KPMG Response to CC's Working Paper "Review of evidence on the price effects of switching"

1 Executive Summary

1.1 This note sets out KPMG's response to the Competition Commission's (CC's) working paper "Review of evidence on the price effects of switching" (the "Working Paper").

1.2 The Working Paper discusses the CC's evidence on the audit fees that are observed after a change in audit firm. The CC provisionally concludes that it reliably observes a reduction in audit fees in the first year after switching audit firm, and a return to pre-switching fee levels by the fourth year after switching. This conclusion is based on evidence from descriptive statistics and an econometric analysis submitted by PwC.

1.3 In our view these pieces of analysis do not support the CC's conclusion that companies' bargaining power is eroded following a tender event. The main reason for this is that the analysis does not actually relate to the variables that the CC thinks it is considering – in particular price and the competitiveness of an audit. In particular, since neither piece of evidence adequately controls for audit scope[1], neither piece can provide any evidence of a pattern in prices, but rather only evidence of a pattern in total audit fees (or, from the audit firm's point of view, revenue per audit engagement). This distinction is crucial. The CC would not infer anything about changes in prices for customers at a grocery store if it had information only on customers' total spend, rather than also having information about the quantity and types of goods that were bought – but by looking only at total audit fees without controlling properly for scope, this is what the CC is doing here. For example, audit scope may be reduced if it was previously more than was required to support the audit opinion itself, and correspondingly the fee may fall, but this does not imply that the *price* has fallen[2].

1.4 Further, because neither piece of evidence controls for audit quality, any pattern that is observed cannot provide any information about the overall competitiveness of the audit. Finally, the CC cannot distinguish whether or not there exists a selection bias in the data, and so can make no conclusions about the causes of the pattern that it does observe.

---

[1] Which is driven, in part, by complexity.

[2] Scope does not map onto the hours worked on the audit. The scope relates to the areas of work that are agreed with the client that will go into the audit. Hours worked don't provide a good proxy for scope in the early years of the engagement because of the significant investment that is required.

1.5 The Working Paper goes on to discuss potential interpretations of the pattern that the CC observes, and seeks to distinguish between competing explanations. The CC provisionally concludes that the pattern it observes is best explained by companies losing bargaining power over the course of an engagement. This conclusion is flawed for a number of reasons. First, the failure to establish a "price progression" (as set out in paragraph 1.3 above) or infer anything about the value for money or competitiveness of an audit (as set out in paragraph 1.4 above) fundamentally undermines the ability to make any conclusions about bargaining power. Second, even if a "price" pattern (rather than a pattern in total audit fees or equivalently audit revenues) was observed (which it is not), this could be explained in a number of ways, and consistently with a competitive market.

1.6 Further, and in our view crucially, the CC has no evidence that there is any change in the offer that a company receives following a tender without a change in audit firm. Even setting aside all of our other concerns in relation to the CC's evidence on the impact of switching audit firm, without any evidence that there is any change in the outcomes achieved by companies following a tender without a switch, there is no evidence to support the CC's conclusion that companies' bargaining power is driven by tender events and eroded outside of them.

1.7 In our view, the pattern in revenues that the CC observes is instead most plausibly explained by a combination of various factors, all of which are consistent with companies achieving competitive outcomes. There is no single explanation for patterns in total audit fees, given that audits are bespoke and companies' characteristics so variable. However, in our view the following factors are all likely to form an important part of an explanation for the pattern in revenues at some point:

- First, the scope of the work may decrease following a switch (compared to the work carried out by the previous audit firm), before rising again. There are at least two possible reasons for this. First, a company may initially agree to a narrower scope, but as the audit firm demonstrates the worth of its other services (e.g. audit-related services and value-added services[3]) the scope may be widened. Once the company is satisfied of the value of the services it will receive, it will agree to increase the scope of the work. Second, it is possible for firms to anticipate that less work is needed to

[3] The insights the audit firm is able to offer as a by-product of t he audit, as noted by the CC in paragraph 6.15 f) of the Provisional Findings.

audit a company than is actually the case. This is often drive by companies seeking to and suggesting that they can deliver more in terms of controls and accounting analyses, for example, which would allow audit firms to reduce the scope of the audit. If these factors cannot be delivered by the company then the scope may need to be widened.

- Second, the value of the services provided by the audit firm increases as time progresses due to the investment that the audit firm (and the company) make in understanding the business and establishing good working arrangements. As the value of services increases, this can lead to a higher compensation for the work that is done, as well as more work being commissioned by the company it being accorded to the audit firm. Both of these factors affect the size of the total audit fees and can explain the pattern set out by the CC.
- Third, audit firms may look to set as low an overall fee as possible in order to encourage the company to switch despite the likely costs it will have to incur in the first years as the new auditor gets up to speed.

1.8 Overall therefore, we believe that the CC cannot place any weight on this pattern in coming to its provisional conclusion that there exists an adverse effect on competition ("AEC") in the supply of statutory audit services. Further, and as a result, the CC cannot use these results to establish the magnitude of any AEC it identifies, as part of its proportionality assessment of its remedy options.

1.9 Even setting aside these concerns, the CC recognises that it cannot infer from the existence of any current or historic price effect that similar effects would remain following the imposition of a mandatory tendering or mandatory rotation remedy. We agree, as we set out in our response to the CC's Provisional Findings into the supply of statutory audit services ("Provisional Findings")[4]. Because of this, the existence of the trend the CC has identified for those companies that did switch cannot be used in the CC's analysis of the proportionality of its remedy options, which would apply across the market more broadly. We look forward to further engaging with the CC's analysis of its remedy options, and in particular their proportionality, following the publication of the PDR.

1.10 We highlighted in our response to the Remedies Notice the substantial costs that are associated with mandatory tendering (with no comply or explain provision) and mandatory rotation. The analysis the CC presented in this paper, in our view shows that there is little or no evidence that benefits will flow from remedies aimed at increasing

[4] Section 2.3.3 of our response to the Provisional Findings.

tendering or switching. Further, and consequently, the greater the frequency of tendering or switching envisaged by the CC, the greater the imbalance between costs and alleged benefits from these remedy options.

1.11 Our disagreement with the basis for an AEC notwithstanding, a more effective and proportionate response to the AEC is to use some combination of the CC's remedy options 3 to 7, to further empower Audit Committees ("ACs") to discharge their duties and to encourage greater involvement of shareholders. The effect of these remedies would be complemented by the existing measures around tendering taken by the FRC.

1.12 In our view the CC therefore needs to take the comments we set out in this response to the Working Paper (as well as the comments of other parties) into account in its Provisional Decision on Remedies ("PDR"). Indeed, if the CC fails to do this, CC's proportionality assessment in the PDR will be flawed.

1.13 Our response to the Working Paper in the rest of this note is in five parts. First, we set out the weaknesses in the evidence base used by the CC to establish the existence of a pattern in total audit fees following a change in audit firm[5]. Second, we set out the flaws in the CC's conclusion that an erosion of company bargaining power is the most plausible explanation for this pattern. Third, we set out the factors which we believe are more likely to drive the pattern that the CC observes. Fourth, we discuss the CC's methodology for distinguishing between competing explanations for the pattern it observes, in particular its use of statements about profitability to conclude that the pattern is informative of companies failing to achieve competitive outcomes. Fifth, we conclude by setting out answers to the specific questions that the CC posed at the end of the main text of the Working Paper.

