

## AUDIT MARKET INVESTIGATION

### Evidence of tacit coordination

#### Introduction

1. Coordinated effects may arise when firms operating in the same market recognize that they are mutually interdependent and that they can reach a more profitable outcome if they coordinate to limit their rivalry. Such coordination can be explicit or tacit. Explicit coordination is achieved through communication and agreement between the parties involved. Tacit coordination is achieved through implicit understanding between the parties, but without any formal arrangements.
  
2. This working paper considers the theory that tacit coordination by the Big 4 audit firms may be restricting competition in the supply of statutory audit services to FTSE 350 companies. This theory was contained in our issues statement.<sup>1</sup>
  
3. Tacit coordination may arise when market conditions are sufficiently stable and rival firms interact repeatedly so that they may be able to anticipate each other's future actions, allowing them to establish an internally and externally sustainable coordinated course of action, without resorting to direct communication and information sharing or agreeing expressly to align incentives and expectations. Such tacit coordination can emerge when competitors are able to arrive at a common perception of how coordination, focused on a particular aspect of competition, should work and, in particular, of what competitive dimension can serve as a focal point.<sup>2</sup>
  
4. Direct communication or information sharing among competitors which leads to an agreement to fix prices, share markets or allocate customers is prohibited by

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<sup>1</sup> [www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/111207\\_issues\\_statement\\_final.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/111207_issues_statement_final.pdf).

<sup>2</sup> CC draft Guidelines for Market Investigations (June 2012) paragraph 226: [www.competition-commission.org.uk/assets/competitioncommission/docs/2012/consultations/market\\_guidelines\\_main\\_text.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/consultations/market_guidelines_main_text.pdf).

competition law,<sup>3</sup> and investigation and enforcement of these matters are the responsibility of the European Commission and/or the Office of Fair Trading, not the Competition Commission (CC). The CC is able to consider varieties of coordination as part of its investigation into the relevant features of a market under the terms of reference.

5. The structure of this working paper is as follows. We:
  - (a) set out the theory of harm we have considered;
  - (b) summarize the parties' relevant responses to the issues statement;
  - (c) explain our approach to the assessment of this theory and set out and assess the relevant evidence we have gathered; and
  - (d) set out our initial views.

## **Theory of harm**

6. In the issues statement we said that conditions conducive to tacit coordination of behaviour appeared to exist in the supply of audit services to FTSE 350 companies, including: high concentration; significant barriers to entry; limited competitive constraint by mid-tier firms; price transparency (since audit fees are publicly disclosed in a company's annual report and accounts); existence of switching costs; stable demand due to the statutory requirement for an audit; and stable market shares.
7. We also said that audit and accounting standards and other regulatory requirements may reinforce similarity in business models and cost structure and reinforce the conditions in which tacit coordinated behaviour may take place.
8. We said that some of the characteristics of the market detailed in paragraph 9 of the issues statement could be a result of tacit coordination, which can take place with

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<sup>3</sup> By section 2(1) of the Competition Act 1998, and by Article 101.1 of the Treaty on the Functioning of the European Union,

respect to price and/or geography or industry sector. In particular, we noted the following characteristics: stable market shares; not all of the Big 4 firms are present in certain industries, such as banking, mining and utilities; and companies switch auditor and tender their auditing services infrequently.

9. We considered that since the appointment of auditors is made by the audited companies, either following a negotiation or tender, tacit coordination on prices is perhaps less likely than some form of tacit coordination with regard to geography or industry sector. The latter would arise if firms choose not to compete for certain customers or if they decide not to enter the audit market in specific sectors.

### **The parties' response**

10. The parties' responses to the issues statement are summarized in [Annex 1](#) to this paper. We consider the key points to be as follows.
11. BDO LLP (BDO) generally agreed with the points made in the issues statement and urged the CC to look at the pricing behaviour of the Big 4 firms following competitive tenders.
12. Grant Thornton UK LLP (GT) argued that features of the market were conducive to tacit coordination, in particular that:
  - (a) The market was highly concentrated, which made it easier for firms to monitor the behaviour of their competitors; the independence rules, conflicts and regulations further limited choice; and the market had remained highly concentrated for a significant period of time.
  - (b) Not all the Big 4 auditors were present across all sectors, which meant that in certain sectors/industries there were even fewer rivals to monitor.

