PwC response to working paper on Evidence on switching costs (and implications for barriers to entry)

1 This is PwC's response to the Evidence on switching costs (and implications for barriers to entry) working paper (**Switching Costs WP**). We comment below on the Competition Commission's (**CC**) initial views of switching costs (particularly as summarised at paragraph 72 of the Switching Costs WP)[1].

Summary

2 We agree with the CC to the extent that it has found that switching costs can be potentially significant for large companies,[2] but that the efforts of both large companies and audit firms can reduce these costs.[3]

3 We note that the Switching Costs WP does not deal expressly with the evidence that shows that switching costs are not so high as to prevent a large company from switching (or tendering) if it decided to do so (whether because it was dissatisfied with the level of service and/or price or for other corporate governance reasons), instead deferring the consideration of how companies approach tendering and the benefits to be weighed against the costs of switching to the Nature and Strength of Competition Working Paper (hereafter, the **Nature and Strength of Competition WP**). However, in order to put the issue of switching costs into perspective, it is important to recognise the evidence that shows that companies are prepared to tender and switch when they consider it appropriate, irrespective of the switching costs they face, and we set this out below.

4 We then deal with what we consider to be the main failing in the Switching Costs WP, which is the CC's initial view that there is a gap between what large companies perceive to be the costs involved in tendering and switching and the reality. In fact, there is no such gap. The individuals at large companies who select the audit firm (being principally audit committee chairs (**ACCs**) and finance directors (**FDs**))[4] assess accurately the costs associated with a tender and switch and exercise their judgement appropriately.

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1 Our comments include some references to: (i) the IFF Survey Results Presentation of July 2012 (**the CC's Survey**); and (ii) our Submission of 12 January 2012 (**our Initial Submission**).

2 Paragraph 72(a)-(d) and many of the case study examples in paragraph 10 (for example, the ACC of Company B "*thought that tendering was not a process to be taken lightly as it was a 'hugely expensive exercise' for both the company and the audit firms*"). We note that in paragraph 7, the CC states that it considers any factor that discourages a company from switching auditors as a switching cost. We disagree with this approach because in theory it would include those costs associated with switching from an auditor that is efficient, charging competitive prices and providing a high quality service to an auditor that was of poor quality and charging excessively. We consider that switching costs should be defined as the one-off costs incurred by a company in switching auditors. These would be balanced against a future stream of potential and actual benefits of switching auditors.

3 Paragraphs 64 and 72(e).

4 We note the CC has found ACCs and FDs to be sophisticated and experienced purchasers who take their responsibilities seriously: see, for example, Nature and Strength of Competition WP, paragraphs 73 to 75 and 92. Where we refer in the Paper to the role and experience of ACCs, this should be extended to other AC members where the context is appropriate.

The evidence is clear that large companies are prepared to tender and switch notwithstanding switching costs

5 There is a range of evidence that shows that irrespective of the size of switching costs, large companies are prepared to tender and switch whenever they decide that it is in their interests to do so. For example:

(a) The CC's Survey shows that:

(i) 94% of ACCs and 86% of FDs of FTSE 350 companies would be likely or very likely to tender if they felt their auditor was complacent (slides 68 and 74);

(ii) only 13% of ACCs and 2% of FDs of FTSE 350 companies would be unlikely to tender if faced with substantial fee increases (slides 68 and 74); and

(iii) the costs of tenders and switching are not significant in deciding not to tender relative to other factors (question B17, slide 60). For example, cumulatively, the two factors relating to disruption / getting the auditor up to speed and the cost / time associated with tenders amount to only 29%, but the positive reasons for not switching amount to 133%.[5] Significantly, responses to this question were unprompted.

