Grant Thornton
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Grant Thornton Response to the Competition Commission ("CC") working paper entitled "Review of evidence on the price effects of switching"

1 Introduction

1.1 This memorandum sets out the response by Grant Thornton to the Competition Commission's ("CC") working paper entitled "Review of evidence on the price effects of switching" ("the working paper") which was issued on 17 June 2013. We comment below on the specific questions raised by the CC and the more general themes expressed in the working paper.

2 General observations

2.1 We note firstly that all of the analysis performed by, and submitted to, the CC on this topic is pointing in the same direction in concluding that tendering and any related switching of auditor leads to a reduction in prices. This conclusion is also consistent with the other evidence presented in the CC's Provisional Findings report.

2.2 We support the CC's recognition that there will always be some level of uncertainty regarding the precise magnitude of the observed pricing effect, which will vary depending on the assumptions and the variables included in the model employed. This uncertainty is entirely consistent with the type of econometric analysis that has been performed. However, in our view this should not detract from the fact that the all available evidence consistently suggests that customers benefit from lower prices when a change of auditor is made.

2.3 Regarding the reasons for the observed pricing effects, we consider that the most plausible explanation is that a tender event results in the company gaining a much better understanding of the true competitive price(s) available (albeit one potentially below an audit firm's average return) and being able to secure those prices for a limited period. However, that position is relatively short lived, with the new auditor then being able to increase prices over time as a company loses its bargaining power during the course of an audit engagement. This view is consistent with the theory put forward by the CC in the Provisional Findings report.

2.4 We also regard the increasing asymmetry in the distribution of price changes over time as being consistent with a loss of bargaining power of the company, as such a loss would be unlikely to impact all companies in exactly the same way through time. The symmetry of distribution in the early years (particularly in the first year after switching) is consistent with the tender process establishing a competitive level.

2.5 Furthermore, if the pattern of audit prices upon switching was one where firms were discounting for the first year before the audit fee returned to competitive levels we would expect, at the individual company level, the audit price to return to something close to the audit fee pre-switching (taking account of any other changes that would impact on the cost of the audit). So at the individual company level, the initial fall in prices would be a good indicator of the magnitude of the subsequent price rise.

However if the pre-switch audit fee was above a competitive level and then dropped to a competitive level for the first year or two of the new audit firm's tenure, we would expect the subsequent increase in audit fee to be less related to the size of the original price fall as it would be unlikely, with a new audit firm and audit partner in place, to reproduce exactly the same degree of the exercise of pricing power. These different patterns at the individual company level would both be consistent with the pattern observed at the aggregate level, as reported in the Working Paper.

3 Response to specific questions

3.1 What is the most plausible explanation for the observed relative price development observed for companies that tendered or switched?

3.1.1 As set out above, in our view the most plausible explanation for the observed relative price development for companies that tendered or switched is that the tender triggers competition at the tendering stage which results in a competitive price, but that the benefits of the tender on price are increasingly eroded over time as companies lose bargaining power and are less able, absent a new tender, to effectively identify and obtain a competitive price level.

3.1.2 We also recognise that given the expectation of long tenure after an audit tender, many tenderers may accept a fee below their commercial average initially, because they have the "option" to seek to gain higher fees in later years, once their bargaining power increases, outside a competitive tender scenario.

3.1.3 A further factor operating to reduce the bargaining power of a company after a tender event is that, in circumstances in which tenders have historically been rare and/or infrequent, there may be a reputational risk to a company of switching auditor too frequently, as this might be perceived as a signal to investors that there is a problem with the accounts. In other words very low levels of tendering may, perversely, make it difficult for companies to tender more frequently. This may be a factor which operates to cause a company to experience a reduction in its bargaining power rather quickly, even if it continues to possess some indicators of what the market would offer it should it (re)tender.

3.1.4 In our experience the pricing effect observed in FTSE 350 companies (i.e. lower prices following a tender but with prices rising over time) is less evident (or less significant) in sectors outside of the FTSE 350 which benefit from more effective competition, such as the public sector and non-listed company audit market. In these sectors, our experience is that tender prices are typically maintained more closely in the years that follow a tender event. This would indicate that where there is more effective competition, evidenced by more frequent tendering and switching, competitive prices are able to be maintained over a longer period.

3.2 How can a relative price development, whereby an initial relative price drop erodes away in three to four years, be consistent with companies that (on average) have strong bargaining power/price transparency outside of a tender situation?

3.2.1 As set out above, we do not consider that the relative price development observed by the CC is, or can be, consistent with companies that have strong bargaining power outside of a tender situation. We note that a number of alterative explanations for the identified pricing effect have been put forward which we consider further below.

3.2.2 Firstly, some respondents have suggested that audit firms offer unsustainable discounts to win tenders, which then results in prices rapidly returning to the competitive level[1]. In our experience, whilst audit firms may tender at a competitive price in order to win an audit mandate which they assess will provide a return over a number of years, this pricing is unlikely to lead to a situation where an audit firm would not generate a sufficient financial return absent an increase in prices in subsequent years (all other factors remaining constant). However, we recognise such returns may be below what an audit firm would seek as an "average" financial return.