- (c) The name of a company's auditor and the audit fee paid was publicly disclosed, which meant that it was easy to determine the auditor for every FTSE 350 company and audit fees could be readily compared.
  - (d) Specific minimum standards meant that there was a high degree of transparency with regard to the audit services provided.
  - (e) Demand for audit services was stable given the statutory requirement for audits.
  - (f) Aggressive price cuts in the market for audit or non-audit services would be an effective punishment strategy as this would have a large detrimental impact on revenue and profitability given that lower prices would not increase demand and the costs were largely fixed in the short term.
  - (g) There were significant barriers to entry and expansion in the audit market and limited existing competitive constraint by mid-tier firms.
13. The Big 4 firms (in separate but similar submissions) argued that market conditions were not conducive to tacit coordination. In particular, they variously argued that:
- (a) Audits were not homogenous products but bespoke services tailored to the specific needs and complexities of large companies, and those needs commonly change from year to year.
  - (b) There was not full transparency on fees: audit fees were individually negotiated with each company management and approved by its audit committees; the fee disclosed related to the relevant financial year and so might not be current; and the level of fees paid would vary from company to company, reflecting its size, the nature of its business, the particular issues encountered in the audit, the nature of the audit carried out, etc.
  - (c) There were only a small number of sectors in which only a limited number of large audit firms were currently providing audit services to large companies, and all the largest firms were capable of making a competitive offer in all market segments.

(d) Audit firms differed materially with respect to their size in terms of revenues and number of clients, their strategies for growth, the relative size of different practice areas, international organization, their client base, and their experience. It was also said that audit relationships were likely to be valued differently by different firms depending on the benefits that an audit was likely to bring in terms of learning by doing, reputation and other factors.

(e) Market shares had not been stable and differed between large audit firms, and the scope of the audit services provided to its audit clients had changed as their businesses had grown and changed.<sup>4</sup>

(f) FTSE 350 companies were strong, well-informed purchasers.

14. The Big 4 firms also argued that they had a strong incentive to compete to win tenders when these happened as: client relationships were long term and high value; tenders for FTSE 350 audits were infrequent<sup>5</sup> and unpredictable as to timing; a refusal to tender would damage an audit firm's relationship with a company and its reputation; and successful firms would invest heavily among other things in their expertise, reputation and international capability and would want to realize economies of scale. Coordination was also said to be unsustainable given uncertain pay-offs from not competing aggressively for a particular engagement.

15. The Big 4 firms also said that there was no evidence of tacit coordination (see [Annex 1](#)).

## **Our approach and evidence of conditions conducive to coordination**

16. We first consider the evidence in relation to the conditions in the supply of audit services to FTSE 350 companies that may be conducive to tacit coordination as set

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<sup>4</sup> KPMG also said that there was great uncertainty about the length, and therefore the value, of the audit relationships. They may be terminated not only because of poor performance, but also because of external reasons such as mergers and other changes at the client outside the control of the audit firms.

<sup>5</sup> KPMG said that tendering and other market testing was becoming more frequent.

out in the issues statement (see paragraph 6). We also consider additional points made by the parties in relation to the ability and incentives for audit firms to coordinate behaviour in the supply of audit services to FTSE 350 companies, and the sustainability of such behaviour.

17. We then consider whether there is evidence that the Big 4 audit firms have in fact adopted coordinated strategies.

### ***Market conditions for tacit coordination***

18. The three general conditions for tacit coordination set out in our draft guidance<sup>6</sup> are (a) whether firms have sufficient awareness of each other and the ability to anticipate rivals' actions, (b) tacit coordination has internal sustainability (ie it is in firms' individual interests to coordinate) and (c) external sustainability (ie coordination is unlikely to be undermined by competition from outside the coordinating group or from the reactions of customers).
19. We assess whether the conditions which would support tacit coordination are present, considering in particular:
  - (a) concentration and stability of market shares;
  - (b) stability of demand;
  - (c) price transparency;
  - (d) barriers to entry;
  - (e) competition from non-Big-4 firms; and
  - (f) switching costs.
20. We also consider (g) other arguments put by the parties.

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<sup>6</sup> [www.competition-commission.org.uk/assets/competitioncommission/docs/2012/consultations/market\\_guidelines\\_main\\_text.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2012/consultations/market_guidelines_main_text.pdf), paragraph 233.

### *Concentration and stability of market shares*

21. Statistics on market shares in the supply of audit services to the FTSE 350 companies are given in the descriptive statistics working paper.<sup>7</sup>
  
22. These results show that over the period 2002 to 2010 the Big 4 firms have consistently carried out the audits for more than 90 per cent of FTSE 350 companies, and that these audits account for more than 95 per cent by total value of FTSE 350 audit fees.
  
