# AUDIT MARKET INVESTIGATION

## Barriers to entry: international networks

### Introduction

1. This paper informs our view of whether international networks may comprise a restriction on entry, because of the difficulty of any new entrant, or smaller firm seeking to expand, replicating a network similar to that of the largest (Big 4) firms. A related issue considered in the paper is the effect of a collapse of a member firm on the network as a whole.

2. The analysis is based on the responses from the Market and Financial Questionnaire (MFQ), an additional set of questions sent to nine parties (Baker Tilly, BDO LLP (BDO), Deloitte LLP (Deloitte), Ernst & Young LLP (EY), Grant Thornton UK LLP (GT), KPMG UK (KPMG), Mazars LLP (Mazars), PricewaterhouseCoopers LLP (PwC) and PKF (UK) LLP (PKF)), analysis of a database of engagement level data and a survey of Chief Financial Officers and Audit Committee Chairs of listed and large private companies.

3. The paper is structured into nine sections. We consider the networks' form and function, in particular:

   *(a)* the structure of an audit firm network, ie how networks are structured legally and operationally;

   *(b)* their function, in terms of service companies and common functions; we review party submissions on the functions that networks share among themselves; and

   *(c)* their role in setting audit methodologies and standards, in particular the implications of a common methodology in delivering large company audits.

We turn to their economic significance, in terms of:

*(d)* the annual expenditure of the network bodies; this section compares the level of expenditure incurred by each of the networks and the UK's contribution;

*(e)* the international coverage of networks, in terms of the number of countries and average size of network firms in each country in which networks are present; and

*(f)* referred income from the UK and to UK firms from their networks.

We then:

*(g)* consider the importance of networks to purchasers of audit services with a summary of survey responses with respect to networks, and evidence gathered from our case studies;

*(h)* set out some initial views of the possible effect of networks on competition; and

*(i)* finally, in light of this evidence and analysis, we consider the potential exit of a major auditor. We consider the collapse of Arthur Andersen US and its effect on the UK firm, as well as other significant accounting scandals that have not had significant, long-lasting economic effects on other firms within the relevant network.

## The structure of an audit firm network

### *Introduction*

4. All but one of the largest audit firms in the UK are members of international networks,[1] and all current auditors of FTSE 350 companies are members of networks. Networks are broadly based around membership by individual firms (or their partners) of a central coordinating entity (CCE). The CCE does not itself conduct audits, but acts to facilitate cooperation between member firms.

[1] Mazars does not consider itself to have adopted a network structure, instead taking the form of an 'integrated partnership'.

5. The network of firms can be structured using alternative, operational models and may differ on the level of standardization and cooperation across the network: alliances and associations offer a looser framework within which firms can collaborate; and integrated partnerships exercise a greater level of central control.

6. International professional service networks have historically developed from a single firm's need to service existing clients that expanded overseas, and have since grown as newly-created overseas offices became legally independent firms which have sought to develop business relationships with companies based in their respective jurisdictions.[2,3] Each network structure evolved over time, but the fundamental legal and organizational structure of networks developed in part because of two factors:

   *(a)* Ownership requirements of audit firms. Many jurisdictions require an audit firm to be owned and/or controlled by qualified auditors in that jurisdiction, and thus cannot be owned by an overseas firm.[4]

   *(b)* Ring-fencing of liability. By remaining independently owned and legally separate, the members of a network are not liable for each other's actions.[5]

7. There are indications that networks are becoming increasingly integrated, specifically with respect to standardized methodologies, software and the level of control exercised by the network.[6] The UK member firms of some networks own, exercise significant control over, or have a significant direct financial interest in other member firms, specifically in Europe and the Gulf States. Other developments indicating

---

[2] This view is based upon the description of the development of firms (and their networks) in 'The origins and evolution of the accountancy profession' by Peter Boys in *Chartered Accountants in England and Wales*, edited by Wendy Habgood, which drew upon the archives of the ICAEW including periodicals and the work of academics and the firms' official histories.
[3] Information on the history of each firm and its network is considered in the paper 'Suppliers of statutory audit services'.
[4] For example, the Chinese Government has recently set deadlines for increasing the proportion of partners of Chinese audit firms that must be Chinese citizens.
[5] If a group auditor relied on a material component's auditor's work, which was subsequently found to be deficient, the group auditor could potentially be held liable for not ensuring that the group financial statements were not free of material misstatement, even though the error originated from a subsidiary's accounts.
[6] At EY, member firms are not controlled by the CCE. The CCE acts as a coordinating entity of the network. In some geographic regions, including within part of the European Union, where permitted by local law or regulation, member firms have created entities that control multiple member firms.

greater global integration include KPMG UK's involvement in creating KPMG Europe with a number of other member firms.

8. The remainder of this section considers:

*(a)* the legal structure and functions of the CCE;

*(b)* types of network membership;

*(c)* governance and control of the network; and

*(d)* recruitment, retention and departure of member firms in the network.

### *Legal structure and functions of the CCE*

9. Networks operate through the presence of a CCE, which puts in place standard legal agreements that member firms must abide by. This means that individual firms need not negotiate a large number of bilateral agreements.

10. The CCE is typically based on firms becoming members of the organization, by signing the network's membership agreement. If incorporated in the UK, this would be a company limited by guarantee, though similar structures are used in those network bodies incorporated elsewhere.[7]

11. The network's membership agreement typically includes provisions that define the relationship between member firms and the service companies. The network may also use the CCE for the purpose of framing legal agreements between member firms (eg those concerning the referral of work on subsidiary audits). The functions of the CCE may be conducted by the CCE itself, or by a number of service companies, which may be either incorporated as subsidiaries of the CCE, or as a separate membership organization.

---

[7] The CCE itself may comprise a number of legal entities or service companies.

12. The staff of the service companies are either permanent employees or secondees from member firms. The intellectual property of the network, such as branding, methodology and software, may be held by a further separate entity.

13. The separation of the different aspects of the network (oversight of cooperation, operations and intellectual property) into different, independent entities protects the network from systematic collapse from legal action against any specific part of the network or member firm. An example of these arrangements is the [✂] network, where a firm joins the network by becoming a member of a [✂] company limited by guarantee, but that participation in the network is only activated on agreeing to separate legal agreements with a service company registered in [✂] and an intellectual property licensing company registered in [✂] .

14. The specific functions and responsibilities of the CCE and its service companies varies by network, but broadly encompass:

*(a)* developing and defending the network's intellectual property rights, including branding and audit methodology;

*(b)* developing and maintaining audit software and servers for storing shared audit files;

*(c)* liaising with professional and standard bodies internationally and in key territories;[8]

*(d)* developing training programmes and materials, and maintaining a global intranet;

*(e)* supporting network development (including financial support for acquiring firms) and overseeing the admission of potential new member firms;

*(f)* performing quality assurance reviews of member firms' audit files; and

*(g)* establishing overseas processing centres.

---

[8] The network as a whole might wish to make submissions to regulators in countries such as the USA on matters which may affect member firms outside of that country (such as Sarbannes Oxley and the requirement to be SEC registered for some financial services clients).

15. Individual member firms are responsible for implementing their networks' policies including methodologies. Subject to local regulatory requirements, the global methodology may need to be amended for additional requirements over and above International Standards on Auditing and disclosures required under International Financial Reporting Standards. Any territory-specific requirements may need to be overseen by the member firm. In the UK, such tailoring might include ensuring that there is specific consideration of UK Ethical Standards and appropriate disclosures under the Companies Act.

16. In networks where the level of global integration is greater, the functions of the network may also be greater, such as overseeing the admission of partners in member firms and their subsequent appraisals.

17. Where networks use a standard audit software platform, the staff providing technical support may be employed by the network, even if those staff are co-located with member firms.

### *Types of network membership*

18. The networks each have different types of firm membership. The terminology and effective rights and obligations of different types of firms differ across networks.

19. Most of the international firms within the Big 4 and mid-tier networks are full member firms. Full members are subject to the quality assurance requirements of the network, such as periodic reviews of audit files, and often are required to use the standard international methodology (appropriately localized) and have access to the network's audit software. Affiliate or 'correspondent' firms may be used where there is not perceived to be sufficient demand to justify establishing or recruiting a firm as part of the network, or where the network has not identified a firm suitable for full membership.

Nearly all of the networks considered in this paper use affiliates.[9] Affiliates do not have the right to use or adopt the branding or name of a network, other than in advertising that they are an affiliate of the network.

20. As an example of the use of affiliates, Deloitte uses 'Independent Correspondent Firms' (ICFs) on a non-exclusive basis[10] in territories where it does not have a member firm.[11] ICFs are not subject to the normal Deloitte requirements of membership, such as use of a standard methodology, and are essentially a pre-selected third party subject to assessment for competence by any audit team taking assurance from them. Since affiliates are not subject to regular quality reviews by the network, the level of work performed by a group auditor will not be reduced relative to using any other firm that is not a full member firm of the network.[12]

21. KPMG International, however, allows its 'correspondent' firms access to certain proprietary materials on payment of a fee. Following a change in strategy, KPMG International has reduced the number of correspondent firm agreements in place and today only five remain in five territories. One of the reasons for the change in strategy included concerns that the use of the term 'correspondent firm' could be erroneously construed as indicating that the firm is part of the KPMG network.