[5] More detailed comments on the CC's descriptive statistics are contained in Annex 1.

2 The CC's evidence base is weak

2.1 Introduction

2.1.1 The CC refers to its Provisional Findings, where it found that "following a 'direct'[6] switch, companies obtained a significant price decrease that eroded over the subsequent two to three years"[7]. Its evidence for this provisional conclusion was composed of: i) descriptive statistics; and ii) econometric analysis submitted by PwC.

2.1.2 In this Working Paper, the CC presents further analysis of these two categories of evidence and discusses their robustness in more detail. In the rest of this section, we comment first on the CC's further analysis and provisional conclusions on the robustness of the descriptive statistics. Second, we comment on the econometric evidence submitted by PwC along with the CC's discussion of it.

2.1.3 In our view, both categories of the CC's evidence are characterised by similar fundamental flaws. Their failure to control adequately for audit scope implies that the two pieces of evidence do not provide any information about patterns in prices following a change in audit firm, and instead only provide information about the revenues an audit firm receives. Further, the failure to control at all for audit quality implies that, even if prices were observed (which they are not), the CC cannot infer anything about the competitiveness of those prices. In addition, the CC is not able to draw any conclusions about the causal relationship between changing audit firm and changes in total audit fees, because it cannot exclude the possibility that there is a selection bias in the data.

2.2 Descriptive statistics

2.2.1 The CC states that *"among 55 direct FTSE350 switches the median price decrease was 17 per cent in the year after the switch, with 78 per cent of companies achieving a fee decrease"*[8]. The CC states that this descriptive statistic shows that some *"companies*

[6] The CC removed all events associated with the collapse of Arthur Andersen, merger and acquisition activity and moves to or from joint audits. It refers to these as direct switching events, adopting PwC terminology.
[7] Paragraph 1 of the Working Paper.
[8] Paragraph 7 of the Working Paper.

have achieved reductions in fees after switching"[9]. However, the CC is mistaken in describing this pattern in the data as a 'price' or 'fee' change. The CC's analysis is of total audit fees, and the descriptive statistics do not take any account of the scope of the audit. Therefore, the pattern that the CC observes is not one of prices, but rather a pattern in total revenue that the audit firm receives from a given audit engagement. For this reason, we refer to the pattern that is the subject of this Working Paper as the 'pattern in revenues' in the rest of this response, rather than a 'price pattern' as the CC terms it.

2.2.2 The descriptive statistics also do not control for audit quality, which undermines the CC's ability to infer anything about the overall competitiveness that a company achieves following a change in audit firm. It may well be that companies are willing to make a trade-off between certain aspects of quality in the first years of an audit (in particular service quality) and a lower overall fee. The CC cannot therefore use this result to infer anything about companies' and audit firms' relative bargaining power. We discuss this further in section 3 below.

2.2.3 Even setting aside this concern, there is a further weakness in the CC's analysis. Even if the CC was able to observe that those companies that did switch achieved a better value (or more competitive) offer after that switch (which it cannot), no more general conclusions could be drawn about the change in the competitiveness in the audit offer that would follow a change in audit firm for any other companies in the population (i.e. those that did not switch). This is because the CC cannot distinguish whether or not there exists a selection bias in the data, whereby those companies that did switch in the observed time period were precisely those that were not receiving a competitive offer previously (but obtained one following a switch). Without being able to establish that there such a bias does not exist, the CC cannot extrapolate from its observations on companies that did switch to hypothetical switches by other companies in the population.

[9] Paragraph 15 of the Working Paper.

2.2.4 The CC recognises these limitations in its descriptive statistics. Referring to the failure of the descriptive statistics to control for other relevant factors that affect audit fees[10], the CC notes that it will focus on the PwC econometric analysis, which, it argues "does control for various factors"[11]. It also notes that the issue of selection bias may be present in its descriptive statistics[12]. We therefore set out our more detailed comments on the PwC econometric analysis in the next section. In particular we discuss our view that the PwC econometric evidence fails to substantially correct for the two key weaknesses in the descriptive statistic analysis that we set out above. In particular, that the PwC analysis fails to control for key factors that affect audit fees, including audit scope and quality, and is still characterised by the issue of selection bias.

2.3 PwC econometrics

2.3.1 The CC's assessment of PwC's econometric evidence

2.3.1.1 PwC submitted an econometric analysis, "An econometric analysis of the prices of large company audits" (the "PwC analysis") which examined the change in total audit and audit-related fees associated with changing audit firm. It sought to answer a range of questions. These included whether there is a statistically robust decrease in the total audit fee following a change in audit firm, for those companies that did switch; whether companies that tender or switch have lower audit fees in the long run than those that do not; and whether any short run gains from switching decline over time, and, if so, how quickly. The key results from the PwC analysis were that:

- PwC's preferred 'company specific effects' model found that those companies that switched auditor paid a lower total audit (and audit-related fee) in the first year. The magnitude of the reduction was around nine per cent[13] under PwC's preferred specification, which excluded banking and financial services companies. The total audit fee returned to pre-switching levels by the fourth year after the switch.
- In PwC's 'industry and index effects' model, companies that tendered or switched at least once during the sample period[14] were not found to achieve long term lower total audit fees on average compared with companies that did not tender or switch.

[10] Paragraphs 15 and 57 of the Working Paper.
[11] Paragraph 17 of the Working Paper.
[12] Footnote 31 of the Working Paper.
[13] In nominal terms.
[14] 2000-2010 inclusive.

2.3.1.2 The CC states that:

> *"PwC's 'industry and index effects model' does not show that there are no long term benefits to switching. The 'company specific effects' model, however, does provide interesting insights in the price development after switching. It is a helpful extension to the descriptive statistics, as it controlled for various observable factors that co-determine the level of audit fees."*[15]

2.3.1.3 In our view, while the 'company specific effects' model shows that there is a reduction in audit revenue following a change in audit firm, we disagree that this provides a helpful extension to the descriptive statistics. The analysis still fails to control for important factors that affect audit fees and therefore does not allow the CC to make any conclusions on the value for money associated with the observed reduction in revenue. We discuss this, and other concerns, in the rest of this section. We note that our comments are made without us having had an opportunity to fully test PwC's model and as a result we cannot be sure whether, for example, any missing data further undermines the usefulness of PwC's results[16].

2.3.2 Insufficient controls for factors that affect audit fees

2.3.2.1 The CC states that "PwC's analysis controlled for various observable factors that co-determine the level of audit fees"[17]. Although the PwC analysis controls for more factors than the CC's descriptive statistics (which did not control for any), we do not consider the variables included by PwC to be sufficient to control for audit scope, quality or costs. In our view this severely limits the usefulness of the PwC analysis as part of the CC's evidence base, and we set this view out in more detail in the rest of this section.

