Competition Commission Audit Services Market Inquiry
19 September 2012

Deloitte response to the Competition Commission’s working paper “Restrictions on entry or expansion”
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1. **Introduction**

1.1 Deloitte is grateful for the opportunity to comment on the paper published by the Competition Commission (the CC) on “Restrictions on entry or expansion” (the Working Paper).

1.2 This paper adopts the following structure:

(a) the approach to assessing entry and expansion;

(b) opportunities for entry;

(c) intrinsic factors;

(d) strategic barriers;

(e) incumbency advantages and reputation; and

(f) regulatory barriers.

1.3 We have already addressed some of these issues in outline in our response to the CC’s Working Paper on “The framework for the CC’s assessment and revised theories of harm” (the Theories of Harm Working Paper). We note that the CC proposes to publish further working papers which may have a bearing on many of the issues raised in this paper. We reserve the right to provide further comments and/or develop our position in the light of further material published by the CC.

1.4 By way of summary of the key points of this submission:

(a) it is critical that the CC properly recognises the realities of the market when assessing the extent of any purported restrictions on entry and expansion. A theoretical exercise in assessing barriers to greenfield entry would not reflect market realities. In practice, mid tier firms have already invested significantly in the capabilities necessary for audit of FTSE 350 companies in the UK;

(b) in assessing possible expansion strategies, much of the work to date appears to have concentrated on winning more FTSE 350 clients from their existing auditors by way of tender processes. In fact, given the fluid nature of the FTSE 350, an equally – if not more – effective way of growing a firm’s FTSE 350 audit client base is to seek to retain clients as they grow and join the FTSE 350. A firm is particularly well-placed to demonstrate its capabilities to a company of which it is already auditor – addressing the concern expressed by mid tier firms that some companies may be insufficiently aware of their capabilities. Deloitte’s analysis of the fluidity of its FTSE 350 client base indicates the opportunities that arise through this strategy: a “half-life” analysis indicates that of Deloitte’s clients in the FTSE 350 in one year, only half would still be Deloitte clients in the FTSE 350 just 6.6 years later;

(c) there is no evidence that mid tier firms are at a cost disadvantage when tendering;

(d) search, tendering and switching costs are not such as to inhibit companies from taking steps when they consider that they may not be achieving the optimal value/quality outcome. On the supply side, no firm has indicated that the costs of participating in tenders inhibits it from responding to invitations to participate;
Deloitte has never invested in order to raise its competitors costs or make their expansion more difficult. It has, of course, invested, in response to client demands, to make its audits more efficient and of higher quality. This has clear benefits for customers;

advertising costs are immaterial in this market: Deloitte is not aware of any advertising spend in the past five years that is attributable to its audit practice;

reputation does not have to act as a proxy for quality in this market: the high level of visibility of audit quality on the part of finance directors and audit committee chairmen (ACCs) means that it is a function of quality;

we believe that mid tier firms have made significant investments in audit quality, although Deloitte believes that its audit quality remains higher than that of mid tier firms;

similarly, while Deloitte believes that its network possesses more strength in depth than that of mid tier firms, it notes the investment that they have made and believes that further investment is within their means should they choose to do so;

we are not aware of any evidence that regulatory barriers are significant in this market; and

Deloitte would be happy for restrictive clauses in loan agreements to be outlawed. The evidence shows that alleged informal pressure to select only top tier firms does not play a significant role in auditor appointment decisions.

2. The approach to assessing entry and expansion

An approach grounded in the realities of the market

2.1 First, the CC is correct to examine the “prospect” of entry\(^1\), rather than the extent to which entry has already occurred. We agree with the mid tier firms including Grant Thornton and BDO that they have increased their capabilities over time\(^2\): so, although the market continues to consider that there remains a gap between their capabilities and those of Deloitte, we believe that with further investment, the quantum of which is not beyond their capabilities, the size of this gap could be reduced\(^3\). We discuss investment by mid tier firms further below. Furthermore, these firms are not greenfield entrants: they have experience of auditing FTSE 350 companies (albeit generally a small number, and the smaller companies)\(^4\); they have extensive experience of auditing other companies (some of whom they say are comparable in size to FTSE 350 companies)\(^5\); and they have strong experience of delivering non-audit services to FTSE 350 (and other companies)\(^6\). They have told the CC that they believe that they already possess all the capabilities necessary to audit many (or most) FTSE 350 companies\(^7\).

2.2 A theoretical exercise in modelling greenfield entry into the FTSE 350 audit market would thus fail to reflect the realities of the prospects of entry and expansion: the mid tier firms already possess a strong base upon which they can (and doubtless will) build. A forward-looking analysis is clearly appropriate.

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\(^1\) Paragraph 3 of the Working Paper.

\(^2\) See, for example, paragraph 13 of the summary of BDO’s hearing with the CC and paragraph 2 of the summary of Grant Thornton’s hearing with the CC.

\(^3\) See Deloitte’s response to the Theories of Harm Working Paper.

\(^4\) See paragraph 3.8 below.

\(^5\) See paragraph 6.13 below.

\(^6\) Ibid.

\(^7\) See paragraph 1.4 of Grant Thornton’s response to the Issues Statement and page 1 of BDO’s response to Deloitte’s summary of its response to the CC’s Market Questionnaire.
An approach that recognises customer requirements and customer benefits

2.3 Second, in this market, it is important that the CC properly addresses the consequences of its recognition that certain apparent barriers to entry may be grounded in customer requirements, and so may generate customer benefits.

2.4 We have explained that the CC should draw a distinction between artificial or strategic barriers to entry (of which we think that the only appreciable example is lender covenants), and necessary capabilities to compete in the market. The latter are firmly grounded in customer requirements, and so generate customer benefits.

2.5 The CC is thus right to observe that:

“In some circumstances restrictions on entry may have a positive effect, for example if they increase incentives to innovate or achieve important goals outside the scope of competition policy.”

The CC goes on to observe that:

“We may weigh any positive impacts up in deciding to what extent restrictions on entry may lead to an [adverse effect on competition].”

2.6 For example, it is undeniable that companies’ demand for auditors to possess a high level of sectoral knowledge and expertise creates benefits for those companies (and therefore also their investors). It enables the audit to be conducted in a manner which is more tailored and which is of a higher “technical” quality (since it reflects an understanding of how key factors play out in a given industry).

2.7 That this expertise is regarded as critical by companies is very clear from the CC’s case studies:

(a) **Company E**: the finance director states that:

“The advantage of using a Big 4 firm was [that] it brought additional [redacted] knowledge of the sector.”

(b) **Company F**: the CC explains that:

“The FD expected sector experience as a given.”

(c) **Company G**: the Global Financial Controller explains that he has no objection to his company’s auditor also auditing a competitor (subject to appropriate confidentiality protections), because

“having a line of sight into the issues the different banks faced in relation to accounting treatment and judgement issues was a benefit to the company”

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8 See page 15 of Deloitte’s initial submission; paragraph 4.4 et seq of Deloitte’s response to the Issues Statement; and Deloitte’s response to the Theories of Harm Working Paper.

9 Paragraph 5 of the Working Paper.

10 Ibid.

11 See further Deloitte’s response to the Theories of Harm Working Paper.

12 See Deloitte’s response to the Theories of Harm Working Paper, where we explain that the CC is wrong to posit a dichotomy between “technical” quality and “service” quality: they are two sides of the same coin. We refer to “technical” quality in this paragraph to avoid the implication that sector expertise simply allows audit firms to provide what management require. Sector expertise is also to the benefit of the company and its shareholders.

13 Paragraph 24 of the Company E case study.

14 Paragraph 24 of the Company F case study.
2.8 The CC refers to Sutton’s theory on incentives to invest in endogenous sunk costs in an expanding market – a category of costs that would include investments to improve product quality. We address this issue in more detail below, but it is important to note that the requirements of the FTSE 350 constituent companies have changed markedly over time, necessitating investment by those auditing such companies. For example, FTSE 350 companies have generally become:

(a) more international;
(b) larger in scale;
(c) more complex;
(d) more highly regulated.

A well-functioning market responds to these changes by making necessary investments among actual and potential service providers. This is exactly what has happened, and, accordingly, a better quality of audit has been provided to companies and their investors.

3. Opportunities for Entry

3.1 The Working Paper appears to focus squarely on a strategy of winning FTSE 350 audit clients via tender processes. This is also the exclusive focus of Oxera’s paper on market entry.

3.2 However, this strategy appears:

(a) to ignore the nature of the FTSE 350, which is not an unchanging block of companies, but a fluid group;
(b) to ignore the existing non-FTSE 350 audit relationships possessed now (and expected to be possessed in the future) by non-top tier audit firms; and hence
(c) to omit to consider the additional strategy for a firm wishing to grow its FTSE 350 audit client base: to retain growing clients who may be expected to enter the FTSE 350 in the foreseeable future.

We address each of these points in turn below.

The nature of the FTSE 350

3.3 Implicit in reliance on a strategy of winning FTSE 350 clients via tender processes is an assumption that the FTSE 350 is an unchanging block of companies. This is mistaken.

3.4 In fact, as at December 2010, 186 companies (53%) had been in the FTSE 350 for less than 10 years and 116 companies (33%) for less than five years. It is, in fact, an exceedingly fluid group of companies. Constituent members are reviewed and are consequently subject to change quarterly.

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15 Paragraph 27 of the Company G case study.
16 For the reasons set out below at paragraph 5.18, the other category of costs identified by Sutton – advertising – are immaterial in the market for FTSE 350 audit.
17 Oxera, Competition and choice in the UK audit market, April 2006 (the Oxera Paper) (see section 6 of this paper). The CC refers to the Oxera Paper at paragraph 61(c) of the Working Paper, observing that it is “considering the use of a model such as that proposed by Oxera (2006)”.
18 See http://www.ftse.com/Indices/UK_Indices/Index_Rules/Review_Process/index.jsp. We are also aware of the useful tool compiled by PwC showing the extent of entry in and out of the FTSE 350 (as well as the extent of switching), at http://www.pwc.co.uk/who-we-are/the-uk-statutory-audit-market-infographic.jsp.
3.5 The fluidity of the auditor-company relationship is further evidenced by analysis of client attrition over time. We have developed a ‘half-life’ measure of client attrition which we consider is highly informative for assessing competitive conditions in the FTSE350. There are two ways one can select the set of companies to analyse: (1) only those who were in the FTSE 350 throughout the entire period of 2001-2010 or (2) all those who were in the FTSE 350 at some point between 2001 and 2010. (For Deloitte, this is 46 companies in case 1 and 73 in case 2.)

