



## **Competition Commission Audit Services Market Inquiry**

5 October 2012

### ***Deloitte response to the Competition Commission's "Working Paper on Competition Commission survey results"***

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# Deloitte response to the Competition Commission’s “Working Paper on Competition Commission survey results”

## 1. Introduction

- 1.1 Deloitte is grateful for the opportunity to comment on the CC’s “Working paper on Competition Commission survey results” (the **Working Paper**).
- 1.2 We set out our views on the IFF survey conducted for the CC (the **CC Survey**) below. We focus on the key points that the CC Survey highlights which we believe have implications for the analysis of competition in the statutory audit market.
- 1.3 We have already addressed some of these issues in our response to the CC’s working paper on “The framework for the CC’s assessment and revised theories of harm” (the **Theories of Harm Working Paper**) and our response to the CC’s working paper on “Restrictions on entry and expansion” (the **Barriers to Entry Working Paper**).

## 2. Audit is a multidimensional product

- 2.1 The Working Paper describes the factors that companies consider to be important in assessing the quality of an audit<sup>1</sup>. The key observation from these results is that companies (both Financial Directors (FDs)<sup>2</sup> and Audit Committee Chairs (ACCs)) see audit quality as multidimensional. This is the case for both FTSE 350 and non-FTSE 350 companies<sup>3</sup>. In addition, clients attribute higher importance to observable aspects of audit quality over ‘reputation of audit firm’.<sup>4</sup> This is not surprising: the expert and informed buyers in this market are interested in, and make their audit appointment decisions based on, the real capabilities of audit firms.

## 3. Survey respondents are well informed and sophisticated purchasers of audit services

- 3.1 We believe that the statistics on the FDs’ and ACCs’ previous employment<sup>5</sup> are indicative of the knowledge, skills and capabilities of FDs and ACCs, but should not be viewed in isolation. The manner in which they undertake their roles is more important.
- 3.2 The most salient characteristics of the respondents are those that emerge from their actual responses to the survey. In particular, in response to the question on factors important in assessing the quality of audit, both FDs and ACCs demonstrate a thorough and robust understanding of audit quality parameters<sup>6</sup>, attributing the highest importance to factors such as:
  - (a) Efficiency of the audit process
  - (b) Ability to detect mis-statements
  - (c) Independence of the audit firm
  - (d) High degree of challenge
- 3.3 Similarly, the criteria cited by the respondents to decide whether to (re)appoint an auditor<sup>7</sup> reflect their ability to discriminate in an informed manner between the various audit suppliers. We note

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<sup>1</sup> Paragraphs 29-31

<sup>2</sup> We use the term ‘FD’ to cover both Financial Directors and Chief Financial Officers

<sup>3</sup> CC Survey, slides 26 (FDs) and 28 (ACCs)

<sup>4</sup> CC Survey, slides 33-34 (FDs) and 38-39 (ACCs)

<sup>5</sup> Paragraph 24

<sup>6</sup> Paragraphs 29-31

<sup>7</sup> Paragraphs 34-35

that these criteria are mostly those linked to the specifics of the audit relationship. These reflect the audit firm's quality offerings: experience and knowledge of the engagement partner and team, good working relationships of audit firm, sector-specific expertise and experience. Criteria related to less relationship-specific factors<sup>8</sup> are less significant (cited as important less frequently).

3.4 The Working Paper notes that companies perform a variety of market testing exercises<sup>9</sup>. We note that FTSE 350 companies appear to perform various evaluation tasks more frequently than non-FTSE companies, such as: audit fee negotiation, post-audit review, informal contact with auditors outside a tender process, benchmark / make formal comparisons.

3.5 In this context, the relevant findings that emerge from the CC Survey are that the buyers of audit services are highly sophisticated and informed about the service (and alternative options) that they purchase. Thus they are highly competent to make buying decisions on behalf of, and in the interests of shareholders, the ultimate customers of the audit services.

#### **4. A tender can be triggered by a wide range of factors**

4.1 There is a wide range of factors that can act as triggers for a company to consider switching auditor. These range from dissatisfaction with the existing auditor on the grounds quality of delivery to factors on the supply side (such as partner rotation or engagements with company's competitors).<sup>10, 11</sup>

#### **5. Mid tier auditors are invited to tender**

5.1 There are a significant number of opportunities for mid tier auditors to win FTSE 350 audit engagements. In the last 5 years, 30% of FTSE 350 tenders (and 48% of non-FTSE 350 tenders) included at least one audit firm outside of the four major audit firms<sup>12</sup>.

#### **6. The observed tendering rates reflect rational behaviour of companies**

6.1 The main observations regarding the companies' tendering behaviour can be summarised as follows:

- (a) Clients are less likely to tender when they receive high quality service and good value for money, and when they are happy with things as they are;<sup>13</sup>
- (b) Clients do not unreasonably exclude auditors from the tender process. When clients restrict the number of companies they invite to a tender, they do so for reasons related to quality and efficiency.<sup>14</sup>

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<sup>8</sup> For example, relationship with audit firm, management preference for specific auditor, good corporate fit.