2.3.2.2 The CC acknowledges that the PwC analysis does not include any variables that would allow it to control for audit quality and costs[18]. This is a key weakness in this analysis. Both of these factors are key drivers of audit fees. A failure to control for audit quality

[15] Paragraph 54 of the Working Paper.
[16] For example, there are 828 firms present over 11 years, but only 7.303 audit fee observations. So there are 1,805 missing observations, due to either missing data or, more likely, entry and exit from the panel.
[17] Paragraph 19 of the Working Paper. In paragraph 50 the CC acknowledges this limitation in the data.
[18] Footnote 12 of the Working Paper.

in particular implies that the CC can make no assessment of the value for money or overall competitiveness of any particular audit fee.

2.3.2.3 In relation to audit scope, PwC uses a range of variables to attempt to control for this factor, including companies' asset value, turnover, merger activity and the previous years' audit fees as well as a dummy variable to indicate when a switch was associated with a merger or acquisition. We do not consider these controls to be adequate overall. Indeed, the CC notes that the *"model likely does not control for all relevant factors that determine the audit fee"*[19]. In spite of this, the CC fails to explain why the set of controls that are in the model are appropriate, also noting, without proper explanation that *"the underlying analysis already controls for a variety of factors that proxy for audit scope"*[20].

2.3.2.4 We have already set out many of the drivers of audit complexity (and therefore scope) in section 4.1 of our Main Submission in response to the CC's Issues Statement ("Main Submission"). These include factors such as global reporting complexity, differing accounting standards and diverse company structures. In addition, a company may decide as part of a tender process to define a narrower scope for its audit (for example that delivers just the audit opinion rather than any value-added or audit-related services) or might seek to limit the scope of an audit by increasing the work they can do to support an audit firm (we discuss these possibilities further in section 4 below). Many of these drivers are not easily observable or measurable, and are not adequately controlled for by the set of variables included in PwC's models. The CC does not discuss these concerns in this Working Paper (and neither did the CC do so in its Provisional Findings), although it does more generally recognise that the model doesn't control for all relevant factors, as noted in the previous paragraph[21]. We note that PwC's model also includes fees for audit-related services, the scope of which can vary enormously and not in any particular relation to any of the controls the CC has used for audit scope.

2.3.2.5 As a result, the CC cannot call the results of the PwC analysis a 'price pattern', anymore than it can infer a price pattern from the descriptive statistics. Instead, what it observes

[19] Paragraph 21 of the Working Paper.
[20] Footnote 17 of the Working Paper.
[21] Paragraph 21 of the Working Paper.

is a 'pattern in revenue' that provides no information on the change in the overall competitiveness of an audit following a change of audit firm. This fundamentally undermines the CC's provisional conclusion that the change in total audit fee following a switch that it observes is most plausibly explained by companies losing bargaining power through the life of an engagement. We discuss this further in section 3 below.

2.3.3 Inconsistencies in the CC's discussion on quality

2.3.3.1 The failure to control for quality in the econometric analysis, as discussed in the previous section, is a fundamental flaw in PwC's approach. This is confirmed by several statements by the CC throughout the Working Paper on the importance of quality, in particular of the audit opinion, as a driver of companies' demand for statutory audit services. Specifically, the CC states that:

- "we have some evidence that companies go out to tender for non-financial benefits such as quality"[22];
- "it is unlikely that a fee reduction could compensate companies for the potential costs of an audit failure"[23];
- "we have evidence that selection is not on the basis of fees alone"[24]; and
- "selection is not driven by price alone"[25].

2.3.3.2 We fail to see how the CC can consider that it can draw reliable conclusions based on an analysis which, by the CC's own admission, does not control for audit quality, while simultaneously recognising that quality is an important driver of demand.

2.3.4 The CC incorrectly includes banks and financial services clients

2.3.4.1 In its preferred model, PwC omits banks and financial services companies. This is primarily due to problems using the inventories/assets of these companies as an explanatory variable, which PwC outlined in more detail in section 3.12 of the PwC analysis and which we agree with. We also note that excluding financial sector companies is commonplace in most academic studies of audit fees. The CC has not provided any counter-arguments to PwC's rationale for the exclusion of banks and

[22] Paragraph 77 of the Working Paper.
[23] Paragraph 78 of the Working Paper.
[24] Paragraph 86 of the Working Paper.
[25] Paragraph 86 of the Working Paper.

financial services companies nor any justifiable reason why it prefers the PwC model that includes them. It is our view that the CC is incorrect to place weight on PwC's specification where banks and financial service clients are included, as (besides problems surrounding inadequate control for costs, quality and scope) the results are likely to be biased[26].

2.3.5 There is no evidence that any effect applies across all companies

2.3.5.1 We set out in 2.2.3 that the CC cannot determine whether or not there exists a selection bias problem in its descriptive statistics. The CC recognises that equally it cannot distinguish whether such a selection bias exists in the PwC econometric analysis[27]. It notes that as a result "it is not clear whether the price effect was a causal effect of tendering or switching, or whether the companies that tendered or switched were paying a higher than average price"[28].

2.3.5.2 As set out in section 2.3.2, we disagree that the PwC analysis provides any evidence on a 'price' pattern or a pattern in the competitiveness of an audit firm's offer. However, even setting this aside, the issue of selection bias implies that the CC could not in any case (as it recognises itself) infer any causal link between the audit and the switching or tendering event itself. This implies that it could not use the existence of any co-existence between switching events and changes in prices to make any judgements about companies bargaining power. Nor can the CC extrapolate the result across companies that did not switch during the time period observed. As summarised in the CC's Provisional Findings, the CC cannot conclude that anyone who switched or tendered could realise a price reduction, but "rather that the average company that switched did"[29].

2.3.5.3 In addition, we note that the CC suggests that the "price effects might be quite different" for companies that tender but do not switch compared to those that tendered and switched. We disagree that any 'price' effects can be observed, for companies that

[26] In addition, we note that the difference between the models is not statistically significant. Figure 1 does not make that clear, which is in our view a bit misleading.
[27] Paragraph 42 of the Working Paper.
[28] Paragraph 39 of the Working Paper.
[29] Paragraph 15, Appendix 30 of the CC's Provisional Findings

switched or for those that did not. However, the CC believes that it can. As a result, it must explain how a result that companies that tender but do not switch achieve *"quite different"* changes in price compared to companies that do switch is consistent with its theory on bargaining power. In particular, the CC suggests that one explanation for companies that tendered but did not switch not achieving a price reduction is that "the incumbent's offer was competitive"[30]. This fundamentally undermines the CC's hypothesis that companies lose bargaining power over the course of an engagement which is only rectified by a tender event. Further, it would suggest that companies that did not switch during the time period observed would not have achieved a fall in price if they had switched, and therefore that there is likely to be a selection bias in the data.

2.3.5.4 We consider it crucial that the CC fully recognises the implication of a possible selection bias in its (and PwC's) analysis. It is fundamental not only to the magnitude of any AEC (and the CC's assessment of the proportionality of any remedies), but to the strength of the CC's evidence for the existence of an AEC in the first place. As we set out in section 2.3.2 and 2.3.3 above, in our view the failure to assess price changes and the failure to control for quality implies that the CC cannot infer anything about the change in the value for money of an audit following a change in audit firm. However, even if the CC disregarded this view, we fail to see how, without being able to distinguish whether or not there is a selection bias in the data, the CC can conclude that the pattern in revenue that it observes is not simply evidence of a self-correcting, competitive, mechanism whereby companies that were paying too high a price switched to achieve a price reduction.