3.6 This half-life analysis indicates that of Deloitte’s clients in the FTSE350 in any one year, only half would still be Deloitte clients in the FTSE350 just 6.6 years later.\(^{19}\)

3.7 Even if we were to consider the broader set of firms that have been in the FTSE350 at any stage over the last 10 years, half-life estimates are around 14 years for Deloitte, giving a further good indication of the number of opportunities that thereby arise for auditors seeking to increase their presence in this market.

**Existing non-FTSE 350 relationships**

3.8 While top tier firms have the large majority of audit mandates in the FTSE 350, this phenomenon is much less apparent outside the FTSE 350. We note that Grant Thornton currently has the largest market share, in terms of number of clients, in the AIM (132 clients out of 811, or 16%) according to the FAME database.\(^{20}\) This is ahead of BDO (11.2%) and four major auditors (between 5-11% each). Grant Thornton’s clients are comparable in terms of size to those in the FTSE 350. On average, the 132 clients paid an audit fee of £52,000 per year. This compares to average audit fees of around £20,000 at the bottom end of the FTSE 250. The top ten Grant Thornton clients in the AIM paid fees of over £100,000 in the last year, more than approximately the bottom quintile of FTSE 250 clients as at end of 2010.

3.9 **Grant Thornton** is the clear market-leader among AIM-listed companies, and markets itself strongly on this basis.\(^{21}\) It has told the CC that:

> “[Hemscott] rankings showed that for all Stock market companies, Grant Thornton’s number of audits (260) was only marginally behind Ernst & Young (275) and not significantly behind the firm with the largest number of audits, KPMG (380)…The Hemscott rankings show that there are a significantly larger number of (i.e. more than four) well represented audit firms of Full List companies outside the FTSE 350 and AIM.”\(^{22}\)

3.10 **BDO** makes the same point that it is a market leader respect to “mid-market companies.”\(^{23}\)

3.11 Both of these firms – and other mid tier firms – therefore have an important client base, some or many of whom have the potential to grow into FTSE 350-listed companies as it changes over time.

**The retention strategy**

3.12 In the light of the above, it would seem intuitive that an appealing strategy for growing a firm’s FTSE 350 client base is to seek to retain growing clients as they (aim to) become listed in the FTSE 350.

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\(^{19}\) This measure captures both clients who have switched from Deloitte as well as those who have ceased to be members of the FTSE 350.

\(^{20}\) These data are not directly comparable to the Public dataset as FAME uses a different definition of the accounts’ relevant year to that adopted in the Public dataset.

\(^{21}\) See [http://www.grant-thornton.co.uk/Services/Audit--Assurance/](http://www.grant-thornton.co.uk/Services/Audit--Assurance/).

\(^{22}\) See paragraph 1.13 of Grant Thornton’s response to the Issues Statement.

\(^{23}\) See [http://www.bdocareers.co.uk/page.aspx/BDO-Story](http://www.bdocareers.co.uk/page.aspx/BDO-Story).
3.13 We note that BDO has told the CC that a non-top tier auditor is more likely to audit a current FTSE 350 company where it also audited that company before it entered the FTSE 350.\(^{24}\)

3.14 We are aware that the CC has proposed to use a model such as that proposed by Oxera (2006) to model the profitability of entry to the market.\(^{25}\) As discussed below, we believe that any model for assessing market entry and expansion must take account of this opening for firms seeking to grow their FTSE 350 audit client base. We provide further comments on the entry profitability model in Annex 1.

3.15 We note that some firms have complained that companies commonly switch to top tier firms as they grow and (in particular) when they enter the FTSE 350. In fact, FTSE 350 FDs/CFOs and ACCs have responded in the CC Survey that the company moving in or out of the FTSE 350 is not an important trigger that would prompt them to seriously consider changing auditor.\(^{26}\) In fact, it appears that the true motivation for switching auditor (and one that explains the higher market share of major auditors among larger clients) is the fact that the company is growing more complex, and perhaps expanding into new geographies. In this sense, the fact that companies have switched auditors as they grow would seem to be indicative of a well-functioning market: companies consider whether their needs (in terms of quality and value) are being met by their current auditor and switch when they are not.

3.16 We are aware of suggestions that companies may switch as they grow for reasons based on “perception” or the influence of advisors; we believe that these suggestions misrepresent the diligence and incentives of those making auditor appointment decisions\(^{27}\), but can address some specific issues in relation to these allegations as follows:

(a) mid tier firms state that companies are not sufficiently aware of their capabilities and that this is a reason why they do not switch to them.\(^{28}\) This is self-evidently not the case for companies already audited by mid tier firms: these companies will be very aware of the capabilities of their mid tier auditor. To the extent that these companies nonetheless choose to switch auditor, this cannot be blamed on lack of awareness of mid tier firms’ capabilities – indeed, such examples suggest well-informed switching;

(b) the CC Survey shows that entry into the FTSE 350 is immaterial as a factor in switching decisions – both for current FTSE 350 companies and current non-FTSE 350 companies\(^{29}\);

(c) that pressure from third parties (such as lawyers or bankers) plays little role in auditor appointment decisions is clear from the CC Survey: only 13% of FTSE 350 CFOs and 15% of FTSE 350 ACCs cite it as a reason for taking the view that they would not consider non-top tier firms.\(^{30}\) The Oxera survey also indicated that the opinion of external stakeholders (company’s bankers, corporate brokers, credit rating agencies and lawyers) in audit

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\(^{24}\) See paragraph 3.1.9 of BDO’s response to the Issues Statement. The other condition cited by BDO is that the mid tier firm “manages to retain that work despite the efforts of the Big Four and the resistance (or even opposition) of other relevant intermediaries (such as the client’s lawyers, brokers and bankers)”. With regard to the first of these points (efforts of the top tier firms to win the client), we assume that BDO cannot expect competitor firms to eschew competition for its clients: competition from top tier firms for those clients is to the benefit of those clients. We address allegations of low pricing targeted at mid tier firms’ clients (which are false) at paragraph 5.26 below. We also address BDO’s second point about the influence of third parties at paragraph 8.3 below.

\(^{25}\) Paragraph 61 of the working paper.

\(^{26}\) See pages 69 and 75 of the CC Survey.

\(^{27}\) See further Deloitte’s response to the Theories of Harm Working Paper.

\(^{28}\) See, for example, 3.1.7 of BDO’s response to the Issues Statement.

\(^{29}\) See pages 69 and 75 of the CC Survey. We note that a small number of case study respondents also discuss whether moving into the FTSE 350 could be, of itself, a reason for switching to a top tier firm (see, for example, the finance director and ACC of Company B) but other, more concrete, reasons for switching are also cited.

\(^{30}\) See page 85 of the CC Survey.
selection is seen as relatively unimportant by the ACCs, and this is also consistent with the case studies:

(i) **Company F**: the finance director explains that:

“There was no external pressure to change the previous [mid-tier] auditor.”

(ii) **Company H**: the ACC states that he:

“had not faced pressure from outside the company to continue using a Big 4 firm.”

(iii) **Company J**: the auditor of this company is a mid-tier firm, but the fund accounting manager states that:

“The FAM [Fund Accounting Manager] had experienced no external pressure to switch to a Big 4 auditor.”

(d) there are also extensive opportunities to win non-FTSE 350 clients – even greater than the opportunities to win FTSE 350 clients. The **CC Survey** shows that nearly half of non-FTSE 350 companies held a tender within the last five years, and 48% of these included at least one non-top tier firm.

### 3.17

We believe that good opportunities exist for a firm wishing to grow its client base (including, in particular, its FTSE 350 client base). This is true for non-top tier firms as well as top tier firms. As noted above, in the **CC Survey** listed non-FTSE 350 companies indicate that they included at least one non-top tier firm in almost half of their tender processes, and FTSE 350 companies did so in 30% of cases.

### 3.18

It is correct to observe that the majority of those tenders are not won by mid tier firms. We have explained that with investment we (and they) think they could compete more effectively to win these tenders:

(a) the crux of many of the mid tier complaints is that company decision makers – who are highly intelligent and appropriately qualified people who are motivated to ensure that their company gets the best deal – do not understand their offering. It is an unusual characterisation of market forces where customers are blamed for not making the effort to understand the universe of suppliers, rather than suppliers acknowledging that they have to do more to inform their customers;

(b) BDO and Grant Thornton have told the CC that they already have extensive and useful points of interaction with FTSE 350 companies through supply of non-audit services.

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31. Oxera (2006) Table 3.1
32. In addition to the examples cited below which specifically demonstrate no pressure on the auditor to switch to a top tier firm, the finance director of Company F (which uses a top tier firm) also notes that he has experienced no pressure to change auditor from advisors or otherwise. We note that a small number of respondents indicate a generalised view that banks may “prefer” a top tier auditor, but there are no indications in any of the case studies of actual pressure being exerted: the only explicit statements are those cited in this paragraph that no pressure has been exerted.
33. Paragraph 18 of the Company F case study.
34. Paragraph 75 of the Company H case study.
35. Paragraph 30 of the Company J case study.
36. See page 48 of the CC Survey.
37. See page 54 of the CC Survey. It is important to note also that 30% of FTSE 350 company tenders also included at least one non-top tier audit firm. See 3.17.
38. See footnote 37 above.
These services are an opportunity to showcase the capabilities on which mid tier firms should be able to capitalise. Grant Thornton has told the CC that this is a part of its strategy; and 

(c) the CC Survey evidence shows that mid tier firms are less active in proactively approaching potential clients – both in the FTSE 350 and outside the FTSE 350. Grant Thornton and BDO are markedly more active than other non-top tier firms (especially as regards non-FTSE 350 clients) but still fall some way short of the top tier firms.

3.19 In summary, we believe that the openings for mid tier firms to grow their FTSE 350 audit client base should not be understated – in particular in the light of the opportunities that arise through the retention strategy, but also in the light of their existing client base and non-audit service provision.

