support the deferral of agreement of the audit fee until after the preliminary selection decision, which would avoid the potential for selection decisions to be made, or be perceived to have been made, on the basis of cost rather than quality.

2.9 Reform of mandatory tendering and auditor rotation²²

The CMA suggests that it will consider measures such as increasing the frequency of both mandatory tendering and mandatory auditor rotation.

As discussed in detail above and demonstrated in the data provided, since the last review, KPMG has observed significantly increased tendering, churn and switching, particularly amongst listed companies, as a result of mandatory tendering requirements. These changes have facilitated streamlining of the tender process and tender processes have become more efficient and cheaper for companies, which affects competition both through the actual, and the threat of, tendering the audit (which destabilises the position of incumbents). KPMG thus considers that the current

²² This section addresses Question 27 of the Invitation to Comment.

rules on audit tendering and rotation are working effectively, but that measures to mandate greater frequency will be counterproductive to choice and competition.

In KPMG's view, a key risk of requiring more frequent audit tenders and auditor rotation would be the potential for a decline in audit quality. Mandatory switching of auditors means that the company might be prevented from reappointing the best placed auditor, and this risk increases directly with the increase in frequency of the requirement to switch. Moreover, it increases the risk that recently appointed audit firms do not fully understand the businesses of audited companies as they do not have sufficient time or incentives to build up the necessary in-depth knowledge of the business and cannot benefit from the knowhow that comes with continuity (and audit risk is said to be the highest during the first few years of an engagement). Therefore, if mandatory switching were required too frequently, this would drive a deterioration in quality.

Increased frequency of mandatory tendering (or switching) also risks diverting the time and attention of senior professionals away from carrying out audit work and onto the tendering process. In the absence of a requirement to do so, we believe that large companies are unlikely to wish to switch audit firm every five years due to significant switching costs and disruption, unless there is a concern with the quality of the audit or the incumbent auditor itself. Therefore, companies may not be incentivised to run a proper, thorough tender process, which would undermine the effectiveness of competitive tendering.

This measure could in practice worsen the challenges around lack of choice. In relation to mandatory tendering, we note that there is nothing restricting individual ACs from tendering more frequently than required by regulation at present. ACs need flexibility to determine the timing of audit tenders so as, for example, to avoid unnecessary cost or, on the other hand, to maximise the number of participating firms that are not conflicted through the provision of non-audit services. Under the existing framework, ACs may choose on occasion not to involve a particular firm in a tender process so that they preserve their ability to use such firm to provide services which would not be considered compatible with auditor independence requirements. Increasing the frequency of tendering on a mandated basis would remove flexibility, potentially resulting in unnecessary cost and less choice for each tender. It would also mean that ACs have less scope to manage the issue of conflicts.

In addition, this measure would significantly increase costs for the audit firms and companies and may lead to increased audit fees. Even with the increased efficiency that has come from regular tendering and an overall shorter process, in KPMG's

experience tendering is still an expensive process for audit firms. This is a particularly important issue for the mid-tier firms.

2.10 Strengthen ACs and/or links to shareholders²³

We note that the role of the AC has evolved over the years and certain responsibilities have only been introduced relatively recently (in the 2016 revisions to the FRC Corporate Governance Code and Audit Firm Governance Code) and consequently there has been limited experience of the impact of such measures. A brief summary of recent enhancements to the role of ACs is set out as Annex 3.

We believe that ACs have an important role in the governance of a company and, in our experience, ACs and members thereof generally take these responsibilities seriously and discharge them diligently. Before making changes, it would therefore be important to understand in more detail why those who are raising concerns are doing so and, in particular, whether any such issues are substantive or based on a lack of transparency.

However, we do hear from large institutional investors that it can be difficult to engage with AC members and, separately, from AC members that they are not contacted by investors. It would appear that both parties would welcome further engagement. This could be achieved by a requirement for companies on a periodic (e.g. annual) basis to invite representatives from their largest shareholders to meet with the ACC to discuss any matters, including areas of concern, in relation to the areas of responsibility of the AC and for these discussions to be summarised in the AC report included in the Annual Report of the company.