23. These results also show that:
  - (a) There are differences between the Big 4 firms in the shares they have had of FTSE 350 audits (measured by number of clients and audit fees). This is the case when we look at the shares across all FTSE 350 companies and shares by industrial sector. The relative size of the audit firms is relevant to the incentives to coordinate and the ability to identify coordinated strategies.
  - (b) The shares each of these firms has had of FTSE 350 audits (measured by number of clients and audit fees) have changed over time, both the overall shares and shares by industrial sectors. We consider the stability of the market to be relevant to the ability of firms to monitor deviation from coordinated strategies.

### *Stability of demand*

24. A statutory audit is a legal requirement for FTSE 350 audits. The level of assurance a statutory audit provides is also specified by regulation (see law and regulation working paper).<sup>8</sup> However, the movement of companies in and out of the FTSE 350 means that the particular companies to which this requirement applies also change

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<sup>7</sup> To be published.

<sup>8</sup> [www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/law\\_regulation\\_wp\\_final\\_for\\_publication.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/law_regulation_wp_final_for_publication.pdf).

over time. Using data submitted as part of the public data set, we know that there have been 542 companies in the FTSE 350 during the period 2006 to 2011.

25. We consider that this change over time in the structure of demand for FTSE 350 audits would not undermine the incentives for tacit coordination. In particular, audit firms would not have an incentive to, say, cut prices in order to achieve growth by expanding demand for FTSE 350 audits. The demand for audit services is outside the control of audit firms.
26. We also consider that this would not adversely affect the ability of the firms to monitor their rivals' behaviour. Our initial view is that competition between firms largely takes the form of competition for engagements and that firms achieve growth in the supply of audit services primarily by gaining clients (see nature and strength of competition working paper, to be published). The companies that must undertake a statutory audit is public information that is immediately available, as will be the identity of their auditor.
27. Equally, the Big 4 firms as informed observers could identify companies that are likely to enter or exit the FTSE 350. Nevertheless we accept that the movement of companies in and out of the FTSE 350 may make tacit coordination based on the identity of the client or the characteristics of the clients such as industry sector more difficult to sustain for the reasons summarized above (paragraph 13).<sup>9</sup>

#### *Price transparency*

28. Audit fees paid by FTSE 350 companies are published in the annual reports and accounts. The audit fee for each FTSE 350 audit is therefore information that is

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<sup>9</sup> And set out in more detail by KPMG (see Annex 1, paragraphs 22 to25).

publicly available soon after an audit is complete. Nevertheless, our initial view is that this is not a market in which prices are particularly transparent.

29. Audit pricing would be transparent if audit firms were able accurately to compare audit fees they have charged or are proposing to charge with those that other firms have charged their FTSE 350 clients. We consider that such comparisons are not straightforward as products are not homogenous and account would need to be taken of the wide range of factors that affect audit fees, including the need for specific sector experience, the complexity and risk profile of the organizations, the scope and extent of substantive testing necessary, and the geographical interests of the company.<sup>10</sup>
  
30. Although some of this information on FTSE 350 companies is publicly available, the level of detail may be insufficient to allow accurate comparison and even where information is available there is likely to be imprecision in the assessment. We found in the survey and in our case studies that companies do benchmark their audit fees, but that comparisons are made with audit fees paid by other companies in the same sector and of a similar size, or are otherwise considered to be good comparators. Accordingly, given the lack of accurate information regarding the benchmarks, we think that such benchmarking gives a broad rather than precise indication of the relative levels of audit fees.
  
31. We acknowledge that audit fees are published after the work has been completed, but our initial view is that this delay is not material in the circumstances. In particular,

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<sup>10</sup> A firm that has bid, but lost, in a tender would have a clearer view of the price of the winning firm, since the loser is likely to have invested in becoming familiar with the requirements of the tendering company's audit through the tender process.

the length of the client relationships<sup>11</sup> and our finding that fees in the previous year tend to be the starting point for the negotiation of fees in the current year.<sup>12</sup>

### *Barriers to entry*

32. The nature and extent of barriers to entry and growth are considered in the restrictions to entry and expansion working paper.<sup>13</sup> In this paper we explain that our initial view is that there are high and persistent barriers to entry and growth in the supply of audit services to FTSE 350 companies. We note that in response to the issues statement, the parties did not argue that tacit coordination would be unsustainable because of low barriers to entry.

