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Competition Commission Audit Services Market Inquiry

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Deloitte response to the Competition Commission's working paper "Evidence on switching costs (and implications for barriers to entry)"

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1. Introduction and summary

1.1 Deloitte is grateful for the opportunity to comment on the paper published by the Competition Commission (the CC) on "Evidence on switching costs (and implications for barriers to entry)" (the ***Working Paper***).

1.2 This paper adopts the following structure:

(a) incidence of switching costs;

(b) timing issues;

(c) the costs of tendering and switching;

(d) avoiding risks to audit quality in the early years of a new engagement;

(e) investors, company management and switching; and

(f) conclusions.

1.3 By way of summary, whilst we agree that there are some costs to companies in switching, it appears that the CC has overestimated such costs, and has failed to take into account the evidence before it that companies' *actual* experience of switching shows these costs to be surmountable, that companies can and do tender and switch when they are dissatisfied with the value for money or quality that they are receiving from their current auditor, and that the costs of switching therefore cannot be considered to be a barrier to entry.

2. Incidence of switching costs

2.1 The Working Paper notes that switching costs are borne both by auditors and by clients. However, for the purpose of understanding the incentives for companies to switch auditors, the relevant costs are those that are faced by the companies, and not the costs to the audit firms of acquiring the knowledge of the company necessary in order to undertake the audit to the standards that we demand in all our audits. However, we address each set of costs below.

2.2 The Working Paper notes that auditors take steps to reduce, to the extent possible, the companies' switching costs.[1] This is correct. Auditors are able to reduce clients' switching costs significantly in many ways.

2.3 The first of these is by ensuring that the costs of familiarisation with the new company are borne by the audit firm, not by the company. This is evident from the higher number of hours (and more senior staff hours) in the early years of a new engagement (particularly the first year). This is expected by clients and significantly reduces any barrier to switching. We discuss this in detail below.

2.4 The second means by which such costs are reduced is by drawing up detailed transition plans. The Working Paper notes[2] that auditors regularly draw up such plans when tendering for an audit engagement. It further notes that top tier auditors have tended to have more thorough transition plans than mid tier auditors. The Working Paper appears to conclude from this (although the evidence base for this conclusion is not clear) that top tier firms therefore appear better able than

[1] Paragraph 60 *et seq*

[2] Paragraphs 64-65

mid tier firms to signal their ability to manage the auditor transition.[3] Deloitte makes significant efforts to ensure a smooth auditor transition, which has strong benefits for the client – including, inter alia, reduced switching costs. This represents the outcome of efficient competitive processes.

2.5 With regard to the firms' costs, the fact that auditors incur costs of tendering[4] is evidence that audit firms are prepared to invest in these relationships. This represents a pro-competitive feature of the market and not, as the Working Paper suggests,[5] a barrier to entry. We believe this suggestion is wrong and indeed does not appear to build on any evidence presented in the Working Paper nor in the working paper on the "Nature and strength of competition in the supply of FTSE 350 audits".

2.6 These costs are incurred as a necessary cost of competition. Without incurring these costs, it would not be possible for bidding audit firms to provide companies with the insights that companies demand during the course of tenders and to compete on the quality dimension. As noted by the CC elsewhere, relatively poor performance in a tender can have adverse effects on a firm's reputation with the potential client.[6]

2.7 Most importantly, no firm has indicated to the CC that these costs represent a barrier to entry or expansion. There is no evidence for any suggestion to the contrary.

3. Timing issues

3.1 The Working Paper observes that companies may decide not to hold a tender at times when they have other corporate priorities.[7] As a matter of principle and of efficiency, we believe that it ought to be within the mandate of the directors to assess their business priorities at any given time, and they are accountable to the shareholders for their decisions.

3.2 In relation to the detailed issues raised by the Working Paper, we address each in turn:

(a) The Working Paper states that there may only be certain times of a year that a tender can take place. While we would agree that the timing of a tender and the planning of an auditor switch needs to be undertaken in order to fit with the corporate reporting cycle, this has no impact on competition and in no way increases the costs of switching (indeed, it reduces them by ensuring that companies can conduct an optimally efficient tender process). Companies are experienced at procurement of all types of service, and are able to plan the appointment process such that it minimises the disruption to the company.