In principle, we would be supportive of measures which strengthen ACs and ensure appropriate accountability. In this regard we note that the ability of the FRC to hold directors to account differs depending on whether or not they are a member of a professional accountancy body – an anomaly which we believe should be resolved. More generally, consideration might also be given as to the adequacy of existing requirements for training of directors (generally) and/or the requirements in relation to how recent and relevant is an AC member's financial experience, as part of a wider consideration of corporate governance. Steps to provide greater AC (and NEDs more generally) accountability would also be an important improvement for AC members that are not chartered accountants.

2.11 Independent body to replace audit committees for audit appointments, managing the scope and performance of the audit and setting the audit fees²⁴

The CMA suggests that an independent body entrusted with a public interest duty to select audit firms for companies and/or manage the scope of the audit, set the audit fees and manage the performance of the audit firms would address an underlying

²³ This section addresses Question 24 of the Invitation to Comment.

²⁴ This section addresses Questions 25 and 26 of the Invitation to Comment.

feature of market concentration and meet some of the concerns around misaligned incentives.

This remedy would remove choice from ACs, companies and shareholders in the appointment of auditors. It is doubtful that a public body could acquire sufficient knowledge of the affairs of each of the FTSE 350 companies, PIEs and possibly other limited companies to be able to select an appropriate auditor or manage the scope of the audit, let alone set appropriate fees or manage the audit performance. Consequently, this remedy would remove or largely neutralise competitive forces – presumably on a UK only basis, which would raise further practical difficulties – and involve a major extension of the role of the State in corporate Britain. KPMG finds it hard to see how this extreme, and in our view disproportionate, measure would enhance competition, encourage innovation, protect and encourage audit quality or increase choice. These downsides, in particular the risk to quality and AC choice and accountability, would need to be assessed in considering the effectiveness and proportionality of this remedy.

KPMG notes that a similar remedy was considered in the CC's investigation, whereby the FRC would be required to appoint auditors for FTSE 350 companies. However, no respondents supported this proposed remedy at that time.

There is an obvious risk that the independent body would select a non-Big Four firm not on an objective evaluation of merit and quality but merely as an artificial exercise to address market concentration.

Moreover, a key consequence of this measure would be the removal of ACs' choice and accountability in relation to the oversight of the audit and/or the auditor appointment and disenfranchise shareholders from the appointment of auditors. As noted above, KPMG also considers that greater AC (and INEDs more generally) accountability would be an important improvement for AC members that are not chartered accountants.

More importantly in the context of audit quality, the AC, with its greater knowledge of the business of the company, is best placed to assess the company's needs from an audit and its auditor, and therefore to assess competing bids in the light of these needs. It is not clear how those without such insights would make a better decision than the AC, the company or shareholders, and therefore avoid adverse impacts on audit quality.

That said, there may be scope for an appropriate individual(s), outside the normal governance structure of the company, to participate in the auditor selection process. That individual might be selected from a panel of experts established explicitly for the purpose and with deep understanding of the audit, accounting and financial reporting processes. They would participate fully in all the aspects of the tender process and the final decision but would not have broader oversight beyond the selection process. Further, that individual might have an obligation to report to shareholders on his/her assessment of the tender process in order that shareholders would have this

information when considering the recommendation for appointment of the auditor at the relevant AGM.

2.12 Insurance based system for audit

The CMA has also sought views on a “more radical alternative” to the current audit model, through what is known as financial statement insurance. Under this model, companies currently requiring an audit would purchase insurance against any diminution in value of shareholders’ invested capital. Insurers would, in turn, need to obtain assurance on the level of risk to that capital, which they could obtain through audit engagement. The insurance firms would then have the incentive to ensure that the audit is carried out in a fair and through way.

KPMG does not believe that this measure would be practicable.

