STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Evidence on switching costs (and implications for barriers to entry)

Introduction

1. Switching costs are likely to affect a company's willingness to change auditor, and so affect its likelihood of tendering, and the opportunities for an auditor (whether currently within or seeking to enter the relevant market we have identified, namely the supply of statutory audit services to large companies) to win the audit engagement.

2. Accordingly, switching costs are relevant to both our assessment of the nature of competition between firms within the relevant market and to barriers to entry to firms outside the market. This working paper presents the evidence we have obtained in relation to switching costs in paragraphs 7 to 71, primarily via:

   (a) the case studies;

   (b) the survey;

   (c) the firms' submissions (responses to our Issues Statement, MFQ etc); and

   (d) other (including: academic literature, company interviews, engagement data base, internal documents, tender documents).

3. Switching costs are incurred by both companies and audit firms. We set out our initial views on switching costs for companies (including the extent to which these costs are mitigated by firms) in paragraphs 72 and 73. We have considered the cost of tendering and switching for firms (another form of switching cost) in our Nature and strength of competition working paper.

4. In the Restrictions on entry or expansion working paper,[1] we said that we would consider companies' switching costs as an intrinsic barrier to entry. We set out our initial views on these potential barriers to entry in paragraphs 74 to 75.

5. The implications of switching costs for the nature of competition within the market are considered separately (in our Nature and strength of competition working paper), also drawing on the evidence set out here.

6. We recognize that when considering the significance of switching costs these costs need to be weighed against any potential benefits of switching.

Switching costs

7. Broadly, we have considered any factor that discourages a company from considering switching auditors as a switching cost. These include factors that have a time or monetary cost implication, but also include disadvantages that companies might see in switching auditor. Based on our Issues Statement[2] and evidence gathered in this inquiry, we currently think the main switching costs (for companies) are:

   (a) management, audit committee and finance department staff time required to run a tender, select a new auditor and to familiarize that new auditor with the company;

   (b) timing issues including:

      (i) the logistical difficulties of appointing an auditor so that it can form its opinion conveniently within the annual reporting cycle;

      (ii) at certain times management time is particularly scarce, and so its cost heightened;

[1] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/barriers_to_entry_framework_wp.pdf.
[2] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/111207_issues_statement_final.pdf.

(iii) at certain times, there may be a risk to a company's reputation from switching auditor (if, for example, this might signal an issue at the company or a dispute with the auditors, or more generally the company wishes to portray stability);

(c) the increased risk of a new auditor making mistakes before it is fully familiar with a company, compared to the risk of mistakes by an incumbent auditor;

(d) the risk to the company that the new auditor takes a different view of an accounting treatment to the previous auditor and that this results in a less favourable financial position for the current management and/or shareholders;

(e) the loss of other advantages of long-term relationships (for example, confidence in the auditor's ability to highlight business recommendations in the course of the audit); and

(f) the loss of a new auditor as an existing provider of non-audit services (if this proves necessary to comply with independence requirements).

8. We also consider *(f)* how audit firms respond to such company switching costs, to reduce the company's cost of switching. This has two aspects: the audit firm's ability to mitigate client costs; and its willingness and/or ability to be able to incur these costs.[3]

9. For each of the items in paragraph 7, we present the evidence (by topic) in paragraphs 10 to 71 below.

Management time and other costs

Case studies

10. From a company's viewpoint we have not identified a significant monetary cost to holding a tender. However, the time cost involved in changing auditors has been

[3] As noted above the costs of tendering and switching for audit firms are considered in a separate paper.

highlighted to us. Many individuals (both FDs and ACCs) told us that the tender process was quite straightforward and that it was educating a new auditor which took time:

(a) At company A, the CFO said that switching costs would not affect a decision to change auditors. He said that the cost fell mainly on the audit firm. The internal time from the company's perspective in terms of getting the auditors up to speed would be spread across a number of companies and offices and so the burden on any one team would not be excessive.[4]

(b) At company B, the FD said that the biggest cost of running a tender and switching auditor was the time spent in the first year answering questions put to the company by the new auditor. It was not the tender that took the time but getting the auditor up to scratch. This was a big factor at the company as the Group (ie head office) finance team was small.[5]

(c) At company B, the ACC 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. For the company, time was spent planning the tender brief and explaining the company to new auditors.[6]

(d) At company C, the CFO said that the largest costs of switching were time and disruption. The selection process itself was somewhat onerous and time consuming but the real issue was educating the new audit team.[7]

(e) At company D, the ACC thought that switching costs amounted to management time, as the first year of an auditor's appointment required significant input from both the executive management and the NEDs.[8]

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[4] Company A, paragraph 35
[5] Company B, paragraph 20.
[6] Company B, paragraph 43.
[7] Company C, paragraph 29.
[8] Company D, paragraph 63.