4. **Intrinsic factors**

4.1 The CC cites two potential “intrinsic factors” which could constitute potential barriers to entry:

(a) economies of scale; and

(b) switching costs.

We deal with each in turn below.

**Economies of scale**

4.2 The first category of “intrinsic factor” that the Working Paper discusses is economies of scale. The crux of concerns in relation to economies of scale is that competitors are unable to match the costs of firms who possess that scale (and so are disadvantaged when bidding). As the CC puts it: economies of scale “may put smaller firms at a cost disadvantage and mean that they are unable to match the prices of larger firms when tendering”.

4.3 In fact, there is no evidence that this occurs in the market for the audit of FTSE 350 companies. No firm has suggested to the CC that inability to meet prevailing prices is a general concern.

4.4 Indeed, mid tier firms generally suggest that they expect the result of greater participation in tenders would be to drive audit fees down, indicating that they expect to be able to undercut the largest firms. It seems difficult to conclude on this basis that economies of scale (to the extent they exist) are a material factor in this market.

4.5 This is not surprising: other factors are far more significant than scale in determining costs and in turn, audit fees. In particular, engagement staff costs correlate much more strongly with complexity than with scale.

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40 See further paragraph 6.13 below. See paragraph 1.5(e) of Grant Thornton’s response to the Issues Statement and paragraph 3.2.2 of BDO’s response to the Issues Statement.

41 See paragraph 23 of the summary of Grant Thornton’s hearing with the CC.

42 Paragraph 14 et seq of the Working Paper.


45 We note that there are suggestions that top tier firms may strategically target mid tier firms’ clients with low rates. The evidence provided is no more than a small set of anecdotes (see, in particular paragraph 5.1.14 of BDO’s response to the Issues Statement). In fact, analysis of Deloitte’s pricing shows that clients won from mid tier firms are on average slightly more profitable than clients won from top tier firms. See further paragraph 5.27.

46 See, for example, paragraph 4.1 of Grant Thornton’s response to the Issues Statement.

47 The CC might also observe that the top tier firms themselves differ in scale: PwC, the largest firm, is markedly larger than EY, the fourth largest. We have seen no suggestion that economies of scale give PwC an advantage over EY or any other firm.
4.6 This is supported by our own analysis of the relationship between FTSE 350 audit client scale and Deloitte’s costs.\textsuperscript{48} There is significant variability in the relationship between client turnover\textsuperscript{49} (as a proxy for scale) and the average total value of staff and partner input (as a proxy for the cost of providing the audit).\textsuperscript{50} This indicates that other factors such as the company’s industry and client complexity also play a role in determining the cost of delivering the audit.

Figure 1: relationship between the value of staff and partner inputs (as a proxy for cost) and client turnover (as a proxy for scale) – Deloitte clients only\textsuperscript{51}

4.7 Furthermore, analysis of the relationship between the value of staff inputs and UK audit revenues demonstrates that the value of the inputs used in delivering an audit have a linear relationship with the scale of the fee received. There is a near perfect correlation between the average UK cost of providing a FTSE 350 audit and the UK audit fee.\textsuperscript{52} This indicates that Deloitte does not achieve a lower cost to fee ratio for larger audits, in terms of audit fee, and thus that there is no evidence of economies of scale for individual engagements.

\textsuperscript{48} For the purpose of this analysis, the multiple of grade gross rates and hours per grade for each audit engagement is used as a proxy for “cost”. By measuring cost in this method, although not perfect, it quantifies the volume (hours) and value (grade) of time spent on each audit. The data used in this analysis was that submitted to the CC on February 28\textsuperscript{th} 2012.

\textsuperscript{49} Sourced from the public data set.

\textsuperscript{50} The correlation coefficient between average client turnover and average total cost of Deloitte staff and partner time is 0.66.

\textsuperscript{51} The ten most costly audits are omitted from this analysis, in order to more clearly show the relationship in the remaining sample. After excluding these outliers, he correlation coefficient between average client turnover and average cost is reduced to 0.29.

\textsuperscript{52} The correlation coefficient between Deloitte’s average “cost” and average UK audit fees for FTSE 350 clients is 0.99 for the full sample and 0.93 for the reduced sample (excluding the 10 most costly audits, see previous footnote).
4.8 An alternative method of assessing whether larger audits, in terms of UK fees, are more profitable, is to consider the relationship between scale of audit fee and RRRs. The RRR signals the percentage of the gross rates actually achieved on the audit and thus allows for relative profitability to be compared between audits.

4.9 Our analysis indicates that there is no discernable relationship between RRR achieved on an audit and the scale of the audit, in terms of UK audit fee. The graph below plots this relationship.

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53 The ten most costly audits are omitted from this analysis, in order to more clearly show the relationship in the remaining sample.

54 The ten most costly audits are omitted from this analysis, in order to more clearly show the relationship in the remaining sample.
4.10 To the extent that RRRs reflect the degree of pricing pressure we face, this analysis shows that our clients are able to exert similar pressure on prices – regardless of the size and complexity of the audit.

4.11 Moreover, even if scale did play a role, FTSE 350 clients are not the only driver of scale in our audit business: they make up less than 30% of the total statutory audit business. It is quite possible to reach an efficient scale without a material FTSE 350 client base.

4.12 The Working Paper also queries whether economies of scope may have a material effect on costs\(^{55}\). Again, there is no evidence that this is a problem, and it has not been raised as one by other market participants. Indeed, the mid tier already possess significant scale in their non-audit work, consistent with their evidence to the CC about the scale and scope of their non-audit client base\(^{56}\).

4.13 Finally, the Working Paper queries whether “learning by doing effects” may give rise to economies – i.e. that “costs decline with the length of service provision”\(^{57}\). We have explained to the CC that costs are higher in the first years (generally the first one or two years) of a new audit engagement, due to additional costs of obtaining a sufficient level of familiarity with the client. Clients expect those costs to be borne by the new auditor\(^{58}\) (and firms’ current willingness to bear these costs removes what would otherwise be a barrier to switching).

4.14 This effect generally ceases after the first few years of a new audit relationship. Were the Working Paper’s posited theory correct, one would expect profitability to increase with auditor tenure. In fact, Deloitte’s own data shows a _negative_ relationship between tenure and profitability (as measured by RRR), highlighting continued pricing pressure as the following graphic shows:

**Figure 4: relationship between auditor tenure and profitability (RRR) – Deloitte clients only**

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56 See paragraph 6.13 below.
58 See, for example, paragraph 18 of the Company J case study. See also paragraph 27 of the Company F case study.
Switching costs

4.15 The second category of “intrinsic factor” that the Working Paper discusses is switching costs. We do not dispute that the audit market involves some switching costs. Where companies are satisfied with the quality and value being provided by their current auditor, they may therefore decide to retain their current auditor.

4.16 It appears that companies’ satisfaction with their current auditor is an important explanation of current levels of switching in the market. The CC may note that the most cited reasons in its market study for not having tendered (among companies who have not held a tender in the past five year) were as follows:

(a) currently receive high quality service: 51%;
(b) currently receive good value for money: 25%;
(c) happy as things are: 21%.

70% of companies gave at least one of the above reasons.

4.17 Many of the participants in the case studies note that there are certain switching costs for companies in this market, but they are clear that these would not inhibit them from holding a tender and, if appropriate, switching. It is clear that where companies are not getting the desired levels of quality or value, they are able and willing to conduct a tender and, if appropriate, to switch.

4.18 The point is well made by the Global Financial Controller of Company G in the CC case studies:

“The trigger points for a tender would be a slip in independence, skills or value for money. These factors had to be considered relative to the competition: if the company thought that another audit firm could provide a better service at a lower cost and with a greater degree of independence, then this would trigger a switch.”

4.19 This is supported by commentary from several other participants:

(a) Company A: the CFO comments that:

“Switching costs would not affect a decision to change auditors.”

(b) Company B: the finance director states that:

“The tender process itself was straightforward, but needed to be run efficiently.”

Even though the ACC of Company B considers that tendering could be an expensive process, she nonetheless indicates that she would plan to hold a tender “every three to four years”.

(c) Company D: the ACC states that:

“The monetary cost of switching auditor would normally be very small as she would expect the new auditors to absorb the initial costs of getting to know the business.”
(d) **Company F**: the finance director states that “running a tender was a valid process” and that switching was “hard work but fairly straightforward”.

(e) **Company G**: The ACC comments that:

“If there was a situation where he said that he felt it was necessary to go out to tender, then this would happen.”

(f) **Company H**: the ACC states that:

“The company was keen to be progressive in matters of corporate governance” and “its policy on tendering [i.e. to tender every ten years] tied into this.”

(g) **Company I**: the ACC states that “tendering would be looked at again in the near future” and that “a tender would have been held [already] if the auditor team led by the new partners had not stepped up to the plate.”

4.20 Moreover, there are features of the market which help to reduce companies’ switching costs such as:

(a) first, auditors absorb learning costs; and

(b) second, sharing of files between the old auditor and the new auditor.

4.21 That costs are far from insurmountable is well-supported by other evidence before the CC:

(a) **Grant Thornton**: switching costs are “unlikely to be unpalatable”;

(b) **BDO**: companies’ switching costs are “overstated”;

(c) **Universities Superannuation Scheme**: switching costs are “exaggerated”;

(d) although **PwC** does highlight high switching costs in its response to the Issues Statement, it also states that they are “not...so high as to prevent the company from moving if it is dissatisfied with the level of service”.

4.22 Moreover, it is clear that there is general support from investors that they are comfortable with companies bearing any costs of tendering and switching where these are considered appropriate, as was made clear at the **Hermes** hearing:

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64 Paragraph 63 of the Company D case study.
65 Paragraph 28 of the Company F case study.
66 Paragraph 27 of the Company F case study.
67 Paragraph 68 of the Company G case study.
68 Paragraph 68 of the Company H case study.
69 Paragraph 50 of the Company I case study.
70 It is clear from the CC’s case studies that this is expected by companies in the reference market: see, for example, paragraph 18 of the **Company J** case study. See also paragraph 27 of the **Company F** case study.
71 Paragraph 9.7 of Grant Thornton’s response to the Issues Statement.
72 Paragraph 5.3.3 of BDO’s response to the Issues Statement.
73 Page 7 of the Universities Superannuation Scheme submission to the CC.
74 Paragraph 5.35 of PwC’s response to the Issues Statement.
“The costs of switching were incurred in management time spent to explain to a new auditor how the company functioned and to justify existing accounting decisions. However, from a shareholder perspective, this was money well spent, since it entailed more rigorous scrutiny.”