2.4 Conclusions on the evidence base

2.4.1 The CC fails to recognise the key limitations of its evidence base on the change in price associated with a change in audit firm. Specifically, whilst a pattern in revenues is observed, this is not equivalent to a change in price and provides no information on the competitiveness of the overall audit offering. Further, even if the CC made a conclusion that the pattern in revenues was informative about the overall competitiveness of the audit offer (which it cannot), then it cannot conclude that this

[30] Paragraph 8 of the Working Paper. We assume the CC is referring here to the incumbent's existing offer.

applies to any companies other than those that actually switched during the observed time period.

2.4.2 The CC concludes that it "cannot take the price pattern as proof of an adverse effect on competition, but [does] consider that it appears consistent with one". Given the serious limitations in the pattern in revenues, a view that this pattern is "consistent with" an AEC is in our view an inadequate basis for drawing any conclusions. In fact, the pattern in revenues is consistent with any number of scenarios, and the CC has no basis for concluding that a scenario involving an AEC is any more likely than any other. In particular, the failure to find any evidence that a tender with no switch is associated with a reduction in the competitiveness of the audit offer received means that the CC cannot in a position to conclude that an erosion of bargaining power following a tender is the most plausible explanation for the pattern in revenues it observes. This is the focus of the next section of our response. Then, in section 4 we set out what in our view are the drivers of the observed pattern in revenues.

3 The CC's explanation for the pattern in revenues that it observes is flawed

3.1 Introduction

3.1.1 We now turn to the CC's interpretation of the pattern in revenues that it observes. The CC examines three potential explanations for this pattern in revenues:

- 'Discounting': audit firms offer a lower fee for the first year(s) of an audit in order to encourage a switch[31];
- 'Changes in scope': audit fees revert to pre-switching levels to correct for audit firms having 'under-estimated' audit scope in the first year[32]; and
- 'Bargaining power': companies get a competitive outcome during a tender (hence the reduction in the total audit fee) then lose bargaining power over time, such that audit firms can increase audit fees back to uncompetitive levels[33].

3.1.2 The CC considers that the most plausible explanation for the pattern in revenues is that a company loses bargaining power over the course of an engagement. This conclusion is

[31] Paragraph 2(a) of the Working Paper.
[32] Paragraph 2(b) of the Working Paper.
[33] Paragraph 2(c) of the Working Paper

flawed for a number of reasons. First, the failure to establish a "price progression"[34] or infer anything about the value for money or competitiveness of an audit, given the CC's failure to control for audit scope and quality, fundamentally undermines the ability to make any conclusions about bargaining power. Second, even if a "price" pattern (rather than a pattern in total audit fees) was observed (which it is not), this could be explained in a number of ways, and consistently with a competitive market.

3.1.3 We discuss each of these points in turn in the remainder of this section. In the next section we then set out what in our view does drive the pattern in revenue that the CC observes.

3.2 Failing to control for scope and quality fundamentally undermines the CC's conclusion

3.2.1 As we set out in sections 2.2 and 2.3.2 the CC's analysis does not control for audit scope or quality. As a result, the CC simply cannot claim to have conducted an analysis that has any informative value on the competitiveness of the services being delivered.

3.2.2 In particular, the CC cannot conclude that bargaining power is being eroded, as bargaining outcomes – which relate to the competitiveness or value for money of the audit – are simply not being observed (instead only total revenues are being observed). The CC addresses this critical point only in one comment in a footnote[35]. The CC concedes that *"this empirical evidence only measures fee levels"*[36] and that quality changes could alter the overall competitiveness of the offer. However, we have already explained why this evidence does not measure 'fee levels' In relation to quality, the CC simply asserts that "we expect [the quality-adjusted price decrease] to be larger given the evidence we have on companies switching auditors for other reasons than price".

3.2.3 This appears to be a profound mistake on the part of the CC. Put simply, the fact that there are many reasons to change audit firm (in other words, there are many aspects that determine the competitiveness of an offer) does not in any way guarantee that all those aspects will move in the same direction. This implies that there is no way that the CC

[34] No more than changes in the total amount spent by customers at a grocery store, gives an indication of changes in the prices charged at that store.
[35] Footnote 43 of the Working Paper.
[36] Footnote 43 of the Working Paper.

can reliably state that a higher level of quality will be associated with the lower total audit fee that is observed for the majority of those companies that changed audit firm during the time period available.

3.2.4 In fact, in most markets where different quality levels coexist, the relationship between price and quality is an inverse one, so that lower levels of quality are associated with lower prices. Indeed the CC itself states that *"there might be a signalling effect of the fee offered [...] a low audit fee might be seen as indicating a poor audit quality"*[37], confirming that this is how the relationship is understood to exist in this audit market as well. However, the CC simply asserts that it would expect that a reduction in total audit fees would be associated with an *increase* in quality.

3.2.5 In reality quality levels can vary independently of fees and without assessing how they change over time, the CC is simply in no position to use this analysis to comment on the competitiveness or otherwise of the services that audit firms provide to companies.

3.3 The CC does not identify the relevant bargaining framework used in its analysis

3.3.1 The CC states that:

"Given the results of the analysis, the question still arises why companies that were previously paying prices that were relatively high should only enjoy short-run reductions following a tender or switch. This would suggest that these companies in particular have a weak bargaining position (outside of a tender), which is improved by a tender or switch, but erodes again over time as the new firm asserts itself further on in the new engagement."[38]

3.3.2 Here the CC states that the "price pattern" that it considers to take place following a switch *would suggest* that a company's bargaining position is strong during a tender but *erodes over time*. First, as the CC recognises, the pattern in revenues considered by the CC is consistent with a number of explanations and hence, in and of itself, it cannot be suggestive of any one interpretation being more appropriate than any other. Alternative

[37] Paragraph 77 of the Working Paper.
[38] Paragraph 41 of the Working Paper.

explanations for the price pattern need to be assessed on the basis of their consistency with economic theory and with the evidence available.

3.3.3 In terms of its consistency with economic theory, the CC's view is confusing. Economic theory assesses the relative bargaining strength of parties in a negotiation by reference to the drivers of that bargaining strength, in particular the negotiating parties' outside options[39]. The CC here simply says that the pattern of prices is *suggestive* of bargaining power eroding after a switch.

3.3.4 The CC provides more detail on its thinking in the following paragraph.

"As the tender process is not undertaken frequently, outside of the tender process a company only has an imperfect understanding of the costs on the one hand and the potential gains on the other hand from tendering and switching. This information asymmetry when compared to audit firms (which are involved in tenders much more frequently), might result in the companies losing their bargaining power over the duration of an engagement."[40]

3.3.5 Here the CC makes two distinct points. The first is that, following a switch, audit firms will be progressively better informed (than the companies they audit) on the costs and benefits that these companies will derive from switching. The second is that this "information asymmetry" might result in companies losing their bargaining power over the course of the engagement. We discuss these points in turn.

3.3.6 We have not seen any evidence to support the existence of such an information asymmetry and cannot see what evidence the CC could adduce to support its assertion. In fact, the evidence clearly points to companies being better informed than audit firms on the benefits they will derive from switching and on the costs they will incur. First, costs and benefits from switching are specific to a particular company (due to each audit being bespoke) and therefore participating in a tender for a different firm simply provides very limited relevant information. The CC's reference to the number of tenders

[39] A view we previously stated in paragraphs 3.10.3 to 3.10.9 of our response to the CC's Provisional Findings
[40] Paragraph 91 of the Working Paper.

in which audit firms participate is therefore irrelevant – far more relevant is the substantial evidence that audits are bespoke.