First, insurance is a risk-transfer product and it is not clear how the insertion of commercial insurers, without any public interest responsibility and where the outcomes sought by insurers may not be the same as those sought by market participants, would help to address current concerns. Audit is not designed to provide a mechanism for compensating investors for market value erosion, regardless of its cause. Rather, audit provides assurance to shareholders that the financial statements on which shareholders and other stakeholders can assess how a business has performed present a true and fair view of the results, cash flows and financial position of a business. Under the insurance model, it would seem likely that insurers would define the scope of audit required depending on their own assessment of risk of market value erosion or corporate failure and this may differ from the current scope of audit (but with less transparency and understanding of that scope). It follows that stakeholders would be uncertain of the scope of the audit and the reliability of the reported financial information.

Secondly, were insurers to seek to pass on the full financial risk (i.e. recovery of any payments made to insureds), this would create significant additional exposure for audit firms which may act as a deterrent to providing audit services.

From a practical perspective, it would be necessary to modify the existing legal framework in order to enact such a measure. The implications for the discharge of auditors’ responsibilities would potentially be profound.

Finally, as the CMA indicates, there would need to develop a market for such insurance services (given insurance markets are not experienced in assessing the types of risk contained in an audit – which include issues such as going concern, cashflow projections, etc.), and this would not necessarily develop quickly or effectively, or at all. In addition, it is uncertain whether the insurance markets would be deep or liquid enough to provide an efficient and effective response. Insurance payments can take years to be made and are subject to numerous exclusions. Insurers routinely withdraw from markets after significant losses.

In summary, it is wholly unclear to KPMG that a measure of this kind would be workable or necessary, and it would appear to relate to much wider issues concerning

the audit and regulatory framework which are at first sight outside the scope of the CMA's market study.

2.13 “NAO style” national auditor

Another potential measure mentioned in the ITC is the establishment of an independent “NAO style” national auditor to replace the auditors of some or all of the large companies and PIEs.

The stated aim of such a measure would be to address the perception of misaligned incentives between shareholders, the company management and auditors, as well as to improve transparency regarding auditor appointments.

Notwithstanding these purported objectives, in KPMG's view this would be a disproportionate and radical intervention that would not address any of the current concerns which are the focus of the CMA's market study around audit quality, competition, choice and resilience, and would not be feasible to implement in practice. It could, in fact, lead to significant distortions of competition in audit services and could destabilise the audit profession.

There would be severe challenges and costs associated with this measure which, in effect, would result in a monopoly audit service provider. First, the measure could result in a decline in audit quality, because the national auditor would be unlikely to consistently have the scale of technical expertise, capability and experience of the Big Four that is required to deliver high quality audit to large companies and PIEs. This would, in part, be due to the audit function being separated from the multi-disciplinary model of the Big Four firms, meaning that the advantages of such models such as scale, specialist advisers, international reach, broad knowledge of many industries etc. would be lacking. Existing technical knowledge and expertise may not necessarily be transferred across to the national auditor and it may be difficult to persuade key skilled staff to move across to this new public body (possibly at lower salaries).

Secondly, this measure would destabilise the balance between regulation and competition in the audit market, which is critical to developing properly functioning audit markets which support the interests of both direct shareholders and wider stakeholders in the economy. The national auditor would not be subject to competition and thus would not be incentivised to invest, innovate and improve quality as is currently the case and is necessary in order to be successful in the competitive market. This could lead to an overall deterioration in audit quality and stagnation of the sector.

Thirdly, the measure would not address concerns about market concentration or lack of choice in audit services and would render such issues irrelevant if the only option for companies (or certain companies) was the national auditor. The measure does not strengthen or support the capabilities of mid-tier firms in any way and would reduce

their incentives to invest and innovate in audit, given that the audits for the larger companies and PIEs would not be open to competition.