### *Governance and control*

22. The voting arrangements in each network vary and may differ based on the nature of the decision (such as election of global board members, or amendments to a

[9] The nature of affiliates varies across networks. BDO stated that it did not use 'affiliates' per se, but member firms may issue sub-licences to other firms, such as in the USA and Spain. [BDO MFQ response Q10] ✂ is the only firm whose network does not include affiliates.
[10] That is, that there may be multiple ICFs in a territory and that a member firm is not required to refer overseas work to an ICF.
[11] There are ✂ affiliates in the Deloitte network.
[12] Admittance as an ICF is after scrutiny by the network, but not to the extent that member firms can take assurance without appropriate additional review of an ICF's work.

network's constitution). Given the wide variety of arrangements, these are not discussed on a network-by-network basis in this paper.

23. The structure and distribution of voting rights also varies, with some networks subject to decisions made by the population of partners across the network, whilst in others each firm (through a designated representative) votes on behalf of its partners (somewhat like an electoral college system), with different firms receiving different weightings.

24. The relative weighting of votes may be affected by a number of factors such as firm revenue, the nature and size of clients (and by extension the level of referred revenue generated for the network) and number of staff.

25. The ultimate strategic and decision-making power within the network sits with a board, committee or leadership team, which may be overseen by an advisory committee, and supported by a number of additional committees, either appointed separate to the board, or as a sub-committee of the board.

26. The individuals present on the network board are chosen in several ways. In some networks, election to the board and other network governance structures is through popular election by all partners globally. For some networks, such as [✂] and [✂], a number of seats may also be reserved for individual firms or geographic areas.[13]

27. Regardless of the model, there is broadly a link between the size of a firm and the level of influence it can exert, although specific provisions may protect or enhance the relative standing of certain firms.

---

[13] Specifically for appointment to policy boards.

### *Recruitment, retention and departure of member firms in the network*

28. It is in the interest of individual member firms and the network as a whole to ensure that there is continuity in the representative member firm for each territory, as this facilitates a better service for companies. Two factors encourage stability.

29. The first is referred income within the network. Without membership of a network, an individual firm is likely to lose audit work on subsidiaries of international companies, and by extension would lose a potentially significant amount of revenue. Referred income is discussed further in paragraphs 103 to 110.

30. The second, which is controlled by the network centrally, is the imposition of exit charges on firms which leave the network. However, the one-off penalty cost may not be a sufficient deterrent to a member firm from one network joining a larger network if the expected level of referred income is large enough.

31. The CCE is responsible for admitting new member firms. If a network seeks to expand into a new jurisdiction, it seeks an existing firm[14] to either join the network or to create a joint venture with another member firm from another jurisdiction where the network is already present which will represent the network. In some instances a network may permit a member firm to provide services in neighbouring countries subject to appropriate regulation with respect to statutory audit, particularly if there is only sporadic demand from international clients and there is no existing member firm.[15]

[14] This may be an independent firm or a member firm of another network.
[15] The network can coordinate communication between firms if expansion is necessary to service an international client. For instance, part of ✂ US's decision to open an office in ✂was that the UK firm's ability to win the audit of ✂ was partially predicated on it having an office there.

32. If a network needs to expand into a new territory (Country X), to service a new client or an existing client's expanded overseas operations (Company A), the network could either create a new firm in Country X (Firm X), or invite an existing firm to join the network. However, if there are regulations in place to prevent a threat to independence as a result of fee dependency, the creation of a new firm would not be possible, unless the new firm could service existing clients' operations in Country X (which may have previously have been done by an overseas firm), or obtain its own domestic clients.

33. Even where there are not domestic regulations over independence, ISA (International Standard on Auditing) 600—Special Considerations—Audits of Group Financial Statements (Including the work of component auditors) requires a group auditor to consider the independence of a component auditor.[16] If Firm X's only client is a subsidiary of Company A, the group auditor of Company A would potentially consider there to be a lack of independence, which would mean that the group auditor would need to re-perform some or all of the work performed by Firm X, or undertake additional procedures.

34. We understand that the UK and US firms created overseas offices and firms to service their domestic clients' international operations which in some instances were driven by a single client. Had the requirements of ISA 600 been in place, this route of expansion might not have been allowable.[17]

35. Because of the regulatory requirements, overseas expansion into new territories appears to require either a member firm from another territory to operate across jurisdictions, or to identify an existing firm which is sufficiently large not to risk a

[16] The EC Audit Directive requires all statutory audits to be conducted in accordance with ISAs.
[17] If the new branch office or firm shared in the profits of the 'parent' firm, this might not be an issue. If the new firm was able to generate sufficient revenue from other new clients this would not be an issue.

threat to its independence as a result of fee dependency. There are a small number of examples where the member firm of one network merges with, or acquires, another local firm which is a member of a different network. Such mergers or acquisitions would lead to a gap in the representation of one of the networks. In the examples we identified it is not clear whether the consolidation of two existing firms into one was driven by the partners or by international motivation.[18]

36. Annex 1 describes the example of Brazil, where the member firms of both GT and BDO left their respective networks to join the pre-existing Brazilian member firms of EY and KPMG respectively. There are potential consequences to a network of such losses and acquisitions and using the Brazilian market as an example these are:

*(a)* loss of a firm to service the Brazilian subsidiaries of international companies, disrupting the completion of ongoing group audits;

*(b)* loss of market share and outward referred income from Brazilian companies;

*(c)* a reputational effect on the network's ability to retain its member firms and thus suitability to service large international clients; and

*(d)* the cost to the network of acquiring a replacement firm of a similar size, which may lead to targeting the member firm of another network, and the need to finance any penalties for the new firm's exit from its previous network, and the costs of integrating the new firm into the network.

37. It appears that the networks are prepared to support member firms in expanding through acquisition in certain circumstances. That the CCE has sufficient funds to provide financial support to member firms (or that the CCE has negotiated preferential borrowing rates despite not undertaking activities other than supporting the network) suggests that other member firms support this approach.

---

[18] There are also examples in the UK, such as Robson Rhodes merging with GT and leaving the RSM network.

38. The House of Lords Select Committee on Economic Affairs considered that such acquisitions impeded the ability of smaller networks to develop:

> The Big Four continue to strengthen their position by using their financial muscle to acquire significant parts of the home and international networks of next-tier firms. There have been several notable acquisitions in recent years in, for example, France and Brazil. These takeovers limit the scope for smaller competitors to develop international networks. The effect seems anti-competitive.[19]

39. On occasion, networks may choose to remove membership from a firm. In their submissions some of the parties indicated that a small number of firms had been expelled from their respective networks for issues of quality, or due to lack of demand for audit services in that country, or political instability in a country.

## Function of networks

40. The networks provide a number of services to member firms in addition to management of common standards and cooperation between firms.[20] The networks are moving towards both shared service centres for corporate support functions and centralized processing centres for standardized, objective audit procedures (audit processing centres). In terms of network functions, this section considers in particular:

*(a)* audit processing centres;

*(b)* shared costs;

*(c)* independence within the network; and

*(d)* strategy.

---

[19] Paragraph 128, Chapter 3, House of Lords, Select Committee on Economic Affairs, 2nd report of Session 2010–11, Auditors: Market concentrations and their role, Volume I; Report, published 30 March 2011.

[20] These services are generally provided through a service company, which may either be a subsidiary of the coordinating CCE or a separate entity controlled by member firms.

### *Audit processing centres*

41. Audit processing centres may be located in emerging economies, or in some instances, areas of the UK which we assume to have a lower cost base. The AIU in its 2012 annual report noted that firms were increasingly using centralized processing centres, or increasing the proportion of testing performed by junior staff to maintain profit margins.

42. The nature of the work performed in the audit processing centres is typically objective, low-level testing or administrative procedures, such as setting up audit files. The nature of testing might include, for example, identifying year-on-year variances or analysis of ratios such as gearing or the level of working capital to assist in identifying areas of possible risk.

43. Audit processing centres are typically established in a territory with a low cost base by one or more member firms of a network, with the work supervised by the local member firm.

44. In the case of PwC, the UK firm has established two joint ventures to run an offshore facility (one with firms from some English-speaking countries to operate a centre in India, the other with the German and Central European firms to operate a centre in Poland).[21] [✂].

45. EY UK anticipates using central processing facilities for some [✂] hours of audit work (approximately [✂] per cent of its total output) in 2011/12. However, the financial benefits have not yet been fully assessed.

[21] PwC UK also operates a centre in [✂].

46. KPMG UK has operated a 'resource centre' in India since 2005 in a joint venture with its Indian firm, and another 'Global Services' centre with its US and Indian firms since 2010. At present, a number of member firms use these facilities. KPMG had not performed a detailed cost assessment, but noted that if audit labour hours were outsourced on a 1-to-1 basis,[22] a crude estimate would be a saving of £✂million, though due to the costs of establishing the centre and additional review in the UK, this may be overstated. Other KPMG member firms also operate their own centres. KPMG UK expected that the resource available to the UK firm in these centres would double by 2012/13.

47. [✂]. In 2012, Deloitte UK established a 'Risk Management Shared Services Centre' in Cardiff, [✂].