Benefits of switching

4.23 The Working Paper states that “we would expect companies to consider the costs of switching against the expected benefits such as lower fees or better quality of service. If the costs are high and/or the expected benefits low, this could explain the infrequency of tender opportunities observed in the FTSE 350 audit market.”

4.24 We agree that companies will consider this balance. They will do so against the background of the quality/value proposition being provided to them by their current auditor. As noted above, many companies appear to be satisfied by their current proposition and this is their primary reason for not switching.”. This is exactly the outcome that would be expected in a market that was functioning well for consumers.

4.25 However, it is clear that companies monitor the quality/value proposition very clearly, and will take steps where they are not confident that they are getting the right outcomes. The CC’s case studies make this very clear:

(a) **Company B**: the finance director indicates that he wants to switch auditor for price reasons:

“He felt [the current auditor] was a bit expensive. He would like to reduce the audit fee by 10 to 15 per cent.”

(b) **Company E**: the finance director indicates that:

“If the auditors were not up to scratch then they would be replaced.”

(c) **Company D**: the finance director explains that an unacceptable price proposition was the primary reason for its most recent tender process:

“The main driver of the decision to tender was the previous auditor seeking a substantial (60 to 70 per cent) increase in the audit fee.”

(d) **Company G**: the Global Financial Controller indicates that “a slip in independence, skills or value” would trigger a tender.

(e) **Company J**: the ACC indicates that the decision to switch from the company’s previous auditor had been driven by “technical errors, communication issues and generally poor levels of service”.

4.26 This is strongly supported by the CC Survey evidence, where the participants indicate that a range of quality and value factors would lead them to tender and, if appropriate, switch. The evidence shows that companies that have switched have generally done so because they considered that their previous auditor was not providing an appropriate quality/value offering.

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75 Paragraph 9 of the Hermes hearing with the CC.
76 Paragraph 26 of the Working Paper.
77 See paragraph 4.16 above.
78 Paragraph 17 of the Company B case study.
79 Paragraph 21 of the Company E case study.
80 Paragraph 16 of the Company D case study.
81 Paragraph 22 of the Company G case study.
82 Paragraph 43 of the Company J case study.
That they have been able to improve the quality/value proposition they are receiving is a sign of a market operating competitively.

5. **Strategic barriers**

5.1 The Working Paper states that strategic barriers “may result from existing firms in the market acting to deter entry”\(^\text{83}\). As an initial point, Deloitte wishes to be very clear that it has not taken steps in order to deter entry.

5.2 The Working Paper suggests that strategic barriers may come under three headings:

(a) bundling and tying;

(b) raising endogenous sunk costs; and

(c) signalling aggressive competitive response.

We deal with each in turn below.

**Bundling and tying**

5.3 The first category of “strategic barrier” that the Working Paper discusses is bundling and tying. Deloitte explained in its response to the Issues Statement that it does not tie or bundle its audit services with any other services that it offers\(^\text{84}\).

5.4 We welcome therefore the CC’s initial views that neither pure bundling\(^\text{85}\) nor tying\(^\text{86}\) appears to be a feature of the market. We also confirm again that Deloitte does not engage in mixed bundling. Indeed, such practice is expressly forbidden by ethical standards\(^\text{87}\). The pricing of audit and non-audit services (to the extent that any non-audit services are supplied) is negotiated and agreed independently.

5.5 This is consistent with the case study evidence, where companies make quite clear that audit and non-audit services are competed and contracted for entirely independently\(^\text{88}\).

5.6 The CC will also have observed from the case studies the extent to which companies carefully monitor and restrict the provision of non-audit services by their auditor\(^\text{89}\). The CC will also have observed from its analysis of NAS to audit fee ratios the significant and ongoing decline in those ratios. It is difficult to understand how mixed bundling would be commercially attractive in these circumstances.

5.7 We also reiterate that our audit partners and staff are not remunerated or evaluated by reference to the selling of any non-audit services to audit clients\(^\text{90}\).

\(^{83}\) See paragraph 27 of the Working Paper.

\(^{84}\) Paragraph 5.2 et seq of Deloitte’s response to the Issues Statement.

\(^{85}\) See paragraph 29 of the Working Paper.

\(^{86}\) Paragraph 30 of the Working Paper. The CC is correct to observe that Deloitte and, to the best of its knowledge, other firms have no market power in relation to non-audit services.

\(^{87}\) See Ethical Standard 4, Paragraph 7: “The audit engagement partner shall ensure that audit fees are not influenced or determined by the provision of non-audit services to the audited entity.”

\(^{88}\) See, for example, paragraph 32 of the Company B case study; paragraph 115 of the Company C case study; and paragraph 44 of the Company D case study.

\(^{89}\) See, for example, paragraph 43 of the Company D case study; paragraph 33 of the Company F case study; and paragraph 62 of the Company I case study.

\(^{90}\) See paragraph 5.7 of Deloitte’s response to the Issues Statement.
5.8 As shown below, there is no relationship between the NAS/AS ratio and the level of profitability (RRR) across our client base. In other words, clients who purchase more NAS are no less profitable (in audit) than those who purchase relatively less.

Figure 5: Relationship between RRR and ratio of non-audit services fee to audit fee – Deloitte clients only\textsuperscript{91}

\hspace{1cm}

\textit{Raising endogenous sunk costs}

5.9 The second category of “strategic barrier” that the Working Paper discusses is the possibility that firms act so as to raise endogenous sunk costs to maintain market concentration. The CC cites two categories of endogenous sunk costs which it proposes to explore as a factor in understanding the growth and concentration of audit firms over time\textsuperscript{92}:

(a) advertising and marketing; and

(b) investments designed to lower the marginal cost of producing each unit or raise the audit’s value.

5.10 We address the relevance of the theory of endogenous sunk costs as an explanatory factor underlying concentration in the audit market before addressing the specifics of the two categories of endogenous sunk costs cited by the CC.

\textit{The relevance of the endogenous sunk cost theory}

5.11 The CC describes “strategic” actions that could contribute to endogenous sunk costs and which, according to the theory developed by John Sutton and summarised and elucidated in Shiman’s 2008 article cited by the CC, may be a factor in understanding the growth and concentration of audit firms over time\textsuperscript{92}.\textsuperscript{93} Such a conclusion (even a preliminary one) is not supported by evidence in the Working Paper and we urge the CC to examine the evidence carefully before reaching any

\textsuperscript{91} Source: CC public dataset. The information includes financial and audit fee information on 337 FTSE 350 companies as listed in Q4 2010, relating to the financial year 2010. Three outlier companies have been excluded but do not materially impact the results (Bwin.Party Digital, Heritage Oil and Shire).

\textsuperscript{92} See paragraph 27 of the Working Paper.

\textsuperscript{93} See paragraphs 31-33 of the Working Paper.
conclusion on this issue. We set out below our preliminary views on this issue, subject to further elucidation from the CC on its views.

5.12 The authors, and the CC, cite advertising, improvements in product quality from product innovations, or process innovations as examples of costs that could be classified as endogenous sunk costs and which could be relevant for this assessment.

5.13 Such an analysis, though, is, of course, market specific – some costs will be endogenous in some markets but exogenous in others. We note that Sutton’s original work was performed in the context of manufacturing industry, the competitive dimensions of which are very different from a high-end service industry with highly sophisticated and demanding purchasers.

5.14 The evidence that is before the CC does not support the conclusion that the costs described are discretionary or endogenous to the firms. On the contrary, the evidence supports the conclusion that those investments are in developing the skills and capabilities necessary to provide the very high level of quality that Deloitte’s actual and prospective clients demand – that is, they are more properly classified as exogenous costs. They are not incurred on a discretionary basis and cannot and cannot properly be considered as examples of strategic expenditure that has any relevance for an assessment of barriers to entry. Using Sutton’s terminology, when properly classified, these should be considered as exogenous fixed costs necessary to develop the skills and capabilities to provide the level of quality of service demanded by clients.

5.15 Similarly, the evidence also shows that the investments that we have made to improve the efficiency of delivering the audit service (which may, in the process, reduce the marginal cost of individual audit products), should not be regarded as discretionary. Instead, they are a reflection of the demands of our clients and reflect the need for innovation in the supply of audit services which is required to adapt to the continually changing market and regulatory environment.

5.16 It is critical that the CC examines the market-specific evidence on this issue in detail, rather than merely assuming that conclusions reached on endogeneity in one market can easily be transposed to another.

5.17 Finally, we note that the CC appears to have interpreted the Shiman (2008) paper as suggesting that “incumbent firms will have incentives to increase endogenous sunk costs to maintain market concentration”94. We note that neither the Shiman (2008) paper cited in the Working Paper, nor the Sutton theory which Shiman elucidates, lead in any way to this conclusion. The theory is that, in an expanding market, firms may choose to invest in endogenous sunk costs in order to gain a competitive advantage. When other firms make similar investments, any competitive advantage for the first firm may be nullified, and the resulting cost structure may result in a lower bound to concentration or, in certain circumstances an increase in concentration. Importantly, firms invest in order to gain a competitive advantage, and not to maintain or achieve an increase in market concentration. It is therefore entirely wrong to suggest that Deloitte has an incentive to maintain market concentration or that its actions are guided by this motive. Deloitte’s market behaviour is driven by client demands and competition from its peers, and not in order to maintain market concentration.

Advertising and marketing

5.18 Advertising and marketing costs are immaterial in this market. Deloitte is not aware of any advertising spend specifically attributable to its audit practice in the past five years – and still less its FTSE 350 audit practice.

5.19 Moreover, it will be clear from the expert nature of the buyers in this market that they are not likely to be swayed by spurious marketing or advertising95. We note also that no firm has

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94 See paragraph 31 of the Working Paper, emphasis added.

95 See Deloitte’s response to the Theories of Harm Working Paper.
suggested that these costs represent any sort of barrier on their ability to compete in the FTSE 350 audit market.

