1 Introduction

1.1 This note responds to the CC’s request for views from parties on its Working Paper entitled: ‘Review of evidence on the price effects of switching’.\(^1\) In that Working Paper, the CC requests views on the following questions.\(^2\)

a) In your view what is the most plausible explanation for the observed relative price development observed for companies that tendered or switched?

b) How can a relative price development, whereby an initial relative price drop erodes away in three to four years, be consistent with companies that (on average) have strong bargaining power/price transparency outside of a tender situation?

c) In your experience, over the period from 2000 to 2010, to what extent were first-year audit fees unsustainable?

d) To what extent do you consider that a tender situation in the market for FTSE 350 audits is subject to competition ‘for the market’?

1.2 This note is structured to provide answers to each of these questions, prefaced by some general remarks.

2 General remarks

2.1 This section is split into three sub-sections:

a) price effects;

b) market characteristics; and

c) participation in tenders.

2.2 Price effects

2.2.1 There appears to be a general consensus about the overall ‘shape’ of prices in response to a tender, which the CC’s paper summarises as ‘following a direct switch, [FTSE 350] companies obtained a significant price decrease that eroded over the subsequent two to three years.’\(^3\)

2.2.2 There are two main observations to make about this pricing pattern: first, while it may be the case for the FTSE 350 market as a whole, it may not be so for companies that switch to BDO; second, on average, companies that tender but do not switch auditor do not receive a price benefit. Those that do switch appear to enjoy a significant price benefit irrespective of the statistical model used to test this. As the CC states regarding its alternative model: ‘we saw a benefit of switching for those


\(^2\) Ibid., p. 32.

\(^3\) Ibid., para 1.
companies that switched roughly in line with the average effects of the “company-specific effects” model.¹⁴

2.2.3

2.2.4

Table 2.2  Change in audit fee in years after switching (compared with previous fee) among FTSE 350 companies

<table>
<thead>
<tr>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>Big Four to Mid-Tier change in audit fee</td>
<td>-83%</td>
<td>-89%</td>
<td>-23%</td>
<td>-25%</td>
</tr>
</tbody>
</table>

Note: All FTSE 350 companies.
Source: Data provided by the Competition Commission.

2.2.5 It is recognised that these results are based on limited data. Nonetheless, the evidence available suggests that it might be only the Big Four that enjoy the pricing power to raise prices back to pre-switch levels. It would seem worthwhile for the CC to explore comparisons between the Big Four and other audit firms in order to see whether the dynamics of post-switch pricing are systematically different.

2.2.6 It is also important to note that a comparison of Tables 2 and 3 in the CC Working Paper highlights the differences between companies that switch auditor following a tender (which experience a median decline in fees of 17%), and those that do not switch auditor following a tender (which experience a median increase in fees of 2%). This suggests that tendering per se does not induce the incumbent auditor to reduce its prices.

2.2.7 While there is broad agreement about the pattern of prices, there is disagreement over the cause. Three explanations are put forward in the Working Paper for the pattern of prices outlined above. These are:⁵

a) audit firms offer discounts to encourage companies to switch auditor. These discounts are not sustainable and the price pattern reflects fees returning to normal, competitive levels;

b) the audit scope is systematically underestimated;

c) the incumbent auditors have power over pricing and so pre-tender prices are excessive.

2.2.8 As the CC notes, these explanations are not mutually exclusive.

2.2.9 On the second explanation, while there is some economic literature that would support the idea of a ‘winner’s curse’ in tendering, it would be surprising if experienced audit partners systematically underestimated the scope of an audit and committed their firms, repeatedly, to unprofitable audits. Therefore the CC’s position on this explanation seems reasonable.

2.2.10 It is difficult to differentiate between the first and the third explanations solely on the basis of information about prices. However, it is reasonable for the CC to use a number

¹⁴ Ibid., para 53.
⁵ Ibid., p. 2.
of sources of evidence to determine which (or which combination) of the various explanations best fits the available facts.

2.2.11 One relevant feature of the audit market may be that when a company switches ‘too frequently’, this could in some circumstances harm the company. As the CC notes, this can occur if investors interpret repeated switching as a signal of instability:

‘In addition, a negative market reaction [to switching] could be triggered, for example where the company was experiencing financial or operational difficulties or otherwise wished to portray stability and continuity.’