(f) At company E, the ACC thought that there would be very little monetary cost to holding a tender and that the tender process would cause minimal disruption to the business.[9]

(g) At company E, the FD (who had not switched auditors) had been told that it was a real upheaval; however, his understanding of the process at Company E (which had occurred before he assumed the role) was this was not too difficult.[10]

(h) At company F the FD thought transitioning auditor was hard work but fairly straightforward. The costs of switching were internal time costs, ie the FD's, Audit Committee's and the finance team's time spent bringing the audit team up to speed.[11]

(i) In the short term, the ACC at 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 of the business. However, this was not a reason not to tender.[12]

(j) At company G, although the auditor had never been switched, given the global structure of the Group, potential bidders would have to meet several hundred members of senior management.[13]

(k) At company G the ACC said that for a bank in particular, switching auditor would be a huge exercise and had a huge risk associated with it. Switching auditor would be a major disruption to the company and would divert significant amounts of management time. For complex organizations (such as company G) switching auditors was an enormous task that needed to be undertaken effectively.[14]

(l) At company H, a tender involved significant management time of 25 to 30 individuals. Aside from the management time the FD was not so worried about the risk associated with the auditor getting to know the business and the technical

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[9] Company E, paragraph 52.
[10] Company E, paragraph 22.
[11] Company F, paragraph 27.
[12] Company F, paragraph 51.
[13] Company G, paragraph 23*(a)*.
[14] Company G, paragraph 67.

issues as part of the tender addressed the ability of the audit firm to do this. 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.[15]

(m) The ACC of company H thought that he would double the number of days he spent on Audit Committee business during a tender year.[16]

(n) At Company I, the FD said that the biggest cost to a company of holding a tender was the time cost, particularly the finance function. There was a substantial amount of time needed to meet all the key operational executives and to get to know the business. The company had experienced these costs to an extent when partners had changed, and although it was not as dramatic a change as changing the whole audit team, the FD thought that changing a partner was not a trivial exercise.[17]

(o) The ACC at company I said that an important factor in deciding whether to switch auditors was the management time required to conduct the tender and the time needed for the new auditors to get up to speed. The ACC highlighted the distraction and disruption to management as a general cost of switching auditor.[18]

Survey evidence

11. In the CC's survey we asked respondents for companies that had not tendered their audit in the last five years why this was the case. Around 25 per cent of the FTSE 350 companies mentioned the disruption and costs involved in tendering audits and changing auditors.

12. For those companies that had switched auditor in the last five years, we asked respondents for their views on the effect this had on fees, quality of the audit and

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[15] Company H, paragraphs 34 & 35.
[16] Company H, paragraph 69.
[17] Company I, paragraph 22.
[18] Company I, paragraph 49.

internal costs. With regard to the latter, the majority of the FTSE 350 companies (of which there were 33) said that there was no material impact on internal costs (15 per cent said that there was an increase in internal costs and 15 per cent said that there was a reduction in internal costs after the first year).

[✂] plc[19]

13. In its recent tender process [✂] plc had used an external consultant (Boston Consulting Group) to provide support to the tender process, but the majority of the work was carried out as part of the finance team's normal work. [✂] plc estimated that the cost of the external consultant was £[✂] in the context of a £[✂] million audit fee (ie less than [✂] per cent of the annual audit fee).[20] Both the tender and auditor transition were disruptive processes, as the company needed to educate the audit teams about the company worldwide. Accordingly, it did not want to undertake these processes very frequently.[21]

14. This interview provided the only example we have identified of an external cost for a company in running a tender process (although it is possible that the work companies undertook on benchmarking fees (see survey and case studies) was completed externally).

Audit firm evidence

BDO

15. BDO considered that customer switching costs could be overstated. It said that the main costs of switching for a company were:

    (a) the additional time of the audit committee and management in selecting an audit firm; and

[19] Published summary: www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/summary_of_conference_call_25_january_2012.pdf.
[20] Email dated 3 August 2012.
[21] Paragraph 18 of published summary.