48. [✂] GT or PKF did not operate any audit processing centres facilities. Whilst [✂] was considering off-shore audit processing centres in the future, GT and PKF had no plans. Mazars International was developing plans potentially to establish some form of processing hub in certain non-audit services, but not in audit.

49. The ability to conduct aspects of the audit work offshore or to use a shared service centre does not depend on membership of a network. However, the ability to use another member firm to supervise such centres to appropriate levels of quality is made easier by the existence of an existing accredited partner firm, though whether an outsourcing specialist could be used instead is not clear.[23]

[22] That is one hour of staff time in the centre replaces one hour of UK staff time.
[23] There may be regulatory requirements over the supervision of audit staff and ability to assess competence. For instance, ISA 220, paragraph 14, states 'The engagement partner shall be satisfied that the engagement team ... have the appropriate competence and capabilities'.

50. Where financial savings are made through offshore centres, the principal benefit appears to be in relocating work to a lower-cost region, rather than necessarily efficiency gains from pooling resources. However, the ability to utilize global centres, and to take advantage of excess capacity in different time zones, may give rise to an economy of scale through international cooperation.

51. However, whilst networks may provide certain services, member firms do not always utilize these. [✂] provides server capacity for individual firms, though [✂] does not use this, whilst PKF International provides central technical accounting advice but the UK firm does not use it, or the PKFI audit manual, choosing to maintain its own. In contrast, Mazars uses global centres of excellence for technical accounting, IT and actuarial teams to support the audits of its international clients. Similarly, EY uses shared services centre for corporate support, which it believed saved the firm £[✂] million per year.

52. The financial benefits of using offshore centres do not appear to be significant at present. However, if the centres are found to be financially viable, the likely expanded use of these centres may have a significant effect on the financial performance of the larger firms.

### *Independence within the network*

53. Member firms may provide a variety of Non-Audit Services (NAS) to the various international subsidiaries of a group. Should one member firm be appointed as group auditor, this may require other member firms to cease offering NAS.

54. The need to compensate another member firm for lost clients under these circumstances varies, though most firms stated that no consideration would be due and that it was felt that the potential loss of non-audit service work would ultimately even out

over time. Mazars, because of its global profit-sharing arrangement, would consider the financial impact on the Mazars group as a whole before accepting an engagement. In the [✂] network, some consideration might need to be paid to another member firm.

### *Strategy*

55. As noted, by being part of a network, member firms benefit from work referred by other firms. As a result, if firms target large international groups and win those audit engagements, the network benefits economically. The fraction of the total audit fee payable to the UK firm will in part depend on where the business activities are based as this will often dictate where the audit work takes place. In some circumstances, such as where the holding company is in the UK, but where the majority of business activity takes place overseas, the UK audit fee might be relatively small. To encourage the domestic firm to attempt to win such audits to bring referred income in, the network may identify companies to target. Similarly, member firms may be requested to target certain sectors.

56. We considered the strategy of several firms:

*(a)* The Baker Tilly network had no central targeting of potential clients.

*(b)* The [✂] network did not require firms to target specific clients or sectors, but encouraged its larger member firms to develop [✂] with an intention of moving towards a [✂].

*(c)* Deloitte UK had autonomy in targeting potential clients and sectors, but considered the strategies of the network and other members as a whole, and as a firm targeted large global clients.

*(d)* [✂].

*(e)* GT International targeted sectors with individuals from member firms chosen to lead on these sectors. However, individual GT member firms decided which sectors they actively wished to pursue.

*(f)* At KPMG, member firms were expected to adopt strategies consistent with the global strategy of KPMG International, recognizing that individual elements of the global strategy will be of different significance to individual firms in light of specific circumstances and markets. The global strategy identified eight priority areas, which included industry sectors, activities ([✂]) and locations ([✂]). The member firms collectively established a Global Accounts Programme, which covered 280 very large existing clients, broadly three-quarters of which have a strong KPMG Europe LLP presence (and of which 30 are UK based or UK listed) with clients designated as audit or non-audit (non-audit clients are presently being reviewed to establish which are target audit clients). Within the global non-audit accounts, there were 42 'focus' accounts identified based on their strategic importance and the scale of additional services that can be sold to the clients. As part of this programme, specific large target clients are identified.

*(g)* Mazars centrally determined major target clients and sectors in liaison with local firms, with targets set for each firm.

*(h)* The PKF network had no involvement in identifying clients for its member firms.

*(i)* [✂].

57. The submissions of the parties indicated that the four largest networks (and to an extent Mazars) had a stronger strategic focus in terms of identifying specific clients and sectors. However, in part this may reflect their existing client bases. Whilst the four largest firms may be able actively to participate in any tender in the FTSE 350, the smaller firms were less likely to succeed and thus, targeting of specific large clients may not be productive.

## The role of the network in setting audit methodologies and standards

58. The network's principal function is to enable cooperation between independent member firms to service their respective international clients for their mutual benefit (through referred income—see paragraphs 103 to 110).

### *Overseeing quality across the network*

59. The UK auditor of the consolidated financial statements of a parent and its subsidiary undertakings must adhere to the requirements of Clarified ISA 600 'Special Considerations—Audits of Group Financial Statements (including the work of Component Auditors)'. The 'group auditor' does not need to audit all the components of a group, but needs to seek assurance that the consolidated financial statements are free from material error at the group level.

60. The firm auditing a component (this may be a subsidiary or an overseas branch) for the purposes of the group audit opinion will not necessarily need to issue a statutory audit opinion on that component. Where a statutory audit is required, the audit firm undertaking the audit will act as component auditor, reporting its findings to the group auditor.[24]

61. The typical method of auditing a large international group is to issue group audit instructions to 'component auditors' outlining the minimum necessary procedures on key balances and confirming the level of materiality used in the audit of the component. Depending on the size of an individual component (subsidiary), the level of detail and subsequent scrutiny of a component auditor's work by the group auditor varies.[25]

---

[24] If a statutory audit is not legally required (or requested) in an overseas subsidiary, a greater level of materiality might be used by the component auditor, to provide assurance to the group financial statements and reduce the overall level of audit testing.
[25] Not all components need to be audited from the group perspective if their results are not material, though may legally need to be audited.

62. The level of review and challenge that a group auditor needs to apply to the work of a component auditor can be reduced if the group auditor can rely on the quality control environment of the component auditor. For member firms of international networks, where a standard methodology is applied and the member firm's quality assurance framework is overseen by the CCE, the amount of work in reviewing the work of component auditors and assessing their competence can be reduced.[26]

63. Where a network has a common audit IT platform, the group auditor may be able to review the audit work relating to the overseas subsidiaries of a UK company in the UK, without the need to visit the local audit team. However, if an overseas component is significant, the UK group audit partner or team may need to review files locally or attend meetings with the component audit team. The extent of this will vary by the nature of the individual components. Where a component auditor is not a member of the network, overseas visits to review files are more likely.[27]

64. Of eight firms which provided information, all had international methodologies and audit platforms. [✂]. Use of the standard audit software was mandatory in all firms except KPMG and [✂].[28] At KPMG, any firm not using the software must use a standard paper-based system based on the same methodology. All the UK firms use their network's software.

65. The nature of each network's international quality assurance programme varies but operates in two layers. The first is the requirement for member firms to operate their own quality assurance programme and the network may set regulations and offer advice on establishing a review programme. [✂], for example, required all member

[26] ISA 600 Special Considerations—Audits of Group Financial Statements (including the work of Component Auditors), Application guidance, paragraph A35.
[27] See, for instance, [✂] [✂] description of [✂] Plc, whose activities are primarily overseas.
[28] Use of the Mazars global audit methodology (and related software) is now mandatory at Mazars.

firms to have reviewed the audits of all partners every three years, unless a firm is very small (five or fewer partners). Similarly, GT and Mazars required all firms to incorporate a quality assurance programme compliant with International Standard on Quality Control 1,[29] issued by the International Federation of Accountants (IFAC) among others. The second layer or review is by the CCE of the quality of individual member firms' quality assurance framework which includes a review of a sample of audits.

66. Where member firms are identified to have weaknesses in their quality assurance framework, or where poor quality has been found in a member firm's audit files, the member firm is required to agree to an improvement programme with various deadlines. Should a member firm consistently fail to meet their network's standards, they will ultimately face expulsion.

67. For example, [✂] expelled [✂] member firms ([✂]) in [✂] on the grounds of quality and have expelled [✂] member firms.

68. A logical consequence of a common quality assurance platform existing across a network appears to be that the resource requirement of the group auditor is reduced, meaning a more efficient audit, allowing either greater margins or the ability to compete more aggressively on price.

69. However, relying wholly on the network's quality assurance arrangements is not necessarily sufficient for all audits, as the group auditor must ensure that it has an appropriate understanding of the audited entity's business including its subsidiaries both individually and in aggregate. PwC stated that the level of interaction with an overseas member firm would vary depending on the scale of financial activity and the

[29] ISQC1 does not specific a frequency of monitoring.

business and audit risks of individual overseas components, to ensure that appropriate evidence was obtained to support the group audit opinion. For example, PwC described one FTSE 350 audit where it had a greater level of interaction with component auditors to understand the issues:

> [✂].

