Competition Commission Audit Services Market Inquiry

30 November 2012

Deloitte response to the Competition Commission's working paper "Characteristics of long audit tenure companies"

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1. Introduction and general comments

1.1 Deloitte is grateful for the opportunity to comment on the paper published by the Competition Commission (the ***CC***) on "Characteristics of long audit tenure companies" (the ***Working Paper***).

1.2 We have already addressed some of these issues in our responses to the CC's working papers on "Evidence on switching costs (and implications for barriers to entry)" (the ***Switching Costs Working Paper***) and "Nature and strength of competition in the supply of FTSE 350 audits" (the ***Nature and Strength of Competition Working Paper***).

1.3 Firstly, we note that the analysis of long audit-tenure company characteristics presented in the Working Paper appears to be motivated by a concern that long tenure may generate adverse outcomes. This concern is unfounded and unsupported by the evidence. Notably, as is shown in other working papers: audit firms achieve cost efficiencies over time and there is no relationship between audit tenure and engagement profitability beyond the initial years.[1] Companies therefore benefit from savings achieved over time, regardless of whether they have retained their auditors for five, ten or more years. This outcome is entirely consistent with the evidence that Deloitte and others have submitted to the CC regarding the intensity and effectiveness of the annual negotiation of audit fee and audit scope. With no evidence that companies with long tenure auditors are disadvantaged in any way, the analysis presented in the Working Paper should have little bearing on the CC's considerations.

1.4 Second, the CC should recognise that changes introduced by the FRC on 28 September 2012 for accounting periods beginning on or after 1 October 2012 represent a step change in the market. Following a consultation earlier this year, the FRC has changed both the Corporate Governance Code (the ***Code***) and the Stewardship Code, one element of which introduces an obligation on all FTSE 350 companies to put the external audit contract out to tender at least once every ten years. As with all elements of the Code, these obligations apply on a "comply or explain" basis. Under the reforms, companies are required to provide fuller explanations to shareholders in any circumstances where they do not comply with a provision of the Code. This change significantly limits the extent to which the CC can draw on analysis of past and current data to inform its assessment of possible future market outcomes.

1.5 The probit model presented in the Working Paper has low predictive power and does not lend itself to drawing reliable conclusions regarding the impact of the various explanatory variables on the probability of auditor switching. This is primarily due to missing variables in the model (see Annex 1 for further details), including a significant number of drivers of switching that have been identified in the IFF survey conducted for the CC (the ***CC Survey***) (quality of the engagement partner, team and service, or value for money)[2] that have not been captured within the analysis. The omission of those relevant factors means that the results of the model are of only very limited probative value. The extent to which we comment on specific indications drawn from the model below should not be understood as indicating that we believe that it is of material evidential weight.

1.6 Notwithstanding the above, the rest of our response comments on the implications that the CC appears to be drawing from the analysis, focusing on the following areas:

(a) Client size

(b) Client retention and value for money; and

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[1] Working paper 'Engagement level profitability analysis', paragraph 11

[2] See, for example, slides 33 *et seq*, 60 and 68 *et seq* of the CC Survey.

(c) Switching events

2. Client size

2.1 The suggestion that larger clients tend to switch auditor less frequently than smaller clients[3] is not inconsistent with our expectations nor with the existence of a highly competitive market in statutory audit services.

2.2 As highlighted above, companies are not at a disadvantage if they switch auditors less frequently. As demonstrated in the working paper entitled 'Engagement level profitability analysis' (the ***Engagement Level Profitability Working Paper***), there is no evidence that audit fees increase with the length of tenure. We agree with CC's observation that while profitability increases over the first five years of an engagement, this is a function of cost, rather than revenue[4] and we believe that this is due to learning effects. This is also consistent with the finding that audit costs tend to decline over the course of an engagement[5].

2.3 Further, the CC should not interpret the apparently greater proportion of larger companies with long-tenure audit relationships as an indication that switching costs for these companies are high. As we submitted in response to the Switching Costs Working Paper[6], whilst we agree that there are some costs to companies in switching, it appears that the CC has overestimated the significance of such costs, and has not taken sufficient note of the evidence (see paragraph 3.2 below) that companies' *actual* experience of switching shows these costs to be limited, that companies can and do tender and switch when they are dissatisfied with the value for money or quality that they are receiving from their current auditor, and that the costs of switching therefore cannot be considered to be a barrier to entry. Deloitte's view is strongly supported by other market participants, including Grant Thornton and BDO[7].