(b) the time of staff, generally in the finance department, in explaining the operations and systems of the company to prospective auditors, and in more depth when a new auditor carries out its first audit.[22]

Ernst & Young

16. In Ernst & Young's (EY's) UK&I Assurance FY11/12 Pricing Guidance (an internal document for its staff and partners to consider when negotiating fees) there was a section on 'handling difficult questions'. It advised, that if a client said it needed to put the audit out to tender, partners/staff should 'highlight the internal time absorbed in a tender process'.[23]

PricewaterhouseCoopers

17. PricewaterhouseCoopers (PwC) identified a number of costs associated with switching which were significant for the company, while not being so high as to prevent the company from moving if it were dissatisfied with the level of service, including:

    (a) the management time and distraction of (i) setting up a tender process; (ii) participating in the process itself (including having meetings with each audit firm); and (iii) introducing a new audit team to the company, was likely to be relatively significant; and

    (b) direct costs incurred in running a tender process. These would vary depending on the procedure utilized but might be material, particularly if external procurement specialists were involved.[24]

[22] BDO response to the issues statement (public version) paragraph 5.3.3.
[23] EY UK&I Assurance FY11/12 Pricing Guidance, p10. Supplied to the CC in response to MFQ follow up questions—pricing decisions .
[24] PwC response to issues statement (public version), paragraph 5.35.

Timing issues

18. We identified a number of different factors related to timing that might create or increase the costs of switching auditors for a company. Our principal evidence for this came from our case studies.

Window of opportunity

19. It appears 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 auditor to conduct sufficient investigations for it to be able to give its opinion. For example:

    (a) Company A. In 2009, the previous auditor took over the full audit of the Scandinavian business and the audit of the full UK business. This appointment occurred shortly before the year-end and so the previous auditor had undertaken its usual interim procedures later than would otherwise have been the case in relation to the newly transferred audits in Scandinavia and the UK. The previous auditors raised a series of issues in relation to the lack of reconciliations for certain balances in the UK business. The previous auditor accepted management assurances—on the basis that high level logic checks (proof in total) were performed by management had been reviewed by the previous auditor and had in previous years been reviewed by the parent company auditor who had been satisfied that there was no significant issue and the previous auditors had discussed this with the parent company auditor—that this would not affect the company materially, but made clear a full reconciliation was expected for the following year's audit.[25]

[25] Company A, paragraphs 116 & 117.

(b) Company B. The FD said that the tender process itself was straightforward, but needed to be run efficiently so the decision could be announced and the new auditors could start in a timely way for the new reporting year.[26]

(c) Company C. The former AEP explained that if the Company wanted to appoint new auditors for the year-end, it must run the tender process in sufficient time to allow new auditors time to work on that year's audit. If the company had waited until the summer, then the new auditors would only have been appointed for the following year-end.[27] The CFO said that company C was never very far away from issuing results to the market as it reported quarterly, therefore it was a logistical exercise in appointing the auditors in time to conduct the audit: it required D-day style planning.[28]

(d) Company H. The FD said that the most feasible time to conduct a tender was after the year-end audit or after the interim review.[29]

Effect of regulations: increased time involved in switching

20. A further timing effect we noted was that for certain companies the lead time required in order to switch auditors was increased by some of the independence regulations.

21. Company G was SEC registered. The GFC said that in its case switching auditor would require significant work for the audit firm to be considered independent. For example; the audit firm's employees would need to change their banking arrangements if they were customers of the company and other non-audit work provided by the firm would need to be suspended. He noted that in many cases consulting contracts were global and multi-year so facilitating this would be

[26] Company B, paragraph 20.
[27] Company C, paragraph 136.
[28] Company C, paragraph 29.
[29] Company H, paragraph 29.

complex.[30] The ACC said that the independence requirements for the SEC added significant hurdles to switching auditor.[31]

22. [✂] plc explained that the SEC independence regulations meant that a new auditor would need time to become 'independent'.[32]

23. In addition to increasing the lead time required to switch auditor, the SEC regulations also have implications for companies in terms of the loss of a provider of non-audit services: the auditor may have been the best choice for those contracts, there may be termination penalties etc in addition to the disruption, timing issues. We consider the potential cost to companies of losing a provider of non-audit services below (see section starting at paragraph 58).

Certain business activities increase the opportunity cost of management time

24. A related issue that prevented companies switching at times was the business activities of the company. For companies undertaking significant restructuring, refinancing or acquisition/disposal activities, diverting management attention on to an (optional) tender process and/or education of a new auditor was perceived as a significant cost (ie the opportunity costs of these individuals' time was particularly high at certain points in time). Generally the internal time costs of running a tender process and switching auditors would fall on the finance team.