**Investments designed to lower marginal costs or increase audit’s value**

5.20 The Working Paper suggests that the market may be characterised by investments by the largest firms which lower the marginal costs of an audit or increases the value of an audit to clients.\(^{96}\)

5.21 It is correct to observe that firms including Deloitte have made such investments. Given Deloitte’s clients’ requirements for both (a) good value and, above all, (b) high quality, these investments have been a necessary response to client demands. They have also been a necessary response to the changing nature of clients in the FTSE 350: as noted above, as clients have become more complex, sophisticated, regulated and international over time, it has been incumbent on their auditors to keep up with these developments by ensuring that their systems and methodologies continue to deliver high quality audits.

5.22 That said, the CC must look at this issue in the context of the actual market participants seeking to grow their position in the FTSE 350. None has put evidence to the CC that there are significant sunk costs that they are unable to meet which would allow them to compete more effectively in this market. Indeed, they have stressed to the CC (a) the significant investments that they have made, and (b) that they do not feel constrained as to capital raising in a way that would limit their ability to make necessary investments. We take each of these points in turn below.

5.23 First, each of the mid tier firms are clear that they have been able to make investments that they consider give them the ability to deliver high quality audits to the large majority of FTSE 350 companies:

(a) **BDO**\(^{97}\):

(i) “BDO noted that it had made significant investments: financially, in experience, in building its brand, risk and policy, and talent recruitment.”\(^{98}\)

(ii) “Its strategy was to continue to invest in developed western economies and also to invest in emerging markets.”\(^{99}\)

(iii) “BDO noted that it had made significant investment over the years into its UK business, funded by a combination of partner capital and bank debt. Access to capital had not been a barrier to growth. It would have an open mind about making significant investments to access the top end of the market if it considered that there would be opportunities for BDO.”\(^{100}\)

(iv) “BDO claimed that it made similar investments to the Big Four in terms of improving its processes.”\(^{101}\)

\(^{96}\) Paragraphs 31 and 33 of the Working Paper.

\(^{97}\) We note BDO does indicate that it would not be willing to invest in sector-specific teams in a small number of highly specialist areas such as top-end financial services, but its point is not that it could not afford such an investment but that it does not believe that it would win sufficient engagements in this sector (in part because there are only a limited number of clients in this sector). We address the separate point about the strategy for growing a firm’s FTSE 350 client base above at paragraph 3.1 et seq; for present purposes, it suffices to note that it is not the quantum of investment that is indicated as a concern.

\(^{98}\) Paragraph 6 of the summary of BDO’s hearing with the CC.

\(^{99}\) Paragraph 9 of the summary of BDO’s hearing with the CC.

\(^{100}\) Paragraph 13 of the summary of BDO’s hearing with the CC.

\(^{101}\) Paragraph 20 of the summary of BDO’s hearing with the CC.
(v) “Contrary to recent comments made by some Big Four firms, BDO, GT and other firms have made significant investments in recent years in broadening and strengthening their international networks. For example, BDO’s UK firm invested substantially in BDO’s Indian network firm and more recently has invested in expansion in the Middle East.”

(vi) “BDO continues to invest in its network.”

(b) Grant Thornton:

(i) “GTI had made a significant investment in the last ten years in its international organization and now spent approximately $60 million a year on its international infrastructure. It had made significant investment into creating a more cohesive organization, for example it had established international practice heads, a global board of governors and the major firm CEOs met on a quarterly basis to discuss international strategy.”

(ii) “GT had continued to invest in its staff and the quality of those staff throughout the difficult economic environment.”

(iii) “GT also explained that it had invested significantly in non-audit skills, in order to be able to undertake complex and large audits properly.”

(iv) “GT outlined the investments it was intending to make in the audit business which it said demonstrated the level of investment it was willing to make in this market. It had a business strategy to grow the overall business by £125 million by 2015. It was hoping to take on additional work in the region of £10 million relating to public sector audit work and was looking at acquisitions. It had a past record of making serious investments to increase the scale of its business, for example the RSM Robson Rhodes transaction. It had also helped to increase the capabilities of the Indian member firm of GT.”

(c) Mazars:

(i) “Investment is clearly needed in areas such as the provision of technical expertise, training and development, the development and updating of audit methodologies and the maintenance of quality control systems and those related to independence. Significant investment has been made by our firm and a number of other firms in this area and thus the existence of some economies of scale cannot be used to justify the dominance of the largest four firms.”

5.24 Second, the mid tier firms are clear that they do not feel constrained as to capital raising in a way that would limit their ability to make necessary investments:

(a) BDO:

102 Paragraph 5.1.10 of BDO’s response to the Issues Statement.
103 Paragraph 6.2 of BDO’s response to the Issues Statement.
104 Paragraph 2 of the summary of Grant Thornton’s hearing with the CC.
105 Paragraph 3 of the summary of Grant Thornton’s hearing with the CC.
106 Paragraph 10 of the summary of Grant Thornton’s hearing with the CC.
107 Paragraph 16 of the summary of Grant Thornton’s hearing with the CC.
(i) “[BDO] does not consider this factor [restrictions on investment] to have restricted its expansion to date”\textsuperscript{109};

(ii) “From BDO’s point of view investment is not holding us back…we don’t see investment is the issue.”\textsuperscript{110}

(b) Grant Thornton:

“Our firm and some others believe we have the cash reserves that we would be able to make the investment to serve the entirety of that market [the FTSE 250] straightaway. So if we’re talking about making a significant change in the FTSE 250 and then building a more stable platform to look at changing the structure in the FTSE 100, we don’t think it’s a question of lack of investment capacity.”\textsuperscript{111}

(c) Mazars:

(i) “Mazars had invested significantly in the UK market and had available funds to do so.”\textsuperscript{112}

5.25 In the light of the above evidence of the mid tier firms themselves, it seems difficult to conclude that the costs of investments in more efficient delivery of audit or in delivery of higher quality audit form a barrier to entry and expansion for mid tier firms.

Signalling an aggressive response to new entry

5.26 The third category of “strategic barrier” that the Working Paper discusses is the possibility that firms could signal an aggressive response to new entry, thereby deterring such entry. Deloitte is aware of allegations from certain firms that Deloitte and other top tier firms target mid tier firms’ clients with “deep discounts”\textsuperscript{113}. The Working Paper notes, however, that “we have not been given specific examples”\textsuperscript{114}. While Deloitte has only very limited visibility on the tendering behaviour of other firms, it can confirm that it does not specifically target clients of mid tier firms with “deep discounts”: it competes in the same way to win new clients from all its major competitors regardless of the identity of the company’s current auditor.

5.27 The Working Paper observes that if BDO’s allegations were true “we might expect to see lower than average margins on audits won from mid-tier firms.”\textsuperscript{115} While the CC should exercise caution in reaching the conclusion that lower margins on audits won from mid tier firms necessarily evidences BDO’s allegation (there could be other reasons why the margins are lower), Deloitte can confirm that this condition is not met with respect to audits that it has won from mid tier firms. Audits won from mid tier firms between 2006 and 2011 in fact show a slightly (2%) higher average RRR (\ldots) than audits won from top tier firms (\ldots).

Conclusion

5.28 We reject firmly the suggestion that we have engaged in any practices designed deliberately or strategically to raise the costs of competition in this market. Our strategy and our investments

\textsuperscript{109} Paragraph 3.1.6 of BDO’s response to the Issues Statement. BDO notes that capital restrictions could in theory be a barrier but in practice are not.

\textsuperscript{110} Oral evidence of Simon Michaels, BDO, to the House of Lords Economic Affairs Committee. See page 133 of Volume 2 of the House of Lords Report.

\textsuperscript{111} Oral evidence of Steve Maslin, Grant Thornton, to the House of Lords Economic Affairs Committee. See page 133 of Volume 2 of the House of Lords Report.

\textsuperscript{112} Paragraph 14 of the summary of Mazars’ hearing with the CC.

\textsuperscript{113} See paragraphs 1.6.2 and 5.1.14 of BDO’s response to the Issues Statement.

\textsuperscript{114} See paragraph 34 of the Working Paper.

\textsuperscript{115} Ibid.
have been driven by clients’ demands, and our efforts to meet those demands have produced significant benefits for those clients and have contributed to the growth that we have achieved. We believe that mid tier firms are similarly engaged in efforts to meet those demands, and are capable of making the investments that would allow them do so more fully.

6. **Incumbency advantages and reputation**

6.1 The Working Paper sets out a number of potential barriers to entry arising under the heading of first mover/incumbency advantages and reputation\(^{116}\). We address each in turn below.

**Reputation**

6.2 The first category of potential barrier discussed under this heading in the Working Paper is reputation.

*The relationship between reputation and deliver of audit quality*

6.3 The Working Paper suggests that “reputation may be a proxy for capability and quality in this market because quality is difficult to observe otherwise”\(^{117}\). This is inconsistent with the evidence on the discernability of audit quality and so gets the relationship between quality and reputation the wrong way round. Reputation is not a *proxy for* quality; it is a *function of* quality.

6.4 The evidence shows that the key decision-makers in relation to auditor recommendation decisions – that is, CFOs and ACCs – have very high levels of visibility over audit quality, in all its dimensions.

6.5 First, the evidence shows clearly that ACCs and CFOs have an *expert background*:

   (a) the CC’s *case studies* show experience built up over many years, commonly across multiple companies\(^{118}\);  
   
   (b) the *case studies* similarly indicate very high levels of relevant professional expertise. In every case, both the CFO/finance director\(^{119}\) and the ACC is a qualified accountant, with several possessing specific and significant audit experience\(^{120}\).  
   
   (c) other evidence makes it clear that the skills and experience of the interviewees in the CC’s case studies reflect those of the buying community more broadly. For example, the CC may note ACCA’s evidence to the House of Lords Economic Affairs Committee:  

   “The buyers of professional services are sophisticated and frequently have a professional background themselves. They are in a prime position to understand the needs of their organisations and to commission services which best support their strategies and objectives.”\(^{121}\)

6.6 The CC will be aware, of course, of the relevant provisions of the Corporate Governance Code (the *Code*), which require that at least one member of the audit committee should have recent


\(^{117}\) Paragraph 37 of the Working Paper.

