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21 February 2018

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Attention: Torrin Crowther / Michael Tilley 11.04/34054

Dear Torrin and Michael

Letter of issues – MYOB Group Limited and Reckon Limited

1. We refer to the application from MYOB Group Limited (MYOB) dated 29 November 2017 seeking clearance to acquire the Accountants Group business of Reckon Limited (Reckon) (the Application).

2. At this stage, we are concerned that the proposed merger would give rise to competition issues in a number of markets for the provision of practice software to accounting practices as a result of horizontal unilateral effects.

3. In setting out our current issues in this letter, we have considered information provided by MYOB and Reckon as well as information gathered from industry participants. The Commission has not yet made any decisions on the issues outlined below (or any other issues) and our views may change, and new competition issues may arise, as the investigation continues.

4. We will advise you if we identify any issues during our analysis of the proposed merger that are not discussed in this letter.

5. We are available to meet with MYOB to discuss this letter.

Timeline

6. The Commission would like to receive submissions from MYOB on the issues raised below by **6 March 2018**. We are happy to discuss this timeframe with you. Please provide a public version of your submission.

7. If other parties indicate to us that they intend to make a submission on the Letter of Issues, we will be requesting that they do so by close of business on **6 March 2018**, and that they provide a public version of their submission.

8. All submissions received will be published on our website with any appropriate redactions.

Assessment of the relevant markets

9. Market definition is a tool that can provide a framework to help identify and assess the close competitive constraints a merged firm would likely face. We define markets in the way that best isolates the key competition issues that arise from the merger. While there may not be a bright line that separates different markets, what matters is that we consider the competitive alternatives available to different types of customers, and the relevant competitive constraint they would pose on the merged entity.

10. In the Application, MYOB submits the relevant market is the provision of practice software to accountants and accounting practices.[1]

11. We are testing whether this market definition is too wide. In particular, we are considering whether there are separate relevant markets for:

    11.1 accounting compliance modules versus business modules;

    11.2 medium to large accounting practices distinct from small practices; and

    11.3 desktop software versus cloud-based software for certain groups of customers.

12. As we discuss below, we are considering whether these narrower markets may be relevant on the basis that there are different conditions of competition in each of these potential markets. In particular, we are exploring whether the range of credible suppliers in each of these potential markets is materially different.

13. The extent to which suppliers are able to price discriminate between different types of customers is relevant to this analysis. For example, if there is a group of identifiable customers that would not switch from desktop to cloud software in response to a price increase, it may be necessary to define a narrow market limited to those customers.[2]

Accounting compliance modules

14. In the Application, MYOB submits that there are two software categories offered by the parties to accounting practices. These are:[3]

    14.1 business modules, comprising practice management[4] and document management[5] functionality; and

    14.2 compliance modules, comprising tax[6] and client accounting functionality.[7]

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1 The Application at [8.1].
2 Commerce Commission, *Mergers and Acquisitions Guidelines* (July 2013) at [3.20].
3 The Application at [8.1].
4 Practice Management includes timesheet, billing and collection, customer relationship management and resource planning functionality.
5 Document management includes filing and searching functionality.

15. In its application MYOB identified that there are additional suppliers of business modules (at [14]). Market feedback supports this view that there is a broader range of providers for business modules, including generic software providers.

16. In contrast, we understand that there are currently only four providers of accounting compliance modules to New Zealand accounting practices, namely MYOB, Reckon, CCH, and Xero. We understand from our market enquiries that compliance modules are designed specifically for New Zealand regulatory requirements and therefore practices require software developed specifically for New Zealand accounting practices.

17. Accordingly, while the merging parties overlap both in business and compliance products, the evidence to date suggests that the competitive conditions for the two types of products appear to be materially different and therefore should be considered separately.

18. Nonetheless, we are still considering the extent to which business and compliance modules acquired from separate providers can be integrated. Some accounting practices have advised us that they cannot mix and match modules from different providers as it would require data duplication (which could cause issues with inconsistent data across the systems) thereby reducing the efficiency of the practice. If the majority of accounting practices considered they can mix and match modules then it is likely business and compliance modules would be considered separately.