25. The ACC of company H said that if there was a major change to the business, then this was not the time for the Audit Committee and the board to 'disturb the ship'. In

[30] Company G,paragraph 23(b).
[31] Company G, paragraph 71.
[32] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/summary_of_conference_call_25_january_2012.pdf, paragraph 17.

this situation it was more important to have continuity of people who really understood the business.[33]

26. We were told that whilst ordinarily a tender/switch might have been or be considered, such a decision was or could be delayed:

(a) At company B the FD said that in evaluating the positives and negatives of holding a tender process he would consider whether the company had time.[34]

(b) Company C had been through an enormous transformation in recent years. During this period the company changed all of its advisors, but it was not thought sensible to change auditors at this time as there was so much going on in the group.[35]

(c) the FD of company H said that changing auditors whilst conducting a major acquisition would not be feasible.[36]

(d) In the case of company I issues with the auditor had occurred at a time when management needed to be focused on other strategic priorities.[37]

Switch timing and company reputation

27. Company H floated its Indian business in 2006. The company was advised by the book-runners that the Indian market would find it strange if the auditor that signed the prospective accounts was not in place for at least three years after flotation.[38]

28. One of our case study companies was another example of company that thought that it had been constrained from switching auditor for signalling reasons for a time [✄].[39]

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[33] Company H, paragraph 70.
[34] Company B, paragraph 20.
[35] Company C, paragraph 58.
[36] Company H, paragraph 29.
[37] Company I, paragraph 49.
[38] Company H, paragraph 28.
[39] [✄]

29. BlackRock told us that they would view frequent changes of auditor as an issue, particularly if the CFO also changed numerous times in a short period of time.[40]

Survey responses

30. In the CC's survey of decision makers, at those FTSE 350 companies that had not tendered their audit in the last five years, around 10 per cent mentioned that the 'time was not right'.

Increased risk of audit error

Case studies

31. At company A, the ACC (a former audit firm partner) thought that changing auditor was risky, especially in the first year of appointment where the auditor had to familiarize itself with the business and management issues. He described first-year audits as 'scary' due to the auditors' lack of knowledge of the particular company and its management.[41]

32. The ACC at company D said that as long as the auditors were independent it was good to have auditors who understood the business and who were able to identify the risks. The risk of switching auditors was that they did not immediately understand the business.[42]

33. The ACC at company F said that to do a good job auditors had to understand the fundamentals of the business. Overly rapid rotation risked losing this understanding.[43]

[40] BlackRock case study, paragraph 19.
[41] Company A, paragraphs 61 & 76.
[42] Company D: paragraph 64.
[43] Company F, paragraph 51.

34. At company G, the ACC (also a former audit partner) considered switching auditor for a bank had a huge risk associated with it. He considered that the risk of audit failure was higher when an auditor was changed, and referred to the empirical research undertaken by Bocconi University.[44] The GFC also raised the risk of auditors missing something that management either did not want to share or that they had not fully understood as being the 'most significant downside' to switching auditor.[45]

Academic literature

Effect of tenure on audit quality

35. Professor Vivian Beattie's review[46] suggested that the evidence in relation to the impact of long tenure on audit quality (and perceptions of audit quality) was mixed, although she concluded that most evidence did not support mandatory rotation to reduce tenure periods:

> For example, Gul et al. (2009) find that short tenure is associated with lower earnings quality (consistent with a lack of client-specific knowledge), especially for non-industry specialists. Jenkins and Velury (2008) find that reported earnings are more conservative in cases of long tenure (US study). Li (2010) extends this analysis, reporting that the result holds only for large companies or companies strongly monitored by their auditors. Ruiz-Barbadillo et al. (2009) investigate a period when audit firm rotation was mandatory in Spain, finding no evidence of a higher propensity to issue going-concern qualifications. Jackson et al. (2008) find that audit quality (measured as the propensity to issue a going-concern opinion) increases with audit firm tenure and is unaffected when measured as discretionary accruals (Australian study). Lim and Tan (2011) find that the relation between audit tenure and audit

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[44] Company G, paragraph 67.
[45] Company G, paragraph 24.
[46] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/initial_review_of_relevant_academic_literature_in_the_audit_market.pdf.

quality is conditional on auditor specialisation and fee dependence (archival US study). The positive link between tenure and quality is stronger in the presence of specialists and lower economic dependence. By contrast, Joe et al. (2011) use a proprietary US Big4 audit firm working paper data set from 2002 to find evidence that audit adjustments are more likely to be waived for clients with whom the firm has had a longer association.[47]

Switching auditors and effect on the cost of capital

36. The Cardiff Business School report[48] highlighted that in some cases there was a tenure effect associated with the cost of debt, and hence there may be a cost implication associated with switching auditor:

> There are some suggestions in the academic literature that debt providers are concerned by the identity and/or quality of borrowers' auditors. Pittman and Fortin (2004) found, based on a sample of 371 newly public US firms, that the cost of debt capital is lower if the firm appoints a (then) Big 6 auditor. This effect was, however, found to subside over time and to be most pronounced for younger firms, for which less financial information is available. Furthermore, this study relied on a 'noisy' measure of the cost of debt estimated from interest payments in the financial statements, rather than directly on lending agreements.

