



Competition Commission Audit Services Market Inquiry

30 November 2012

Deloitte response to the Competition Commission's working paper "The life cycle of FTSE 350 companies"

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Deloitte response to the Competition Commission’s working paper “The life cycle of FTSE 350 companies”

1. Introduction and summary

1.1 Deloitte is grateful for the opportunity to comment on the working paper published by the Competition Commission (the **CC**) on the “The life cycle of FTSE 350 companies” (the **Working Paper**).

1.2 We comment on the following areas:

- (a) opportunities created by new entrants to the FTSE 350;
- (b) no evidence of specific targeting of mid tier firms’ clients; and
- (c) new measures introduced by the FRC.

2. New entrants to the FTSE 350

2.1 The Working Paper calculates that, out of 695 companies, 470 (68%) have changed index at least once, and 237 (34%) have changed index more than once¹. At least 405 companies² (58%) moved from the ‘other listed’ or ‘private’ categories to the ‘FTSE 350’ category at some point between 2001 and 2011.

2.2 However, despite setting out the above findings, the Working Paper then makes the statement that “*the data [set out in the WP] suggests that there has not been substantial movement of companies between the index designations during the last ten years*”³. This conclusion seems at odds with the facts.

2.3 As previously discussed in our responses to the CC’s working papers on “The framework for the CC’s assessment and revised theories of harm” (the **Theories of Harm Working Paper**)⁴ and “Restrictions on entry and expansion” (the **Barriers to Entry Working Paper**)⁵, we consider that movement of companies into the FTSE 350 provides significant opportunity for auditors of small cap and private companies to continue their relationship with such companies as they enter the FTSE 350. For this reason, we consider movement between indices to be relevant information for the CC to consider in its investigation, and would urge it to reconsider its conclusion that dynamism between indices is not significant.

3. Specific targeting of mid tier firms’ clients

3.1 Based on the pattern of switches around the time of movements in indices, the Working Paper states that “*it is not necessarily the case the Big 4 Firms target Mid Tier clients in advance of FTSE 350 listing (any more so that Big 4 firms target other Big 4 firm clients)*”⁶. Whilst we agree with the direction of this comment, we consider it to be unduly tentative.

3.2 In fact, there is no evidence to suggest specific targeting of mid tier firm’s clients by Deloitte or by top tier firms. In respect of Deloitte’s own experience, we have (in response to specific questions

¹ Table 1

² 305 and 60 per Table 3, and an additional 40 per paragraph 12

³ Paragraph 13

⁴ Deloitte response to the Theories of Harm Working Paper, paragraphs 4.7 to 4.9

⁵ Deloitte response to the Barriers to Entry Working Paper, paragraphs 3.12 to 3.19

⁶ Paragraph 23

from the CC) provided information with respect to two prospective clients which also undermines the argument of 'lowballing' to win clients specifically from mid tier firms⁷. We seek to compete for the audit of all companies regardless of their current incumbent.

4. New measures introduced by the FRC

4.1 We would like to take the opportunity to note that analysis of historical switching behaviour would only be relevant for the purposes of the current investigation to the extent that the historical observations have some predictive power for future switching behaviour. In fact, due to the new measures recently introduced by the FRC, this is no longer the case:

- (a) The FRC has amended the UK corporate governance code to require that companies put out their external audit to tender at least once every ten years. This dramatically alters the environment in which the CC's analysis should be considered.
- (b) We note that since the majority of auditor switches have historically been demand-driven, the observations on the impact of such switches have severely limited predictive power for the impact that auditor switches driven by *mandatory* tendering are likely to have in the future. In particular, any auditor switch driven by mandatory tendering requirements is unlikely to have the same qualitative or quantitative impact on quality, price or internal costs as has been observed historically.
- (c) The relevance of the analysis of past auditor switches has therefore been significantly reduced. We would encourage the CC to consider to what extent, if any, the analysis of historical switching continues to have any predictive power for the analysis of the statutory audit market.

⁷ See Deloitte response (sent on 5 November 2012) to email from Denis Kelly of 30 October 2012 entitled 'Audit market investigation: Pricing query (Deloitte)'

Annex 1

Responses to points of detail

¶	Working Paper wording	Comment
15	'We identified 208 instances where companies switched audit firms'	We cannot recalculate the CC's conclusion of 208 switches, but it appears that the CC does not include any switches from Andersen following its collapse. This is incorrect: with the collapse of Andersen, former Andersen clients made a choice as to which audit firm they would like to engage going forward, in many cases through a formal tender.