### *Competition from non-Big-4 audit firms*

33. The evidence gathered on the competitive pressure the Big 4 firms face from smaller audit firms in the supply of audit services to FTSE 350 companies is presented in working papers on restrictions to entry and expansion<sup>14</sup> and the nature and strength of competition.<sup>15</sup> In these papers, we explain that it is our initial view that in this market the Big 4 audit firms face limited competitive pressure from other audit firms.

### *Switching costs*

34. Our assessment of switching costs is set out in the evidence of switching costs working paper.<sup>16</sup> It is our initial view that there are substantial costs to a company associated with switching auditor but that these may be mitigated by the efforts made by firms, particularly the Big 4 firms, to make the transition process smooth, and the fact that companies seem to achieve substantial reductions in audit fees in the first

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<sup>11</sup> See working paper 'Evidence relating to the selection process: tendering, annual renegotiations and switching', paragraphs 184–187 (to be published).

<sup>12</sup> See working paper 'Evidence relating to the selection process: tendering, annual renegotiations and switching', paragraph 145 (to be published).

<sup>13</sup> [www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/barriers\\_to\\_entry\\_framework\\_wp.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/barriers_to_entry_framework_wp.pdf).

<sup>14</sup> [www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/barriers\\_to\\_entry\\_framework\\_wp.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/barriers_to_entry_framework_wp.pdf).

<sup>15</sup> To be published.

<sup>16</sup> [www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/switching\\_costs.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/switching_costs.pdf).

year after switching (the evidence suggests that any reductions in fees will be smaller in following years<sup>17</sup>).

### *Consideration of additional arguments by parties*

35. Additional arguments made by the parties can be summarized as follows.
36. In the issues statement we said that audit and accounting standards and other regulatory requirements may reinforce similarity in business models and cost structure and reinforce the conditions in which tacit coordinated behaviour may take place. In response, Deloitte LLP (Deloitte) said that the firms differed materially, in particular with respect to their size in terms of revenues and number of clients, their growth, the relative size of different practice areas, international organization, their client base, and the client and people experience of the firm. Deloitte also said that substantial differences in business structures between audit firms reduced the ability to coordinate, including differences in the size and value of the customer base. This meant that the firms could not easily identify a common optimal price.
37. PricewaterhouseCoopers LLP (PwC) said that each large audit firm had its own commercial strategy and structure, and that it was, and it believed other large audit firms were, committed to growth which was primarily driven by winning clients from other audit firms.
38. The Big 4 gave a number of reasons why they would not have the incentive or ability tacitly to coordinate their behaviour, based on the identity of the clients. These included: the number of firms in the international networks that would need to be party to such behaviour; the number and complexity of factors that would determine the audit firms' decisions in relation to the sectors in which they operated; uncertainty

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<sup>17</sup> Working paper 'Descriptive Statistics', to be published paragraphs 20 -23

about when audits would come up for tender; long-term nature and high value of client relationships; the damage a refusal to tender would cause to an audit firm's wider relationship with a company; and the economies of scale in the provision of audit services.

39. Deloitte said that it was not clear that there existed ways for the firms to enforce tacit coordination.
40. Ernst & Young LLP (EY) said that the relative infrequency of tenders, the limited number of potential customers in the FTSE 350 and the delay before audit fees were available publicly meant that it would be difficult for firms to establish a credible rapid retaliatory threat against competitors.
41. In considering these points, we have drawn on analysis contained in several of our working papers, in particular: descriptive statistics (to be published); firms' stated competitive strategies;<sup>18</sup> the suppliers of statutory audit services to large companies;<sup>19</sup> and international networks.<sup>20</sup>
42. Results extracted from the public and engagements database support statements that the Big 4 firms differ in respect of their revenues, number of clients, client base and the growth they have achieved on these measures. We would also agree that these differences are likely to mean that client and people experience will differ between these firms.

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<sup>18</sup> [www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/firms\\_stated\\_competitive\\_strategies.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/firms_stated_competitive_strategies.pdf).

<sup>19</sup> [www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/firms\\_stated\\_competitive\\_strategies.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/firms_stated_competitive_strategies.pdf).

<sup>20</sup> To be published.