37. Professor Beattie's review[49] noted that: in a study of the impact of audit tenure, Boone et al (2008) proxied investors' perceptions of audit quality using the ex ante equity risk premium (the company cost of equity capital minus the risk-free rate of

[47] Initial review of relevant academic literature prepared by Professor Vivian Beattie Section 2.6 (pp20 & 21).
[48] To be published.
[49] Professor Beattie's review section 2.11.1, p26.

interest). They found that the premium falls in the early years of tenure (indicating higher perceived audit quality consistent with learning effects), and rises thereafter (consistent with independence impairment). Mansi et al (2004) found that longer tenure was associated with a lower cost of debt. Both of these studies were based on US data.

38. Professor Beattie's review[50] reported that in their synthesis of the (mainly US) auditor switching literature, Stefaniak et al (2009) concluded that auditor change generally results in negative share price reaction.

Survey responses

39. In response to the CC survey, of those FTSE 350 companies that had not tendered their audit in last five years, 7 per cent gave as a reason that the auditors know their business and 6 per cent that they like continuity and familiarity with the auditor. These figures are 10 per cent for FTSE 100 companies. For context, other reasons given for not tendering included interviewees considering: they received good quality service (47 per cent); or received value for money (25 per cent); or that tendering was not necessary as they were happy with their current auditor (18 per cent).

Evidence from Audit firms

Deloitte[51]

40. Deloitte considered the benefits of a long-term relationship with audit clients included: developing a more in-depth understanding and knowledge of the client, its business and markets, systems, controls, processes, personnel, culture, tone from the top, values and transactions.

41. It said these in turn led to:

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[50] Professor Beattie's review section 2.11.2, p26.
[51] Deloitte response to MFQ Q79(a) and (b).

(a) a much greater appreciation of the risks inherent within the client's business;

(b) being able to deliver a more robust and challenging audit;

(c) being able to provide more insights of value to the client; and

(d) a more efficient audit.

42. Deloitte said that the benefit could be demonstrated by the length of time taken to perform certain tasks in the first year of an audit when compared with the time required in subsequent years. For example, for one client that Deloitte had now completed two audits for, the group audit team's activities to understand the client's systems and processes and establish and coordinate component audit teams around the world took around 10,000 hours in the first year. In the second year audit, these tasks took around 6,000 hours.

43. Deloitte said that possible adverse outcomes in terms of audit quality (and cost) might arise from switching due to an auditor's inevitable initial lack of knowledge, understanding and familiarity with the company, its operations and people. It said that the greatest concern was the possibility that frequent switching could lead to a reduction in the reliability of financial statements. In the first few years of an audit relationship, the auditor's knowledge and understanding of the business would naturally not be as developed as in later years. There was, therefore, a greater chance that the auditor would not identify that certain transactions were unusual for the business. With greater knowledge and experience of the company gained over a period of time, the auditor would be better placed to identify such transactions and to challenge management as to their purpose. Deloitte said this meant that even if the

auditor conducted the audit entirely properly, there was an increased risk in the earlier years that material errors in the financial statements would go undetected.[52]

44. Deloitte cited the following academic literature/research in support of its view that in the earlier years of an audit relationship, there is an increased risk of unreliability of the financial statements:

(a) Ghosh and Moon (2005) conducted some research into the relationship between auditor tenure and audit quality. Their results were generally consistent with the hypothesis that reported earnings are perceived as being more reliable as auditor tenure increases.

(b) Myers, Myers and Omer (2003) suggested that in the then current environment longer auditor tenure, on average, resulted in auditors placing greater constraints on extreme management decisions in the reporting of financial performance.

(c) The Public Company Accounting Oversight Board (PCAOB) reviewed several studies on the relationship between auditor tenure and audit quality between 2002 and 2010. It found that: 'Many, though not all, tend to support the view that engagements of short tenure are relatively riskier.'[53]

EY

45. We note that EY, in a tender proposal where it was the incumbent auditor, emphasized the risks associated with a new auditor including a view that allegations of failure occurred more frequently when a firm was in its first years if an audit engagement (Evidence relating to the Selection Process: Tendering, Annual Renegotiations and Switching paper, paragraph 80).