Fourthly, in order to provide global coverage, the national auditor would have to sub-contract the audits of companies with international subsidiaries or establish new audit firms in foreign jurisdictions that must be permitted by law to audit companies in those local jurisdictions, or indeed rely on the Big Four member firms in other jurisdictions. The international complications further add to the downside of such a measure.

2.14 Other potential remedies not covered by the Invitation to Comment²⁵

2.14.1 Graduated findings

KPMG considers that a measure requiring “graduated findings” to be provided in all audit reports would be an effective and proportionate way to help partially close the expectation gap, strengthen the quality of audit and thus increase stakeholder and public confidence in the audit profession. In order for this to be consistently applied and effective, this would need to be mandated within a regulatory framework.

While requiring graduated findings would not address the need for a broader review of the purpose of audit (which KPMG believes is the most fundamental reason for the current “expectation gap”, particularly with regard to whether audit provides a detailed assessment of future business viability, which is a point that could be expressly clarified in the audit report), graduated findings would be an immediately implementable action that would cover the “part” of the expectation gap relating to auditors telling shareholders what they have found under the current auditing regime.

Annex 2 sets out in more detail how a graduated findings measure could be designed, based on our own experience of providing such services and the potential benefit and cost of this measure.

2.14.2 Reducing financial risk for smaller audit firms

Whether financial risk is a deterrent against smaller firms competing for the audits of public companies, in particular large complex audits, is more a matter for those firms to respond to, although we recognise that: (a) the increasing level of financial sanctions relative to the profits attributable to the audit businesses of the firms; (b) the, in practice, unlimited (rather than proportionate) liability for audit work; and (c) the level of upfront investment to build in-house human and technological skills and capabilities are important considerations.

Measures to reduce these costs might, over time, increase the ability of firms outside the Big Four to compete more effectively for the audits of larger companies, promoting more competition in audit services and potentially increasing choice in audit services.

²⁵ This section responds to Question 15 of the Invitation to Comment.

Possible measures might include:

- a) Sharing of the significant investment costs which would be incurred by smaller firms in order for them to compete for FTSE 350 and other larger audits.
- b) Liability being proportionate or capped at a multiple or percentage of the audit fee.
- c) Rebalancing sanctions with greater emphasis on measures aimed at improvement and non-financial sanctions away from financial sanctions (regulatory costs) which can prove prohibitive to smaller firms, particularly for PIE audits.

There are, however, risks associated with these measures. First, if liability is reduced only for the smaller firms, the measures could in fact reduce incentives: (a) for such firms to deliver audits to the same quality as firms subject to greater exposure; and/or (b) for ACs to appoint such firms as auditors. Secondly, a further challenge may be winning political and public support for such measures at a time of heightened scrutiny of the audit profession. Many commentators are, in fact, calling for an increase in financial sanctions as opposed to a reduction.

Annex 1: KPMG continuous improvement initiatives

This annex presents an overview of the KPMG quality improvement initiatives that have been put in place since the CC inquiry, and again since the new leadership was appointed in 2017.

Changes to the depth of our reporting since the 2013 CC inquiry

Since the last CC report, KPMG has introduced a number of significant quality initiatives with the purpose of providing more insight to stakeholders into our audit findings:

- The introduction of long form reports for a wider array of entities. These reports provide shareholders with a window into the audit including setting out specifically what audit issues the auditor faced, their underlying causes and how they were addressed. It tells a company's shareholders what their auditor did on their behalf, explained in terms highly specific to the audit in question.
- Binary findings, which offer an intermediary step towards graduated findings. Binary findings advise whether the degree of caution or optimism is within or outside the acceptable range for a key accounting estimate that the audit focused on.
- Offering graduated findings more widely to clients (graduated findings are discussed further in Annex 2).
- Risk maps: These cover all the risks to which the company is exposed, including those that were not quite significant enough to merit full explanation in the report.