(b) Several of the case studies reported at paragraph 10 of the Switching Costs WP make the explicit point that while costs are high they are not a reason not to switch. For example,

(i) Company A: "…*the CFO said that switching costs would not affect a decision to change auditors.*"

(ii) Company E: "…*the tender process would cause minimal disruption to the business.*"

(iii) Company F: "*However, [the hassle involved in switching] was not a reason not to tender.*"

(iv) Company H: "*The FD did not mind incurring the additional management costs in bringing a new auditor up to speed as it was valuable to the company to ensure the accounts were thoroughly scrutinised.*"

6 The final quotation (from Company H above) illustrates well the fact that large companies regard the audit as a service that is of importance, and that they are prepared to invest the necessary time and resources to ensure that the best audit firm for the company is in place.

[5] Those reasons being: (i) high quality service (51%); (ii) good value for money (25%); (iii) happy as things are (21%) ; (iv) partner rotation keeps things fresh (15%); (v) for continuity / familiarity (6%); (vi) incumbent understands business (7%); and (vii) benchmarking suggests get good value (8%). We have included continuity and business understanding as positive reasons on the basis that they represent a benefit to the company that arises from the audit firm developing knowledge of and relationships with the company.

Our experience is that these companies are continuously reassessing their procurement priorities for all services, including the audit, as they search for shareholder value. This means that the company - as well as prospective audit firms, which are keen to win new appointments - are willing to invest the time and effort required for the audit firm to understand the business fully. This allows the firm to participate effectively in a tender process, and if appointed, to get up the steep learning curve quickly in the first few years. These motivations for both the company and the audit firm are critical to put the question of switching costs properly into context.

There is no gap between the perception and the reality of switching costs

7 We do not accept the CC's initial view that large companies *perceive* the switching process and costs involved to be greater than they are *in reality.*[6] In our experience the ACCs and FDs of large companies are well capable of evaluating the real direct and indirect costs associated with a tender and switching process to a new audit firm, and are therefore well informed when determining whether it is appropriate for the company to tender or switch, given the circumstances.

8 In particular, we are concerned that the CC's initial view that "*[t]hose that have switched have not found the process particularly burdensome or the costs particularly high*"[7] coupled with "*[h]owever, the perception that switching causes upheaval is widespread, and appears sufficient to deter tendering, particularly when management is preoccupied with other concerns*"[8] fails to reflect the reality of the factors described below. In particular, while switching costs can be substantial in reality, and there are certain times when a change of auditor may be more difficult, part of the reason why companies may not find the process particularly burdensome is because of the considerable investment made by audit firms in trying to make the process of switching auditor as smooth as possible. In any case, in deciding whether to tender the company will also take into account the benefits of retaining its existing auditor, provided that auditor is delivering a high quality and cost-effective service.

The costs of tendering and switching can be substantial

9 The fact that some companies in the FTSE 350 have undertaken a switch of auditor and reported that the costs involved were not significant, or as great as they might have expected, should not lead the CC to the conclusion that this is the reality for all large companies.[9] This would be seriously to underestimate the costs that can be involved for many large companies of tendering and switching auditor, and is not supported by the evidence:

(a) As the CC has recognised, the costs involved of conducting a tender and/or a switching process are felt most keenly by management and staff in terms of their time[10]. While the

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6 Paragraph 72(e) and (f).

7 Paragraph 72(e).

8 Paragraph 72(f).

9 We note in this context that switching costs currently occur relatively infrequently relative to expected audit tenure, with companies typically unwilling (for good reasons) to tender too often. For example, if a firm tenders every ten years, then the costs need to be amortised over ten years. This overall context is lacking in the CC's assessment.

10 Paragraph 72(a).

CC's survey respondents may have suggested that internal costs change little as a consequence of undertaking an audit tender,[11] this appears to be because respondents replied based on ongoing costs rather than one-off costs (otherwise it is difficult to explain those that reported that costs fell). In any event, companies are not likely to change staffing levels because of an audit tender, but instead will re-prioritise their activities.