[52] Deloitte response to Issues Statement (public version), paragraph 6.4.
[53] Deloitte response to Issues Statement (public version), footnote 41.

PwC

46. PwC said that 'the more familiar the auditor is with the client's business, the better it will be at identifying potential areas of concern for the audit, and in effectively and efficiently carrying out the audit'.[54]

47. PwC identified a number of costs associated with switching which were significant for the company, while not being so high as to prevent the company from moving if it were dissatisfied with the level of service, including 'increased risks for the company in the first few years of the new audit firm, as the new audit team strives to get to know and understand the business to be able to exercise informed judgement on those issues particular to the company and the industry'.[55]

Change in auditor's opinion of an accounting treatment

Case studies

48. We considered whether there was evidence that a new auditor might take an alternative view of a company's accounting treatment to the previous auditor; or might approach the audit in a manner that unearthed something new/unexpected. This might be a cost (or in some cases a benefit) that management and/or the company factor in when considering switching auditor.

49. We note that the AEP at company I said that it was important to ensure a 'seamless transition' when audit partners rotated from a relationship and judgement point of view.[56] This indicates that a change in approach may be less likely when companies continue with the same firm.

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[54] PwC MFQ response, paragraph 79.3(a).
[55] PwC response to Issues Statement (public version), paragraph 5.35.
[56] Company I, paragraph 88.

50. The evidence we found related to where a company had changed auditor following a disagreement in accounting treatment, rather than where a disagreement followed the appointment of a new auditor. For example:

[✂]

Quality of advice

Case studies

51. 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).

52. At company B, the AEP said that it was not 'completely unfair' to categorize him as being 'at the top of his game' when he did his fifth audit of the company, although he said that there were benefits to having a fresh look.[57]

53. At company F, the ACC thought that there was a time for fresh eyes but five years was too short a period before switching, as the company lost the benefit of knowledge acquired by the auditors (company F, paragraph 53).

Evidence from audit firms

Deloitte

54. Deloitte said that a long-term relationship with an audit client allowed it to provide more insights of value to the client, see paragraph 40 to 41 above.

PwC

55. PwC said that while there were switching costs, these were not the main reason that companies did not tender—rather there were enhanced quality benefits accruing

[57] Company B, paragraph 107.

from the knowledge and experience gained over time by the existing auditor, and companies could take advantage of these benefits while the threat of tender ensured competitive pressure was placed on the audit firm.[58]

56. It said that a thorough knowledge of the business allowed the auditor to ‘provide insight and advice on issues such as: the effectiveness of the company’s operating and financial management systems; the design and implementation of its internal controls; and recommendations for improvement’.[59]

Survey responses

57. In the CC’s survey of those FSTE 350 companies that had not tendered their audit in the last five years, around 15 per cent said that the rotation of the partner kept things fresh.

Provision of non-audit services

[✂] plc[60]

58. [✂] plc noted that one Big 4 firm decided not to tender for its audit work as this would mean terminating its significant consulting contracts with the company. It also explained that the audit firm that was selected as a result of the tender would lose some consulting work as a result.[61] The company had strong relationships with all the Big 4 firms and had to weigh up the loss of the preferred auditor providing non-audit services in selecting the preferred auditor as the auditors.[62]

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[58] PwC response to issues statement (public version), paragraph 1.11(c).
[59] PwC MFQ response, paragraph 79.3(a).
[60] www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/summary_of_conference_call_25_january_2012.pdf.
[61] Paragraphs 14 & 21 of published summary.
[62] Paragraph 16 of published summary.

59. This example highlights a potential cost to companies of switching auditors as they may not be able to continue with their preferred provider of non-audit services (see also paragraph 23 above).

How firms respond to company switching costs

60. We considered how audit firms respond to such potential company switching costs, in order to minimize them and so facilitate switching. We note that PwC considered the costs incurred by firms to be independent of the costs of switching for companies: we accept that some of the costs would always need to be incurred by the new auditor but view the efficiency of transition as an area where firms can seek to reduce company switching costs.

Case studies

61. Companies and firms expect the time cost of auditors becoming familiar with a new company to be absorbed by the audit firm. Managing the transition was mentioned as a feature of the tender process by company H (see paragraph 10(l) above).