43. With regard to the business models of these firms, however, information presented in working paper on the suppliers of audit services<sup>21</sup> suggests that the Big 4 firms are organized by service line and each offers broadly similar services. The proportion of the Big 4 firms' revenue generated from statutory audit varies between 17.7 and 25.5 per cent. The type of people they employ and their mix of staff by grade are also similar.
44. In this working paper, we observe that the Big 4 firms' strategies for expanding their business, in particular their audit business, have similar elements. These include: marketing strategies including the sponsorship of events and awards, and the provision of technical briefings aimed at building awareness and reputation; strategies for targeting particular existing and potential clients, including organizing meetings with key staff of the company to discuss their proposed approach to the audit engagement; and strategies for attracting, developing and retaining staff. Nevertheless, it appears to us that how these strategies are implemented at a detailed level differs between firms.
45. Finally, the information in our working paper on the international networks<sup>22</sup> of the audit firms suggests that although the Big 4 firms are moving towards network structures with shared service centres that deliver corporate support functions and some standard substantive and analytical audit procedures, these are not universally driven by the network centrally, and there remain significant differences between the Big 4 firms in the structure and organization of their respective networks. These differences are reflected in the autonomy of the national firms in determining strategic direction, the geographical grouping and organization of the firms and the availability of financing to support the development of individual international member firms.

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<sup>21</sup> [www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/suppliers\\_of\\_statutory\\_audit\\_services\\_to\\_largecompanies\\_wp.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/suppliers_of_statutory_audit_services_to_largecompanies_wp.pdf).

<sup>22</sup> To be published.

46. Whilst we have not found it necessary to have an initial view on each of these arguments given our overall position in relation to this theory of harm, we consider that some of the factors identified by the Big 4 firms would make tacit coordination based on price or clients less likely.

### ***Evidence of tacit coordination***

47. We have considered whether there is evidence that the Big 4 audit firms adopted tacitly coordinated strategies in competition for FTSE 350 audits. In particular, we look at:
- (a) the information we have on market shares and whether this is consistent with coordinated behaviour; and
  - (b) the documentary evidence provided by the parties, in particular the documents relating to the tendering of FTSE 350 audits.
48. The Big 4 argued that there was no evidence of tacit coordination. Deloitte said that generally the largest audit firms provided audit services across almost all industry sectors and that the exceptions, such as banking and mining, were in industries where there were a limited number of FTSE 350 companies. Deloitte also noted the change in market shares over time.
49. EY said that it competed aggressively for audit business.
50. PwC said that there was overwhelming evidence of fierce competition between the large audit firms, including targeting of each other's clients.

### ***Market share information***

51. With regard to the shares of the Big 4 firms in the supply of audit services to FTSE 350 companies, we observe that over the period 2002 to 2010:

- (a) the market shares (measured by number of clients and audit fees) of each of the Big 4 firms in the supply of audit services to FTSE 350 companies have changed;
- (b) the market shares (measured by number of clients and fees) do not suggest sector specialization as the Big 4 firms have each had FTSE 350 audit clients in all of the ten industry sectors, with one exception (EY has not had any FTSE 350 telecommunications sector audit clients but does audit a number of global telecommunications companies); and
- (c) although market shares in some sectors have been fairly stable (for example, the industrial companies sector), generally this is not the case.

### *Documentary evidence*

52. At our request, the parties provided documents in their possession relating to their business strategies in the supply of audit services and the tendering of FTSE350 engagements over the last five years. It is our initial view that the behaviour described by these documents is not consistent with coordinated behaviour as follows.

### *Strategies for winning business*

53. The information provided is summarized in the working paper on competitive strategies.<sup>23</sup> We consider that the evidence suggests that all the Big 4 firms invest heavily in attributes that underlie reputation and strategies aimed at building relationships with potential FTSE 350 audit clients. This investment includes high-level marketing activities that are not sector specific, recruitment and training, IT systems, knowledge and methodologies, and the provision of technical briefs, and company-specific strategies. There is evidence that all the Big 4 firms actively target companies that are currently audit clients of rival firms, for example approaching the

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<sup>23</sup> [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/firms\\_stated\\_competitive\\_strategies.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/firms_stated_competitive_strategies.pdf)

company specifically to discuss their proposed approach to the audit engagement together with an alternative fee schedule.

### *Tendering*

54. The documents provided and the information we extracted from these is set out in the working paper on the evidence relating to the selection process including the tendering of engagements, annual renegotiations and switching.<sup>24</sup> These documents provide information in relation to how audit firms decide whether to accept an invitation to tender and their approach to the preparation of a bid and any further negotiations with the potential clients.
55. The documentary information available to us has not provided evidence of behaviour that would suggest that the largest audit firms have adopted cooperative strategies in the process of competing for FTSE 350 audit clients that have come up for tender over the last ten years. In particular, the evidence suggests that the Big 4 audit firms usually participate in tenders when they are invited to do so. Where one of these firms has declined an invitation to tender, this has been because of conflicts of interest created by non-audit work the firm has done for the client and an assessment by the firm that it would prefer to maintain this relationship with the prospective audit client. We do not have any evidence to suggest that firms have participated in, but competed less strongly for, some tenders.<sup>25</sup> The evidence we have suggests that participation in tenders for FTSE 350 audits requires a considerable amount of partner and senior management time, and we consider that a poor performance could be damaging to the firm's reputation.<sup>26</sup>

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<sup>24</sup> To be published.