\(^{118}\) See paragraphs 5, 35 and 58 of the Company B case study; paragraphs 5 and 45 of the Company C case study; paragraphs 5 and 47 of the Company D case study; paragraphs 3 and 37 of the Company E case study; paragraphs 4 and 35 of the Company F case study; paragraphs 5-6 and 49 of the Company G case study; paragraphs 5 and 51 of the Company H case study; paragraphs 4 and 36 of the Company I case study; and paragraphs 6 and 32 of the Company J case study.

\(^{119}\) In the case of Company G, the relevant respondent was the Global Financial Controller, and, in the case of Company J, the Fund Accounting Manager, who similarly have an accountancy background.

\(^{120}\) See, for example, the ACC of Company C, the finance director of Company E, the ACC of Company F, the Global Financial Controller of Company G and the ACC of Company H.

\(^{121}\) See page 33 of Volume 2 of the House of Lords Report.
and relevant financial experience\textsuperscript{122}. The FRC’s \textit{Guidance on Audit Committees} goes on to explain that:

“It is desirable that the committee member whom the board considers to have recent and relevant financial experience should have a professional qualification from one of the professional accountancy bodies. The need for a degree of financial literacy among the other members will vary according to the nature of the company, but experience of corporate financial matters will normally be required. The availability of appropriate financial expertise will be particularly important where the company’s activities involve specialised financial activities.”\textsuperscript{123}

It also contains details of appropriate training for members of audit committees. In Deloitte’s experience, FTSE 350 audit committee members and, especially, ACCs, are nowadays highly expert and highly qualified to perform their roles\textsuperscript{124}.

6.7 Second, the evidence overwhelmingly shows that ACCs and CFOs commit large amounts of time to understanding and monitoring the audit, and hence have very strong visibility:

(a) first, the case studies show very high levels of involvement of the CFO and finance team in performance of audit. For example:

(i) Company C: the CFO indicates that he has “monthly meetings” with the audit engagement partner and hence:

“pretty good visibility of what the auditors were doing, the geographies they were looking at and the matters that concerned them.”\textsuperscript{125}

(ii) Company G: the Global Financial Controller describes his interaction with the company’s auditors as:

“…extensive throughout the year. The interaction was most intense around the half-year and year-end reporting when he spoke with the auditors daily and sometimes several times a day.”\textsuperscript{126}

(iii) Company I: the finance director observes that he has “very frequent contact with the senior AEP during the year, approximately every two weeks”\textsuperscript{127}, with a yet closer relationship with the company’s finance team who are “responsible for the day to day running of the audit process”\textsuperscript{128};

(iv) Company J: the Fund Accounting Manager indicates that he has:

“clear visibility of the auditor’s work as he answered many of the questions the auditor had.”\textsuperscript{129}

(b) second, the case studies also show very high levels of engagement between the ACC and the auditor. For example:

\begin{itemize}
\item \textsuperscript{122} Paragraph C.3.1 of the Corporate Governance Code.
\item \textsuperscript{123} FRC, \textit{Guidance on Audit Committees}, paragraph 2.16.
\item \textsuperscript{124} Ibid, paragraph 2.17 \textit{et seq}.
\item \textsuperscript{125} Paragraphs 7 and 8 of the Company C case study.
\item \textsuperscript{126} Paragraph 8 of the Company G case study.
\item \textsuperscript{127} Paragraph 5 of the Company I case study.
\item \textsuperscript{128} Paragraph 7 of the Company I case study.
\item \textsuperscript{129} Paragraph 9 of the Company J case study.
\end{itemize}
(i) **Company C**: the ACC notes the “continual dialogue between the Audit Committee, management and the auditor”, meaning that issues are always well-ventilated\(^{130}\);

(ii) **Company E**: the ACC notes his “regular contact with the AEP”, involving the audit committee meetings, pre-meetings and informal discussions\(^{131}\);

(iii) **Company G**: the ACC explains that he has:

> “very regular contact with the external auditors (PwC). He would meet or talk with them monthly throughout the year to discuss any issues that they might have.”\(^{132}\)

The ACC also notes that he travels to overseas subsidiaries to meet with local audit teams\(^{133}\);

(iv) **Company H**: the ACC notes both his interactions with the auditor (in particular the audit engagement partner)\(^{134}\) and:

> “[the] very full report from the auditors which described discussions between management and the auditors on significant accounting issues”\(^{135}\)

(v) **Company I**: the ACC indicates that he has “quite a lot of detail of the auditors’ work”, based (inter alia) on “comprehensive reports of the extent and scope of their work”\(^{136}\).

(c) third, a similar picture emerges from the **CC interviews** with 3i Group and the anonymous company, both of which indicate extensive engagement:

(i) **3i Group**: the company notes the “peer-to-peer engagement”\(^{137}\) that characterises the audit, as well as the more formal interactions through the audit committee\(^{138}\);

(ii) **Anonymous company**: the summary of the discussion with the anonymous company notes the “weekly meetings between the auditors and management” leading to “interactive discussion and multiple layers of contact between the company and the auditors as the audit was delivered”\(^{139}\). They are clear that “senior management ensured that it had a line of sight on all relevant issues”\(^{140}\). They also note that the audit committee “worked very hard and was an important source of challenge”\(^{141}\);

(d) fourth, this position is confirmed by the most recent and most comprehensive empirical study in the literature, undertaken by **Professor Vivien Beattie, Professor Stella Fearnley and**

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130 Paragraph 50 of the Company C case study.
131 Paragraph 39 of the Company E case study.
132 Paragraph 52 of the Company G case study.
133 Paragraph 54 of the Company G case study.
134 Paragraph 55 of the Company H case study.
135 Paragraph 60 of the Company H case study.
136 Paragraph 39 of the Company I case study.
137 Paragraph 5 of the summary of the conference call with 3i Group.
138 Paragraph 4 of the summary of the conference call with 3i Group.
139 Paragraph 7 of the summary of the conference call with the anonymous company.
140 Ibid.
141 Paragraph 9 of the summary of the conference call with the anonymous company.
Tony Hines[^142]. Their study finds, in particular, that “audit committee chairs are fully engaged with the financial reporting process[^143];

(e) fifth, the CC’s case studies show detailed review of auditor’s performance, commonly involving large numbers of people who have interacted with the auditor. For example:

(i) Company C: the CFO explains:

> “[the] annual appraisal of the auditor’s effectiveness [was undertaken] through a formal questionnaire completed by members of the Audit Committee, the Chief Auditor, General Counsel and regional senior management[^144].

(ii) Company D: the finance director explains that:

> “most years, the company sent a survey to its subsidiaries to rate the quality of the audit…The survey covered topics such as meeting deadlines, understanding the local businesses, the audit team continuity and performance, insights provided by the audit team.^[145]

(iii) Company E: the finance director notes that there is an annual “discussion at all levels of the business”[^146] on the auditor’s performance, conducted by management and also involving the audit committee[^147];

(iv) Company F: the ACC notes the “annual review process” based on the multiple quality-related criteria[^148];

(v) Company G: the Global Financial Controller explains a detailed process for assessing the performance of the auditor, by means of a “thorough questionnaire…sent each year to around 40 or 50 people around the company who had the main contact with the auditors”[^149];

(vi) Company H: the FD explains that the company “produced a full written report on the auditor every year”, based in part on best practice guidelines produced by ICAS[^150];

(vii) Company I: the company runs an annual appraisal process, assessing the auditor against a range of quality-related criteria[^151];

(f) sixth, the CC Survey shows that this level of appraisal of auditor’s performance is common and widespread. The survey indicates that 91% of FTSE 350 companies undertake an


[^143]: Ibid, page 8. See also the joint work of the FRC, ICAS and the Institute of Chartered Accountants in Australia, Walking the line: discussions and insights with leading audit committee members, 2012.

[^144]: Paragraph 25 of the Company C case study.

[^145]: Paragraph 39 of the Company D case study.

[^146]: Paragraph 19 of the Company E case study.

[^147]: Paragraph 50 of the Company E case study.

[^148]: Paragraph 49 of the Company F case study.

[^149]: Paragraph 17 of the Company G case study.

[^150]: Paragraph 30 of the Company H case study.

[^151]: Paragraph 17 of the Company I case study.
annual post-audit review of the quality and value provided by the auditor\textsuperscript{152}. This is supported by other surveys of audit committee behaviour\textsuperscript{153}.

(g) seventh, as shown by the CC Survey, two thirds of audit committee chairs sit on three or more audit committees, giving them exposure to multiple auditors\textsuperscript{154}; and

(h) finally, the CC will note that the picture set out in the evidence that has been submitted to it is consistent with (and generally exceeds) the standards nowadays set in the Code\textsuperscript{155}.

6.8 In the light of the above, we welcome and strongly concur with the CC’s acknowledgement that its initial view (as set out in the Theories of Harm Working Paper\textsuperscript{156}) is that ACCs and CFOs have a high degree of visibility on audit quality, in all its facets. This has equally important implications in the context of the present Working Paper. It has a very important impact on the role of reputation: it means that, for these decision-makers, there is no need to rely on exogenous reputation in auditor appointment decisions — they are well able to assess actual quality. Reputation thus becomes the result of such insight, rather than a proxy for such insight.

6.9 The Working Paper captures something of this in its comment that:

“To the extent that reputation is an accurate reflection of capacity, quality, expertise and efficiency, it allows companies to distinguish between potential suppliers of audit services and select the most appropriate for their needs. However, if it is not an accurate reflection, then any inaccuracy may distort companies’ decisions as to choice of auditor and so amount to a barrier to entry…”\textsuperscript{157}

Given the insight that auditor appointment decision-makers have into the “capacity, quality, expertise and efficiency” of their audit suppliers (to a greater extent than many markets), it should be clear that reputation will accurately reflect delivery on these features since reputation is the product of the total of all audits a firm performs in its market.

**Experience and reputation**

6.10 The Working Paper appears at times to posit a concept of reputation that is built solely on the possession of pre-existing experience\textsuperscript{158}. This is wrong.

6.11 Where reputation is built on the delivery of quality — as it demonstrably is in this market — this can be evidenced in many ways. For example, the sector expertise that is demanded by clients may be evidenced not just through conducting audits for companies in the same sector, but also by performing non-audit work in that sector or displaying expertise through thought leadership and similar activities\textsuperscript{159}. This is exactly what Deloitte did in the context of seeking to win large financial services clients such as major retail banks and major insurers. Deloitte did not have pre-existing FTSE 350 audit experience in these sectors to draw on, but was able to demonstrate the required expertise through other work and so win major clients such as Alliance & Leicester, Abbey National, RBS Group and RSA.