3.3.7 Second, and crucially, audit firms have little or no information about the size of any switching costs that companies face, especially in comparison to the information companies have *available* in this regard. This is because the costs and benefits to a company from switching depend on factors that are visible to companies but not (or much more imperfectly) to audit firms. These include:

a) information on the amount of management time and the opportunity cost of that time that will be required to get the new audit firm up to speed in the first years of the;

b) information on the value of the incumbent audit firm's services compared to those of competitors (which companies regularly test and the ACs are aware of given contacts at other companies, as we set out in numerous submissions including in particular Annex 2 of our response to the CC's working paper on the Nature and Strength of Competition); and

c) audit information on the management time that the company will devote to the tender process and the opportunity cost of that time.

3.3.8 Conversely, there are no factors determining the costs and benefits of switching for a given company that audit firms could be seen to have a better handle on than the companies concerned. We also set out in our response to the Provisional Findings that audit firms face substantial uncertainty in their negotiations with companies[41]. The CC has still continued to take into account this aspect of the bargaining relationship.

3.3.9 Third, even if after a switch has occurred there was a reduction in companies' information on the costs and benefits of switching, the CC's interpretation of the pattern in revenues rests on the informational value of a tender process decreasing from as early as the first year and depleting completely (ie returning to pre-tender levels) in the space of only three years. However, the CC provides no explanation for why this would be the case. Specifically, the CC does not explain what information is gathered during the tender process that has a particular value in this sense, and why or how this information becomes outdated in the short span of three years. There is no empirical evidence to support this claim.

[41] Paragraphs 3.10.6 to 3.10.8 of our response to the Provisional Findings.

3.3.10 The discussion in paragraphs 3.3.6 to 3.3.9 clearly shows that the premise of the CC's argument (the existence of an information asymmetry) is simply incorrect. However, as set out in the previous paragraph, even if that premise was correct, the CC has not explained why its conclusion would follow. In other words, even if such an information asymmetry existed (which it does not) it is not clear why it would follow that companies' bargaining power would erode as a result. In order for its conclusion to hold, the CC would have to explain in what way the information affects the drivers of bargaining strength of the parties, namely their outside options and through what mechanism any information asymmetry results in worse outcomes (possibly higher fees) starting from the first year.

3.4 Conclusion on the CC's 'erosion of bargaining power' hypothesis

3.4.1 In sum, the CC is in no position to conclude that:

"The observed price progression is consistent with an erosion of company bargaining power post-switch or tender as firms increase audit fees to pre-tender levels."[42]

3.4.2 Specifically, the CC is in no position make any inferences about the competitiveness of an audit firm's offer from the pattern it observes in total audit fees. The CC's explanation for why companies' bargaining power might be eroded is not grounded in economic theory, is inconsistent with evidence available to the CC and the CC offers no evidence to support its view.

4 Our explanation for the pattern in revenues that the CC observes

4.1 As discussed above, we disagree that the evidence points to a pattern of prices decreasing after switching and then increasing (to pre-tender levels). The pattern that the CC observes for some companies is instead a pattern with respect to revenues or total audit fees.

4.2 In the previous section we set out our view that the CC cannot conclude that the pattern in revenues that it observes is 'most plausibly' explained by companies losing

[42] Paragraph 92 of the Working Paper.

bargaining power over the course of an engagement. In this section we set out what in our view does drive the pattern in revenues that the CC observes.

4.3 In the first instance, it is important to note that companies are different and audits are bespoke. Therefore it is unrealistic to expect a single explanation for a pattern that occurs in a number of cases that are necessarily different from one another. In fact, we believe that there are different factors determining why total audit fees may decrease following a change in audit firm, before increasing again. All of these factors may be relevant for a single company and, of course, may well vary in their relevance and importance for different company-auditor relationships. However they are in our view all likely to be relevant at some point and, importantly, they are all consistent with a competitive market.

4.4 The first of these factors is changes in audit scope. The scope of the work may decrease following a switch (compared to the work carried out by the previous audit firm), before rising again. There are at least two possible reasons for this. First, a company may initially agree to a narrower scope (for example limiting the amount of value-added services or audit-related services) then, as the audit firm demonstrates its skills and expertise, the company may decide to expand the scope of its work it will agree to increase the scope of the work. Second, it is possible for firms to anticipate that less work is needed to audit a company than is actually the case. This may be due to ambitious assumptions around efficiency during the course of the tender or incorrect information of existing controls set out by the company during the tender process[43]. In particular, in our experience it is often the case that during a tender companies will commit to increasing the support for the audit process themselves in order to reduce the amount of work required by the audit firm. If the company cannot deliver on those commitments in practice, then in our experience fees are often increased to compensate[44].

[43] The CC considers whether the price pattern can be explained by audit firms that win tenders having under-estimated the scope of the audit (and therefore reduced the price). It concludes that this is not a plausible explanation for the price effect it observes. We disagree with the CC's reasoning in this regard, and we set this out in more detail in Annex 2 to this response.

[44] In some instances we will specify this explicitly in our tender documents but in any event we have the following standard clause which is invoked if legitimate expectations are clearly not met: "If the timetable

4.5 Of the case studies that discuss the drivers of change of audit fees, almost all attribute this to changes in audit scope[45]. This provides strong support for this explanation for the pattern in revenues the CC observes, compared to the CC's own explanation of companies losing bargaining power over time.

4.6 The second, and related, factor is that the value of the audit services provided by the audit firm increases as time progresses due to the investment that the audit firm (and the company) make in understanding the business and establishing good working arrangements. As the value of services increases, this can lead to both more work being done and a higher compensation for it being accorded to the audit firm. Both of these factors affect the size of the total audit fees. This is entirely consistent with companies also achieving as good or better value for money, despite the higher total fee that they pay, and therefore with a competitive market.

4.7 A third factor is that audit firms may look to set as low a price as possible in order to encourage the company to switch despite the likely costs it will have to incur in the first years as the new auditor gets up to speed.[46] We discuss the CC's views on alternative explanations for the pattern in revenues it observes in Annex 2 of this response.

5 Distinguishing between the explanations for the pricing effect

5.1 We set out in section 3 why in our view the CC is in no position to conclude that the pattern in revenue that it observes is explained by companies losing bargaining power over the life of an engagement. Further, in section 4 we set out our views on the real

---

materially slips because of delays in making information or documentation or personnel available to us, we may charge additional fees for any work performed outside of the original timetable on the basis of our agreed hourly rates in force when the relevant work is done." We note that case study B also refers explicitly to us agreeing to reduce our fee on the condition that the company provide further support to the audit process.

[45] Company A case study, paragraphs 41, 42 and 104 – 107; Company B case study, paragraph 50; Company C case study, paragraphs 23d), 71 and 104; Company D case study, paragraphs 35 and 70; Company E case study, paragraphs 28 – 30 and 96; Company H case study, paragraphs 37, 38 and 111; Company I case study, paragraph 27; Company J case study, paragraph 50; Company M case study, paragraph 10; Company R case study, paragraph 40; Company S case study, paragraph 13; Company T case study, paragraph 14; and Company V case study, paragraphs 1, 14 and 15.