Changes to our internal quality check since the new leadership was APPOINTED in 2017

Additional changes have been introduced since Bill Michael became Chairman in 2017, to ensure that all audits are delivered to the same standards as those which achieve the highest grade from the AQR. The aim is for KPMG to be able to compete most strongly in relation to audit quality.

KPMG has the full support of the entire UK firm and KPMG International for this work, which will result in a more structured and standardised approach and greater central command and control through increased oversight.

KPMG is also focusing not just on audit but also on wider risk management processes and has appointed a Chief Risk Officer to oversee how we redefine risk management.

In addition, KPMG is working closely with the FRC to ensure we are meeting their expectations as we implement these enhancements. There is now a Board subcommittee focused on Audit Quality and every Board and Executive Committee

member must actively contribute to the delivery of our Audit Quality Plan. Each has performance objectives related to the improvement of audit quality.

Providing a new framework

KPMG recently appointed a new Head of Audit, Michelle Hinchliffe, who has 27 years of professional experience within the Financial Services sector. Michelle initiated KPMG's Audit Quality Transformation Programme to ensure the highest standards of consistency and rigour are applied across all KPMG audits.

Under this new model, KPMG is investing in a considerably larger Audit Centre of Excellence that is structured to deliver consistency across all of our audits, including:

- More mandated audit programmes, standard work papers and case study templates of what teams need to achieve in specific circumstances to demonstrate proper execution under our Audit Quality Transformation Programme (“AQTP”).
- Greater support and challenge to engagement teams through an expansion of our 2nd Line of Defence (“2LD”) support team, introduced in response to past root cause findings, and recognising the complexity of designing, delivering and evidencing a high quality audit.
- Accelerated implementation of our existing technology-based audit tools, expanding their application and supporting teams with their use in the field.
- Increased central monitoring of audits at the planning, delivery and completion stages to ensure that teams are fully adopting expected best practices and that emerging issues are identified and addressed early in the audit cycle.

Training and development initiatives

We are also changing our core processes relating to recruitment and people development alongside our client acceptance processes to ensure we only perform engagements where we have the right capacity to deliver them to the highest standards. As an example, in 2018 all experienced auditors (those with three years or more experience) have attended an additional mandatory face-to-face three day training programme to ensure that they are fully up to date in all of our recent audit developments and aligned with our new approach to audit delivery.

The AQTP has delivered its first 10 programmes for use on audits of companies with 31 December 2017 year-ends with a further 10 issued for use on audits of companies with 31 December 2018 year-ends and more in development. Each programme has been designed with substantial input from field auditors to reflect current best practices while reflecting our root cause analysis. These have been supported by a programme of targeted communications from our UK Head of Audit and other subject matter experts, covering specific topics and key quality “watch out” areas.

We are investing heavily in our 2LD team and now require candidates for senior promotions to have been active in an area ensuring audit quality, such as the Audit



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Centre of Excellence, as part of their progression to partner. Quality has also been reinforced as the benchmark for performance assessments, remuneration and promotions. Additionally, Bill Michael and the other members of our Executive Committee and Board each have specific objectives relating to delivery of improvements in audit quality.

Annex 2: Graduated findings

KPMG considers that a measure designed to either require or strongly encourage auditors to provide “graduated findings” in their audit report, and thereby create transparency of the views of the auditor in relation to key judgements, could be an effective and proportionate way to help close the expectation gap, strengthen the quality of audit and thus increase stakeholder and public confidence in the audit profession.

Graduated findings provide additional information beyond that required by auditing standards and require the auditor to give a view on management decisions on all key audit matters and provide a year on year comparison of how balanced account estimates and judgements are made. Instead of merely expressing the results of an audit test in key risk areas in terms of “acceptable” or “unacceptable”, graduated findings provide shareholders with a more nuanced understanding of the findings of the audit that allows them to understand the professional judgements weighed up in arriving at the audit opinion on the accounts as a whole. For example, estimates within a range might go from “optimistic” to “cautious”, with a “balanced” mid-point.