(b) Staff time has a real opportunity cost (their time could be spent on other corporate activities), so to conclude that there are no internal economic costs would be incorrect - indeed, involvement of senior finance staff in audit tenders inevitably distracts from their focus on the financial management of the company for the period in question. This is supported by the case studies reported at paragraph 10 of the Switching Costs WP, which almost universally mention that there are real costs of tendering and switching.[12]

(c) Self-evidently, the larger (often more international) and more complex the company, the greater the switching costs are likely to be.[13] For example, the costs involved for [✂] in conducting a tender and switch are clearly of a far higher order of magnitude than those incurred by Company E.[14]

(d) While there may be relatively limited external costs for companies tendering or switching their audits, in our experience companies can engage third party consultants to assist in more complex tender processes when they think this will make their procurement more effective and efficient [✂].[15]

(e) The CC recognises that there is a potential cost in terms of the increased risk of audit error following a switch - this is supported by evidence from the case studies and other sources.[16] There is also the related loss of the benefits of continuity - in particular, the loss of the existing auditor relationship that is more efficient in dealing with complexities and continuing areas of exposure (which we elaborate on below).

(f) A point that is significant, but understated in the Switching Costs WP, is the level of switching costs faced by audit firms[17] who make significant investments in winning tenders; in helping companies manage the switching costs they face; and in investing extra auditor hours in the early years of an audit to minimise the risk of failing to identify misstatements while becoming familiar with the company. Any reluctance companies may have to switch because of switching costs is balanced out by the concern auditors

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11 CC's Survey, slide 67.

12 For example: (i) the ACC of Company B "*thought that tendering was not a process to be taken lightly as it was a 'hugely expensive exercise' for both the company and the audit firms*"; (ii) the ACC of Company F "*thought that switching auditors was a hassle. The process required considerable work and preparation, and there was time spent for the auditors to build up their knowledge…*"; and (iii) the ACC of Company G said that for a bank in particular, switching "*would be a huge exercise and had a huge risk…*" and "*would be a major disruption… and would divert significant amounts of management time*".

13 Paragraph 72(a).

14 [✂]

15 Paragraph 13. See also paragraph 12 of the summary of a conference call with 3i Group that reports the use of outside consultants (the Buying Team), albeit in the context of fee negotiations with audit firms.

16 Paragraphs 31 to 47. See also paragraph 5.35 of our Initial Submission where we covered this point.

17 Audit firm switching costs are noted to exist in paragraph 3, but otherwise not covered in the Paper. They are covered briefly in paragraphs 162 to 165 of the Nature and Strength of Competition working paper.

have at losing FTSE 350 audits: the existing auditor will face significant costs if a tender process is run through needing to prepare a tender proposal, and there is the obvious risk that the auditor may ultimately lose the client.[18] This creates a strong incentive for the auditor to provide a continuously high quality service to reduce the risk of a tender, and means the explicit or implicit threat to tender can be used highly effectively by companies to achieve competitive outcomes without needing to incur the full costs of a tender, as is shown in the market outcomes.[19]

Audit firms go to considerable lengths to try to minimise the costs and disruption experienced by a company when it does decide to change auditors[20]

10 The CC recognises that in the current market audit firms go to considerable lengths to minimise switching costs.[21] However, these efforts on the part of audit firms do not mean that switching costs are in reality negligible. There remain real costs for both the new audit firm and the company in ensuring that the new auditor is capable of providing an effective audit in the first few years after appointment:

(a) As the CC recognises, audit firms do more work in the early years (and use more senior staff in the first year) than the previous auditors.[22] We agree that to minimise the risks for the company in the first few years after appointment, the new audit team will commit the necessary resources to get to know and understand the business that they are auditing in order to be able to identify the audit risks and design the audit approach. (In this respect, the CC should note that the data analysis of hours is complicated by possible scope changes after a switch and the need to standardise year ends.)[23]

(b) Although the time costs of auditors becoming familiar with a company are currently absorbed by the audit firm and are effectively sunk costs,[24] the company is still exposed to additional costs of management time involved in educating the new auditors. Effectively both parties make investments in the audit relationship, and therefore have an

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18 This risk is particularly significant, given the Survey WP result that only 21% of existing auditors retain their appointment after a tender by a FTSE 350 company (paragraph 49 of the Survey WP - we note this figure is 20% in paragraph 125 of the Selection Process WP).

