ERNST & YOUNG

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

ERNST & YOUNG LLP - RESPONSE TO RESTRICTIONS ON ENTRY OR EXPANSION

1. We set out below the response of Ernst & Young LLP ("EY") to the Competition Commission's working paper *Restrictions on Entry and Expansion* (the "Paper"), which sets out the framework that the Commission intends to use when considering possible restrictions on entry and expansion in the audit market.

2. On the basis that the Paper sets out a framework for the Commission's analysis, rather than the Commission's detailed views, EY does not seek to address every point raised in the Paper.

3. However, EY has a number of general observations on the Paper, which are set out below:

   (i) Audit firms other than the four largest firms, for example GT and BDO, are established audit firms in the UK with significant revenues, overseas presences, staff and clients (including FTSE 350 companies). As a result, any discussion of barriers to entry *per se* is misplaced: the relevant question concerns barriers to expansion.

   (ii) The Commission appears to recognise, at paragraph 6 of the Paper, that there are no absolute barriers to entry (or expansion, as we would have it). This is relevant not just to assessing future possibilities for competition but also for evaluating the current state of competition. In the presence of significant firms other than the largest four audit firms, and in the absence of absolute barriers to entry, non-expansion by rivals is entirely consistent with a situation where the market currently serves its customers well.

   (iii) There is a fundamental distinction between costs of entry and barriers to entry. EY recognises that there would likely be a need for certain investments smaller audit firms wished to gain more FTSE 350 clients. But these are costs that the four largest firms have incurred and continue to incur. Indeed, EY considers that its market position is significantly due to investments it has made and continues to make (including, for example, investments in EY's network, developing audit methodologies, graduate recruitment and human capital), and that the same is true for the other of the largest four audit firms. It is for other audit firms to explain why they have not chosen to make these investments over time and/or not sought to grow by amalgamation.

   (iv) Given that other audit firms are active audit firms of some scale, the investments required to serve additional FTSE 350 clients are not of a level corresponding to *de novo* entry. Moreover it is possible to (indeed, it is impossible not to) grow an audit business "one client at a time", and the investments can be made continuously and gradually. In this context, we note in particular the success of Deloitte in gaining FTSE 350 clients over recent years.

   (v) The analysis contained in the Paper omits a highly significant feature of the market. The discipline exerted by entry and expansion operates because it means that an incumbent firm can rapidly lose its current level of business if it underperforms on a relevant dimension. However, to the extent that an audit firm deviates in a material

way from gold standard professional and ethical standards, or is perceived to have done so, it faces a positive and non-trivial probability of irreparable harm to its reputation and the commercial consequences that flow from that. Thus, as regards the trust and integrity aspects of product quality, which are arguably the core of the "product" being supplied by auditors, the four largest audit firms already face a continuous prospect of sudden, complete and irreversible loss of market share, and the disciplines that imposes, irrespective of the competitive pressures they face.

(vi) Whilst EY recognises that large scale expansion in the short term (except by amalgamation) is not realistic, entry barriers need to be appraised over the time period in which investments and competition operate. The current position of the current largest four audit firms is a consequence of continuous investment over 10-15 years, and there is no reason to suppose that a determined entrant could not break in over that sort of horizon by a combination of amalgamations, selective but continuous investments, entrepreneurial opportunism and investment in key lateral hires.

4. As regards the specific factors cited by the Commission, we note that EY addressed a number of these issues at paragraphs 10-27 of its response to the original Issues Statement. Those points are not repeated here. However, we make the following additional initial remarks on some of the specific factors cited.

5. **Switching Costs**

We consider that the existence of switching costs does not reduce the level of competition, but does change the nature of that competition.

In particular, audit firms compete very hard to get appointed as an audit, including through aggressive bidding and accepting to bear much of the "getting up to speed" learning costs. As previously stated, EY has in the past offered to complete initial work at reduced rates, and has agreed to absorb initial costs associated with understanding the business of a new client and setting up the audit approach.[1]

In relation to the other points raised at paragraph 25 of the Paper concerning the nature of switching costs and the risks of error or omission in the period following a switch, we refer the Commission to paragraphs 53-57 of EY's Response to the Issues Statement.

