STATUTORY AUDIT SERVICES MARKET INVESTIGATION

ERNST & YOUNG LLP - RESPONSE TO REVIEW OF EVIDENCE ON THE PRICE EFFECTS OF SWITCHING WORKING PAPER

1. Introduction

1.1 This document is the response of Ernst & Young LLP ("EY") to the Competition Commission's Working Paper *Statutory Audit Service Merger Inquiry: Review of evidence on the price effects of switching* (the "Working Paper").

1.2 In the Working Paper, the CC seeks views on three possible explanations for an observable pricing pattern – i.e., that following a direct switch, companies tend to obtain a price decrease in the first year, but that prices increase in subsequent years.

1.3 In this response, we express EY's views on a number of the issues raised, and in doing so express the following key concerns relating to the analysis contained in the Working Paper:

(a) The CC has failed to fully consider and investigate the potential explanations for the observed pattern. In particular, the CC's cursory dismissal of Explanation B as an explanation as to why – in <u>some</u> cases – prices increase in subsequent years, exemplifies a failure to take the reality of commercial practice into account.

(b) That the CC has engaged in an unjustified leap of logic to reach the conclusion that the observed pattern provides evidence that companies are paying excessive prices. The analysis contained in the Working Paper does not provide an adequate basis for an assessment of whether prices are excessive.

1.4 The unsatisfactory approach adopted in the Working Paper is further exemplified by paragraph 58 of the Working Paper where, although the CC notes that there is "*no single description of a well-functioning market, and this includes price developments after tendering or switching*", it nevertheless states that the Working Paper reviews "*the observed outcomes in the context of the characteristics of the market, and evaluate whether we think they are compatible with a well-functioning market*". By seeking to determine whether the observed pattern is consistent with a well-functioning market, despite recognising that there are multiple descriptions of a well-functioning market, the Working Paper adopts a wholly unsatisfactory, flawed and one-sided analysis.

2. Failure to fully investigate potential explanations

2.1 The three alternative explanations for the observable pattern are identified at paragraph 2 of the Working Paper as follows:

(a) <u>Explanation A</u>. Firms offer unsustainable discounts in order to encourage companies to switch auditor. The price pattern demonstrates audit fees returning to normal, competitive levels. This is dismissed by the CC as "*not a plausible explanation*".[1]

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[1] Working Paper, paragraph 77.

(b) Explanation B. Audit scope is underestimated by firms bidding for an engagement and, once engaged, firms may have to undertake more work than they predicted, necessitating increased fees. Again, this is dismissed by the CC as being "*not… very plausible*".[2]

(c) Explanation C. Incumbent auditors have some power over price, and so pre-tender prices are excessive. The tender reveals the competitive price (hence the price drop), but the new incumbent also enjoys some power over price, and so is able to increase prices to pre-tender levels over two to three years. This is the position that the CC adopted in the PFs, and appears to be the only explanation that the CC is willing to countenance.

2.2 The CC's preferred explanation is clear, and the analysis contained in the Working Paper reveals a "confirmation bias" in this regard. For example, evidence that supports Explanation C is relied upon, irrespective of the recognised flaws in that evidence. By contrast, Explanations A and B are dismissed as being not "plausible" without any reasoned substantive analysis or effort on the part of the CC to obtain appropriate evidence.

2.3 For the reasons set out below, the observed pattern does not provide a sound basis for a conclusion that price levels are excessive. However, the Working Paper also gives rise to unjustified innuendos about the way in which audit firms negotiate audit fees following the first year of an audit engagement. We therefore address the CC's approach to the potential explanations, and in particular the failure of the CC to fully consider and investigate potential explanations for the observed pattern, to the extent that this reveals a one-sided approach which needs to be rectified before the CC's final report. This is clearly demonstrated in relation to the CC's approach to Explanation B.

2.4 At paragraphs 82 *et seq* of the Working Paper, the CC refers to EY's view that one of the reasons (but not the only reason) why prices reduce immediately following a tender and subsequently increase is that non-incumbent firms often have an incomplete knowledge of the adequacy of the control environment. In those instances where such problems are identified, increases in the audit fees are negotiated (if necessary) for subsequent years once the reality of the control environment becomes apparent.

2.5 To be clear, EY's view is that, in part, however well run and thorough a procurement exercise, and however diligent the bidders, there may be occasions where a bidder takes a mistakenly optimistic view of the control environment, and as a result the price is insufficient to deliver the service that, in practice, is found to be necessary or becomes apparent is necessary over time (particularly during the first year of the relationship). Where such problems arise, that deficiency is made good over time, so that (for example) prices rise over the next two years. As we made clear at the hearing, this is common in other types of multi-year complex service contracts, such as certain types of outsourcing. The asymmetry of information between the incumbent and non-incumbent bidders, and the impact this can have on an audit firm's view on the control environment (and therefore its pricing proposals), is one of the reasons why EY supports open-book tenders.