70. Some firms have stated that they consider the use of audit firms outside their network to either increase the risk to the group audit opinion or, in mitigating these risks, increase the cost of the audit. For instance, PwC provided the example of [✂], where it stated that working with a non-network firm incurred a 'significant addition to the local audit firm's fee', though it should be noted in this case that the estimated increase in PwC's group audit fee was only two per cent, which would suggest that this is an issue of the level and extent of the local firm's testing rather than increasing the complexity of the group audit.

71. KPMG UK had a stated policy that specific approval must be obtained for any engagement where member firms of the KPMG network were not the auditor of a significant proportion of a group's components, ostensibly for quality control purposes:

> ... our policy requires that where we are appointed as the group auditor, but the audit of more than 30 per cent (as measured by consolidated assets or consolidated gross revenues) of a group / entity is carried out by component auditors who are not Member Firms, approval is required from the Quality and Risk Management Partner. Such approval will generally be given only where the situation is expected to be temporary and the group auditor has extensive direct involvement in the relevant component audits so that we can be confident in the overall quality of the work.

72. One of the considerations that EYUK takes into account when considering whether it is appropriate to perform a group audit is [✂].

73. We obtained some information on the costs incurred by firms in the development of audit software platforms. This indicated that one network had spent $400 (£250) million on development and one was planning to spend a similar amount in the near future. Other networks had spent significant, albeit lower, sums, although we had some reservations about the accuracy of these numbers given that they reflected internal development costs. Table 2 contains further information on costs.[30]

74. A development cost of £250 million would be unlikely to be economically viable for a single firm (unless it could license the product to other firms), but by acting as a network, the firm can benefit from an economy of scale (in the case of PwC, the UK's contribution is estimated at £[✂] million to receive the features of a software tool that cost $400 million (approximately £250 million)). Given the lower level of referred income in the smaller networks, it is not clear whether such investment would be financially beneficial given the lower level of international engagement.

75. Similarly, the ongoing maintenance costs of the software vary between £5 million and £17 million a year, but rather than falling on a single firm, are able to be shared.

[30] All the networks have a standard international methodology and, with the exception of PKF, its use is compulsory.

TABLE 1 **Costs of developing methodologies and software**

| | *BDO* | *DEL* | *EY* | *GT* | *KPMG* | *Mazars* | *PwC* | *PKF* |
|---|---|---|---|---|---|---|---|---|
| Cost of global methodology | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Localisation | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Last full refresh | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Annual update costs | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Software package | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Is use mandatory in the network | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Development cost | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | $400m | ✂ |
| Localization | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | $400m | ✂ |
| Annual costs | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Notes | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | | |

*Source:* CC Analysis

---

*Notes:* 1. Where firms have provided the total cost incurred in updating their systems or methodologies over a number of years, the CC has used this to calculate an average annual cost.
2. N/A = not available.

## Annual expenditure of the network bodies

76. The CCE and any service companies are funded by contributions from individual member firms. The relative level of contribution will be determined by a number of factors, though the principal determinant is the relative revenue generated by each firm. Other factors, such as number of professional staff and referred income, may also be included in the formula to calculate a firm's contribution.

77. Table 2 shows the level of annual expenditure of each network and the contributions paid by the UK member firms in absolute terms and relative to each UK firm's revenue.

78. In 2011, the Big 4 networks spent between £[✂] million and £[✂] million with the other networks spending between £[✂]. million and £[✂] million. This disparity is indicative of the differing levels of integration and activity undertaken at the network level.[31]

79. The UK member firms contribute between [✂] and [✂] per cent of these running costs, with the relative contributions of the firms clustered into two groups. The first ([✂]) contribute between [✂] and [✂] per cent of running costs, whilst the other ([✂]) contribute between [✂] and [✂] per cent of running costs. It is not clear that there is any specific cause for the different relative contributions.[32]

[31] It is not fully clear whether the expenditure is as a result of the relative scale of the largest networks and linked to actual coordination of activities, or whether the largest networks engage in a broader range of activities

[32] As noted, the basis of the calculation will vary, so some variation in contribution is to be expected.

TABLE 2 **Financial scale of the networks and firms, 2011**

| | *BDO* | *DEL* | *EY* | *GT* | *KPMG* | *Mazars* | *PwC* | *PKF* |
|---|---|---|---|---|---|---|---|---|
| UK revenue (£m) | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] |
| UK contribution (£m) | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] |
| % of UK revenue | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] |
| | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] |
| Network expenditure (£m) | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] |
| UK contribution as % of network costs | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] |
| Network expenditure as % of UK revenue | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] | [✂] |

*Source:* CC analysis.

*Note:* Some numbers have been converted from other currencies, using the average mid-market rate for that network's financial year. The relative level of contribution will vary year on year depending on the factors used in determining contributions.

80. The financial burden on the UK firms varies, with the contribution paid ranging from [✂] to [✂] per cent of the firms' revenue. The largest relative contributions were paid by [✂] and [✂], which are the [✂].

## The international coverage of networks

81. In this section we set out: *(a)* the number of countries to which networks can supply audit services; and *(b)* the number of staff employed by international member firms.

### *Number of countries to which networks can supply audit services*

82. To establish the relative international coverage of the networks, we compared the number of member firms and the number countries in which they operate.[33] Table 3 on page 27 shows the range of the scale of the networks.

83. The number of member firms varies significantly (between 69 and 305), but this does not give an accurate representation of geographic coverage, as in part the number of member firms may be dictated by the networks' legal structure.

[33] In some jurisdictions, an audit firm does not need to be a local firm to undertake statutory audit.

84. In analysing the relationship between number of firms and number of territories covered, it is apparent that *(a)* some member firms operate in territories outside their domestic jurisdiction and *(b)* in some territories a network may be represented by more than one member firm.[34]

85. Due to the variation in the nature of each network and their member firms' operations, a detailed comparison of the networks is not easily performed, nor would a detailed assessment of a network's coverage in a given separate territory be any more enlightening.[35] However, the relative coverage in G7 and BRIC countries is considered in Table 6 on page 32.

86. The Big 4 firms report that their networks have member firms with audit or assurance operations in between 146 and 164 countries. The other firms report that their networks have operations in between 84 and 135 countries.

87. The firms are able to offer further international coverage through the use of affiliate or correspondent firms which are not full member firms of the networks.[36] Table 3 shows, however, that the use of affiliates is not widespread for any of the six largest networks, with at most 11 affiliate firms used. The only network which has a significant number of affiliates is PKF. However, its use of affiliates is relatively infrequent and the 70 affiliate firms are concentrated in only 15 territories. Mazars, which has adopted an 'integrated partnership' model, is a member of the Praxity alliance, which extends coverage by another 13 countries.

---

[34] In Australia, for instance, BDO has a separate member firm in each federal state which cooperate with each other as 'BDO Australia'. In some instances, there may be separate member firms for the provision of audit and non-audit services, which may be a local requirement.

[35] For instance, it would be difficult effectively to compare two networks that both serviced companies in Monaco, but where one had a dedicated Monaco office, whilst the other had staff commuting from its Nice office.

[36] In a number of instances, these affiliate or correspondent firms may be present in a country where a full member firm is operational, even if the firm is not legally registered there.

TABLE 3 **International scope of networks**

| | *BDO* | *Baker Tilly* | *Deloitte* | *EY* | *GT* | *KPMG* | *Mazars* | *PKF* | *PwC* |
|---|---|---|---|---|---|---|---|---|---|
| Number of member firms (number providing audit) | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Number of countries member firms active in | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Number of affiliate firms | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Number of countries affiliate firms active in | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Total number of countries firm active in | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |

*Source:* CC network data request. Baker Tilly taken from MFQ.

*Includes branch offices of member firms.
†Firms in alliance with the network's US and Spanish firms.
‡EY did not provide a specific number of affiliate firms outside of its network other than as 'less than ten'.
§Mazars is also a member of the Praxity alliance which increases overall coverage to 97 firms.

88. Table 4 analyses the changes in the number of countries to each network over the period 2007 to 2011.[37] All the networks added new member firms and accompanying additional geographic coverage. The largest four networks added between [✂] and [✂] net new firms, with the other networks adding between [✂] and [✂] net new firms.

89. As a proportion of their network coverage, these increases were particularly significant for the smaller networks, and may be seen as evidence of increasing international coverage. The lower number of additions for the largest networks may be due to having reached a saturation point in respect of economically viable territories.

[37] These changes all relate to firms which appear to be the sole member firm in a given country.

TABLE 4 **Changes in the number of countries where networks are present**

| | *2007* | *2008* | *2009* | *2010* | *2011* | *Net increase* |
|---|---|---|---|---|---|---|
| BDO | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| BT | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Deloitte | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| EY | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| GT | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| KPMG | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Mazars | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| PKF | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| PwC | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |

*Source:* CC analysis of MFQ responses.

*Notes:*
1. Responses have been analysed on the basis of calendar years or firm reporting years depending on format of data supplied. Depending on the data supplied, this may relate to changes in either the number of member firms, or activity of existing member firms in another territory or a combination of the two.
2. GT's net figure includes two departures from the network which did not have a date disclosed.
3. PKF has not responded.