\textsuperscript{152} See page 46 of the CC Survey.

\textsuperscript{153} See, for example, the KPMG survey of audit committee members at http://www.audit-committee-institute.be/dbfetch/52615e646f6d4956837c649d722e3cc59976a839ccbbef6b/aci_survey_june2010_1_.pdf.

\textsuperscript{154} Calculated from information provided in paragraph 24c of the CC’s Working Paper on its survey results.

\textsuperscript{155} See paragraph C.3.2 of the Code and the Guidance on Audit Committees. See further Deloitte’s response to the Theories of Harm Working Paper.

\textsuperscript{156} Paragraph 63 of the Theory of Harm Working Paper.

\textsuperscript{157} Paragraph 38 of the Working Paper.

\textsuperscript{158} See paragraphs 39 and 40 of the Working Paper.

\textsuperscript{159} We discuss the suggestion that thought leadership could itself be a barrier to entry at paragraph 6.26 below.
6.12 Moreover, firms may also possess and display relevant expertise through working in the same sector for companies outside the FTSE 350 or outside the UK.

6.13 We note in this context that major mid-tier firms have told the CC about their experience which would seem, prima facie to cover many of the categories above:

(a) **BDO:**

(i) “BDO said that it audited companies across the marketplace which were equivalent to companies in the FTSE 350.”

(ii) “BDO said that its core UK market included businesses that were turning over many hundreds of millions of pounds and included businesses that might be owner managed or private equity backed.”

(iii) “BDO provided services other than statutory audits for 57 FTSE 350 companies in 2010/11 (including 23 FTSE 100 companies). BDO currently audits one company in the FTSE 100 and five companies in the FTSE 250. BDO believes that it has acted (in a non-audit capacity) for more than [redacted] of companies in the Reference Market over the last three years.”

(b) **Grant Thornton:**

(i) “Grant Thornton currently acts for a number of companies that, while they are not FTSE 350 companies themselves, have similar features (e.g. substantial international operations, complex activities or significant scale).”

(ii) “Grant Thornton has experience of auditing FTSE 350 companies (it currently audits 5 FTSE 350 companies plus 150 subsidiaries across 27 countries of one of the largest FTSE 100 companies).”

(iii) “GT also explained that it already audited some very complex organizations (e.g. in the public sector) which were larger than some of the FTSE 350 companies.”

(iv) “In the year ended December 2011, Grant Thornton provided non-audit services to 36 FTSE 100 clients and 66 FTSE 350 companies, with a varying degree of fee level and complexity, mostly in providing various ad-hoc advisory work, demonstrating our credentials in providing a range of services to large corporate firms.”

(c) **Mazars:**

(i) “Mazars considered that it had very significant expertise and capability in auditing large companies, as demonstrated by its French client base and the number of mandates it held in the CAC 40 market. This client base provided Mazars with a very

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160 Paragraph 18 of the summary of BDO’s hearing with the CC.
161 Paragraph 11 of the summary of BDO’s hearing with the CC.
162 Paragraph 5.3.7 of BDO’s response to the Issues Statement.
163 Paragraph 1.7(c) of Grant Thornton’s response to the Issues Statement. Grant Thornton lists examples in Annex 1 to its response to the Issues Statement.
164 Paragraph 1.7(d) of Grant Thornton’s response to the Issues Statement. Grant Thornton elaborates on the latter point in its response to PwC’s submission.
165 Paragraph 7 of the summary of Grant Thornton’s hearing with the CC.
166 Paragraph 1.5(e) of Grant Thornton’s response to the Issues Statement.
deep and wide sector of expertise, covering three of the key sectors with distinguishing features: banking, insurance and energy.\textsuperscript{167}

(ii) Mazars also acted in 35 countries for a large global bank [redacted] and its work for this client had enabled it to invest in its banking capability in the UK market.\textsuperscript{168}

(iii) Mazars “has a substantial portfolio of major international clients for its regulated activities, performing audits for more than 500 listed companies worldwide.”\textsuperscript{169}

6.14 It would seem that this work should give these firms good opportunities to demonstrate expertise even where they do not have pre-existing FTSE 350 audit experience in a given sector. Experience \textit{per se} does not appear to be a material barrier to entry.

\textit{International network effect}

6.15 The second category of potential barrier discussed under this heading in the Working Paper is the effect of international networks. The Working Paper states that international networks “may produce a barrier to entry which is hard for non-Big 4 firms to replicate”\textsuperscript{170}.

6.16 We understand the theoretical grounding for the CC’s view, but we believe that its assessment of this issue needs to be focused on the realities of the market. In practice, the biggest mid-tier firms have made substantial investments in their networks.

6.17 Each of the major mid tier firms makes their case in their evidence to the CC:

(a) BDO:

(i) “BDO, GT and other firms have made significant investments in recent years in broadening and strengthening their international networks. For example, BDO’s UK firm invested substantially in BDO’s Indian network firm and more recently has invested in expansion in the Middle East.”\textsuperscript{171}

(ii) “BDO believes that the BDO network is large enough to audit almost all companies.”\textsuperscript{172}

(iii) BDO has “offices in 135 countries.”\textsuperscript{173}

(iv) “Over the last two years we have committed resources to strengthening and further improving [our network’s] operation and management. Actions include the global launch of a new audit methodology tool and continued investment in our corporate finance office in Dubai and our Indian member firm.”\textsuperscript{174}

(b) Grant Thornton:

(i) “Grant Thornton has the necessary international capability to audit the large FTSE 350 companies. Grant Thornton is a member of Grant Thornton International, a network of accounting and audit firms present in more than 100 countries, including all of the

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\textsuperscript{167} Paragraph 7 of the summary of Mazars’ hearing with the CC.

\textsuperscript{168} Paragraph 10 of the summary of Mazars’ hearing with the CC.

\textsuperscript{169} Page 38 of Mazars’ Annual Report 2010/11.

\textsuperscript{170} Paragraph 46 of the Working Paper.

\textsuperscript{171} Paragraph 5.1.10 of BDO’s response to the Issues Statement

\textsuperscript{172} Paragraph 2.3 of BDO’s response to the Issues Statement.

\textsuperscript{173} Paragraph 3.1.7 of BDO’s response to the Issues Statement.

\textsuperscript{174} Page 11 of BDO’s Annual Report 2010.
major business hubs across the world; in aggregate member firms employ over 30,000 staff.\textsuperscript{175}

(ii) "GTI had made a significant investment in the last ten years in its international organization and now spent approximately $60 million a year on its international infrastructure.\textsuperscript{176}

(c) Mazars:

(i) "It was present as an integrated single partnership in countries representing 90 per cent of global GDP and had looser arrangements in other countries so that it could serve the vast majority of countries. Virtually all of its offices throughout the world had the primary purpose of undertaking large corporate work and the substantial majority of offices were accustomed to working for global clients.\textsuperscript{177}

(ii) "Mazars had grown internationally by opening offices to service the local work of its CAC 40 clients and had taken this approach in the UK market, where its team of approximately 40 to 50 staff initially only serviced its global clients. However, as its clients grew and demand increased, it became necessary to increase the depth and scale of its teams. It had an office in the USA for more than 20 years, which had not undertaken any local activity. It had sought to increase the size of this business by merging with Weiser in 2010 after previously being in a joint-venture arrangement. It considered that the liability risk had become more manageable in the USA. It had arrangements in other parts of the world beyond the Mazars global partnership which it could access should that be necessary to serve its clients.\textsuperscript{178}

6.18 These are important steps, which have substantially increased the footprint of the largest mid tier firms. That said, we do believe that there remains a difference in capability in key jurisdictions between Deloitte’s network and that of the largest mid-tier firms.

6.19 We believe that this capability gap (rather than the issue of simple scale) is the focus of most informed observers. Companies – rightly – need to be satisfied that a sufficient level of audit quality can be delivered in each jurisdiction. The CC will note that certain case study companies note differences in international capability even between top tier firms\textsuperscript{179}.

6.20 We note again that none of the firms has indicated that constraints on their ability to raise capital constitute a barrier to expansion, and we also note that they have been able to make selective strategic investments in their networks in the past few years – for example, BDO’s investment in its Chinese practice\textsuperscript{180}.

6.21 That it is possible to grow a competitive practice from a position of relative weakness with meaningful but achievable investment is consistent with our own recent experience. Since 2005, Deloitte has almost doubled total revenues from its Swiss business, from a position where it was only the fifth largest market player. In that period, its audit revenues have grown from CHF \textsuperscript{181}m in FY06 to CHF \textsuperscript{182}m in FY12. Deloitte has won the audits of major Swiss businesses such as Givaudin, Orascom, SR Technics, Nyrstar, BNP Paribas, Candax Energy, WWF International,  

\textsuperscript{175} Paragraph 1.5(a) of Grant Thornton’s response to the Issues Statement.

\textsuperscript{176} Paragraph 2 of the summary of Grant Thornton’s hearing with the CC.

\textsuperscript{177} Paragraph 5 of the summary of Mazars’ hearing with the CC.

\textsuperscript{178} Paragraph 6 of the summary of Mazars’ hearing with the CC.

\textsuperscript{179} See, for example, paragraph 22 of the Company H case study, where the finance director explains that Deloitte was not invited to participate in the previous tender because of what the company considered to be a lack of “a compelling presence in India”. Since this time, Deloitte and others (notably BDO – see paragraph 5.1.10 of its response to the Issues Statement) have invested strongly in India.

\textsuperscript{180} See paragraph 5.1.11 of BDO’s response to the Issues Statement.
Kempinski Hotels, Publimo Group. The investment by the UK firm has included the transfer to Switzerland or external recruitment of significant numbers of partners and people, investment in property and infrastructure, development of strong international linkages to fulfil the service requirements of global audit clients and the establishment of a comprehensive range of industry and specialist capabilities to support growth in audit market share.

**Technical resources**

6.22 The third category of potential barrier discussed under this heading in the Working Paper is technical resources. Deloitte agrees that investment in technical resources is critical to compete effectively in this market: technical capabilities (including those non-audit skills that contribute to the audit such as tax and actuarial skills) are critical to the delivery of the level of audit quality which FTSE 350 companies demand.