2.6 However, the Working Paper dismisses this point out of hand – describing it as "*not… very plausible*". However, the CC has reached this view without any substantive analysis or investigation. By way of example, one of the reasons given for dismissing this point it that,

[2] Working Paper, paragraph 84.

according to the CC, if the position put forward by EY were correct audit firms "*would likely price in a premium to cover the risk of an under-estimated scope*".[3] However, as was made clear to the CC at the hearing, this is not how the issue is dealt with in practice:

(a) ([✂])

(b) ([✂])

(c) Even if the audit fee is not renegotiated in the first year of the audit for commercial reasons (or because it is only at the end of the first year that EY can fully take stock of the situation), if a problem has arisen EY will seek to renegotiate the audit fee in subsequent years as EY gains a fuller understanding of those matters that have an impact on the work necessary to conduct an audit of appropriate quality. Not all such negotiations are successful.

(d) As stated, there is nothing unusual about such an arrangement. This type of arrangement is common in other types of multi-year complex service contracts, including certain types of outsourcing. It would be instructive for the CC to consider such arrangements more widely, in order to satisfy itself that they represent standard commercial practice, before dismissing this point out of hand.

2.7 It may be that, as a matter of theory, this should not happen and audit firms should add a premium into their original tenders. However, the practical reality is that it does happen. As on other occasions where real world issues have been brought to the CC's attention, EY would invite the CC to investigate this issue with an open mind, rather than dismiss it out of hand because it does not accord with the CC's preferred explanation. Explanation B is just one explanation as to why, in some cases, the total audit fee (which may relate in part to non-UK activity) rises after the first year. Without fully considering all such possible explanations, which may relate to non-UK activity, the CC cannot reach any safe conclusions in this context.

2.8 However we would note that:

(a) Even if in relation to multi-year complex service contracts the observed pattern reflects a degree of bargaining power shifting back to the supplier, for the reasons given below it does not follow that the customer is paying excessive prices, nor does it follow that the market is not competitive. The CC has not put forward any analysis or evidence to support such a position.

(b) The price analysis conducted by the CC is limited to the first three or four years of an audit relationship. Given that, as the CC has observed, audit relationships last for longer than this, the CC's analysis is clearly deficient in this respect.

3. The analysis contained in the Working Paper does not provide an adequate basis for an assessment of whether prices are excessive

3.1 It is common ground that, when a company switches audit firm following a tender, the price falls in the first year but rises to some extent in subsequent years. The explanations, interpretations and magnitudes of this observable pattern are debatable. However, such

[3] Working Paper, paragraph 88.

debates are not relevant for present purposes, and neither are the questions posed by the CC at paragraph 108 of the Working Paper.

3.2 The CC states that one of the aims of the Working Paper is to establish "*what the observed patterns imply for competition in the market... in particular, which of the explanations set out in paragraph 2 appears to be most plausible*".[4] However, it is clear from the Working Paper that the CC considers that the observed pattern provides evidence for a conclusion that the market is sub-competitive. Although the CC considers that EY does not understand the subtleties of the CC's views, it remains the case that the CC's views, as clearly expressed in the Working Paper, are that "*[t]here is evidence that companies have achieved reductions in fees by switching. That this is the case suggests that companies that have not tendered or switched for some time <u>may be paying excessive prices</u>*" (emphasis added).[5]

3.3 In fact, the observed pattern of pricing tells the CC precisely nothing about whether prices are below, at or above the competitive level (not least because of the short-term analysis conducted by the CC). Nothing whatsoever follows from the pattern itself: only the relationship between price and cost is relevant to the question of whether price levels are above the competitive level. Price levels alone do not provide an indication as to the extent or exercise of bargaining power. As a result, EY regards much of the discussion set out in the Working Paper as being of limited relevance to the fundamental question of whether the evidence suggests that fees are excessive, or whether the audit market is or is not competitive. Rather, the question comes down to whether average fees, over the life cycle of a project, and aggregated over all actual and potential projects in an audit firm's portfolio, do or do not yield excess returns judged against all capital employed.[6]

3.4 The profitability of a project varies over its life cycle. This may be a result of revenue increases over the life cycle, or because (for example) the costs in the first year of an audit engagement may be higher. Since any audit firm has, at any snapshot in time, multiple projects at different stages of the life cycle, the only reliable way of testing whether prices are excessive is to establish whether the revenues generate excess returns for the firm in aggregate over a period of years. That is almost precisely the exercise the CC attempted to undertake previously, and where the CC was unable to demonstrate excess profitability, on any reliable measure. As the CC stated in its Provisional Findings "*we have not found good evidence regarding the overall profitability of the Big 4 firms*".[7] Indeed, the CC was only able to produce high ROCE estimates by focussing on "profits per partner" and in doing so spuriously omitting the vast part of capital employed.[8]

4. Sustainability of the price in the first year after switching

4.1 At paragraph 68 of the Working Paper, the CC identifies two questions:

(a) whether the price in the first year after switching is a sustainable competitive price or not; and

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4 Working Paper, paragraph 3.