<sup>9</sup> Paragraphs 36-38

<sup>10</sup> Table 16 of the Working Paper

<sup>11</sup> At paragraph 39, we would welcome further clarification from the CC of the relationship between the following three observations: (i) 15% of FTSE 350 companies do not carry out benchmarking or other formal comparisons with audits; (ii) about 25% of FTSE 350 companies never request a formal proposal or presentation from the auditor before reappointment, and (iii) 31% of FTSE 350 companies had never carried out either of these activities. It seems that the third statement is inconsistent with the previous two: if 85% companies benchmark or carry out formal comparisons of audits, then it is not possible that 31% of companies had never carried out either of these activities.

<sup>12</sup> CC Survey, slide 54

<sup>13</sup> CC Survey, slide 60

<sup>14</sup> When companies choose to limit the number of auditors they invite to a tender, they do so for reasons related to the observable characteristics of the auditor – the top one being the specialist knowledge of the auditor, but geographic coverage and quality of service have also been cited by a significant number of respondents. Conversely, we note that only a small minority (2%) of FTSE 350 clients reported that they limited the number of companies they invited to tender because 'Investor perceptions and financial institutions expect a Big Four auditor'.

- (c) As a result, when companies do hold a tender and switch auditor, they tend to obtain a lower price and/or a higher quality audit. This is evidence that the competition in the market is effective.

## **7. Companies self-select to switch auditor**

- 7.1 We note that because the population of companies who do switch is (in most cases<sup>15</sup>) self-selecting, it is not the case that the effects of switching would be borne out in the wider client population. Specifically, it is not necessarily the case that involuntary switches would lead to lower fees and/or higher quality while not increasing internal costs.<sup>16</sup>

## **8. Auditors cannot afford to become complacent over time**

- 8.1 The Working Paper notes that one of the most frequently cited motivations to consider switching auditor is *'complacency of the audit firm'*<sup>17</sup>. The immediate implication of this is that auditors cannot afford to reduce the effort they put into delivering a high quality and efficient audit. This requires that the auditor continuously improve the audit delivery – including process as well as the product itself (for example by continuing to provide insights on current topical issues). The CC Survey thus demonstrates that audit firms have a continued incentive to make sure they do not lose focus on improving the audit service.

## **9. Mid tier auditors do not always maximise their chances to expand their presence in the FTSE 350 market**

- 9.1 As the Working Paper notes, major auditors frequently approach the FDs and ACCs of both FTSE 350 and other companies<sup>18</sup>. We note that, by contrast, mid tier auditors approach the FDs or ACCs much less frequently, arguably thus failing to take the opportunity to make themselves known to the potential FTSE 350 buyers of audit services. BDO has been cited by 11 FTSE 350 respondents and Grant Thornton by 10 FTSE 350 respondents as approaching them over the past five years (i.e. c.2 clients per year). Smaller auditors, including Baker Tilly, Mazars, RSM Tenon Group and PKF have each been mentioned by only 1 or 2 FTSE 350 companies<sup>19</sup>.
- 9.2 Mid tier auditors approach non-FTSE 350 clients more frequently (BDO has been cited by 44 non-FTSE 350 companies, and Grant Thornton by 42 companies<sup>20</sup>), which suggests that they may be strategically focussing on winning non-FTSE 350 clients, rather than on winning FTSE 350 clients. It is not surprising that firms who seek to win the business of FTSE 350 companies more actively are more successful in doing so.

## **10. Most companies do not face any limitations in terms of auditor choice**

- 10.1 The Working Paper observes that the majority of FTSE 350 companies do not face any restrictions regarding the choice of auditor between Big 4 firms<sup>21</sup>. We note that crucially, there is a time dimension involved in making this assessment of potential restrictions. The fact that some companies may find themselves currently restricted in terms of auditor choice does not mean that active steps cannot be taken to widen the choice over time, for example by making use of the transitional rules which apply to provision of non-audit services.

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<sup>15</sup> Exceptions include situations where a company switches auditor due to corporate action such as M&A activity.

<sup>16</sup> Paragraph 84: *"Companies that decide to put their engagement out to tender are more likely to be those that expect there be gains to be had from doing so."*

<sup>17</sup> CC Survey, slide 68

<sup>18</sup> Paragraphs 60-61

<sup>19</sup> CC survey, 'survey\_set4\_company\_level\_tabulations.xls'. Question C7a 'Which firm or firms approached you?'. Cells O8284:O8309.

<sup>20</sup> CC survey, 'survey\_set4\_company\_level\_tabulations.xls'. Question C7a 'Which firm or firms approached you?'. Cells P8284:O8288.

<sup>21</sup> Paragraphs 71-73

10.2 In light of this, we believe that the proportion of companies who find that they are not restricted in terms of auditor choice would be higher when considered over a period of time, rather than as an immediate assessment. We explain this in more detail in our response to the CC's working paper "Nature and strength of competition in the supply of FTSE 350 audits".

## **11. Conclusion**

11.1 In summary, although the Working Paper is substantially fact based, we believe that the above points regarding FTSE 350 tendering and switching behaviour should enable the CC to draw the conclusion that the FTSE 350 audit market is functioning effectively.