Medium to large accounting practices

19. MYOB submitted that there is no distinction between the software requirements of different sized firms because "[a]ll Tax software must comply with IRD requirements for tax reporting, and all Client Accounting software needs to be compliant with accounting rules". MYOB further submitted that "[t]hese requirements are the same, regardless of the size of accounting firm using them".[8]

20. MYOB recognises [ ] different groupings of accounting practices based on the number of users[9] while Reckon recognises three different groupings of accounting practices based on the number of users in the accounting practice.[10]

21. Market feedback suggests that medium to large accounting practices require more sophisticated software. For example, larger firms require different levels of management sign-off which needs to be provided for by the software (eg, at the first level the associate prepares the preliminary accounts, second level the manager signs off the preliminary account and sends it to the client, third level partner sits down with the client for ultimate sign off) and greater reporting ability. The medium

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6 Tax functionality enables the calculation, compliance, and lodgement of tax and tax returns.

7 Client accounting includes functionality that allows accountants to validate client accounts and compile and lodge statutory reports.

8 MYOB response to information request (2 February 2018), at [16].

9 Ibid at [17].

10 Reckon information memorandum (September 2015), at [14].

to large accounting firms that we have spoken with have regularly identified Reckon APS and MYOB as the first two software choices for their firms.

22. As such, we continue to test whether the supply of practice software to medium to large accounting practices should form a separate market from smaller accounting practices.

Desktop software

23. We are testing the extent to which desktop customers would be unwilling to switch to cloud software in response to a price increase or quality decrease, such that supply to those customers may form a separate market. From market feedback it appears that customers that have recently switched between desktop providers, or those customers that consider retraining costs to be high,[11] are unlikely to move away from desktop products in the short to medium term.

24. We have consistently heard from accounting practices that switching costs are high. A MYOB Board document from June 2015 identifies [ ].[12] For practices with younger managers, that are coming to the end of a desktop product contract, and are smaller and more agile, moving from desktop products to cloud-based products appears to be a more realistic/acceptable alternative.

25. Further, we have been advised that market research supports the view that there are a set of customers that may be unwilling to switch from a desktop to cloud-based software. These practices tend to have older managers and/or have a perception that their data is not safe in the cloud.

26. As we discuss below, we are considering whether suppliers are able to identify customers who would be unwilling to switch to cloud software in response to a price increase or quality decrease.

The counterfactual

27. We consider the relevant counterfactual is the status quo, where MYOB and Reckon continue to independently provide desktop products. We continue to consider the extent to which MYOB and Reckon would transition their desktop products to the cloud without the proposed merger.

Competition assessment

28. The merging parties are the principal providers of desktop accounting compliance software to accounting practices, while Xero and CCH both provide cloud software.

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11 Retraining costs involve accountants having to learn how to use new systems and process of the software.

12 MYOB Board Meeting (18 June 2015), at [15].

The merger would therefore result in significant aggregation in the provision of desktop software, particularly to medium to large accounting practices.[13]

29. Given the significant aggregation in the provision of desktop software to medium to large accounting practices, our main areas of concern at this stage are whether the merged entity would have the ability and incentive to unilaterally raise prices or reduce quality to:

    29.1 medium to large practices that do not consider Xero and CCH to be an option; and

    29.2 accounting practices that would not consider switching to cloud based providers.

30. These concerns have been raised because the merging parties may have the ability to identify and price discriminate between groups of customers. We note, for example, an MYOB document which identified that [ ].[14] If the merged entity was able to identify and price discriminate between customers for which the merging parties are currently their main options, and there are few or no other options, the merger could result in higher prices or reduced quality for those customers.

31. We are still assessing the extent to which the merged entity could identify customers that are unlikely to switch and its ability to price discriminate to them. We welcome submissions on this.