19 The CC's engagement data shows audit fees are declining in real terms, in most cases without companies having to resort to tender, while slide 60 of the CC's Survey shows that costs of tenders and switching are not significant factors deterring tendering relative to other factors - cumulatively the two factors relating to cost and disruption amount to 29% (13% for cost and 16% for disruption) whereas positive reasons for not switching amount to 133% - and responses to this question (B17) were unprompted. 94% of ACCs and 86% of FDs of FTSE 350 companies would tender if they felt their auditor was complacent (slides 68 and 74 of the CC's Survey), with slides 64 to 67 suggesting that such companies achieve competitive outcomes when they do tender.

20 Paragraph 64.

21 The current levels of switching affects the frequency with which such costs arise, the period of likely engagement over which audit firms can assume such costs might be recovered, and hence what level of costs is economic to be incurred in the first place.

22 Paragraph 69 and 72(e).

23 Fee and hours data have been presented according to the audit firm's accounting year. Using such data will not necessarily relate to the time spent performing a full year's audit, and fees and hours relating to more than one year could be intermingled and therefore misrepresent the extent of changes in fees and hours following a switch being analysed correctly. Also, the CC should be careful in interpreting its analysis of the number of audit hours undertaken three to four years after a switch because of the time elapsed since the tender and the small sample of data available. We can identify clients which have required a growing amount of auditing hours after a switch, so the reduction the CC finds in the third year after a switch is not always the case and sometimes the reduction in hours does not occur until year four to five.

24 Paragraph 61.

interest in making the relationship work in the medium to long term to avoid re-incurring such costs.

(c) Notwithstanding this incentive, as we discuss in our response to the Nature and Strength of Competition WP, there is abundant evidence of companies being able to put pressure on auditor performance and price without conducting a tender. For example, in response to client dissatisfaction we recently changed, within a period of about four months, the lead audit partner and others in the audit team for [✂] to head off the risk of a tender, and this proved successful with [✂] now very satisfied with our service. We have also provided several other examples of clients where we have had to rectify problems to retain the audit engagement.[25]

There may be certain times in the corporate cycle when a large company would not choose to prioritise conducting a tender process and/or switch auditor

11 To suggest, as the CC seems to[26], that deferring such decisions may be inappropriate, fails to recognise: (i) that such a decision is likely to be commercially rational; (ii) that existing audit firms cannot and do not take advantage of such situations; and (iii) such periods do not last for any length of time:

(a) We agree that at certain times (for example, during restructuring, refinancing and acquisition/disposal activities, etc.), business activities of the company mean that switching auditors would not be practicable or may risk a company's reputation.[27] At such times investors are likely to prefer that company management focus on the immediate issues, and indeed these are precisely the times when the existing audit firm's knowledge can be particularly valuable, such that a tender and/or switch during this period would be badly timed. It follows that we do not accept the CC's suggestion that at these times "*diverting management attention on to an (optional) tender process and/or education of a new auditor was <u>perceived</u> as a significant cost*" (emphasis added).[28] In fact, such costs are always real and can be significant.[29] It is not the costs which change, rather the business priorities at such times.

(b) As to the suggestion that there are only certain times of the year when a large company can consider running a tender process as it takes time to select and introduce a new auditor, and for the new auditor to conduct sufficient investigations for it to be able to give its opinion[30], this concern is in reality rarely an issue and is readily managed. Companies can predict with certainty that they will need a statutory audit each year (in contrast with the need for procurement of other professional services which can arise unexpectedly) and can therefore plan their procurement of that audit well in advance, thus ensuring that: (i) any related effort needed (for a tender, etc.) can take place at a time that best suits the

25 See the examples at paragraph 4.46 of our Initial Submission - especially the example of [✂].
26 Paragraph 72(g).
27 Paragraph 7 (b)(ii) and (iii).
28 Paragraph 24.
29 Indeed, as mentioned above, the case studies summarised in paragraph 10 of the Paper almost universally mention that there are real costs of tendering and switching.