<sup>25</sup> See working paper to be published 'Evidence relating to the selection process: tendering, annual renegotiations and switching', paragraph 57.

<sup>26</sup> See working paper to be published 'Evidence relating to the selection process: tendering, annual renegotiations and switching', paragraphs 101–115.

## **Overall initial view**

56. We consider that certain features in the supply of audit services to FTSE 350 companies appear to be conducive to tacit coordination based on the identity of clients. However, there appear to be other factors, in particular the frequency of switching, uncertainty around the value of engagements and movements in the FTSE 350 companies which, for some of the reasons given by the parties, would not be conducive to tacit coordination.
57. Accordingly, whilst many of the market conditions conducive to tacit collusion in relation to market share appear to be satisfied, we do not currently have the further evidence necessary to establish that there has been tacit coordination. This position would change if, as a result of further work on other work streams, we were to identify information that could be evidence of tacit coordination (or of any mechanisms in place to enhance the possibility of coordination).

## Summary of responses to the issues statement

### **BDO**<sup>27</sup>

1. BDO generally agreed with the comments made in the issues statement. BDO urged the CC to scrutinize audit pricing, in particular:
  - (a) to compare audit pricing following tenders in which only the Big 4 firms participated, in comparison with those tenders in which BDO and/or other firms outside the Big 4 also participated, and where the incumbent auditor was a Big 4 firm, in comparison with those where the incumbent auditor was BDO or another firm outside the Big 4; and
  - (b) to compare audit prices over time following a competitive tender, as research had found that the Big 4 put their prices up within three years of winning a competitive tender, and to consider whether this was indicative of tacit coordination.

### **Deloitte**<sup>28</sup>

2. Deloitte said that market conditions were not conducive to tacit coordination as the largest audit firms had neither the incentive nor the ability to engage in tacit coordination; and there was no evidence of tacit coordination.
3. On the similarity of business models, Deloitte said that the Big 4 audit firms differed materially, in particular with respect to their size in terms of revenues and number of clients, their growth, the relative size of different practice areas, international organization, their client base, and the client and people experience of the firm.
4. Deloitte said that the issues statement wrongly suggested that the market was relatively stable, as Deloitte's share of the FTSE 100 audit market had grown very

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<sup>27</sup> BDO, [Response to issues statement](#), 13 January 2012, section 5.

<sup>28</sup> Deloitte, [response to issues statement](#), 23 January 2012, section 8.

substantially from 5 to 22 appointments over the past 15 years, and the scope of the audit services provided to its audit clients had also changed as their businesses had grown and changed.

5. Deloitte said that there was no evidence that the Big 4 audit firms would have the ability to engage in tacit coordination on price as follows:
  - (a) Audits were not homogenous products but bespoke services tailored to the specific needs and complexities of international companies and those needs commonly changed from year to year.
  - (b) Audit fees were individually negotiated with audit committees, who were expert and well-informed buyers.
  - (c) While audit fees could be benchmarked at an aggregate level, it would not be possible to discern a deviation from alleged coordinated behaviour by a firm given the multiplicity of factors that were reflected in the audit fee.
  - (d) Although audit fees were publicly disclosed, this is the fee for the previous year's audit, not the fee for the current year's audit. This lack of immediate transparency meant that it would not be possible for any significant deviation from the prevailing behaviour by a firm to be observed by other firms in the market.
  - (e) Substantial differences in business structures between audit firms reduced the ability (as well as the incentive) to coordinate, eg differences in the size and value of the customer base meant that the firms could not easily identify a common optimal price.
  - (f) It was not clear that there existed ways for the firms to enforce any agreement, thereby undermining its stability.
  
6. Deloitte said that the conditions for tacit coordination on geography were not present in the audit market. It explained that auditing of FTSE 350 companies was not provided within defined sub-regions, either within the UK or internationally, and that the

companies determined those jurisdictions in which they would be present and the distribution of their operations across those jurisdictions. Deloitte said that there was no meaningful way in which the largest audit firms could seek to coordinate on a geographical basis. Many audit firms had offices in all major cities across the UK and their international networks would include member firms in most major jurisdictions across the globe.