3.2.3 We acknowledge that the costs borne by an audit firm in the first year of an audit engagement may be unsustainable if the audit were a one year project, but this is, in our experience, due to the significant set up (familiarity) costs in the first year of an audit engagement and not necessarily because the tender fee has been set at an unsustainable level. We note that in our own firm internal recovery rates for a new audit win tend to be lower in the first year post tender but, absent an increase in price, typically return to a more acceptable level in the second year and onwards. Only very occasionally is an improvement in margin in later years due to increased fees from the original tender price and, even where increased margins are due to price increases, this is generally because the audit has increased in size or complexity due to factors outside of our control (e.g. an increase in the size of the audited group due to acquisitions). Such initial recovery rates are for all our audit clients, including those in the FTSE 350. However, FTSE 350 companies would make up a relatively low proportion and therefore this observation is indicative of pricing and audit firm bargaining power outside the FTSE 350, where, in our view, greater competition and willingness to switch exists.

3.2.4 We note further that the CC has found that audit fees are profitable (and therefore sustainable) even in year 1 of an audit engagement and so there is no credence to a suggestion that tenders result in audit fees being discounted to unsustainable levels.[2] This is consistent with our approach to pricing, and our expectation of the approach of other firms. We note also that the CC found no evidence of so-called low-balling in its Provisional Findings report.

3.2.5 For our own part, in participating in tenders in all sectors our bidding policy in relation to price is to bid at a price that, if the scope of the audit were to remain unchanged, would be the price we expect to charge throughout the audit assignment (clearly, where the scope changes we would renegotiate the price so that it continued to reflected the amount of work required to undertake the audit.) In the first, and possibly the second, year of the audit tenure we would expect to achieve a lower revenue per hour, reflecting the additional work required to get a full understanding of the new client's systems etc (see paragraph 3.2.3 above). However, as far as the client is concerned, we absorb this extra cost.

3.2.6 Where we depart from the above approach (which is rare) and offer a discount, this will normally be made explicit to the client and the unwinding of the discount over the first year or two will be explicitly included in the audit engagement agreement. As a result, in these markets we do not have hidden discounts which we aim to recover by raising our prices once the client is somehow "locked-in" to taking our audit service (for the avoidance of doubt, we do not believe that in our market segments and with our market position that our clients feel that they are locked-in).

[1] CC working paper, paragraph 2(a).
[2] CC working paper, paragraph 103.

3.2.7 An alternative explanation for the price observation which has been put forward is that the audit scope is consistently underestimated by firms bidding for an engagement[3]. We think this explanation is implausible. Whilst it is possible that in isolated instances a bidder may underestimate the scope of an audit engagement when bidding, it is not credible to suggest that over the long term auditors bidding for a tender would continuously and repeatedly underestimate the scope of audits (and fail to learn from previous errors).

3.2.8 Nor is it likely that Audit Committees and companies themselves would fail to identify low priced bids that underestimate the scope of the audit. In our experience most companies provide a very clear scope in a tender situation. That scope changes only rarely if the company is dynamic and acquires or creates new entities in the aftermath of the tender event. In our experience, Audit Committees in the FTSE 350 are adept at comparing tenders across a range of characteristics, including the resources to be devoted to an audit, and so we would expect that any apparent lack of resource submitted by a tendering firm would be noticed during the course of tender discussions.

3.2.9 The resource applied to a new audit engagement in the first year are therefore typically only higher than in subsequent years due to the time commitment necessary to gain familiarity with the company and its internal processes and controls, and not due to an underassessment of resources required on a recurring basis.

3.3 Over the period from 2000 to 2010, to what extent were first-year audit fees unsustainable?

3.3.1 We have no documented evidence in this respect. However, in our experience, we would expect first year audit fees to be unsustainable in a very low proportion, if any, of audits for the reasons noted previously.

3.4 To what extent do you consider that a tender situation in the market for FTSE 350 audits is subject to competition 'for the market'?

3.4.1 Given the very low level of tenders in the FTSE 350, and the long duration of many audit engagements, there is inevitably an element of 'competition for the market' whenever a tender event occurs. This is because the opportunity to tender for the audit work of that company may not come around again for a very considerable period of time. However, we do not consider the supply of audit services to FTSE 350 companies to be an example of true competition for the market (in the same sense as might be the case, for example, in respect of a tender to build a nuclear submarine). Nor do we believe that such elements are an inherent and unavoidable characteristic of the market in the same way as might be the case in our submarine example. Rather, we consider that, to the extent that there is an element of competition for the market, this is a consequence of the weakened competition in the market identified by the CC. In other words, it is an adverse consequence of ineffective competition.

3.4.2 Moreover, to the extent that there is an element of competition for the market, it cannot be assumed that so long as there is effective competition at the tender stage, competition is effective. This is because all the evidence collated by the CC, including the observed relative price development suggests otherwise. Further, for the reasons given above we do not consider that competition is so fierce at the tender stage that it results in unsustainable (below cost) audit fees in the first years of an engagement.

[3] CC working paper, paragraph 2(b).

3.4.3 Finally, we would observe that, to the extent that there is an element of competition for the market in the supply of audit services to FTSE 350 companies, this characteristic would disappear in a world in which tendering, and indeed switching of auditor, becomes a more frequent feature of the market. This because more tender events would inevitably have he consequence of making each tender event less critical, and allow audit firms to target those tenders for which they consider themselves best placed to succeed.