90. Seven firms provided a list of where their network had operations and our analysis indicates that these networks have a combined representation in approximately 202 nations or territories.[38,39]

91. The Big 4 networks were each present in approximately 150 of the 202 territories. There were 116 territories where all of the largest four networks were present. Of these 116 territories, both BDO and GT were present in 88 (76 per cent), with one of BDO and GT present in a further 18 territories and neither present in the remaining 10 territories.[40]

92. Of the 28 countries where BDO and GT were not both present, nine were in Europe (all are Baltic or Balkan states, with the exception of Monaco), seven were in Africa and five were in Central Asia, the Middle East and the Pacific. The only country from

[38] The lists of territories submitted by each firm have been compared against each other and, wherever possible, the named territories have been compiled. In some instances, such as with reference to individual islands that were formerly in the Dutch Antilles, we have needed to make a judgement over how these are treated based on information supplied.
[39] ✂, Deloitte, EY, GT, KPMG and PwC were the only firms to provide a full list of countries where the network has operations.
[40] ✂ has operations in 100 of the 118 and ✂ has operations in 94 of the 118.

this group of 28 that is in the IMF's list of the 50 largest global economies is Nigeria.[41]

93. It appears that the Big 4 firms have a wider coverage of international territories, and each is present in a similar number of territories, but that no single network offers universal coverage. Where all the four largest networks are present, both BDO and GT show a broadly similar level of international coverage. However, as discussed below, the number of staff in each member firm varies.

### *The number of staff employed by international member firms*

94. As part of the MFQ, we requested data on the number of staff employed by each member firm in a network. Due to the different ways that the firms presented data and how their individual member firms are managed (such as the number of countries serviced by each member firm), a simple numerical comparison of their size by number of employees is difficult. However, there are distinctive differences. Further, the proportion of staff in each member firm that are qualified to work on an audit will vary and as such the data in Table 5 should be treated as indicative of relative scale, rather than conclusive in respect of a network's international audit capacity and capability.[42]

[41] Based on nominal GDP from IMF's World Economic Outlook Database, April 2012.
[42] Particular caution should be applied to data for Deloitte, which has provided staff data for 61 individual firms/named territory groupings, as this will make Deloitte's individual firms appear disproportionately large.

TABLE 5 **Analysis of international distribution of staff 2011**

| | *BDO* | *Deloitte* | *EY* | *GT* | *KPMG* | *Mazars* | *PwC* |
|---|---|---|---|---|---|---|---|
| Number of firms/territories that firms have provided staff figures for | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| **Total reported staff** | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Median number of staff per firm/ territory | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| **Mean number of staff per firm/ territory** | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| % of firms/territories with fewer than 100 staff | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| % of firms/territories with fewer than 50 staff | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Number of territories per CC analysis | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| **Average per territory** | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |

*Source:* CC analysis.

95. There are two identifiable tiers of networks. Deloitte, EY, KPMG and PwC employ on average approximately [✂] staff for each country serviced, compared with an average of approximately [✂] for BDO and GT.[43] Mazars, which has member firms in fewer countries, has a smaller average number of staff at [✂]. Baker Tilly and PKF were not able to provide figures for staff internationally.

96. A simple comparison of average number of staff needs to be treated with caution, but other statistics such as the median also indicate that there is a disparity in the average size of firms in each network. There is also, however, a significant variation in the relative size of member firms in the networks. For all networks, the smallest member firms (which employ between 1 and 43 staff) are dwarfed by the largest firms (2,000 to 53,000 staff) in their respective networks.

97. The larger networks' member firms are larger on average, and also have fewer small member firms. For the larger networks, the proportion of member firms that employ

[43] This has been calculated to allow comparison with [✂] whose structure means that it reports 60 member firms, approximately half the number of the other firms.

fewer than 50 staff ([✂] per cent) is lower than for the other networks (approximately [✂] per cent).[44]

98. The Big 4 networks are not identical in size, despite being present in a similar number of countries and having a similar average number of staff in each country (Table 5). The median EY member firm, for instance, employs [✂] staff, whereas the same figure for KPMG is [✂] ([✂] per cent higher) despite their mean number of employees ([✂] and [✂] respectively, KPMG [✂] per cent higher), indicating that [✂]. Further evidence of this difference is that only [✂] per cent of KPMG member firms employ fewer than 50 staff, compared with [✂] per cent for EY.[45]

99. [✂] networks have broad international coverage. Their overseas member firms are typically smaller than member firms of the Big 4 in those countries where they are present, which is particularly notable when considering the median sized firm in each network.

100. The smaller networks have expanded the number of countries in which they are present and are approaching a coverage similar to the largest networks, but individual international member firms are smaller and potentially have less capacity to resource engagement teams for large subsidiaries at short notice.

101. Table 6 gives an overview of the size of international member firms in a selection of large and significant emerging economies.[46] All the networks are present in all these economies, but the largest four networks' presence is significantly larger with at least [✂] staff in each of these economies. The BDO and GT networks have a relatively

[44] A similar trend is observable in the proportion of member firms with fewer than 100 staff.
[45] [✂] has fewer member firms but has a similar level of coverage in the number of territories served, so direct comparison is difficult.
[46] These are the G7 and BRIC economies.

strong presence with on average over [✂] in these territories. However, [✂], for instance, has fewer than [✂] staff in [✂] of the ten countries. Mazars is smaller, with an average of 502 staff, but with significant variation in firm size, with only 18 staff employed in its Japanese office (although through a joint venture with a larger Japanese firm, Mazars has the ability to draw upon additional resources as necessary).

TABLE 6 **Number of staff employed by member firms in significant economies (G7 and BRIC)**

| | *BDO* | *Deloitte* | *EY* | *GT* | *KPMG* | *Mazars* | *PwC* |
|---|---|---|---|---|---|---|---|
| USA | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| China | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Japan | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Germany | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| France | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Brazil | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Italy | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Russia | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| India | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Canada | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| UK | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Mean (excluding UK) | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |
| Median (excluding UK) | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ | ✂ |

*Source:* CC analysis of MFQ.

†Deloitte Russia figure is for CIS firm.
‡KPMG Russia includes Georgia and Kyrgyzstan.
*KPMG France includes Algeria and Ivory Coast.

102. This analysis of staff numbers indicates that whilst the smaller networks have representation in a large number of countries, their member firms are also smaller.

## Referred income

103. The existence of networks with member firms in a number of countries produces 'referred' income, ie revenue generated from the servicing by one member firm of a network of the overseas operations of a company from another jurisdiction on behalf of another firm. For UK firms, the level of both outward referred income (subsidiaries of UK companies being serviced by foreign firms) and inward referred income (UK subsidiaries of foreign companies) is substantial (see below). The greater the level of

referred income within a network, the greater the economic incentive there will be for a firm to remain within that network.

104. The historic development of the largest four networks dates back to the 19th century, and the expansion of the founding firms (through overseas branches and child partnerships as well as alliances with other firms) was driven primarily by British and US mercantile activity and client demand.

105. In contrast, BDO, GT and PKF all can trace their roots to a founder firm established in the 19th or early 20th century but their international activity developed primarily from the 1960s onwards.[47] Mazars' development as an international network was later, with the firm established in 1940, and exhibited relatively little international growth until the 1980s.

### *Outward referred income: audit fees from UK companies paid to overseas firms*

106. One measure of the importance of an international network is the proportion of a UK company's group audit fee that relates to work undertaken by the UK audit firm, as the remaining element must be paid to other member firms. Table 7 shows that the proportion of the total audit fee for FTSE 350 payable to the UK firm declined by 11 percentage points in the period 2006 to 2011.

107. Both the UK and the total audit fee have increased over the period, although whilst the total audit fee increased by 5.2 per cent each year, the UK element increased by only 1.1 per cent.[48] The reason for the different growth rates is not clear. Whatever the cause, approximately half of the financial value of FTSE 350 audit work is now

[47] This was also true to an extent with respect of Arthur Andersen.
[48] The non-UK element increased by 11.2 per cent each year.

undertaken by overseas auditors, meaning that the quality of the international network is of increased importance.

TABLE 7 **Proportion of FTSE 350 audit fees receivable by UK firms**

| | *2006* | *2007* | *2008* | *2009* | *2010* | *2011* | *CAGR %* |
|---|---|---|---|---|---|---|---|
| UK audit fee | 280,081 | 303,720 | 307,926 | 314,526 | 304,526 | 295,138 | 1.1 |
| Total audit fee | 475,077 | 547,697 | 565,468 | 635,750 | 664,001 | 611,324 | 5.2 |
| UK element of the total fee (%) | 59 | 55 | 54 | 49 | 46 | 48 | |

*Source:* CC analysis.

*Notes:*
1. EY excluded as non-UK element of audit fee not provided.
2. The fees relate to all FTSE 350 audits, and not just those with overseas elements per Table 8.
3. UK audit fee is net of any international costs billed via the UK firm.
4. The data provided by firms includes a number of instances where the UK audit fee is greater than the total audit fee. If these are excluded, a similar trend is evident, with the UK proportion of audit fees declining albeit from 50 to 42 per cent. Where supplied total audit fee is less than the UK audit fee, and the total audit fee is adjusted to be equal to the UK audit fee, the proportion of audit fees receivable by UK firms falls from 57 to 47 per cent.