(b) Although it is not apparent from the Working Paper, it was suggested at Deloitte's hearing[8] that auditors could conceivably seek to exploit circumstances in which companies may find it difficult to hold tenders by seeking to increase the audit fee beyond the level which would otherwise have been agreed. We do not believe that any audit firm would seek to exploit such short-term situations, as to do so would be received negatively by the company and would undoubtedly result in a significant increase in the risk of the loss of the client.

(c) Further, there is no evidence to support any allegation that the incumbent auditors are able to exploit this position at times when business activities may reduce the likelihood of running a tender (examples given by the CC include significant restructuring, refinancing, or acquisition or disposal activities).

[3] Paragraph 75(a)

[4] Paragraph 61

[5] Paragraph 74

[6] Working Paper on the Nature and strength of competition, paragraph 154(f)

[7] Paragraphs 24-26

[8] Hearing held at the CC with Deloitte LLP, September 26th 2012

4. Costs of tendering and switching

4.1 The Working Paper concludes that switching costs are a deterrent to tendering and switching and thus represent a barrier to entry.[9] This is not consistent with the basis of the evidence which the CC has before it.

4.2 The public data set (between 2001 and 2010) shows that among the 678 companies on which data was collected that have been listed in the FTSE 350 at some point over the period, there were 267 auditor switches (and a further 262 auditor change events). There is therefore significant experience of actual switching among the population of companies on which the CC is focusing its attention. This shows that any switching costs that exist have not deterred switching.

4.3 The evidence before the CC shows that two-thirds of the companies that switched faced equivalent or lower internal costs following a switch.[10] Greater weight should be placed on this evidence, which would lead to the conclusion that for the majority of companies in the FTSE350, associated costs would not deter a company from switching when it is dissatisfied with the services of its incumbent auditor. The following detailed evidence highlights this point:

(a) The IFF survey conducted for the CC (the ***CC Survey***) shows that only 16% of respondents reported that the costs of getting new auditors up to speed was a relevant factor in tender decisions, and only 13% that the costs of tendering was a relevant factor.[11] This is vastly outweighed by other reasons why companies may choose not to tender – primarily that they are happy with the quality and value they are currently receiving. In particular, in response to the question in the CC Survey it is clear that companies that have not tendered have most commonly done so because they are happy with the quality of service and value for money that they are receiving from their current auditor, and not because they are in any way trapped in a sub-optimal relationship with their auditor due to the costs of switching. In particular, regarding FTSE 350 companies12:

(i) currently receive high quality service: 51%;

(ii) currently receive good value for money: 25%;

(iii) happy as things are: 21%.

70% of companies gave at least one of the above reasons.

(b) The CC cites the evidence set out in its case studies with company management, auditors and other protagonists (the ***Case Studies***) that some respondents were concerned about inefficient use of management time. However, the evidence from the Case Studies supports the conclusion that for most respondents this was not a concern and/or would be immaterial. None indicated that it would be a deterrent to switching and many were very clear that it would not be. The following extracts from the Case Studies support these points, and warrant inclusion and emphasis, to reflect the balance of evidence before the CC:

(i) **Company B**: The ACC *"quite liked to tender every 3-4 years"*, suggesting that while tendering may be expensive, these costs do not in themselves constitute a barrier to switching.[13]

[9] Paragraph 72(f)

[10] Survey results, page 67

[11] CC Survey, slide 60. The Working Paper states, at paragraph 11, that 25% of FTSE 350 companies give one of these responses. The information to validate this statement has not been made available by the CC.