2.2.12 This statement is consistent with the hypothesis that audit firms regain pricing power in the years following a switch.\(^7\) We note, however, that the negative signalling function of switching would be much diminished if mandatory tendering or switching were introduced. Indeed, if tenders/switches become a frequent event as a consequence of any remedy the CC might impose, the negative signalling function will be diminished.

2.2.13 If the market was functioning competitively, auditors would be expected to price their tenders on the basis of the expected profitability over the duration of the assignment. As there is reputational risk for a company switching auditors too frequently,\(^8\) and the average length of an audit assignment is more than 10 years, an auditor could reasonably expect a payoff over a period of time. In these circumstances, if the profitability of the assignment is at a normal level over the length of the assignment, it should be expected that the first year audit is unprofitable.\(^9\) However, there appears to be no evidence to support that this is the case, with the CC noting:\(^10\)

‘There was no indication that Big 4 firms consistently offered very low initial prices (referred to by some Mid Tier firms as ‘low-balling’) to reduce engagement profitability to zero (i.e. only covering direct costs) or incurred a loss in the first years of an engagement before increasing fees significantly in subsequent years.’

2.2.14 Therefore, in light of the available evidence, the CC’s conclusion that ‘Given the market characteristics, we consider it more plausible that companies lose bargaining power over the course of an engagement’\(^11\) is a reasonable conclusion to draw.

2.3 Market characteristics

2.3.1 The CC sets out ‘the most important characteristics of the market’.\(^12\) The first of these is described as ‘Periodic open competition for engagement’. However, this description is not accurate because:

a) a significant number of FTSE 350 audits have not been subject to competition in the form of a tender process for many years, and some appear to have never been put out to tender; and


\(^7\) However, given the barriers to selection and expansion affecting audit firms outside the Big Four (as identified elsewhere in the CC’s provisional findings), it is likely that a mid-tier firm would have less ability to ‘regain pricing power’, were it to win a FTSE 350 client from a Big Four firm.

\(^8\) Paragraph 12 of Company G’s Case Study 2: ‘It was right for the company to test the market, but having made the investment in this beneficial process, it would want to keep the appointed auditor in place for at least ten years’.

\(^9\) This logic is consistent with the CC’s statement in paragraph 100 of the Working Paper.

\(^10\) Competition Commission, ‘Statutory audit services for large companies market inquiry: provisional findings report’, 22 February 2013, p. 78.

\(^11\) Ibid., p. 32.

\(^12\) CC Working Paper, p. 18.
b) BDO believes that for at least some FTSE 350 audit tenders, only Big Four firms are invited to participate. BDO refers the CC to its letter to Dipen Gadhia dated 3 May 2013, which stated:

‘the revised Code introduces a requirement for FTSE 350 companies to tender their audit every ten years, or explain why they have not, with effect from 1 October 2012. The revised Code has therefore been in force for some 7 months.

From monitoring the trade and national press, we are aware of only four tenders following the introduction of the revised Code. The results of them appear to have been as follows:

- Cairn Energy: switched from EY to PwC (March 2013);
- British Gas: switched from PwC to EY (October 2012);
- RSA: switched from PwC to KPMG; and,
- Schroders: remained with PwC (as a consequence of conflicts) after initially deciding to switch to KPMG.  

2.3.2 Therefore, ‘periodic open competition for engagement’ is not a characteristic of this market. ‘Occasional limited competition for engagement’ would be a more accurate description of this market.

2.4 Participation in tenders

2.4.1 The CC states: ‘A firm that expects competitors to underbid its lower bound, all else equal, will likely not participate in a tender’, 14 but this seems incorrect and inconsistent with other parts of the Working Paper. The CC has evidence that audit tenders are not awarded just on price, which it acknowledges in other parts of the Working Paper:

a) Footnote 43 refers to ‘the evidence we have on companies switching auditors for other reasons than price’;

b) Paragraph 77: ‘we have some evidence that companies go out to tender for non-financial benefits such as quality … a low audit fee might be seen as indicating a poor quality audit’;

c) Paragraph 78: ‘we have not seen evidence that a reduction in fee would make companies more inclined to accept risks to audit quality’; and

d) Paragraph 86: ‘we have evidence that selection is not on the basis of fees alone.’

2.4.2 Thus, even if a firm expects competitors to underbid its lower bound, it may participate in a tender if it believes that it can distinguish its offering based on audit quality, sector expertise and/or knowledge of and relationship with the company, for example. Pricing appears to be only one of several factors determining the outcome of a tender.