3. Client retention and value for money

3.1 The observation that companies that were audited by a top tier firm at the beginning of the period were less likely to switch auditor[8] is consistent with our understanding of how the audit services market operates, and with the evidence collected by the CC Survey. Clients who receive high quality services from their auditor, and are satisfied that they receive value for money are less likely to switch auditors.[9] By contrast, clients who believe that they are not receiving the required level of quality or price are more likely to switch.[10]

3.2 The CC's suggestion that it is not 'immediately clear' how the finding that *'companies that were audited by a Big 4 firm at the beginning of the period were less likely to switch auditor should be interpreted'*[11] is therefore unwarranted. In light of the above, it is clear that the finding should be seen in the context of highly sophisticated and well informed purchasers of audit services, who have the incentives, capacity of judgement and powers to make companies switch auditors when appropriate. We have summarized the evidence on companies' propensity to switch auditor in our earlier responses, particularly:

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[3] Paragraph 27

[4] Engagement Level Profitability Working Paper, paragraph 17

[5] Working paper 'Econometric analysis of audit costs' working paper, paragraph 71

[6] Deloitte's response to the Switching Costs Working Paper, paragraph 2.1 *et seq*

[7] See, for example, paragraph 9.7 of Grant Thornton's response to the Issues Statement, and paragraph 5.3.3 of BDO's Response to the Issues Statement.

[8] Paragraph 34

[9] CC Survey, slide 60

[10] CC Survey, slide 63

[11] Paragraph 4

(a) Response to the Switching Costs Working Paper

(b) Response to the 'Working paper on Competition Commission survey results'

(c) Response to the 'Restrictions on entry or expansion' working paper

3.3 The CC observes that of those companies who had a top tier auditor at the start of the observation period, 71 per cent did not switch auditor, compared to 32 per cent among companies who did not have a top tier auditor. This relationship between auditor identity and subsequent likelihood of switching is good evidence that top tier auditors deliver the quality of audit services that clients require more often than do non-top tier auditors. If this were not the case, there would be no difference in the conditional probability that a given client would switch depending on the identity of their auditor.

3.4 The behaviour of clients who have reappointed their auditor over a longer period of time is open to the same analysis: certain auditors consistently deliver high quality audit, continue to improve and innovate their offering and as such remain an attractive option to the client (after consideration of the offering of other competing firms). This has been corroborated through the CC Survey which found that firms tend not to tender formally when they have been receiving a high quality service and good value for money.[12]

3.5 The Working Paper also comments on the reasons why some FTSE 350 companies had not tendered in the last five years[13]. The implication of the last sentence[14] appears to be that around a quarter of companies may not have tendered *"due to reasons other than the quality of the audit, for example high switching costs"*.

(a) This speculation is misleading because the CC Survey asked explicitly whether the company decision to not tender was due to switching costs. Only 16% of FTSE 350 respondents indicated that disruption / getting new auditors up to speed was a factor in their decision not to tender and only 13% of FTSE 350 respondents indicated that a view that tendering was costly and time consuming was a factor.

(b) In addition, it is *not* the case that the only remaining reasons for not tendering are related to switching costs. Rather, in addition to the high quality of service and good value for money, other reasons cited by the survey respondents included: "happy as things are", "partner rotation keeps things fresh", "time not right" or "benchmarking suggests get good value"[15]

3.6 It is not the case that long-tenure clients would be less or worse informed than clients who switch auditor more frequently. The Working Paper shows that there is no difference in benchmarking activity between long and short tenure companies[16]. The evidence shows that companies carefully consider their options and make their decision to reappoint their current auditor or go out to tender accordingly.

4. Switching events

4.1 The Working Paper does not consider auditor changes from Arthur Andersen to Deloitte or to any other auditor to be a switching event. The justification put forward by the CC is that it does not consider them to be switching events "given the exceptional circumstances that drove the changes".