6. **Endogenous Sunk Costs**

EY does not support the characterisation of the fixed and sunk costs required to operate in the market as endogenous sunk costs. It is clear that the fixed and sunk costs required to operate as an auditor to FTSE 350 companies should be characterized as exogenous fixed costs.

---

[1] EY's Response to the Issues Statement, paragraph 55(a).

In particular:

(i) Whilst the necessary investments to serve major global audit accounts have undoubtedly risen in the last two decades, this is a direct consequence of external events, notably the globalisation of business and increased regulatory requirements introduced in response to specific events.

(ii) Large companies and groups expect and demand a single audit firm or network to audit their entire group, and expect the enhanced level of oversight and consistency of service that is provided by a single firm / network audit.

(iii) Many of the necessary investments have to be incurred repeatedly, and many such investments are made annually in order to maintain the levels of service expected by clients.

Accordingly, the fixed costs are most plausibly characterised as "exogenous" fixed costs.

The following remarks in relation to the theory of endogenous sunk costs are also pertinent:

(i) It should be noted that, almost by definition, the number of FTSE 350 audits cannot grow. Endogenous sunk costs models by contrast seeks to explain a constant number of firms supplying a growing market not a static one.

(ii) Moreover, market concentration is related to the aggressiveness of price competition: a concentrated market, other things equal, is a sign of aggressive price competition (because given the level of fixed costs, tougher competition reduces the number of firms that earn gross margins sufficient to cover them).

7. **Reputation**

As EY stated in its response to the original Issues Statement, the audit services market is the same as all other professional service markets in that reputation is undoubtedly highly important.[2] EY's strong reputation has been earned over time through, for example, building up its national and global network, and developing its expertise. The extent of the investment EY has made, and continues to make, to earn that reputation is a direct result of the competition that exists between EY and other audit firms.

EY therefore accepts that reputation is important, and that capital markets appear to attach weight to the credibility of the four largest audit firms.

However, EY has two specific observations in this context:

(i) Of the factors set out in Figure 1 (page 13 of the Paper), and addressed at paragraphs 42 to 51 of the Paper, we consider that the significance placed on lobbying and alumni networks as factors contributing to the establishment and maintenance of reputation is overstated.

---

[2] EY's Issues Statement Response, paragraph 19.

(ii) A number of key factors that contribute to the establishment maintenance of reputation are omitted. Most importantly, the Paper omits consider the importance of quality in this context. Continuing to perform audits of a high quality in accordance with applicable standards on a consistent basis is a key driver of reputation. However, the Paper suggests that quality is a mirage by suggesting that:

(1) reputation "*serves as a proxy for capability and quality in this market because quality is difficult to observe otherwise*" (paragraph 37); and that

(2) "*[s]ize may be seen as a signal of quality since larger firms have reduced incentives to lower audit quality opportunistically in order to retain any single client*" (paragraph 40).

Performing high quality audits on a consistent basis is the key factor in establishing and maintaining reputation. Equally, for the reasons given above, a failure or a perceived failure, to provide high quality audits risks irreparable harm to an audit firm's reputation. Audit firms are subject to constant scrutiny in this regard, including (for example) through the published reports of the Audit Inspection Unit.

8. **Regulatory Barriers**

As EY has previously noted[3], the nature of the audit is tightly prescribed by applicable standards and regulations which, as the Paper recognises, regulate technical quality and independence.

We consider that many of the factors mentioned by the Commission raise the complexity and cost of the audit, and have an impact on the number of firms able to audit certain companies (for example, small firms might find it difficult to meet partner rotation requirements).

However, these factors reflect the demands of the ultimate customers, the investment community.

9. **Loan Agreements**

As previously stated[4], EY's longstanding view is that contractual restrictions preventing companies from appointing audit firms from outside of the largest networks, which are imposed by lenders without the encouragement from EY, and undesirable.

---

[3] EY's Issues Statement Response, paragraph 31(b).
[4] EY's response to Issues Statement, paragraph 23.