3 Responses to CC’s questions

3.1 In your view what is the most plausible explanation for the observed relative price development observed for companies that tendered or switched?

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13 BDO, letter to Dipen Gadhia, 3 May 2013.
14 Ibid. p. 19.
3.1.1 Of the three explanations put forward in the CC's working paper, the explanation that the scope of an audit is systematically underestimated appears weak.

3.1.2 As KPMG comments, the observed pricing pattern is consistent with either competitive or excessive prices.\textsuperscript{15} Therefore, to distinguish between the first and the third explanation, other information needs to be incorporated into the evaluation.

3.1.3 As explained above, if the market were functioning competitively, auditors would be expected to price their tenders on the basis of the expected profitability over the duration of the assignment. As there is reputational risk for a company switching auditors too frequently,\textsuperscript{16} and the average length of an audit assignment is a number of years, an auditor could reasonably expect a payoff over a period of time.

3.1.4 If the profitability of the assignment is at a normal level over the length of the assignment, and discounting brings down the initial fee, the first year audit would be expected to be unprofitable.\textsuperscript{17} However, there is no evidence to support that this is the case, with the CC noting:\textsuperscript{18}

‘There was no indication that Big 4 firms consistently offered very low initial prices (referred to by some Mid Tier firms as ‘low-balling’) to reduce engagement profitability to zero (i.e. only covering direct costs) or incurred a loss in the first years of an engagement before increasing fees significantly in subsequent years.’ [Emphasis added]

3.1.5 Therefore, while the observed pattern in prices may be a combination of the explanations outlined above, the available evidence suggests that the conclusion reached by the CC is the most likely to be correct.

3.2 How can a relative price development, whereby an initial relative price drop erodes away in three to four years, be consistent with companies that (on average) have strong bargaining power/price transparency outside of a tender situation?

3.2.1 It is not clear that these two points are consistent. If a company has strong bargaining power outside of a tender situation (as to which see below), it is not obvious why the price reductions from tendering its audit service would be eroded over time.

3.2.2 In this context, we refer back to the points made above in section 2.1, in particular that:

a) BDO's pricing may not follow the same pattern as the Big Four;

b) one relevant market dynamic is that a company might face additional switching costs, in terms of investor relations, if it switches auditor frequently (or at least switches auditor twice in a short period, for example changing auditor only two years into the engagement).

\textsuperscript{15} Ibid., p. 30.
\textsuperscript{16} Paragraph 12 of Company G's Case Study 2: 'it was right for the company to test the market, but having made the investment in this beneficial process, it would want to keep the appointed auditor in place for at least ten years'.
\textsuperscript{17} This logic is consistent with the CC's statement in paragraph 100 of the Working Paper.
\textsuperscript{18} Competition Commission, ‘Statutory audit services for large companies market inquiry: provisional findings report’, 22 February 2013, p. 78.
3.2.3 However, BDO considers that the extent of companies’ bargaining power over their incumbent auditors outside a tender situation has been overstated, in particular by the Big Four firms.

3.3 In your experience, over the period from 2000 to 2010, to what extent were first-year audit fees unsustainable?

3.3.1 BDO does not quote first-year audit fee levels to new clients that are unsustainable, as evidenced by BDO’s willingness to fix fee levels for 2 to 3 years, subject only to scope changes.

3.3.2 As outlined in Table 2.1, BDO has, on average, experienced a small increase in the fee per hour in the second (and subsequent) years of an audit assignment. This is because there are considerable costs incurred (and more time spent in familiarisation with the client’s business, personnel, procedures and records) during the first year of an audit assignment, which are not incurred in subsequent years.  

3.4 To what extent do you consider that a tender situation in the market for FTSE 350 audits is subject to competition ‘for the market’?

3.4.1 It appears that FTSE 350 companies are reluctant to switch auditors frequently, as evidenced by extremely low switching rates. This suggests that, once an auditor has been engaged, it can rely on that engagement continuing for many years, unless there is a serious problem. In that sense, the only opportunity for active competition is at the time of the tender. This could be characterised as competition being largely ‘for’ rather than ‘in’ the market, but this terminology does not seem particularly useful in this context.

19 This point is widely agreed and is reflected in the CC’s Working Paper, for example, para. 72.