[46] The CC largely dismisses the concept that audit firms might offer a low bid to encourage a company to switch audit firm. However, the CC's rationale for that dismissal is not sound, and we set out our reasons for that view in Annex 2 to this note. In fact, in our view the CC's reasons for rejecting an explanation of the price pattern associated with audit firms and companies underestimating audit scope are flawed, and we discuss our view in more detail in Annex 2

drivers of the pattern in revenues that the CC observes, all of which are consistent with companies having effective bargaining power and achieving competitive outcomes. In our view the CC has provided no sound arguments for dismissing these explanations and preferring its view.

5.2 The CC notes *that "in order for the parties' explanations and the observed price pattern to be compatible with a competitive outcome, we would not expect first-year audits to be profitable"*[47]. However, the CC has only established that its *"available evidence on profitability does not suggest that even in the first year firms do not cover direct costs"*[48]. As we noted in our response to the CC's putback on this Working Paper, as well as in our response to the Provisional Findings[49], this implies that indirect costs and partner time are not being taken into account in the measures of cost that the CC is considering.

5.3 An analysis based only on direct costs, and which does not cover partner remuneration cannot allow the CC to make any conclusions about the profitability of audit engagements. The CC goes on to suggest that the *"first year audit fee is sustainable"*[50]. If first year audit fees are only sufficient to cover direct costs, then they are not sustainable, precisely because they do not allow audit firms either to remunerate their partners properly or to make necessary investments in quality.

5.4 As a result, and contrary to the CC's arguments, it has not provided evidence on profitability in the Working Paper to support its conclusion that the pattern in revenues is consistent with companies losing bargaining power over the course of an engagement.

5.5 In fact, the CC recognises in the Working Paper that there is a competitive constraint on audit firms throughout the life of an engagement. Specifically, it notes that:

"The ability to raise prices after a switch will be limited. A firm would not be able to raise prices beyond the point where the company, even despite the uncertainty

[47] Paragraph 100 of the Working Paper.
[48] Paragraph 103 of the Working Paper.
[49] KPMG response to CC putback, submitted 13 June 2013; paragraph 2.3.2.15 of our response to the Provisional Findings.
[50] Paragraph 104 of the Working Paper.

surrounding it, would feel that the benefits to tendering or switching exceeded the expected costs."[51]

5.6 We agree. Given this, the relevant question for determining whether or not an AEC exists in the supply of statutory audit services is therefore whether audit firms can increase prices beyond (or reduce quality below) competitive levels. The CC has provided no evidence to show that they can. Indeed, the only reliable evidence available to the CC to assess whether or not audit firms' offers are competitive, is our analysis of profitability of our audit function as a whole, as this takes into account indirect costs and the costs of partner time.

5.7 The CC has not explained why that analysis is less informative on profitability than considering direct costs on individual engagements. In fact, our profitability analysis shows that we do not make excess profits and therefore that we are not able to increase prices beyond or reduce quality below levels which are competitive.

5.8 As a result, the CC cannot conclude that companies losing bargaining power over the life of an engagement is the most plausible explanation for the pattern in revenues it observes. Instead, our explanations for the pattern in revenues the CC observes, which are consistent with competitive outcomes, are at least as plausible – and in fact, given the evidence in our profitability analysis and the failure of the CC to find any evidence of companies achieving a change in the audit offer following a tender with no switch, more likely.

6 Conclusions

6.1.1 Overall therefore, we disagree with the CC's conclusion that the pattern in revenues it observes is "most plausibly" explained by companies losing bargaining power, rather than other explanations that are consistent with companies achieving competitive outcomes.

6.1.2 To conclude, we set out our specific answers to the questions the CC posed in its Working Paper.

[51] Paragraph 94 of the Working Paper.

a) In your view, what is the most plausible explanation for the observed relative price development observed for companies that tendered or switched?

In our experience, any reduction in audit revenue after a change in audit firm, followed by an increase to pre-switching levels is explained by a number of factors, all of which are consistent with competitive outcomes. We set these out in section 4 of our response.

The CC has no evidence to show that these are any less plausible than its own preferred explanation of companies losing bargaining power over the course of an engagement. Indeed, we set out in our response why this hypothetical explanation is fundamentally flawed and not drawn from a sound evidence base. Further, the CC's explanation for distinguishing between its own and other competing explanations for the pattern in revenues is based on statements about profitability that it is not in a position to make. In particular, it is not able to conclude that first year audit fees are sustainable as it has not taken into account indirect costs or the costs of partner time. The only reliable evidence available to the CC on profitability shows that we do not make excessive profits, which suggests that the CC's bargaining power hypothesis is incorrect.

b) 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?

As we set out above, the explanations that we put forward for the pattern in revenues are consistent with companies having strong bargaining power outside of a tender. Given that the CC has no evidence that there is any change in the outcomes companies achieve following a tender with no switch, we fail to see how the CC can conclude that there is any evidence in this Working Paper to show that companies' bargaining position is eroded outside of a tender event. The available evidence shows that the explanations we put forward are more plausible than the CC's own hypothesis.

c) In your experience, over the period from 2000 to 2010, to what extent were first year audit fees unsustainable? Please provide supporting evidence if available.

As we have set out here and in previous submissions[52]*, to fully understand engagement profitability the CC would require an allocation of indirect and full partner costs to engagements. The CC has not been able to do this due to limitations in the data. However, the evidence on profitability shows that we do not make excess profits overall once all the costs are properly taken into account. The CC has not taken account of that evidence and we fail to see how it can make any conclusions about the profitability of first year audit fees without doing so.*

d) To what extent do you consider that a tender situation in the market for FTSE350 audits is subject to competition 'for the market'? Please provide supporting evidence if available.

The CC defines competition for the market as "firms compet[ing] to obtain an engagement, in which they are able to extract additional rents due to reluctance of companies to tender or switch"[53]*. We are not aware of any other source that defines 'competition for the market' in this way. In particular, we are not aware of any definition which equates 'competition for the*

[52] For example, paragraphs 2.3.2.15 to 2.3.2.16 of our response to the Provisional Findings.
[53] Paragraph 101 of the Working Paper.

market' with a situation where firms are able to extract additional rents due to their customers' inability to switch. In any case, we do not think that this is a good description of competition in relation to statutory audit services for FTSE350 companies. As we set out in response to parts a) to c) above, and in numerous other submissions, there is no evidence that audit firms make excessive profits and therefore that they "extract additional rents".

A more standard definition of 'competition for the market' is a situation where a number of firms compete, for example through a tender process, to serve the whole market (often for a defined period of time). Once a firm has won that 'competition' it then does not face further competition in order to continue to serve the customers in the relevant market. This definition of 'competition for the market' is also a poor description of competition in relation to the supply of statutory audit services, for two key reasons.

First, the CC has defined the relevant antitrust market as 'the supply of statutory audit services to FTSE350 companies'. Audit firms do not compete to supply all of this relevant market at one time, and so we fail to see how the term 'competition for the market' can apply to the market for statutory audit services to FTSE350 companies.