Different requirements of medium to large practices

32. We have received mixed views on CCH and Xero's ability to meet the needs of medium to large practices. MYOB submitted that all New Zealand providers are able to meet the needs of all sizes of accounting practices, in particular in relation to the compliance modules.[15] However, in an MYOB document from November 2016 it identifies different competitors based on the size of the accounting practices.[16] We are continuing to assess CCH and Xero's ability to meet the requirements of medium to large accounting practices at present, and their ability to expand in a timely manner to be able to do so, particularly in respect of accounting compliance software.

33. From market feedback it appears that there is group of customers that are reluctant to switch to Xero and CCH's accounting practice software because they have limited functionality compared to Reckon and MYOB. We are concerned that the merged entity would have both the ability (including identifying these customers) and the incentive to unilaterally raise prices or reduce quality of compliance products to medium to large accounting practices.

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13 MYOB Board Strategy Offsite (16 November 2016), at [92].

14 MYOB Board Strategy Offsite (4 October 2017), at [138].

15 MYOB response to information request (2 February 2018), at [16].

16 MYOB Board Strategy Offsite (16 November 2016), at [92].

Customers not willing to switch to cloud-based software

34. MYOB and Reckon are the only suppliers of desktop compliance software to New Zealand accounting practices. As we discuss above in relation to market definition, we are considering the extent to which cloud compliance software providers would constrain the merged entity's supply of desktop software. We also note that, irrespective of the market definition ultimately adopted, we must take into account all constraints on the merged entity, including those from outside the relevant markets.

35. Our focus for this theory of harm is testing whether the merged entity would have the incentive and ability to unilaterally raise prices or decrease quality to particular customers that are not willing to switch in response to a price increase to cloud software.

36. There are a number of different types of customers who may be less likely to switch to cloud software in the medium term:

    36.1 those practices that have recently switched between desktop products and so may not be willing to switch to the cloud if faced with a price increase;

    36.2 those practices that have concerns over the security of the storage of data on the cloud; and

    36.3 those practices that have managers that are unwilling to make the required changes to shift to cloud software.

37. Market research from one provider suggests that there are a set of customers with some of these characteristics that may be unwilling to switch from desktop software to cloud-based software and, as such, would be unable to discipline a price increase or quality decrease by threatening to switch. We are seeking to identify the number and characteristics of any such customers. As part of our assessment, we are considering the extent to which the merged entity could price discriminate against these customers.

38. We are also assessing whether there are some customers who, in the counterfactual would not have switched between MYOB and Reckon's desktop software given a price increase or lowering of quality or innovation. This is because the merger would be unlikely to have a significant effect on them.

Potential competition

39. MYOB submitted that there are a number of potential entrants who would likely enter the New Zealand market in the event that the merged entity raised prices.

40. We continue to consider whether entry into this market (either desktop or cloud) would constrain any exercise of market power by the merged entity following the merger. Market feedback suggests the potential entrants identified by MYOB would be unlikely to enter the New Zealand market. We understand compliance modules are designed specifically for New Zealand regulatory requirements, and that software providers in other countries would therefore need to rebuild their software

to enter the New Zealand market. Additionally, we have received some feedback that the small size of the New Zealand market would not warrant the cost associated with entry.

41. Finally, from market feedback we understand that it is unlikely a potential entrant would make the required investment to enter with a desktop solution, though there would remain a potentially significant number of practices that require desktop software. Those numbers are unlikely to grow given the emergence of cloud solutions.

Countervailing power

42. MYOB submitted that large accounting firms have demonstrated an ability to bypass accounting software providers by building their own accounting software solutions. While our evidence suggests that some large accounting practices have developed their own business modules, all practices purchase compliance modules from accounting software providers, such as MYOB and Reckon. Market feedback also suggests small and medium sized accounting practices do not have the resources to build their own business software.

43. We continue to consider whether accounting practices may provide a constraint through their ability to discipline the merged entity in other markets, ie, whether accounting practices could discipline the merged entity by threatening to switch business module providers in response to any attempt to increase the price or reduce quality for compliance software.

Yours sincerely

Joshua Dawson
Investigator
Competition and Consumer Branch