Graduated findings were part of a KPMG initiative first trialled on three 31 December 2013 year end audits, which received strong positive investor community feedback. Due to the ongoing investor community feedback, KPMG has continued to promote long form audit reports including graduated findings, albeit uptake by ACs has been limited to date. Notwithstanding this, KPMG firmly believes that this enhanced form of reporting would bring considerable benefits to shareholders, companies and the wider public and is thus currently considering adopting mandatory graduated findings unilaterally as noted below.

KPMG believes that the highest level of audit reporting helps to improve the trust and relationship between companies and their shareholders. In addition, requiring this additional information to be included in the audit report of all companies improves the usefulness of the audit report for investors and other users and therefore increases quality, as well as enhanced transparency and comparability.

Currently, graduated findings are based on a scale that is not well defined. In order to increase the effectiveness of this remedy and to better increase the accuracy of predicting when a company is in trouble/close to failure, the CMA could consider imposing a more rigorous scale. More in-depth reports could be mandated, although this would likely be more costly to deliver as it would require more bespoke analysis, rather than just drawing on work that is already done through an audit.

Certain implementation hurdles mean that this innovation would only be possible as a concerted industry action, and KPMG believes that the CMA could help achieve the co-ordination of this measure in audit services. Additionally, KPMG considers that it will be necessary to consult further with institutional investors, regulators (including the FRC and the PRA), ACCs and CFOs to highlight and avoid unintended



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consequences and to explore whether there are alternative/better ways to achieve this across all UK listed company audits, not just those conducted by KPMG.

Therefore, in terms of how to design and implement graduated findings as a measure, KPMG submits that its effectiveness would be enhanced by introducing a requirement or a strong encouragement to companies to take it up, thus creating a market-wide practice. For example, KPMG is considering mandating graduated audit reports for FTSE 350 audited companies for 31 December 2019 year ends, unless outreach shows that there is a fatal flaw in wider unilateral implementation absent a market wide approach or regulators propose a similar reporting initiative.

Annex 3: Audit Committees: significant regulatory developments 2014 to date

Competition and Markets Authority (CMA) Order

NEW: The CMA Order *The Statutory Audit Services for Large Companies Market Investigation (Mandatory Use of Competitive Tender Processes and Audit Committee Responsibilities) 2014* requires that for FTSE 350 companies, only the audit committee, acting collectively or through its chairman, is permitted:

- to negotiate and agree the statutory audit fee and the scope of the statutory audit;
- to initiate and supervise a competitive tender process;
- to make recommendations to the board of directors as to the auditor appointment pursuant to a competitive tender process;
- to influence the appointment of the audit engagement partner; and
- to authorise an incumbent auditor (or an auditor appointed to replace an Incumbent auditor) to provide any non-audit services (to the company or the group of which that company is a part), prior to the commencement of those non-audit services.

NEW: Where a FTSE 350 company has not completed a Competitive Tender Process for Auditor Appointments in relation to five consecutive Financial Years, the Audit Committee must set out in the Audit Committee Report relating to the fifth Financial Year, and thereafter:

- the Financial Year in which the FTSE 350 Company proposes that it will next complete a Competitive Tender Process; and
- the reasons as to why completing a Competitive Tender Process in the Financial Year proposed is in the best interests of the FTSE 350 Company's members.

UK Corporate Governance Code (FRC, 2016)

NEW: "The audit committee as a whole shall have competence relevant to the sector in which the company operates."

Guidance on Audit Committees (FRC 2016)

NEW: The audit committee should have primary responsibility for the appointment of the auditor and this includes negotiating the fee and scope of the audit, initiating a tender process, influencing the appointment of an engagement partner.

NEW: The audit committee should be responsible for the selection procedure for the appointment of audit firms. When considering the selection of possible new

appointees as external auditors, it should oversee the selection process, and ensure that all tendering firms have such access as is necessary to information and individuals during the duration of the tendering process.