### *Inward: audit fees earned by UK firms from overseas companies*

108. The UK firms also receive referred work relating to the UK subsidiaries and branches of overseas companies. For the largest firms, the value of this work is very substantial and accounts for approximately one-third of all revenues. In 2011, ✂ per cent of Deloitte's firm revenues came from 'foreign' clients (2007: ✂ per cent)[49] and ✂ per cent of PwC's revenue was 'inbound' (✂ per cent of assurance) (2007: ✂per cent/ not available).[50] KPMG stated that 'around ✂ of KPMG's UK revenues are attributable to clients which are identified on our finance systems as having an overseas entity as the parent'.

109. In 2011, BDO received some £✂ million of inward referred income, of which £✂ million was related to audit (✂ per cent of firm revenue and ✂ per cent of audit revenue). GT UK received approximately US$ ✂ million (approximately £✂ million) of inward referred income annually, of which an estimated approximately ✂ to ✂ per

[49] Deloitte May 2011 management accounts.
[50] PwC 2011 Firm and Assurance Management accounts.

cent (approximately £[✂] million) related to statutory audit ([✂] per cent of firm revenue, and [✂] per cent of audit revenue).

110. When the European Commission considered the nature of the economic relationship and interdependence of member firms in the Deloitte network (during the acquisition of Andersen's business), it found there to be little financial incentive for a member firm to leave this large network and stated that 'The interdependence of the member firms is further strengthened by the consideration that the possibility for a member firm to leave DTT [Deloitte's CCE] is economically almost unfeasible and very unlikely'.[51]

## Importance of networks to purchasers of audit services

### *Current FTSE 350 use of networks*

111. In 2011, 76 per cent of the FTSE 100 and 63 per cent of the FTSE 250 (Table 8) paid audit fees that related to non-UK audit activity. Of those companies that needed non-UK audit services (such as for a branch or subsidiary), the non-UK element in 2011 accounted for some 52 per cent of the total audit fees for the group for FTSE 100 companies and 29 per cent of the group for FTSE 250 companies (Table 8).

112. In the period 2006 to 2011, there is some evidence of an upwards trend in the level of non-UK audit work. The proportion of FTSE 350 companies that have needed some non-UK audit has increased (four percentage points), driven primarily by increases in the FTSE 250 (a seven percentage point increase). The relative value of the non-UK proportion of total audit fees in the FTSE 350 has also increased (six percentage points), with the increase in the FTSE 100 some 14 percentage points.

[51] Case No *COMP/M.2810 - DELOITTE & TOUCHE/ANDERSEN (UK)*, paragraph 14.

These trends indicate that members of the FTSE 350 increasingly have international operations and that the non-UK element of the audit is increasing.

TABLE 8 **Proportion of companies which have an element of non-UK audit**

*per cent*

| | *2006* | *2007* | *2008* | *2009* | *2010* | *2011* |
|---|---|---|---|---|---|---|
| FTSE 100 | 75 | 77 | 78 | 78 | 80 | 76 |
| FTSE 250 | 56 | 64 | 63 | 65 | 67 | 63 |
| FTSE 350 | 62 | 67 | 67 | 69 | 71 | 66 |

*Source:* CC analysis.

*Notes:*
1. Excludes EY, as UK and total audit fee data not both supplied.
2. Where the supplied total audit fee for an engagement was less than the UK audit fee, the engagement was assumed to have no international element.

TABLE 9 **Average proportion of total audit fee payable for non-UK audit work**

*per cent*

| | *2006* | *2007* | *2008* | *2009* | *2010* | *2011* |
|---|---|---|---|---|---|---|
| FTSE 100 | 38 | 41 | 41 | 43 | 47 | 52 |
| FTSE 250 | 26 | 25 | 25 | 28 | 28 | 29 |
| FTSE 350 | 30 | 30 | 30 | 32 | 34 | 36 |

*Source:* CC analysis.

*Notes:*
1. Excludes EY, as UK and total audit fee data not both supplied.
2. Where the supplied total audit fee for an engagement was less than the UK audit fee, the engagement was assumed to have no international element.

113. This increased demand from large listed companies for some form of international audit (and the extent of that audit work) suggests that to service large companies it appears increasingly important for an audit firm to have a suitable network to deliver this work.[52]

114. However, 24 per cent of the FTSE 100 and 37 per cent of the FTSE 250 do not require any non-UK audit work (or if they do, it is performed by the UK firm) and thus the network is not an immediate barrier to entry for these sections of the FTSE 350.

[52] In some circumstances, a UK firm might be able to service the non-UK element directly, but as the proportion of the total audit work undertaken overseas increases, this is likely to be less economically viable due to travel and subsistence costs.

115. However, for UK companies with no overseas activities, but with expectations of expanding overseas in future, the existence of an international network may be perceived as beneficial, as a company would not need to seek either a local auditor, or potentially seek a new group auditor. Our survey of Chief Financial Officers and Audit Committee Chairs indicates that this is not a universal consideration, with only 8 per cent of respondents from companies with no international operations considering a firm's international network as important when choosing an auditor (see paragraph 125).

### *FTSE 350 views: CC survey*

116. The CC used the services of an independent research company to undertake a survey of the views of the Chief Finance Officer/Finance Director (CFO) and the Audit Committee Chair (ACC) (herein referred to as purchasers) of the companies comprising the FTSE 350 and over 1,750 other companies comprising the smaller FTSE indices, the Top Track 350 and a sample of companies listed on the Alternative Investment Market (AIM).[53, 54,55]

117. Companies whose CFO or ACC estimated that at least 40 per cent of their audit fee related to overseas work are herein referred to in this paper as 'international companies'.[56]

118. The survey found that the individuals involved in the purchase of audit services for FTSE 350 companies and for international companies of all types (FTSE 350 and non-FTSE 350) were more likely to identify the international network as an important

---

[53] Not all companies responded. The overall number of responses at the company level was 474.
[54] In this section, use of the word 'significant' refers to differences which are statistically significant at the 95 per cent confidence interval.
[55] Some results from the survey indicate that a greater proportion of purchasers of audit services may consider a network as important than might be expected based on the figures included in Table 8; however, as the table does not include EY clients, and the survey does not have full coverage, the two populations will not be directly comparable. The expectation of possible overseas expansion may also drive some element of this relationship.
[56] However, other companies may have some element of international .

factor in a number of scenarios. The survey also found that not only do the four largest firms audit almost all the international companies, but that international companies make up a significantly higher proportion of those firms' client base.

*International companies' choice of auditor*

119. In the survey, of the 114 international companies, 97 per cent were audited by one of the four largest firms. This indicates that international companies are almost entirely audited by one of the four largest firms. In contrast, the four largest firms audited 90 per cent of the total survey responses.[57]

120. Further, international companies accounted for 26 per cent of the largest four firms' clients, compared with 6 per cent of clients for the other firms. This difference in client base is statistically significant and shows that not only do almost all international companies choose the four largest firms, but that for those firms, these companies make up a larger proportion of their client base by number than for other firms.

*The importance of the network in companies' assessment of quality*

121. When purchasers were asked to identify how they assess audit quality, significantly more FTSE 350 purchasers (66 per cent) identified 'consistency of delivery worldwide' as an 'important' factor (ie answered important or very important) than the 47 per cent of purchasers from non-FTSE 350 companies.[58] Within the FTSE 350, significantly more FTSE 100 purchasers (84 per cent) identified this as an important factor compared with the FTSE 250 purchasers (58 per cent).[59] Similarly, significantly

[57] The largest four firms audit a similar proportion of the FTSE 350, but it should be noted that 40 of the 114 companies were not in the FTSE 350, and the market share of the four largest firms is lower.
[58] Respondents were asked to rate factors on a scale from 'Not at all important' to 'Very Important'.
[59] The proportion of the FTSE 100 purchasers identifying this as an important factor was significantly greater (ie the difference is statistically significant) than any other group of purchasers, and the proportion of FTSE 250 identifying this an important factor was statistically greater than for respondents from AIM, the Top Track 250 and Top Track 350.

more purchasers from international companies (92 per cent) consider this to be an important factor than non-international companies (39 per cent).[60]

*The importance of a network in choosing an auditor*

122. The strength of the international network was considered to be an important factor in the decision to appoint or reappoint an auditor by 83 per cent of the FTSE 100 purchasers[61] and 64 per cent of the FTSE 350 purchasers,[62] significantly more than the 45 per cent of purchasers from other companies.[63] This difference was even greater for international companies, with 96 per cent of international company purchasers considering this to be an important factor compared with 62 per cent of purchasers for non-international companies.[64]

123. Geographic considerations were seen to be a reason not to invite or include companies in a tender situation. Of the 175 companies which had tendered in the past five years, 24 per cent responded that 'regional strength/geographic coverage' was a reason used to exclude some firms from tendering. The proportion of international companies which used this as a basis for filtering (48 per cent) was significantly higher than for other companies (22 per cent for those with 1 to 40 per cent of their audit fee relating to overseas audit and 10 per cent of firms with no international element).[65]

124. Of the 260 companies which would only consider the four largest firms, only 4 per cent of respondents considered that the strength or coverage of any of the four firms' respective networks would exclude one or more of those firms.