62. A number of AEPs told us that their recovery rates in the first year were poor, but increased in subsequent years once their knowledge of the business and efficiency increased. Summarizing, company E's AEP told us that in the first year of an audit there were inevitably set-up costs which affected the recovery rate. The AEP wanted to understand the business properly and therefore the review time was longer. He needed to have more meetings with more people.[63]

63. Our case studies indicate that both firms and companies viewed provision of non-audit services as a way of developing a working relationship with one another. If firms already have a working relationship with the company this may reduce some of the

[63] Company E, paragraph 99.

time costs involved in building an understanding of the company—however, this is likely to be limited as the same individuals are unlikely to be closely involved in audit and non-audit work.

Evidence from audit firms

Tender documents

64. Our review of the tender documents (Evidence relating to the Selection Process: Tendering, Annual Renegotiations and Switching[64]) showed that audit firms tended to set out detailed transition plans to minimize costs and disruption to a company when changing auditor. Details of the transition plan included:
    - *(a)* identifying a ‘transition partner’ who would help the company and the firm during the beginning of the relationship;
    - *(b)* defining a precise timetable for the transition period; and
    - *(c)* defining relevant meetings and deliverables concerning transition.

65. Knowledge of the company through previous relationships was often emphasized by the audit firm as a reason why transition should be smooth. The Big 4 firms tended to have more thorough transition plans, and also were able to point to a broader range of experience in transitioning companies, sometimes even being able to point to firms transitioned specifically from the company’s incumbent auditor. While non-Big-4 firms did mention transition experience they had fewer and smaller clients.

EY

66. EY considered that some of the costs of switching were met by the incoming audit provider as an initial cost of delivering the service to reduce the costs to the client and to induce switching. For example:

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[64] In preparation

(a) EY had in the past offered to complete initial work at reduced rates, and had agreed to absorb initial costs associated with understanding the business and setting up the audit approach. These costs were normally built into EY's commercial pricing decisions, and in the majority of cases the fee quote would be fixed, subject to material change within the client, for a period of up to three years.

(b) Good project management by EY could significantly reduce companies' switching costs.

(c) When establishing a new audit relationship, EY would take positive steps to ensure that the risk of 'making mistakes initially' was minimized. For example EY:

(i) would work with the client to put in place an appropriate audit strategy and methodology;

(ii) would ensure that the team conducting the audit had the requisite industry knowledge and expertise, to the extent possible; and

(iii) was required to liaise with the outgoing auditor in order to understand all relevant facts.[65]

PwC

67. PwC said that the significant client-specific investments that audit firms made during a tender process and in the early years of an audit were effectively sunk costs. It considered these costs were necessary to ensure that an appropriate quality of audit service could be provided in the first year (and so reduce the likelihood of failure) and increase the effectiveness and efficiency of performing the audit in future years. PwC said that the only way for an auditor to recoup these costs was by offering an ongoing attractive price and service proposition which ensured it maintained the audit

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[65] EY response to Issues Statement (public version), paragraph 55.

appointment from the company for at least a few years to recoup these investments.[66]

Data analysis

68. We analysed data from the 'engagement database' to see if there was evidence of increased time costs incurred by firms in early years of an audit. Table 1, sets out the percentage change in total hours worked by an audit firm following its appointment compared with the previous auditor (ie in years 1 to 4 it is compared with the total hours worked by the previous auditor in year 0). We considered FTSE 350 engagements where data was available pre- and post-change in auditor.

TABLE 1 **Percentage change in total hours worked by an audit firm in the years following appointment compared with hours worked by previous auditor.**

Number of years after appointment	*Number of companies in sample*	*% change in total hours*
0	19	0.0
1	19	24.3
2	13	31.5
3	6	14.3
4	5	8.2

Source: CC analysis.

Note: Year 0 represents the previous auditors' financial year ending prior to the *start* of the company's financial year audited by the new auditor

69. Table 1 shows that across all engagements the number hours worked in the first year of appointment was 24.3 per cent higher than the hours worked on the companies' audits by the previous auditors. In the second year of appointment the number of hours worked increased again to 31.5 per cent more than the previous auditors. In the third year the number of hours worked by the audit firm reduced but remained higher than the hours worked by the previous auditor.[67]

[66] PwC response to issues statement (public version), paragraph 5.36.
[67] We reviewed the data on the basis of 'Year 0 represents the previous auditors' financial year ending prior to the *end* of the company's financial year audited by the new auditor', and also found that the total hours worked increased in the three years following the switch compared with auditor hours worked prior to the switch.

70. We reviewed the share of hours by grade and found that across all engagements the share of senior audit staff time increased slightly in the year following a switch compared with the previous auditor, as set out in Table 2.