[12] See footnotes 9 and 10 above

[13] Paragraph 2

[14] *"This leaves a set of companies which may not have tendered due to reasons other than the quality of the audit, for example high switching costs."* Working Paper, paragraph 2

[15] CC Survey, slide 60

[16] Paragraph 19

4.2 We disagree with this conclusion. The fact that some companies changed auditor from Arthur Andersen to auditors other than Deloitte indicates that they made a conscious and informed decision in their choice of auditor.

4.3 However we appreciate that the CC may wish, as suggested by PwC in their response to the CC's working paper "Descriptive Statistics" to investigate "demand-driven" auditor switches only, as opposed to supply-driven (which is how one might classify most of the Andersen transaction switches). If this is the case, we would encourage the CC to state this explicitly, and to define the criteria for assessing what constitutes a demand-driven switching event.

5. Conclusion

5.1 Companies that have long engagements with their existing auditor are not in a fundamentally different position from companies which switch auditors more frequently. The fact that they may tend to be larger or more complex companies has been shown by the evidence before the CC to have no bearing on the competitiveness of the audit services those companies receive.

5.2 Companies which receive high quality services and good value for money have no reason to switch their auditor. On the other hand, companies which are *not* satisfied with their auditor *do* tender and switch auditor.

Annex 1: Drivers of switching and the nature of the probit model

1. Drivers of switching and the nature of the probit model

1.1 The Working Paper notes that a large proportion of the probability of whether a company has switched audit firm is driven by unobserved factors[17].

1.2 These "unobserved"[18] factors may include factors similar to those identified in the CC Survey (most of the switching drivers identified in the CC Survey are not captured in the probit model presented in the Working Paper). The table below presents the factors that could be thought of as drivers of auditor switching identified in the CC Survey:

Factors in deciding whether to (re)appoint auditor	Reasons for not tendering	Tender triggers
Experience and knowledge of engagement partner	Receive high quality service	Complacency of audit firm
Good working relationships with audit team	Good value for money	Substantial increase in audit fee**
Reputation of audit firm*	Happy as things are	Problematic relationship between auditor and management
Experience and knowledge of engagement team**	Partner rotation	Pressure from shareholders, bankers, lawyers or analysts
Sector-specific expertise or experience	Switching costs	Change in company ownership, nature or scale of activities*
Expertise in audit related services**	Continuity / familiarity	Scandal in UK or another country related to current auditor
Adverse comment by regulator	Time not right	
	Incumbent understands business**	
	Benchmarking suggests get good value	

Source: CC Survey, slides 33, 60 and 68.

Key:

- *No asterisk: Factors could not be included in the model due to dataset limitations*
- *Single asterisk (*) Factors were included or proxied in the probit model.*
- *Double asterisk (**) Factors could have been, but were not, included or proxied in the probit model.*

1.3 Most of the factors identified in the table above were not included as explanatory variables in the probit model. However some of the ignored factors could have been included or at least proxied, as described below:

(a) 'Experience and knowledge of engagement team' and/or 'Incumbent understands business' could both have been proxied through the number and/or asset base of clients audited by the auditor in the same sector.

[17] Paragraph 42

[18] We emphasize that it is not the case that these factors are unobservable to those at the client company who make the decision whether to switch; rather, these factors are not immediately observable by the external parties, and the data were not available in the dataset collected by the CC.

(b) Expertise in audit related services could have been proxied in the model through the non-audit services fees provided – either historically, or to other auditor's clients.

(c) Substantial increase in audit fee could have been included in the model as a lagged change in the audit fee (e.g. Δauditfee_l).

1.4 Another metric that could have been included among the explanatory variables in the probit model is a measure of how long it has been since the firm last switched auditor. Intuitively, one might expect that a company which had switched auditor recently is unlikely to switch again soon afterwards, and this variable could have some degree of explanatory power in the model. The absence of these factors significantly diminishes any probative value of the model set out in the Working Paper.

1.5 Furthermore, the model does not capture the dynamic aspect of auditor switches and treats each year's probability of switching auditor as an independent event. A dynamic model could have been tested to evaluate whether it would provide a better specification of the underlying dynamics of the switching process.