Second, once appointed, audit firms continue to face competitive pressure through companies' bargaining power and through companies being approached by rival firms. We provided ample evidence of this in our response to the CC's working paper on the Nature and Strength of Competition. There is therefore no sense in which once a firm has won a competition for an engagement it then no longer faces any competitive pressure.

ANNEX 1: More detailed comments on the descriptive statistics

1 The CC sets out two descriptive statistics which are the subject of its discussion and analysis in this Working Paper:

- Among 55 direct FTSE350 switches the median price decrease was 17 per cent in the year after the switch, with 78 per cent of companies achieving a fee decrease. However, the median price decrease disappeared over time[54]; and
- Among 29 tenders where no change of audit firm occurred, the median price change was a two per cent increase in the year following a tender where there was no switch[55].

2 We have discussed the key limitations of these descriptive statistics in the main text of this response, and what this implies for the CC's conclusions. In this annex we set out some further, more detailed concerns on the CC's use of these descriptive statistics.

No controls for other relevant factors that influence audit fees

3 Broadly speaking, we set out our concerns about the CC's failure to control for audit costs, quality and scope in the main text of this response. In this annex we discuss statements that the CC makes in relation to these descriptive statistics and whether or not they adequately control for audit scope.

4 In particular, the CC argues that to some extent the descriptive statistics aimed to control for changes in audit scope by isolating only "direct switches"[56]. This amounts to excluding those switches that are related to merger activity from the sample. As merger activity is by no means the only explanation for changes in audit scope, limiting the analysis to direct switches is not sufficient to control for changes in audit scope. Indeed, the scope of an audit may change as a result of a number of other factors, such as organic growth, the introduction of a new processing centre, the expansion into new overseas territories. In addition, audit scope may increase because a company asks the audit firm to do more work than that which is required just to give the audit opinion, for example more value-added services or more audit-related services.

[54] Paragraph 7 of the Working Paper.
[55] Paragraph 8 of the Working Paper.
[56] Paragraph 13 of the Working Paper.

5 The CC recognises the limitations in its analysis as a result of not controlling for other relevant factors that affect audit fees. For example, the CC notes that "scope could have changed significantly over time, even if there was no merger activity"[57] and further that "numerous other factors" might affect the level of audit fees, and that "a more extensive analysis is required that controls for these other factors" [58]. In addition, the CC finds that "there were substantial changes in some of these factors [including audit scope] quite soon after tendering or switching"[59] for a number of companies, which further highlights the importance for controlling for scope.

The use of the median as a descriptive statistic

6 The CC notes the concerns we raised in our response to the Provisional Findings over the large range in the magnitude and direction of the change in price following a change in audit firm. In response to this concern, the CC argues that:

"the measure we [the CC] focused on, the median, is much less affected by outliers. This means that there might be some instances where other factors significantly affected fees, if there are sufficient observations where this was not the case, the median fee change is informative regarding the 'typical' price development after switching."[60]

7 We disagree with the CC's view set out above that the median is informative about the 'typical' price change after a change in audit firm. The median simply indicates the point in the distribution above which half of the observations lie and below which lie the other half. Whilst we agree that it is less likely to be affected by outliers, compared to an average, this does not mean it's a more reliable indicator of the 'typical' price change. Rather, it's precisely because the median is not supposed to provide information about what is typical, or average, in the market that it is less affected by outliers. There is a trade-off between a statistic providing more information about the average affects in a market and a statistic being less affected by outliers.

[57] Paragraph 16 of the Working Paper.
[58] Paragraph 15 of the Working Paper.
[59] Paragraph 96 of the Working Paper.
[60] Paragraph 10 of the Working Paper.

8 This is illustrated by the CC's figure 18 in Appendix 5 to the Provisional Findings, which shows that if all companies that switched are aggregated then fees in total fall in the third and fourth years after a switch. This shows that the pattern of revenues/ total fees increasing from the second year onward is unreliable.

9 The CC's statement that the median is informative of typical price changes relies on there being sufficient observations in the sample where other factors do not significantly affect fees. Setting aside our more general concerns about the use of the median to infer the 'typical' price change (as discussed in the previous paragraph), we fail in any case to see how the CC can be confident that there are sufficient observations in the sample where other factors do not significantly affect fees. The CC has not controlled for any other factors that affect audit fees in this analysis, including audit scope and quality. Further, the CC gives no indication as to how many observations are deemed to be "sufficient" and no view on how many cases in this sample meet these criteria.

10 Overall therefore, we think the CC is incorrect to conclude that the median statistic can provide any information about the 'typical' change in price after changing audit firm.

Inconsistent approach to sample sizes

11 As set out in paragraph 1, the CC observes 55 direct and 29 tenders with no switch. The CC appears to place no or limited weight on the descriptive statistics associated with the latter sample, while continuing to place at least some weight on the descriptive statistics associated with the former.

12 In particular, for the 29 observations of a tender with no change in audit firm, the CC observed that the median price change was a two per cent increase. The CC notes that one explanation for this latter descriptive statistic is that "in these cases the incumbent's offer was competitive, and during the tender the company concluded that there might be no clear gain from switching"[61].

13 The CC's basis for rejecting this descriptive statistic (and, therefore, the potentially pro-competitive explanation for it) is that "the sample is much smaller than that of direct

[61] Paragraph 8 of the Working Paper.

switches (55 vs 29)"[62]. In other words, the CC appears to conclude that it can place weight on descriptive statistics based on a sample of 55 observations but not on descriptive statistics based on a sample of 29 companies. We are not aware of any statistical basis for such a distinction.

14 Further, for later years after a change in audit firm, the sample of direct switches decreases (to 31 and 25 observations for the third and fourth years after a change in audit firm respectively). The sample size of direct switches in these years is comparable to the number of tenders without a switch that the CC observes. It is therefore inconsistent to place weight on observations about direct switches in the third and fourth years after a switch, while simultaneously placing less weight on observations of tenders without a switch.

15 Overall, therefore, the CC is inconsistent in its treatment of evidence and sample sizes.

No statistical tests

16 In presenting its descriptive statistics, the CC provides no statistical tests to establish the robustness and significance of the results[63]. This is despite us noting the importance of presenting statistical robustness tests in our response to the Provisional Findings[64].

17 This failure to present statistical robustness and significance tests further adds to the weakness in the descriptive statistics as a piece of evidence.

[62] Paragraph 8 of the Working Paper.
[63] For example, paragraph 10 of the Working Paper.
[64] REFERENCE

ANNEX 2: Our views on the CC's dismissal of discounting and audit scope changes as an explanation for the pattern in revenues.

"Discounting"

1 The CC considers whether the price pattern it observes "amounts to a discount offered by the firm that wins the tender to compensate companies for their switching costs"[65]. However, the CC provisionally concludes that, although it "cannot exclude that there have been cases where a discount was given", that this is not the most plausible explanation of the price pattern it observes.

2 The term 'discount' is in our view misleading. That suggests that there is some kind of list price or established price against which audit fees are reduced. That is not accurate. Instead audit firms put together an overall offering that is as competitive as possible to encourage companies to change audit firm. However, setting aside that concern, in this section we discuss why in our view the CC is incorrect to dismiss the possibility that the pattern in revenues is explained, at least in some cases, by audit firms seeking to encourage companies to change audit firm.

