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Competition Commission Audit Services Market Inquiry

3 December 2012

Deloitte response to the Competition Commission's working paper "Engagement level profitability analysis"

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1. Introduction

1.1 Deloitte is grateful for the opportunity to comment on the paper published by the Competition Commission (the ***CC***) on "Engagement level profitability analysis" (the ***Working Paper***).

1.2 We welcome the CC's findings that:

(a) there is no evidence to suggest that anti-competitive behaviour in the form of systematically achieving high levels of profitability exists within the reference market; and

(b) there is no indication that audit firms "low-ball".

1.3 The analysis presented in the Working Paper provides yet further evidence that competition between firms in the reference market is generating positive outcome for companies and strongly supports Deloitte's view that there is no evidence of adverse outcomes.

1.4 This response comments on the following areas:

(a) Market segment profitability

(b) Variation in profitability; and

(c) Audit life cycle

2. Market segment profitability

2.1 The evidence that engagement level profitability inside the reference market is broadly consistent with profitability outside the market (other listed companies) supports the view that there is no evidence of unduly high profits for suppliers in the reference market.

2.2 However, the conclusion that can be reached is in fact stronger than this as the CC definition of 'other' is only a subset of the audits outside of the reference market. The Working Paper refers to the profitability of 'non-FTE 350' audits, but this analysis relates only to the performance of firms that were in the FTSE 350 at some point between 2006 and 2011, but in the year in question were not FTSE 350 constituents (or were private companies). To be conclusive, information on 'other' should include all other audits, not just those for which the CC has detailed information[1]. [✂]. This shows that returns in the reference market are below the return achieved in the unambiguously competitive supply of audit services [✂].

2.3 As evidence for this, in our submission responding to the Working papers "Profitability – part one" and "Profitability – part 2" (the ***Profitability Working Papers***) we discussed the use of the Revenue Recovery Rate ***(RRR)***. The RRR is used as a method of reporting relative profit performance between engagements in our business. Deloitte's RRRs for 2006 to 2011 are presented in Table 1 below. Our analysis shows that [✂]:

[1] We recognise the limitations of the data collected by the CC: our point is that the CC should mention these limitations

Table 1: Deloitte RRRs

Year	FY06	FY07	FY08	FY09	FY10	FY11	Average
FTSE 350 audit	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Non FTSE 350 audit	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]
Non-audit	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]	[✂]

2.4 This evidence complements that in the Working Paper and leads to the strong conclusion that profits are not unduly high in the reference market, and are consistent with normal competitive outcomes.

2.5 The Working Paper's finding that FTSE 100 audits are, on average, more profitable than FTSE 250 audits is consistent with our own analysis. The requirements of each audit engagement vary depending on the characteristics of the company. Thus it is not surprising that FTSE 100 audit engagements on average achieve a higher profit margin. Those engagements are likely to expose the auditor to higher risk, are more complex, are likely to require specialised input and greater international input (with, for example, senior UK teams overseeing the work of audit staff based in other countries) relative to FTSE 250 audits.

3. Variation in profitability

3.1 The Working Paper finds that there is significant variation in the level of profitability achieved not only by individual firms, but also by each firm from year to year. Collectively, and individually at the firm level, there is no consistent year-on-year increase or decrease between 2006 and 2011. These findings are consistent with our analysis of Deloitte's engagement data. Indeed, further disaggregation would show considerably more variation in engagement level profitability and fewer systematic patterns in the data.

3.2 The scope of audit work on any individual audit is constantly changing, in response to changes in client circumstances and efficiencies, as well as changes in the commercial and risk environment. All these factors affect the costs of delivery, which will in turn affect the profitability of the individual engagements, as auditors are unable to pass through all cost changes to companies. Audit fees are negotiated on an annual basis in part to reflect these changing audit requirements, and also due to the competitive constraints faced by the auditor.

3.3 The absence of any systematic trend in the data supports the view that the market for audit services is highly competitive and that the outcomes reflect the company specific negotiations that take place on an annual basis.

3.4 The Working Paper finds that there is a degree of variation in profitability across individual industries. On average the aggregate engagement profitability for the Oil and Gas sector is highest, whilst Industrials is the lowest. The Working Paper does not conjecture an explanation.

3.5 We welcome the Working Paper's finding that there is no evidence of 'low-balling'. As we have discussed in previous submissions[2], Deloitte does not set audit prices to unprofitable levels with the purpose of 'low-balling' competitors. The evidence in the Working Paper supports Deloitte's previous submissions on the issue and should enable the CC to dismiss these unfounded allegations.

3.6 The Working Paper also considers the profitability of engagements depending upon the year end of the client. No evidence of seasonal price discrimination was identified in the large company market. This is consistent with Deloitte's submission that no systematic targeting of mid-tier firms' clients takes place on a seasonal basis (or at all).

[2] Deloitte response to the Competition Commission's working paper "Firms' stated competitive strategies", section 5

4. Audit life cycle

4.1 The analysis in the Working Paper finds that whilst audit profitability increases over the first five years of an engagement, there is no evidence that the profitability continues to increase past this point. We welcome and agree with this finding. As we have previously commented, there is no evidence of a positive relationship between profitability and audit engagement tenure[3].