5 Working Paper, paragraph 99.

6 In many markets the fact that the price, whilst on average equal to cost, may - in different periods - be above or below cost, may have implications for welfare, which depend on demand elasticities. However, in the market for statutory audit, which essentially has unit inelastic market demand, all that matters is whether the averaged price equals cost.

7 Provisional Findings, paragraph 7.91.

8 See, for example, EY's Preliminary Observations on the profitability follow-up questions of 23 October 2012.

(b) whether the relative price progression after the first year is consistent with a competitive market.

4.2 In relation to (b), for the reasons set out above, the observed pattern is entirely consistent with a competitive market.

4.3 In relation to (a), at paragraph 100 of the Working Paper the CC notes that "*in order for parties' explanations and the observed pattern to be compatible with a competitive outcome, we would not expect first year audits to be profitable*". We agree that this is a significant question. However, the CC's analysis of this issue at paragraphs 103 *et seq* is wholly inadequate:

(a) At paragraph 103, the CC states that "*available evidence on profitability does not suggest that even in the first year firms do not cover direct costs.*" However, by focussing solely on direct costs the CC significantly underestimates the costs of conducting an audit. In businesses such as ours, with material fixed and common costs (for example IT, central functions and branding), a focus on direct costs not only underestimates the costs of conducting and audit, but also underestimates the costs that need to be recovered across all services for the firm to remain financially viable. As a result, the CC's inferences in this regard are unsound.

(b) At paragraph 104, the CC reports PwC as claiming that it set the Year 1 fee by reference to an estimate of audit costs in Year 3, meaning that the fee in Year 1 did not take into account the additional work incurred in the early period of an engagement. The CC states that "*[t]his suggests to us that the first year fee is sustainable*". The CC's inference is wrong. Even if the Year 1 price would (without a further price rise) be profitable in Years 2 and 3 this does not mean that profits in Years 2 and 3 would cover the losses made in Year 1. Accordingly, the price rises may be necessary to cover the Year 1 losses.

(c) The CC's analysis in paragraph 105 is also wholly inadequate. The fact that companies face switching costs, and that firms are able to increase prices by some degree (as reflected in the observed pattern), does not by implication support the CC's preferred explanation for the observed pattern, nor does it preclude other alternative explanations. The CC has not put forward any analysis or evidence to support this inference.

4.4 Furthermore, even though the CC accepts at paragraph 106 of the Working Paper that the observed price pattern could be compatible with a well-functioning market, it takes the remarkable step of stating that:

(a) Because the dynamics of the project lifecycle are "*complicated*", the claim that a trade-off with an up-front discount is "*less plausible*". This reasoning is wholly inadequate and unsubstantiated, and reveals a failure to investigate and consider commercial realities.

(b) It is more plausible that "*companies lose bargaining power over the course of an engagement*", and that it has "*seen no robust evidence suggesting that competition for engagements fully compensates companies for this*". However, we would note that the CC has not adduced any evidence that competition does <u>not</u> fully

compensate companies for this – the CC cannot rely on a lack of evidence for Y as evidence for X.

4.5 Again, it is clear that the CC's assessment of what is "plausible" or not is deficient, is not based on a thorough investigation or consideration of the issues, but instead is based on inferences that support the CC's preferred explanation.

5. Is a tender situation subject to competition "for the market"?

5.1 For the reasons given above, the questions raised by the CC at paragraph 108 of the Working Paper are misguided.

5.2 However, in EY's view, the answer to the question posed at paragraph 108(d) – is a tender situation subject to competition "for the market"? – is essentially "yes". Firms compete aggressively during the tender process and, moreover, that competition is fuelled at least in part by the belief that the engagement will be profitable and last some years.

5.3 This leads to two final points:

(a) If tenders occur more frequently, winning a tender is less valuable, so firms will compete less aggressively to win them. Moreover, if more frequent tendering leads to higher total tendering costs, this will, in the medium term, be reflected in pricing, and will be paid by the customer. As a result, even if tenders currently lead to lower prices, more tenders will not necessarily lead to even lower prices and may lead to higher prices.

(b) Given the recent changes introduced by the FRC requiring mandatory tendering on a "comply or explain" basis, the number of tenders is expected to increase (indeed an increase can already be observed). It is to be expected that, for the reasons given at (a) above, this could have an impact on prices. However, the analysis contained in the Working Paper is based on an environment with lowering tendering levels, and does not take these important developments into account.