company's needs; and (ii) they can exert maximum competitive pressure on the existing audit provider. In the unlikely event that a quick switch of auditors is needed, the largest auditors have the capabilities and resources to provide the customer with the necessary service.[31]

(c) Further, the periods in which a company would not choose to tender are relatively short, meaning auditors remain keenly aware of the threat of tender even during such periods.[32] Case study C illustrates this point clearly, with the company going out to tender as soon as it had got through a challenging period.[33]

There are substantial benefits for a large company of not tendering and switching when the existing audit firm is delivering a high quality and value for money audit

12 While this is a general reason why companies do not tender (as opposed to a specific switching cost reason), the Switching Costs WP does not give sufficient weight to the fact that a very material factor for a company that switched when satisfied with its existing audit firm would be the loss of that audit firm's knowledge of the business (making it all the more illogical why a company would switch when satisfied with its current auditor):

(a) The quality of advice received from an auditor increases as the audit firm becomes more familiar with the company's business. The CC's recognition of this factor is inappropriately hedged in a way that other findings from the CC's survey are not, reporting that "*some companies thought that the quality of advice received from the auditors increased over time. If this is true, then there is a potential cost in changing auditors, if the quality of advice deteriorates (at least initially)*"[34] (emphasis added).

(b) In fact, there are mutual benefits for the company and the audit firm in building a relationship - the knowledge and experience gained by the existing auditor over time allows the auditor to provide better insight and advice to the business. As the evidence from the CC's survey and case studies shows, risks can be identified earlier; difficult judgements can be made more efficiently; and the prospect of spotting internal fraud is enhanced.[35] In short, an audit which is based on the auditor's in-depth understanding of

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30 Paragraph 19.

31 Our transition to audit [✂] is a good recent example in this respect.

32 Paragraph 196 of the Nature and Strength of Competition WP also supports our understanding that audit firms do not raise their fees in such periods. There the CC indicates that it can take up to three years for an audit firm to become fully familiar with a new company, making it unlikely that a company would want to change its auditor before three years has elapsed. While the CC suggests that knowledge of this could in principle allow audit firms to raise their fees after the first year, the CC has instead observed that: (i) fees in several tender proposals are fixed for three years or more; and (ii) fees decline after the first years of engagement; and (iii) "*firms do not take advantage of the learning by doing curve of the contract*".

33 Paragraph 58 of the Company C case study.

34 Paragraph 51.

35 For instance, regarding Company G: (i) the GFC said that "*[t]he most significant downside to switching auditor would be an increased risk of the auditors missing something that management either did not want to share or that they had not fully understood*" (paragraph 24); and (ii) on partner rotation (i.e. not even an overall change of audit firm), the GFC said that "*[t]he new AEP had taken time to understand and be comfortable with his firm's approach to auditing the company and to judgement issues*" (paragraph 42). For Company F, the ACC said "*[t]o do a really good job the auditors had to understand the fundamentals of the business. Overly rapid rotation risked losing this understanding*" (paragraph 51). Furthermore, efficiency of the audit process is one of the key factors that ACCs and FDs look for when assessing the

the business developed over time results in more relevant and reliable information being produced and made available to third parties (for example, the capital markets).

(c) The fact that switching costs are incurred by audit firms (as well as companies)[36] - including financial costs and potential reputation damage if a high profile client is lost - means that a company's existing audit firm has a real incentive to avoid a tender wherever possible. We seek to ensure our existing clients are satisfied with the service they receive by offering competitive prices and a high quality audit, and we monitor our clients closely to address any concerns that the company may have promptly and robustly.[37]

13 It may be that the reason the Switching Costs WP does not reach as balanced a conclusion on the role of switching costs as we consider appropriate is because it has been influenced unduly by the experience of those companies that have switched. Such companies are of course largely dissatisfied customers (the CC's survey results show that the main reasons for companies switching include price, previous auditor performed poorly, better quality of service in delivery of audit etc).[38] They are therefore inevitably more likely to report that the switch has produced positive outcomes. The CC acknowledges this selection bias in the Nature and Strength of Competition WP.[39]