TABLE 2 **Share of hours by grade, by year following appointment compared with previous auditor**

per cent

Number of years following appointment	*Partner*	*Director*	*Senior Manager*	*Manager*	*Other Qualified*	*Unqualified*	*Administrative*
0	3.9	2.0	8.7	13.5	23.2	46.8	1.8
1	4.7	4.4	10.3	13.7	23.4	42.7	0.7
2	4.6	5.2	10.2	16.2	18.9	44.2	0.6
3	4.9	2.9	10.8	16.0	17.9	46.9	0.5
4	4.5	2.6	10.0	15.7	14.8	51.8	0.5

Source: CC analysis.

71. Table 2 shows that compared with the previous auditor, the proportion of hours spent on the audit by senior staff (ie senior manager, director and partner) increases in the first year following a change in auditor. The proportion of hours spent by managers and other qualified staff remains broadly the same in the year following a change in auditor and the proportion of total hours spent by unqualified and administrative staff reduced.[68]

Initial views of switching costs

72. Based on the evidence above, our initial view is as follows:

(a) Management and staff time is the most frequently cited cost: before, during and after a tender or switching process. We have evidence that supports these costs (both perceived and real) as a deterrent to switching. The larger (often more international) and more complex the company, the greater the costs.

(b) We have very limited evidence of external costs for companies tendering or switching their audits.

[68] Again looking at this data on the basis of ‘Year 0 represents the previous auditors’ financial year ending prior to the *end* of the company’s financial year audited by the new auditor’, and found similar results with a reduced proportion of hours spent in the first year by unqualified and administrative staff and an increase in qualified and above staff/partners.

(c) We have some evidence of other costs associated with switching, particularly the increased risk of getting the audit opinion wrong in the early years of appointment:

(i) This view was stressed in particular by the Big 4 audit firms (and ACCs who were former Big 4 audit partners). They considered as a result switching should only be considered carefully (ie that the possible costs are very high).

(ii) The academic literature with regard to the risk of switching auditors on quality is mixed: Deloitte and the Cardiff Business School report point to literature that either supports the view that audit quality increases with audit tenure or that there is a cost associated with switching; however, Professor Beattie's literature review presents a mixed view of the effects of auditor tenure on quality (we note that much of the literature is focused on US studies rather than the UK).

(d) The loss of provision of some non-audit services (by a new auditor) needs to be weighed-up, as does the loss of the existing auditor's provision of general business advice (as a by-product of the audit). Whilst there may be company specific issues with these factors, they seem unlikely to be a major barrier to switching.

(e) Those that have switched have not found the process particularly burdensome or the costs particularly high. Firms go to considerable efforts to ease the process and to manage the risks involved. Our data analysis suggested that audit firms tend to do more work in the early years (and use more senior resource in the first year) than the previous auditors.

(f) However, the perception that switching causes upheaval is widespread, and appears sufficient to deter tendering, particularly when management is preoccupied with other concerns (eg significant transactions; financial stresses; any other reason where the company wishes to portray stability). We have

evidence of instances where, at a particular point in time, switching auditor was not feasible.

(g) There is no obligation to tender. Accordingly, while companies may wish to tender for reasons of good governance, or for a change, or to obtain a somewhat better fee, it appears that such a process may easily be postponed for a time. Switching auditor tends not to be a top corporate priority, other than in specific circumstances. We examine those circumstances in our Nature and strength of competition working paper. That is also where we examine the benefits that must be weighed against the costs of switching discussed in this paper, and so inform any management decision to run a tender process.

73. We consider that the risk of a new auditor taking a different view, with regard to a company's accounting treatment, to the existing auditor might be a switching cost that companies consider. However, at this stage we do not have clear evidence of this.

Switching costs as a barrier to entry

74. The switching costs we have identified above apply to both Mid-Tier and Big 4 firms. They also apply to firms operating within the market and those seeking to enter it. Individually, these costs do not seem to amount to an insurmountable barrier to entry. However, collectively, or when weighed against the potential benefits of switching, they may be. The costs of tendering and switching for firms are explored separately but the ability and willingness of firms to incur these may also act as a barrier to entry.

75. There was some evidence that switching costs may be heightened for particular firms in certain circumstances:

(a) For firms entering the market—Big 4 firms appear better able than Mid-Tier firms to signal their ability to managing the transition from one audit firm to another.

(b) For firms entering a specific sector—The literature suggests that that short tenure was associated with lower earnings quality (consistent with a lack of client-specific knowledge), especially for non-industry specialists.