---

[60] Non-international companies comprise those where the overseas element of the audit fee is between 1 and 40 per cent and may still require international audit services.
[61] This is a statistically significant difference compared with non-FTSE 100 companies.
[62] This is a statistically significant difference compared with non-FTSE 350 companies.
[63] Respondents were asked to rate factors on a scale from 'Not at all important' to 'Very Important'.
[64] As noted above, non-international companies are those where the overseas element of the audit fee is between 1 and 40 per cent. For those companies without any international element to the audit, 8 per cent considered this important.
[65] The wording of the responses makes it unclear if respondents are referring to just overseas coverage, or regionally within the UK as well.

### *Case studies*

125. Companies taking part in our case studies told us that they wanted their auditors to be experienced both within the industry within which they operated and within the FTSE. Companies wanted the quality of the audit to be consistent across their international business. For example:

*(a)* One company [✂] required experience of large and global FTSE companies; and

*(b)* Another company [✂] said that the main selection criteria used were: did the firm have the right industry skills and the quality of the team across the international group).

126. The main concern raised by our case studies about non-Big-4 firms was that they did not have the geographic spread and quality in those locations to be able to undertake some of the international audits. Many perceived that non-Big-4 firms used affiliates. For example:

*(a)* One company [✂]'s ACC was concerned about the geographic coverage and experience of acting for global clients of the mid tier. The ACC did not know, but guessed that mid-tier firms were represented by affiliates in other areas of the world. She thought it was difficult to maintain global standards and training when using affiliates.

*(b)* Another company [✂] CFO was concerned that currently using a mid-tier firm would mean using mid-tier 'partner' firms in different territories and that this was an added difficulty.

*(c)* A third company [✂] ACC did not think that the mid-tier firms had the necessary reach to be able to deal with the geographic spread of the company. The ACC was not sure if this view would still be valid for firms with simple operations solely in the UK.

*(d)* A fourth company [✂] ACC thought there was a significant gap in terms of coverage (but not skills) between the Big 4 firms and the larger mid-tier firms.

*(e)* A fifth company [✂] —the ACC said that it was 'almost inconceivable' that the external audit would go to a non-Big-4 firm because of the company's international presence and the fact that the locations of the company were unknown and changing. Whilst the mid-tier firms audited AIM-listed companies in the extractive industries sector, they did not have a consistent presence in enough countries.

*(f)* The fifth company [✂] did not know where it would have operations in the near future, therefore it needed an audit firm with broad international strength.

127. Accordingly, in general our case studies thought that international capacity was important, and this was principally to be found in the Big 4 networks.

## Initial views on the possible effect of a network on competition

128. There are a number of economic and strategic issues that membership of a network entails that may affect the level of competition in a market and the level of profit that a member firm may be able to extract:

*(a)* As a barrier to entry – without a network with sufficient international breadth, it appears that a firm may be excluded from being invited to participate in tenders or being awarded the tenders of large international audit clients. At least two-thirds of FTSE 350 companies require some level of international audit.[66] The networks of the Big 4 do appear to be somewhat more extensive and include international operations that are substantially larger than those of the mid tier.

*(b)* Economies of scale – by centralising functions, there may be an avoidance of duplication of activity leading to a reduced resource requirement, and reduced costs. For example, if a global methodology and quality assurance programme can be employed across a network, member firms will not have to perform as

[66] 66 per cent of FTSE 350 companies require international audit services that are not provided by a UK firm.

much work assessing each others' competence when using each other to audit international subsidiaries. Similarly, bespoke audit software tools can be developed with the cost shared across the network, and with the added benefit of each firm being able to share audit files electronically, potentially reducing the time required to review files (such as needing to travel overseas).

*(c)* Generation of additional revenue. By virtue of being a member of a network, firms will gain business from the international subsidiaries of other members' domestic clients. These amounts may be significant to a firm. Member firms of a network will generally be the sole representative in a given territory, and will receive referrals by default, without incurring costs in developing a number of bilateral arrangements (though these will be incurred by the network on behalf of all members as it expands). This increases the cohesiveness of the network (because the local firm stands to lose more revenue should it decide to leave the network) and increases the ability of the local firm to attract high quality staff.

*(d)* Reputation and branding. To some extent member firms will benefit from the accumulated reputation and strength of brand of the network, either by direct association with the 'brand', or acknowledgement that the firm has been accepted into a prestigious international network which may be perceived to have higher standards than domestic firms.

*(e)* International opportunities. The opportunity to gain experience of working on audits of subsidiaries of large international companies and the possibility of secondments or transfers to other international offices within the firm is likely to be an advantage in attracting high quality graduates and other personnel.

129. It should be noted that operating a network also introduces additional costs which would not otherwise be present in a fully independent firm, such as costs of coordinating member firms and quality assurance compliance reviews that may

partially offset some financial savings. However, larger networks appear better able to incur those costs.

130. Some aspects of forming an international network, most notably, ring fencing of liability, are possibly unique to the network model (compared to say, a traditional parent-subsidiary business combination) of developing an international presence.[67] Even if, as in the case of the more integrated partnerships of EY and Mazars, the CCE may exercise control over member firms but those firms are independently owned.[68]

131. Not all of the economic and financial benefits of a network are readily quantifiable. For the majority of the large networks, the UK member firm (or an antecedent) has been providing professional services for at least 50 years and has had a link with the network since its formation.[69] Because of this shared heritage it is not therefore possible to measure the impact of the network's reputation on the domestic performance of most UK firms in a large established network.

132. In our initial view, it does appear that international networks are a good example of the virtuous/vicious circle indentified in our Restrictions on Entry and Expansion working paper. Those with large, established networks may compete for and win the audits of large companies, with any success reinforcing the strength of the network and making it more attractive to potential future customers. Those without such a network are likely to be excluded from tender processes where there is expected to be a significant level of international audit work, and so the risk of any investment in network expansion is increased.

---

[67] A looser affiliation would also have this benefit, but without several of the other aspects.
[68] If the network model was replaced by a parent-subsidiary relationship, there is potential that the parent as controlling entity could be found liable for a subsidiary's actions and its assets targeted.
[69] This is certainly the case for the largest four firms, GT and PKF.

## The network and the potential exit of a major auditor

133. Whilst the network model ring-fences legal liability, it does not eliminate the risk of collapse of one member firm spreading to other member firms. Through close economic and business association, member firms are susceptible to reputational damage, to the same extent as they may benefit from the positive effects of brand reputation. We consider various examples.

### *Arthur Andersen*

134. The clearest example of the effect of reputation on a network is the case of Arthur Andersen Worldwide (Andersen). The US (and founding) member firm's involvement in alleged failures in auditing and destruction of evidence had a significant reputational impact, which was compounded when the US firm surrendered its audit licence. Member firms began to identify other local firms that they could merge with (these were predominantly member firms of the other four largest networks).

135. The collapse of the network was driven by a number of factors:

*(a)* The network was unable to provide audit services to the US subsidiaries of overseas companies.

*(b)* There was a reputational impact which meant that international companies did not wish to be associated with such a perceived catastrophic audit failure.

*(c)* The loss of the US audit practice meant that referred income to other member firms would have decreased significantly.[70]

136. In its conclusions on the subsequent acquisition of most of Andersen UK's business by Deloitte UK, the European Commission stated that international networks were a requirement of a large-company audit business: 'Large clients demand a global

[70] Non-US firms would be likely to have found that they were overstaffed on the loss of referred engagements from the US firm, meaning that their firm profitability would have fallen.

network, a high degree of international expertise and a reputation ... Andersen Worldwide was able to offer this, but Andersen UK on its own cannot.'[71]

137. In the case of Andersen, the actions of one member firm damaged the reputation of other firms in the network but the effect was possibly greater than it might have been in other circumstances. It appears that the Andersen network was more focused on servicing the subsidiaries of the US firm's clients relative to the other networks (though in almost all networks the US firm is the largest member by revenue), and the loss of the US firm would be likely to have had a much greater effect on the revenue of member firms than the loss of other constituent territories.[72,73]

138. There have been other examples of accounting scandals concerning member firms of the four largest networks, which have not led to the collapse or any noticeable long-term detriment to the networks.

### *PwC Japan Chuo Aoyama*

139. The events surrounding the PwC Japanese firm ChuoAoyama provides some evidence that networks can recover from the damage caused by the actions of member firms. After accounting irregularities were found at Kanebo (a Japanese cosmetics company), ChuoAoyama, the PwC network firm[74] in Japan, was suspended from practice for two months in July 2006 by the Japanese accounting regulator. In the same month, a group of partners from the Japanese firm entered into dialogue with the PwC network to discuss how to ensure continuity of service to ChuoAoyama's existing inbound and major Japanese clients.

---

[71] http://europa.eu/rapid/pressReleasesAction.do?reference=IP/02/968.
[72] That is not to say that Andersen did not have a significant presence in the UK public company market, and had a 10 per cent share of the audit market, making it the fourth or fifth largest firm on the basis of audit revenue (Oxera). Historic global revenue data is not readily available. For FY2000, both Andersen Worldwide and PwC Global reported that 44–45 per cent of their network revenues were generated in North America. However, it is not clear what proportion of non-North-America revenue was generated from local firms rather than referred income from the US firm. Figures from archived webpages.
[73] In the four largest firms we believe the US member firm to generate approximately 20 to 30 per cent of global revenues.
[74] Network firms in the PwC network have a slightly lower level of rights and responsibilities compared with member firms and cannot, for example, participate in the election of the Chairman and Global Board of PricewaterhouseCoopers International Ltd.