3 The CC offers a number of reasons for its view throughout the Working Paper. We disagree that any of these reasons are a sound basis for the CC's conclusion. In the rest of this section of this annex we set out the CC's reasons alongside our views on why this reasoning is flawed.

4 First, the CC notes that price is not the only relevant factor in a decision to change audit firm, and other non-financial benefits such as quality may be important. As a result, it argues that audit firms may have no incentive to offer a discount, as a low audit fee might signal poor quality[66]. While we agree that non-financial benefits are an important factor for companies when selecting an audit firm, the CC's reasoning that as a result companies may have no incentive to offer companies a discount to encourage them to switch is flawed. While a lower price might, all else being equal, be associated with a

[65] Paragraph 70a) of the Working Paper.
[66] Paragraph 77 of the Working Paper.

lower quality, this does not imply that the CC relies on price in order to judge quality in a tender.

5 In fact, a non-incumbent audit firm might be of lower quality in relation to certain aspects than the incumbent in the first year(s) of an audit. As we suggested in our response to the CC's Provisional Findings, audit firms might offer a lower price to encourage a company two switch despite this initial reduction in quality. However, this does not imply that a company is not uses the price to judge the quality of an audit firm – the company is well aware that in the first year(s) of an audit engagement a new firm will be associated with some aspects of lower quality.

6 Further, this does not imply that as a whole or in the longer term, a new audit firm would not be able to offer real quality improvements, which might be one important reason why a company chooses to change audit firm. Therefore, the CC's suggestion that price is used as a signal of quality, and that this would disincentivise audit firms from offering 'discounts' during a tender fails to understand fundamental aspects of the audit product and the tender process.

7 In addition, the CC made no mention of companies needing to rely on price as a signal of quality during tender processes in its Provisional Findings. Indeed, the CC concluded that tender processes generally worked well and delivered competitive outcomes[67].

8 Second, the CC notes that companies do not recognise the concept of a 'discount', as it is not presented as such by audit firms during the tender process[68]. We discussed this line of argument in our response to the CC's follow-up questions after our Response Hearing[69]. In particular, we noted that during the tender process audit firms make an overall offer which combines quality, service and price at a competitive level to encourage potential clients to switch audit firms. The audit firm will not necessarily identify those specific components of the audit fee that represent a discount, and so companies may not identify a reduced audit fee as a 'discount' as such. However, this is entirely consistent with the audit fee constituting a discount on the previous year's audit

[67] Paragraph 9.255 of the Provisional Findings.
[68] Paragraph 80 of the Working Paper.
[69] Paragraph 2.7 of our response to the CC's follow-up questions from our Response Hearing.

fee and a low fee being proposed in order to encourage a change of audit firm. The CC has not addressed this or set out why it is important that companies to recognise certain aspects of the price offer as a discount in order for this to constitute a plausible explanation for the price pattern the CC observes.

9 Third, the CC suggests that audit firms face uncertainty over the lifetime value of an audit engagement, due to imperfect information on a range of factors including audit scope, duration and the provision of non-audit services, complicating the trade-off faced by audit firms when bidding to supply audit services. The CC concludes that this uncertainty makes it less plausible that an audit firm will offer companies an up-front discount to encourage a change in audit firm[70]. The CC has not supported its view with a coherent explanation of relevant economic theory, setting out how uncertainty over the lifetime value of the engagement would be expected to influence the pricing behaviour of audit firms. The CC has also failed to provide any supporting evidence, demonstrating that uncertainty reduces the likelihood that a discount is offered by audit firms. We therefore fail to see how the CC can reasonably conclude that audit firms will not give up-front discounts when faced with uncertainty over the lifetime value of an engagement.

10 Finally, the CC argues that for the price pattern to be explained by companies offering discounts to encourage companies to switch and the observed pattern being compatible with a competitive outcome, it would not expect first year audits to be profitable[71]. It goes on to state that its evidence suggests that audit firms are able to cover direct costs, even in the first year of an audit[72]. The CC cannot adduce any evidence on profitability to distinguish to dismiss any one explanation for the pattern in revenues from another, as we set out in the main text of this response.

[70] Paragraph 106 of the Working Paper.
[71] Paragraph 100 of the Working Paper.
[72] Paragraphs 103 of the Working Paper.

Underestimating audit scope

11 The CC dismisses as an explanation of the pattern in revenues the possibility that the *"the firms that underestimate costs win the tender, and thereby suffer a 'winner's curse' that needs to be rectified in the years following the switch"*[73].

12 It is important that the CC recognises the inherent uncertainty on the part of an audit firm about a company's detailed control environment. In some cases, audit firms do underestimate a company's control environment and discover that they need to increase the scope of the audit (and the fees) as its understanding of the control environment develops. The CC argues that this is inconsistent with companies having bargaining power, asserting that "companies would be reluctant to accept fee increases resulting from a firm's estimation error". We disagree that companies with substantial bargaining power will not accept fee increases that are associated with increases in the audit scope. The CC has not provided any evidence for its view and has not set out any coherent explanation, grounded in economic theory, as to why the observed outcome cannot be consistent with companies having bargaining power.

13 Further, the CC dismisses the possibility that company management might provide inaccurate information in tender specifications, stating that *"it is not clear to us why on average companies would be unable to provide correct assumptions in the tender proceedings"*[74]. We think this is an over-simplified view. In some instances a company will make certain commitments during a tender that will limit the work required on the part of an audit firm (and thereby secure a lower audit fee in the first year). If the company is no longer able to deliver on those commitments, the audit firm is again likely to have to do more work, and therefore increase the fee. This is one explanation, among many others, for the pattern in revenues that is observed following a change in audit firm, and it is perfectly consistent with companies having strong bargaining power and achieving competitive outcomes.

14 The CC asserts that a different price progression would be observed if company management provided inaccurate information in tender specifications. On the one hand,

[73] Paragraph 84 of the Working Paper.
[74] Paragraph 87 of the Working Paper.

the CC argues that if audit firms can renegotiate, that it would not expect to see a discount in the first year as audit firms include a price premium to cover the risk that companies have underestimated audit scope. The CC has not provided any supporting evidence or cited any economic theory to explain why this would be the case.

15 The CC goes on to claim that if audit firms were in a position to renegotiate the audit fee, they would do so immediately, such that the additional work required to perform the audit is reflected in the first year audit fee. In our view this claim is flawed and inconsistent with our experience. In particular, the CC incorrectly assumes that audit firms develop an immediate understanding of the control environment, and are able to quickly detect any assumptions made by company management which are too optimistic. In reality, it takes time for the audit firm to develop a full understanding of the control environment, which is why there is an efficiency benefit associated with retaining the incumbent audit firm[75].

16 Finally, we again note the CC's view that for a change in audit scope to provide a plausible explanation of the pattern in revenues, audits would have to be unprofitable in the first year[76]. As set out in paragraph 10 of this annex, the CC cannot make any judgements about whether first year audits are profitable overall. The CC's failure to engage with our profitability analysis means it is not able to make any conclusions about profitability, as we set out in the main body of this response.

[75] Which we have discussed in several other submissions, including for example paragraph 231 of our Main Submission.
[76] Paragraph 100 of the Working Paper.