14 To provide a balanced account, it should also be noted that for those companies that have not switched, there are material benefits for such companies of retaining their existing audit firms which are providing a high quality service which is good value for money. Indeed, the CC's Survey shows that of those companies that have not tendered in the last five years, the vast majority cite positive reasons for not doing so.[40] Furthermore, of those companies that have switched, a substantial percentage of respondents from the FTSE 350 - 36% - (and also non-FTSE 350 respondents - 44%) suggested that switching had no impact on the audit quality, that quality decreased, or that they did not know.[41] Moreover, analysis that was included in our Initial Submission shows that there is no relationship between the profitability of our FTSE 350 audit engagements and the length or tenure of these engagements, demonstrating that companies that do not switch are just as able to negotiate competitively scoped and priced audit

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quality of an audit (91% of FTSE 350 ACCs and FDs consider efficiency and the ability to detect misstatements as important for quality - see the CC's Survey, slides 26 and 28).

36 Paragraph 3.

37 For example, see paragraphs 2.67, 4.44 - 4.48 and 6.59 - 6.62 of our Initial Submission where we explain how we collect and use client feedback from Client Perspective Reviews (CPRs), Independent Senior partner Reviews (ISPRs), Client Satisfaction Surveys (CSSs), Post-Decision Reviews (PDRs) and the Audit Relationship Risk Diagnostic (ARRD). This activity would be unnecessary and a waste of our resource if we did not feel threatened by the possibility of losing our clients.

38 See CC's Survey, slide 63.

39 See paragraph 186 of Nature and Strength of Competition WP: "*we recognise that these results may suffer from a selection bias in that those companies most likely to gain from switching are more likely to be those that decide to do so, and they may do so only if they are dissatisfied with the price or quality of their current auditor.*"

40 The positive reasons amount to 133% cumulatively being: (i) high quality service; (ii) good value for money; (iii) happy as things are; (iv) partner rotation keeps things fresh; (v) for continuity / familiarity; (vi) incumbent understands business; and (vii) benchmarking suggests get good value. The negative reasons (disruption and cost) amounted to only 29% cumulatively. We have categorised one response - time not right - as neutral (i.e. neither positive nor negative). This response accounted for 10% of the cumulative 173% of responses given.

41 See CC's Survey, slide 65. FTSE 350: Sample size 33 - 64% Audit quality improved; 18% no material impact; 15% don't know; and 3% audit quality lower. Non-FTSE 350: Sample size 100 - 55% Audit quality improved; 20% no material impact; 21% don't know and 3% audit quality lower.

as those that do.[42] This conclusion is also supported by the data showing that the overall audit fee / hour has declined significantly in recent years, given that only around 4% of FTSE 350 companies will have switched in any particular year.[43]

15 We agree with the CC's view that switching costs do not amount to an insurmountable barrier to entry[44] - although we do not consider this position changes when considered collectively or against the potential benefits of switching.

16 Finally, something that is not recognised in the Switching Costs WP is that should levels of tendering and/or switching materially increase in the future (as is envisaged by the current FRC "comply or explain" proposals), certain observations made by the CC on the way the market operates at the present time may not apply - in particular, as regards the willingness of audit firms to incur tendering costs and bear a share of the costs of transition for companies were these costs to arise more frequently and be amortised over shorter appointment periods.

PricewaterhouseCoopers LLP

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[42] See our Initial Submission, figure 11, which plots our audit profitability (in terms of our internal CPy measure) against audit tenure - there is no indication that shorter tenure clients are more or less profitable than longer tenure clients (i.e. those who have not recently switched).

[43] See Chart 9 and paragraph 35 of the Descriptive Statistics WP, showing that while audit hours have remained broadly static, nominal audit fees have declined by 15% in the last five years (implying an even higher decline in real terms).

[44] Paragraph 74.