7. Deloitte said that the conditions for tacit coordination on a sector/industry basis were not present in the audit market. In particular:
  - (a) Generally the largest audit firms provided audit services across almost all industry sectors and where there were exceptions, such as banking and mining, these were industries where there were a limited number of FTSE 350 companies.
  - (b) Decisions in relation to which industries to operate in, such as banking, would depend upon the firm's own risk appetite. In respect of mining, the decision to operate would depend upon whether the firm's international network had a sufficiently robust audit capability in the jurisdictions where the mining operations took place. There was no sense in which these complex factors were susceptible to tacit coordination.
  
8. Finally, Deloitte said that its experience clearly demonstrated that there had been no tacit coordination by industry sector. It said that its FTSE 350 wins over the past 15 years had been spread across all sectors. It was actively considering investing in the necessary capabilities where it was under strength and was constantly monitoring the opportunities offered in each sector.

9. EY said that the conditions necessary for tacit coordinated behaviour were unlikely to exist in the audit market because: (a) there was no consistent, homogeneous product; (b) there was a lack of sufficient price transparency; (c) there was a lack of an effective retaliatory mechanism; and (d) scale economies incentivized growth.
10. EY said that there was therefore no standard FTSE 350 audit product. Each audit engagement was a distinct, bespoke product, and could differ as to the nature of the audit product delivered, and the way in which it was delivered. The work that was carried out to produce the audit report was said to vary significantly from company to company, reflecting the varying nature and scope of the companies' businesses and the design and effectiveness of their risk management and control systems.
11. EY said that although FTSE 350 companies were required to publish audit fees, there was no 'going rate' for FTSE 350 audits. The level of fees paid would vary from company to company, reflecting its size, the nature of its business, the particular issues encountered in the audit, the nature of the audit carried out, and the value of the appointment to the auditor (in terms of, for example, prestige or experience). EY also said that the negotiation of fees at the time of initial appointment and annual reappointment (and potentially during the course of the audit if it proved necessary to carry out additional work that was not reasonably foreseeable when the audit scope was agreed), coupled with the delay between the price being agreed and the price being published, further added to the lack of price transparency.
12. EY said that the relative infrequency of tenders, the limited number of potential customers in the FTSE 350, and the delay before audit fees were available publicly meant that it would be difficult for firms to establish a credible rapid retaliatory threat

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<sup>29</sup> EY, [Response to issues statement](#), 12 January 2012, paragraphs 80–91.

against competitors who had displaced them at particular clients. These factors were said to provide strong incentives to compete aggressively to win a contract whenever it was up for tender.

13. EY said that audit firms which were successful in winning audit work from FTSE 350 companies would have made considerable investments in developing their expertise, reputations, quality of service, size and geographic coverage and the 'back office' support functions needed by such businesses. It said that there was an incentive for each audit firm to secure more large company audit work in order to: (a) realize economies of scale if these resources could be deployed over an increased number of large company audits; and (b) to gain the reputational advantage from expanding their representation in the FTSE 350.
14. EY also said that in a market with only 350 potential clients, who only put their audit work out to tender relatively infrequently, the incentive to compete aggressively to secure the appointment and to achieve consequent economies of scale (coupled with the risk for one firm of losing an existing audit client) was a further reason that tacit collusion was unlikely. EY said that the possibility of tacit coordination on a geographic basis was therefore highly implausible.
15. The culture at EY was said to be to pursue and hopefully win any plausible business prospect, and the idea of competing lightly to encourage reciprocation was not part of EY's mind set. EY considered that the aggressive pursuit of audits was essential to the development of broader market relationships.

## Grant Thornton<sup>30</sup>

16. GT said that all the conditions set out in the legal precedent necessary to facilitate tacit coordination were present in the supply of audit services to FTSE 350 companies.
17. GT said that:
- (a) The market was highly concentrated, which made it easier for firms to monitor the behaviour of their competitors; the independence rules, conflicts, and regulations further limited choice; the market had remained highly concentrated for a significant period of time; and there was transparency among the Big 4 auditors which allowed them to observe and monitor the behaviour of their rivals.
  - (b) The name of a company's auditor and the audit fee paid was publicly disclosed, which meant that it was easy to determine the auditor for every FTSE 350 company and audit fees could be readily compared with the fees charged by rivals.
  - (c) Not all of the Big 4 auditors were present across all sectors, which meant that in certain sectors/industries there were even fewer rivals to monitor.
  - (d) Given that audits were subject to specific minimum standards, there was a high degree of transparency with regard to the audit services provided.
  - (e) There was stability in the demand for audit services due to the fact that it was a statutory requirement for medium and large companies to have their financial statements audited.
18. GT also said that it was easy for the Big 4 auditors to punish deviation from a common policy by engaging in aggressive price cuts in the audit market or in the markets for non-audit services. It considered that such a price response would have a large detrimental impact on revenue and profitability as lower prices would not have

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<sup>30</sup> Grant Thornton, [Response to issues statement](#), 13 January 2012, section 5.

any market-expanding effect and the costs to the Big 4 of providing auditing services were largely fixed in the short term.