NEW: The audit committee is responsible for approving non-audit services. It should set and apply a formal policy specifying the types of non-audit service for which use of the external auditor is pre-approved. But such approval should only be in place for matters that are clearly trivial. The committee should set a policy for how it will assess whether non-audit services have a direct or material effect on the audited financial statements, how it will assess and explain the estimation of the effect on the financial statements and how it has considered the external auditors' independence.

NEW: The audit committee may also wish to hold an initial discussion without the auditor to consider factors that could affect audit quality and discuss these with the auditor. The audit committee should [inter alia] ask the auditor to explain how they addressed the risks to audit quality; weigh the evidence they have received in relation to each of the areas of significant judgement; and ask the auditor for their perception of their interactions with senior management and other members of the finance team.

NEW: The assessment of audit quality requires consideration of mind-set and culture; skills, character and knowledge; quality control; and judgement, including the robustness and perceptiveness of the auditors in handling key judgements, responding to questions from the audit committee, and in their commentary where appropriate on the systems of internal control.

NEW: In the course of its assessment of effectiveness, the audit committee should *inter alia*: ask the auditor to explain the risks to audit quality that they identified and how these have been addressed; and discuss with the auditor the key audit firm and network level controls the auditor relied on to address the identified risks to audit quality and enquire about the findings from internal and external inspections of their audit and their audit firm.

NEW: The audit committee report should include *inter alia*:

- a summary of the review of the audit committee's effectiveness, including how the performance evaluation has been conducted;
- the current audit partner name and for how long the partner has held the role; when a tender was last conducted; and advance notice of any tendering plans;
- the nature and extent of interaction (if any) with the FRC's Corporate Reporting Review team; and
- where a company's audit has been reviewed by the FRC's Audit Quality Review team, the Committee should discuss the findings with their auditors and consider whether any of those findings are significant and, if so, make disclosures about the findings and the actions they and the auditors plan to take.

Amendments to the Companies Act 2006 (based on the EU ARD)

NEW: Legally binding requirements for PIEs in relation to the new audit tendering and rotation rules - EU PIEs being required to put their audit out to tender at least every 10 years and change their auditor at least every 20 years. Specifically, the Act now requires that:

- For each financial year, the audit committee must make a recommendation to the board – for it to put to the shareholders for their approval in general meeting – in relation to the appointment or re-appointment of the auditor.²⁶
- The audit committee must state in its recommendation that recommendation is free from influence by a third party and does not result from a contractual term restricting the choice of auditor.²⁷
- When proposing the auditor for appointment, the board must include in the proposal the recommendation made by the audit committee in connection with the appointment and, if the board's proposal does not accord with that recommendation, the reasons for not following the recommendation.²⁸
- Where an audit tender is required in accordance with the new regulations, the audit committee shall be responsible for the selection procedure and, unless the company qualifies as a small or medium-sized company or is a company with reduced market capitalisation, must:²⁹
 - ensure that the tender process does not in any way preclude the participation in the selection procedure of firms which received less than 15% of the total audit fees from public-interest entities in the Member State concerned in the previous calendar year;
 - ensure that tender documents are prepared that allow the invited auditors to understand the business of the audited entity and the type of audit that is to be carried out;
 - ensure that the tender documents contain transparent and non-discriminatory selection criteria that shall be used to evaluate the proposals made by the auditor;
 - ensure that the audit proposals are evaluated in accordance with the predefined selection criteria and that a report on the conclusions of the selection procedure is prepared and validated by the audit committee. Consideration should be given to any findings or conclusions of any inspection report on the potential auditors;
 - identify in its recommendation its first and second choice candidates for appointment and give reasons for its choices; and

²⁶ S.485A(2)(a) / s489A(2)(a).

²⁷ S.485A(5) / s489A(5).

²⁸ S.485A(2)(b) / s489A(2)(b).

²⁹ S.485A(4) / s489A(4).



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- ensure that the company is able to demonstrate to the competent authorities, upon request, that the selection procedure was conducted in a fair manner.