140. Having concluded that ChuoAoyama's reputation was tarnished, a group of former ChuoAoyama partners initiated the formation of Aarata, a new firm, which applied for and was granted membership of the PwC network. At this point, a number of partners and staff of ChuoAoyama as well as several large clients chose to transfer to the new firm.

141. On 1 September 2006 (on completion of its two-month suspension), ChuoAoyama changed its name to Misuzu. In the summer of 2007, Misuzu's status as a network firm of the PwC network was terminated and the firm ceased trading. The remaining staff of Misuzu transferred to either Aarata or the member firms of the other three largest networks.[75]

142. In FY2012, the PwC network generated $[✂] million from the Japanese firm's clients' overseas operations, across all service lines.

### *PwC India*

143. Two partners in one of the PwC audit firms in India have been subject to disciplinary proceedings by the Indian accounting regulator for their alleged failure to detect the management-perpetrated fraud at Satyam Computer Services Ltd (SCSL). One inquiry remains pending before the Indian accounting regulator. In the second case, the Indian accounting regulator barred the partner from practice and has assessed a fine against him; that judgment has been stayed, pending the resolution of judicial appeals. Also in the SCSL matter, the PwC audit firms in India registered with the PCAOB settled administrative proceedings with both the PCAOB and the US Securities and Exchange Commission; the settlement included payment of a financial penalty.[76,77] In FY2012, the level of revenue generated by the PwC network from

---

[75] PwC submission; www.accountancyage.com/aa/news/1788528/misuzu-operations-formally-halt-japan.
[76] www.accountancyage.com/aa/news/2131072/auditors-barred-life-satyam-scandal.

subsidiaries of the PwC firm in question was some $[✂] million across all service lines.

### *Discussion*

144. In these Japanese and Indian examples, there does not appear to have been any significant and persistent adverse effect on the network. In the Japanese example, ChuoAoyama was a network firm, rather than a member firm. PwC's share of the Japanese market fell, with several clients switching to other auditors. ChuoAoyama was barred for a two-month period from performing certain types of audit work, was subsequently renamed Misuzu, and then ceased trading shortly after it left the PwC network. In India, the PwC member firms have continued trading. Had either firm lost its ability to deliver audits, the effect may have been more significant. Similarly, if the firms had been full members, there may have been greater damage to reputation, if clients had doubted the effectiveness of the network's methodology and quality control procedures.

145. The possible exit of a participant in the UK audit market as a result of actions of another member firm seems therefore to depend on a large number of factors, principally:

*(a)* whether the overseas member firm is prohibited from providing audit as a result;

*(b)* the ability to source a replacement firm should the original firm cease trading or providing audit services;

*(c)* the level of income referred by the firm to the UK;

*(d)* the proportion of the UK firm's client base with significant subsidiaries in the overseas territory;

*(e)* the size and global impact of any corporate collapse (and thus impact on the network's reputation); and

- - - - - - - - - -

[77] www.sec.gov/news/press/2011/2011-82.htm.

*(f)* the extent of financial interdependence between other firms.[78]

146. However, if a firm in the UK, or any other market, failed, the network has the ability to create a new 'clean firm' which might replace or run in parallel to a previous, potentially troubled firm. The incentive for the network to create a new firm, or to financially support a failing firm, would necessarily be greatest where the greatest level of referred work is found.

### *Initial views*

147. It appears from examples of significant audit failures that there has been no notable impact on the respective international networks. The potential collapse of a network would likely be triggered by a member firm in a large developed economy, and one which has a significant level of referred work to and from other large member firms. Given the Japanese example, it is a possibility that a 'clean' firm could be created, but this would be contingent on any large audit failure being perceived as a one-off event. Should there be a series of alleged audit failures, there may be resultant reputational damage.

148. The collapse of a network seems potentially most likely to occur from the actions of a very large member firm, which audits large international domestic companies and potentially a number of local subsidiaries of overseas international companies (that is they service the subsidiaries of other member firms clients). The chain of events that could lead to a network collapse may proceed as follows:

*(a)* Erosion of reputation - A series of notable, alleged or proven, audit failures, primarily in a large international member firm (Firm X), but also elsewhere in the

[78] For instance, if the 'offending' firm had significant economic ties through referred income with a third firm, which led to the third firm seeking to leave the network, it might be this exit that affects the UK firm, rather than the 'offending' firm.

network. These may lead to litigation, but not to an extent that Firm X is unable afford the settlement.

*(b)* Triggering event - A significant audit failure in a large Public Interest Entity which:

(i) coincides with the collapse of the company and, or,

(i) results in a significant financial liability which the firm is unable to finance without assistance from the network.

*(c)* Response of large customers – large significant international companies stating that they would switch from Firm X or from another member firm in Firm X's network.

149. This chain of logic is based on the assumption that as long as the audit failure can be isolated to a single member firm, and to a single audit engagement team, there is the potential to ring-fence blame on individuals. A more pervasive perception of poor quality within the firm or network would likely develop from multiple (and high-profile) instances of audit failure. Such reputational damage might prevent a clean firm from being established. However, if individual clients are satisfied that their individual audit team is providing a quality product (and for listed companies that the market does not consider this to be an issue) and do not choose to switch networks, the firm and ultimately the network would be more likely to survive.

150. A theoretical alternative might be for the network to open a new, clean firm that focuses on servicing the overseas subsidiaries incorporated in Firm X's domestic territory. This model would reduce the risk of collapse by providing audit services to other member firms existing clients but would be dependent on avoiding being tainted by the previous firm. By not competing directly in the domestic market it may be easier to recruit from other firms, or, subject to regulatory requirements overseas staff might be able to perform the statutory audits. However, whilst this might act to

prevent collapse of the network, it would still lead to the exit of a participant in that market.

## Example: the Brazilian audit market

1. The member firms of both GT and BDO left their respective networks to join the pre-existing Brazilian member firms of EY and KPMG respectively. Further, the BDO firm which merged with the KPMG firm had previously been a GT affiliate.

2. GT's Brazilian member firm was acquired by EY Brazil in 2010. GT's Brazilian firm was the fifth largest firm in Brazil (with EY Brazil's revenues approximately four times larger). GT UK believed that EY Global instigated the transaction, though EY Global stated that the acquisition was instigated by EY Brazil, [✂].

3. [✂].[79]

4. The main effect on the GT network was that of the [✂] international clients that were serviced by GT Brazil, [✂] did not transfer to the new GT Brazil member firm; however, two of those companies subsequently merged with other companies audited by the new GT member firm. Referred income to and from the Brazilian firm and the GT network was under £ [✂] million.

5. The direct financial effect on the UK firm was not significant, due to the limited number of its clients operating in Brazil, but led to at least one client challenging GT UK on whether its network could support the client's growth ambitions.[80]

6. The firm acquired by EY Brazil had revenues of US$52.2 million in 2009, of which [✂]. The replacement firm in 2010 had revenue of US$18.8 million, which increased

[79] It is not clear to what extent this assistance was driven by EY operating as a 'globally integrated partnership'.
[80] This challenge arose when a UK audit client asked GT UK to introduce it to the Brazilian firm to assist with the acquisition of a company in Rio de Janeiro; the replacement firm's Rio de Janeiro assurance and due diligence team was not as strong as the previous firm's.

to US$35.6 million in 2011, of which [✂]. This was a decrease in assurance revenues [✂], and the GT share of the audit market is likely to have similarly declined.

7. Similarly, in 2011, KPMG Brazil acquired BDO Brazil, which was at the time the fifth largest Brazilian audit firm. As a result of this, the BDO network lost its representation in Brazil and was forced to find a new firm of its own and identified Crowe Horwath's Brazilian firm to replace it.

8. KPMG Brazil noted that the firm had previously had discussions with the BDO firm in 2002 about joining KPMG Brazil prior to the firm's admission to the BDO network (in 2002 it was a GT affiliate). The transaction was initiated by BDO Brazil and KPMG Brazil subsequently contacted KPMG International to inform it of its intent to proceed and to seek financial support from KPMG International. A loan of US$[✂] to assist with the net consideration payable of [✂] was provided. A further US$[✂] million is being made available by KPMG International to the Brazilian firm over a number of years to assist with the integration of the firm.[81]

9. BDO considered the acquisition of the Brazilian firm to be anti-competitive and made submissions to the Brazilian competition authorities.[82]

10. That the growth of KPMG Brazil was perceived to benefit the network as a whole appears to be supported by KPMG Brazil's submission to the Brazilian competition authorities, which stated that:

> The decision to acquire BDO Trevisan [BDO Brazil] took into consideration, as a strategic issue, the current requirements of Brazilian com-

[81] The additional $[✂] million is not expected to be repaid, though there are conditions which may trigger repayment if not complied with.
[82] BDO, Response to issues statement, 13 January 2012, section 5.

panies, including the requirement to be able to compete in both national and international markets. In addition, Brazilian companies that are growing quickly are also the focus of international investors (International investment in Brazil was approximately US$ 45 billion, or 2.3% of GDP in 2010).

11. In both cases above, there was an exit fee to the departing member firm of approximately $[✂] million payable to the network.[83]

[83] The amount receivable by the network would have been subject to a 15 per cent withholding tax levied in Brazil.