4.2 This is due to the fact that auditors' services are subject to extensive annual renegotiation from expert and well informed purchasers, able to achieve improvements in the value for money they receive from their auditors.

4.3 As the Working Paper rightly points out, the initial increase in profitability in the first years of an audit are driven by cost rather than revenue. Auditors factor a familiarisation cost in to audit planning, with the expectation that more resource will be required in the first years as the audit team becomes more informed about the client (assuming no significant changes in scope). Following this familiarisation period, the profitability of an audit is not related to tenure. Audit cost is a function of changes to the audit scope, regulatory requirements or changes to the audit team.

Familiarisation cost

4.4 The Working Paper appears to introduce the theory that familiarisation costs may represent a barrier to entry and expansion. We have the following comments:

(a) This is an excessively theoretical approach: the CC must base its conclusion on the experience of actual market participants. In fact, no firm has indicated to the CC that familiarisation costs are any impediment to tendering for or winning new audit clients.

(b) Indeed, all firms have indicated that they would embrace the opportunity if tendering rates were to increase[4] (as they are likely to do pursuant to the recent FRC reforms[5]).

(c) The Working Paper's observation that larger firms may be better able to absorb familiarisation costs than much smaller firms may have some theoretical basis, but little practical relevance: the major mid-tier firms are all of significant size and can easily absorb these costs. As BDO observes in its response to the CC's working paper on 'Switching costs': *"BDO has thousands of clients; the management of transition is a core activity of any audit practice and BDO does it on a daily basis."*[6] There is no basis on which the CC could conclude that this is a significant factor in competitive dynamics in this market.

(d) Furthermore, as the Working Paper states[7], there is no evidence that the first years of an engagement are unprofitable, only less profitable than following years. Consequently, there is no indication that the existence of familiarisation costs acts as a barrier to entry for any firm.

(e) In fact, the practice of auditors absorbing familiarisation costs is pro-competitive, as it has the impact of reducing the cost of switching to companies, which theoretically increases the likelihood of tender opportunities.

Tenure

4.5 The Working Paper correctly finds no evidence to support the theory that audit profitability increases with tenure. Following the initial familiarisation period, audit profitability is determined

[3] Deloitte response to the Competition Commission's working paper 'Restrictions on entry or expansion'

[4] See, for example, paragraph 1.8 of Grant Thornton's response to the Issues Statement.

[5] See further Deloitte's response to the working paper on the 'Life cycle of FTSE 350 companies'.

[6] Paragraph 1.8 of BDO's response to the 'Switching costs' working paper

[7] Paragraph 16

by the variation in costs due to changing scope and demands of the audit and the ability for auditors to pass these cost changes through to clients. This outcome demonstrates that the process of determining the scope of an audit and negotiating audit fees annually continues throughout the duration of an audit relationship.

4.6 The Working Paper performs further analysis whereby the average engagement profitability is determined by the date of the last switch. We believe the time periods used to group the companies' tenure are arbitrary, and that the results of this analysis are potentially misleading when read in isolation. We have the following comments:

(a) Contrary to the point raised earlier in the Working Paper that "*profits appear to remain constant in the long term*"[8], this analysis seeks to explore whether the profitability of audits for companies which more recently switched is lower than that of companies with longer tenure audit relationships.[9]

(b) The grouping of audits between the groups of last switch occurring in 2001 or later, 1995 to 2000 and 1994 or earlier is arbitrary. Due to the small number of companies on which data is available for longer tenure audits and the impact of significant company specific factors there is the potential for the results to be affected by the choice of groupings.

(c) The results appear inconsistent with the data presented in Figure 3 of the Working Paper which clearly shows no relationship between tenure and profitability after the first five years. Thus the findings from the grouped analysis is potentially misleading if read in isolation.

4.7 It is therefore no surprise that profitability is lower for those audits where the company has switched in 2001 or later (shown in Figure 3 of the Working Paper). Furthermore, the trend shown by Figure 3 shows no sustained trend between the level of profitability and tenure after five years. This analysis of tenure groups is contrived and it is likely that the outliers such as in years 12, 17 or 24 of engagements are driving the results.

5. Detailed comments

5.1 We have noted an oddity in the average engagement profitability analysis that calls into question the validity of these results. We would expect that including partner hours in the average profitability calculation would consistently reduce the profit margin (as it does for the calculations in respect of Total hours and Chargeable hours). However, in respect of Standard hours, Table 2 *'Average engagement profitability (including partner hours)'* shows that including partner hours in the 'Standard hours 1 x directors' calculation in fact increases the margins relative to the comparable figures in Table 1 '*Average engagement profitability (excludes partner hours)*'. For example the average FTSE 100 margin for the period is 65.3% including partner hours compared to 55.3% when they are excluded.

5.2 We note that the first section of Table 2 says 'Total hours 1 x partners'. We assume this a typo which should read 'Total hours partners 1 x directors'.

[8] Paragraph 45

[9] For example, paragraph 54 states "*In five out of the six years, the average engagement profitability for relationships founded before 1994 was greater than those switching in 2001 or later.*"