[12] Page 60 of the CC Survey

[13] Paragraph 43 of the Company B case study

(ii) **Company C**: The ACC mentioned a breakdown in relationship with auditor and that it was *"healthy to review all professional relationships on a regular basis"* – we note that the ACC did not mention any switching costs associated with this review.[14]

(iii) **Company D**: The FD said that the change in auditors *"had been smooth but that it took time to manage"*. This suggests that while some costs may have been incurred, they did not constitute a barrier to switching. [15]

(iv) **Company E**: The FD indicated that there was *"some upheaval getting the new team up to speed, but with capable individuals who were quick on the uptake and a professional handover service from the outgoing auditor, the process should be smooth."*[16]

(v) **Company F**: ACC: *"The ACC would have the necessary time to conduct a tender alongside his full time role [redacted] as the Audit Committee's role would be to oversee and understand the process."* This suggests that the ACC did not see the time required to conduct a tender to be so significant as to prevent switching from being seriously considered.[17]

(vi) **Company J**: Fund Accounting Manager: *"If there were to be a switch, the FAM said that he expected the new audit firm to absorb any additional costs for the first year as part of the cost of winning the audit. He expected any new audit firm to be familiar with investment trust businesses and therefore thought new auditors should not need too long to understand the company."*[18]

(vii) **Company J**: The ACC did not mention any switching costs involved in tendering and switching auditors. We note that the company had issues with the previous auditor and that in this context any potential switching costs were likely to be of secondary importance.[19]

(c) The strength of these findings is reinforced by the fact that the majority of the companies selected for the Case Studies have experienced switching of auditors, either of the business as a whole, or of significant parts of the business following a corporate event. The table below summarises the switching and tendering observed in the Case Studies:

[14] Paragraphs 58-64 of the Company C case study

[15] Paragraph 32 of the Company D case study

[16] Paragraph 22 of the Company E case study

[17] Paragraph 52 of the Company F case study

[18] Paragraph 18 of the Company J case study

[19] Paragraphs 43-48 of the Company J case study

Table 1: Case Study switching summary

Company	Switch	Current auditor	Former auditor
A	Yes, for significant parts of the business post-merger, and following resignation of auditor in 2010	Big 4	Big 4
B	Yes, in mid 2000s	KPMG	Mid tier
C	Yes, last five years	Big 4	Big 4
D	Yes, in 2003	Big 4	Big 4
E	Yes, in 2009	Big 4	Big 4
F	Yes	KPMG	Mid tier
G	No	PwC	
H	No, but tendered in 2003	EY	EY
I	No	Big 4	
J	Yes	Mid tier	

(d) The Case Studies clearly show that companies would not hesitate to hold a tender in circumstances where price or quality was wrong. Given that these opinions are formed based on actual experiences of switching, this provides further evidence that switching costs are not a deterrent to holding a tender, and that any actual or perceived switching costs have not, and would not in the future, deter them from switching. It is clear that where companies are not getting the desired levels of quality or value, they are able and willing to conduct a tender and, if appropriate, to switch.

(e) In addition, we note that Hermes[20] stated that: *"The costs of switching were incurred in management time spent to explain to a new auditor how the company functioned and to justify existing accounting decisions. However, <u>from a shareholder perspective, this was money well spent,</u> since it entailed more rigorous scrutiny."* (emphasis added). Companies will find no pressure from their investors to avoid tendering where they consider it appropriate to do so.

(f) That switching costs are not significant was further evidenced by previous research undertaken by Oxera.[21] Oxera's survey shows that ACCs do not view a number of the switching costs described by the CC as significant in discouraging companies from switching auditor. In particular, only a minority of respondents considered that management and/or ACC time was a significant factor affecting the decision to switch. An even smaller share of respondents were concerned that switching could be a negative signal to shareholders, or that the company would have to change the supplier of non-audit services:

[20] Summary of hearing with Hermes Equity Ownership Management held on 15 March 2012, paragraph 10

[21] Oxera (2006). Competition and choice in the UK audit market. Prepared for Department of Trade and Industry and Financial Reporting Council. April 2006

Table 2: Oxera (2006) Table A1.7. Factors discouraging companies from switching

	5 (very significant)	4	3	2	1 (not significant at all)	Don't know	Sample mean
Management time required	2	10	19	12	7	0	2.8
A new assessment of your company's internal controls required	1	5	18	10	15	1	2.4
Possible negative signal to shareholders of changing auditors	3	1	9	16	21	0	2.0
Audit committee time required	0	3	11	16	20	0	2.0
Company would have to change the supplier of related services such as tax or corporate finance	1	1	9	20	18	1	1.9

Base: 50 respondents.
Source: Q7: How significant or not, are each, if any, of the following factors in discouraging you from changing your company's auditor?, audit committee chairs survey.