19. GT said that the statutory requirement for an audit created a clear profit incentive from engaging in tacit coordination. This was said to be because the overall market demand for audits was likely to be price inelastic. If audit fees increased, large firms would still have to purchase auditing services.
20. GT said that there were significant barriers to entry and expansion in the audit market, and limited existing competitive constraint by mid-tier firms, which meant that it was difficult for rivals to enter and destabilize any coordinated behaviour among the Big 4 auditors.
21. GT said that it was not clear why the CC considered tacit coordination on prices to be less likely than coordination on geography or industry sector.

### **KPMG**<sup>31</sup>

22. KPMG LLP (KPMG) said that coordination around prices was highly unlikely as public sources on audit fees did not include sufficient information on the detail of the work to be undertaken and the locations to be covered in order to issue an audit opinion, so the fee alone was not informative to competitors. This was said to be particularly the case for larger and more complex clients.
23. KPMG said that it was difficult to see how audit firms had the incentives to sustain tacit coordination on customer identity or sector. It explained that for coordination to be sustainable, audit firms would have to forgo the opportunity to compete for a given customer's audit with a view to being rewarded in the future. KPMG said that for such

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<sup>31</sup> KPMG, [Response to issues statement](#), 16 January 2012, section 9.

behaviour to be internally sustainable, audit firms would have to be confident that they knew which future customers were allocated to them and be comfortable that the increased profits due to less than effective competition in the future more than compensated for the forgone opportunity to gain a new client in the present tender round. KPMG said that this was unrealistic for the following reasons.

24. First, KPMG said that there was great uncertainty about the length of audit relationships; audit relationships were likely to be valued differently by different firms depending on the benefits that an audit was likely to bring in terms of learning by doing, reputation and other factors; and the audits of large companies came up for tender at an unpredictable rate. KPMG said that in practice audit firms competed for audit engagements whether invited or not, and that audit firms continuously sought to win new audit clients by putting themselves forward and trying to win the confidence of companies that were not currently audit clients, including that of audit clients of the other Big 4 firms.
25. KPMG said that, secondly, any punishment of a deviation from a tacit agreement, for the same reasons, would be very uncertain in its timing and effect. KPMG also said that far from being provided in a stable market, audit services were constantly evolving due to changing regulatory requirements and best practice, audit firms' investments in quality improvements and new capabilities as well as companies' evolving audit needs.

**PwC**<sup>32</sup>

26. PwC said that there was no tacit coordination and that coordination on geography or industry sector was no more likely than price coordination. It said that in order to coordinate tacitly on geography or sector, a firm would have to decline an invitation to

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<sup>32</sup> PwC, [Final responses to issues statement](#), 12 January 2012, section 7.

tender or actively make it known that it was not interested in certain business. PwC said that there was no evidence that this happened other than for good objective reasons, and the overwhelming evidence was of fierce competition between the large audit firms, including the targeting of each other's clients, which would make any tacit coordination impossible.

27. PwC also said that market conditions were not conducive to tacit coordination:
- (a) the structure of demand was not stable (companies moved in and out of the FTSE 350 and there were changes due to Merger & Acquisition activity etc);
  - (b) there were strong well-informed purchasers;
  - (c) each large audit firm had its own commercial strategy and structure, and PwC was (and it believed other large audit firms were) committed to growth which was primarily driven by winning clients from other audit firms;
  - (d) there were only a small number of sectors in which only a limited number of large audit firms were currently providing audit services to large companies, and all the largest firms were capable of making a competitive offer in all market segments;
  - (e) client relationships were long term and high value over the period of the relationship;
  - (f) tenders were infrequent and unpredictable as to timing;
  - (g) refusal to tender would damage an audit firm's wider relationship with a company;
  - (h) market shares were not stable and differed between large audit firms; and
  - (i) at the time of tender there was only limited predictability of audit scope over the life of the audit relationship; for example, future restructuring or mergers could not necessarily be predicted.