5. Avoiding risks to audit quality in the early years of a new engagement

5.1 The Working Paper cites the potential risks to quality in the first years of an audit appointment as a reason not to switch.[22] We agree that the risk is higher in these years, since the auditor is less familiar with the company and its operations.

5.2 However, the CC must take into account the evidence that Deloitte and others have given about the steps taken to mitigate this risk. The CC's own data analysis shows the efforts that firms go to when taking on a new audit. In particular, not only does the share of partner hours increase by 20% in the first year following a switch, but as the total number of hours also increases by 24.3% on average, the total impact on partner hours is an increase of almost 50%.[23] A comparable analysis of director time shows that actual hours spent by directors increased by almost 175% in the first year following a switch. These increases are not 'slight'[24] but represent a highly significant investment by the new auditor in seeking to mitigate the risks associated with taking on a new audit.

5.3 As we stressed in response to the CC's MFQ,[25] *"in circumstances where Deloitte has taken on a new audit client, it has employed additional efforts in the early years of the relationship – and, given the competitive pressures in this market, at its own expense – in order to ensure that this risk is minimised. In all audits where we are appointed, we never compromise on quality and mitigation of risk and we therefore invest heavily in resource, particularly ensuring that we have the very best partner and director resource devoted to the audit and relationship, in the first year or two of the appointment."*

5.4 It is clear from the evidence before the CC that companies expect auditors to take these steps since they cannot afford to have a quality failing, and they expect their auditors to bear the cost of doing so (which reduces any costs to the company of switching still further).

[22] Paragraphs 31-35

[23] Using the data in Table 2 and paragraph 69, the relevant calculation is a multiple of the increase in the share of hours and the increase in the total number of hours. For partners, this is ((4.7/3.9)*1.243)-1=49.8%; and for directors, ((4.4/2.0)*1.243)-1=173.5%.

[24] Paragraph 70

[25] Deloitte's response to Question 80

5.5 Firms do this, and bear the cost, because they are strongly incentivised both to win the new business and to ensure that the quality is of the usual high standard in the first years of the relationship: from the perspective of their own risk, they could not do otherwise.

6. Investors, the company and switching

6.1 Although it does not feature in the Working Paper, it was suggested at the hearing[26] that investors and company management may have different interests with regard to switching, because the costs of switching fall on the management, while the benefits would be primarily in the investors' interests. There is no evidence for this proposition.

6.2 The incentives of management and investors are entirely aligned in this respect: they are both interested in ensuring that a high quality audit is delivered at the right price. Where this is not the case, both have an interest in ensuring that an auditor switch takes place to ensure that a better outcome is obtained. As has been shown above, the costs to management of tendering and switching have not been sufficient to deter switching, and there is no evidence from the Case Studies that companies' direct experiences of switching would in any way deter them from tendering and switching in the future.

6.3 To the extent that this concern may relate to management time, it is hard to understand how the interests of investors and management may diverge. To the extent that management consider that there are other overriding corporate priorities in any given year, this will be a decision taken in the best interests of the company, and hence the shareholders. Management are accountable to shareholders for their decisions on corporate priorities.

7. Conclusion: no evidence of a barrier to entry or expansion

7.1 The Working Paper correctly concludes that none of the identified switching costs constitute an insurmountable barrier to entry.[27] However, it goes on to conclude that cumulatively they may constitute such a barrier. The evidence base does not support this, for all of the reasons set out above. Rather, the evidence shows that where companies consider that they may not be obtaining optimal quality and value, they will go out to tender.

[26] Hearing held at the CC with Deloitte LLP, September 26th 2012

[27] Paragraph 74