6.23 Again, the starting point for understanding the extent to which this operates in practice as a barrier to entry or expansion must be the existing situation of the largest mid tier firms. The evidence that they have put to the CC is that they believe that they have been able to acquire technical skills at the level necessary to compete in this market:

(a) **BDO:**

(i) “BDO had pensions, technical, valuation and tax specialists.”

(ii) “BDO claimed that it made similar investments to the Big Four in terms of improving its processes.”

(iii) “In our drive for technical excellence we have overhauled our professional training with the launch of our Development Hub.”

(iv) “We’ve continued to invest in the resources our clients need.”

(b) **Grant Thornton:**

(i) “GT also explained that it had invested significantly in non-audit skills, in order to be able to undertake complex and large audits properly. For example, it carried out regulatory work in the area of insurance, pension work on covenants, and worked as trustees on the disposal of British Airport Authorities’ assets.”

(c) **Mazars:**

(i) “We are able to assist our clients by complementing the high level technical competence of our finance experts and the strict methodology of our auditor, ensuring reliability and security, on the one hand [and] the added value of our consultants and their capacity to set change in motion by offering a freshly relevant and innovative view of the client’s problems on the other.”

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181 BNP Paribas was won through the French member firm, and SR Technics through the German member firm, but in each case the Swiss member firm had to show credibility and scale in Switzerland in order for Deloitte to win the work in Switzerland.

182 Paragraph 19 of the summary of BDO’s hearing with the CC.

183 Paragraph 20 of the summary of BDO’s hearing with the CC.

184 Page 5 of BDO’s Annual Report 2010.

185 Page 4 of BDO’s Annual Report 2009.

186 Paragraph 10 of the summary of Grant Thornton’s hearing with the CC.

(d) **Baker Tilly**: it is a “myth” that “non-Big Four firms lack the necessary expertise or methodology”\(^{188}\).

6.24 There is no doubt that the top mid tier firms have strong offerings in this respect. That said, a number of the respondents in the CC’s **case studies** noted the following\(^{189}\):

(a) **Company A**: the ACC observes that the mid tier firms “do not have the breadth of knowledge”\(^{190}\).

(b) **Company C**: the ACC states that “he considered [that the mid tier firms] lacked depth in expertise and skills required for the company’s audit”\(^{191}\).

(c) **Company E**: the finance director states that he:

> “had also made a comparison between Big 4 and Mid-Tier staff when interviewing potential candidates for roles at the company, particularly at manager level. Manager level was where the majority of work was done on an audit and was therefore a very important position. There was a marked difference in overall capability between candidates from each type of firm—when interviewing ‘you are more likely to find a better candidate from the bigger firms’. The FD explained that by capability he meant both technical accounting skills as well as wider skills such as: the ability to interact with individuals, think out of the box, be challenging to others and themselves, think about the bigger picture of the business, commercial awareness and a mindset to not just tick a box. He thought that there was more likely to be a higher calibre individual in one of the Big 4 firms than in other firms.”\(^{192}\)

(d) **Company F**: the finance director says that “there were concerns about the capability and depth of capability of the audit team”\(^{193}\) of their (former) mid-tier auditor;

(e) **Company G**: the Global Financial Controller states that:

> “He did not think that they had suitable experience and expertise to audit the company as they did not audit other global banks or global FTSE 100 companies.”\(^{194}\)

6.25 However, again, we do not believe that the quantum of investment that is required to close this gap is beyond the capabilities of the mid tier firms if they choose to make it their investment priority. As they explain above, they consider that they have made significant investments in technical capabilities and do not suggest that they are constrained in continuing to do so.

**Thought leadership**

6.26 The fourth category of potential barrier discussed under this heading in the Working Paper is thought leadership. Deloitte believes that its role in thought leadership is an important one, and consistent with the public interest role of audit and auditors. It is entirely mistaken to consider that it is a mere form of marketing. There is a clear customer and public benefit in the thought leadership role taken by Deloitte and its competitors.

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\(^{188}\) Page 3 of Baker Tilly’s submission to the CC.

\(^{189}\) In the interests of balance, we note that some company representatives (see e.g. Company H and Company J) do consider that mid tier firms possess sufficient skills in the context of their businesses.

\(^{190}\) Paragraph 64 of the Company A case study.

\(^{191}\) Paragraph 66 of the Company C case study.

\(^{192}\) Paragraph 25 of the Company E case study.

\(^{193}\) Paragraph 17 of the Company F case study.

\(^{194}\) Paragraph 28 of the Company G case study. We note that Company G, a large global bank, may be among those companies that mid tier firms are clear they would not be able to audit.
We do not believe that thought leadership work represents, in practice, any sort of barrier to the expansion of the audit businesses of the major mid tier firms. Each of them already invests in thought leadership:

(a) **BDO:**

> "Whether it is through the expertise of our teams and individuals or through our industry-leading thought leadership publications, BDO is committed to providing clients with the best and most valuable advice and insight."\(^{195}\)

(b) **Grant Thornton:**

(i) The firm devotes a section of its website to “Thinking”: see [http://www.grant-thornton.co.uk/en/Thinking/](http://www.grant-thornton.co.uk/en/Thinking/)

**Attracting talent**

The fifth category of potential barrier discussed under this heading in the Working Paper is the ability to attract talent. Deloitte believes that its people are the cornerstone of its business. Its investment in their development is at the heart of its offering to its clients.

We believe that our ability to attract a high standard of people is due to a wide range of factors which require careful management and investment. We pride ourselves on this, but we do not believe that it is impossible to replicate: it is not a barrier to entry or expansion\(^{196}\).

For completeness, Deloitte’s talent strategy is not based on offering “above market” salaries\(^{197}\): it is based on a holistic offering to its people which includes a strong salary package as well as a range of other benefits and career development opportunities.

**Influential alumni network**

The final category of potential barrier discussed under this heading in the Working Paper is the posited existence of an “influential” alumni network. The Working Paper picks up on the complaint that has been made by a number of smaller firms that the alumni of Deloitte and other top tier firms somehow bias regulatory decision making\(^{198}\) and auditor appointment decisions in favour of top tier firms and against mid tier firms.

No evidence has been put to the CC in support of this contention: it is purely based on supposition. Deloitte is proud of its alumni and hopes that they continue to recognise the quality of its offering. It is deeply aware, though, that they are highly intelligent and dedicated people who, if they are in a position to make or influence auditor appointment decisions, will not favour Deloitte out of mere loyalty\(^{199}\).

**7. Regulatory barriers**

The Working Paper cites a number of facets of regulation which could in theory constitute barriers to entry. Before addressing each one in turn, we note that no party – including those agitating for

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\(^{195}\) Page 10 of BDO’s Annual Report 2010.

\(^{196}\) We note that mid tier firms such as Grant Thornton have given evidence to the CC that they are able to attract top tier talent: see, for example, paragraph 4.8 of Grant Thornton’s response to PwC’s paper on third party submissions.

\(^{197}\) An internal Deloitte employee communication from August 2012 regarding the forthcoming pay review included the following text: “Our strategy is to match our salaries to the market in which we operate, creating salary ranges that wrap around the market median”.

\(^{198}\) We have addressed the specific issue of regulatory bias in our response to the Theories of Harm Working Paper.

\(^{199}\) We note in this context the reluctance of the ACC of Company A (of the CC’s case studies) to consider the firm of which he was a former partner because of his concern that it might appear that he had favoured that firm in some way. See paragraph 66 of the Company A case study.
action by the CC – has suggested that regulation is a material barrier to entry in this market. Indeed, Grant Thornton was quite clear in its response to the Issues Statement that:

“We have seen no evidence that there are regulatory failures which could lead to a reduction or distortion in competition in the market.”\(^\text{200}\)

**Increasing complexity (and globalisation) of accounting standards**

7.2 The first category of potential regulatory barrier discussed in the Working Paper is the increasing complexity of global accounting standards. We agree that accounting standards have become more complex and more globalised\(^\text{201}\). Companies expect their auditor to be highly expert in understanding and applying them, and we believe that the degree of expertise is an area in which firms may differentiate their offering: we believe that some firms are more expert than others.

7.3 However, there is no evidence that understanding these standards presents a barrier to entry and expansion. No firm has indicated to the CC that it considers that complexity of accounting standards inhibits its ability to compete in the FTSE 350 audit market. For example, Grant Thornton explains that it is able to “keep abreast of changes in regulations and standards relating to accounting and auditing requirements”\(^\text{202}\).

**Limited ability of the auditor to differentiate itself in the audit report**

7.4 The second category of potential regulatory barrier discussed in the Working Paper is the suggestion that regulation may make it difficult for firms to differentiate themselves. The Working Paper suggests that the “binary nature of the audit opinion may give investors very limited ability to judge the quality of the audit process. This inability to measure quality may increase the importance of auditor reputation and thus favour incumbent firms.”\(^\text{203}\).

7.5 This contention again appears to be based more in theory than in practice: investors have made it very clear that in the vast majority of cases they play no meaningful role in the auditor appointment process. Rather, the decision is, in the nature of decision-making generally in limited companies, delegated to the company’s board and management. As such, the fact that investors may have limited ability to judge the quality of the audit process has no effect on the importance of auditor reputation and gives rise to no incumbency advantage. We have explained above\(^\text{204}\) that the relevant company officers have very strong insight into the level of audit quality delivered (which complements their status as expert buyers). Moreover, the CC has indicated that its initial view is the same\(^\text{205}\).

7.6 We have explained in our response to the Theories of Harm Working Paper that we take on board the concerns expressed by investors as to audit reporting\(^\text{206}\); it is clear that they do not find audit reports as useful as might be the case. However, this has none of the effects posited by the CC in the present Working Paper.

\(^{200}\) See paragraph 10.1 of Grant Thornton’s response to the Issues Statement. We note that BDO states that the CC is “right to raise this issue” (see paragraph 5.4.1 of its response to the Issues Statement) but does not elaborate save to note that it has elsewhere addressed the issue of innovation (which is a separate point, and one we have addressed in our response to the Theories of Harm Working Paper).

\(^{201}\) See further Deloitte’s response to the Theories of Harm Working Paper where we urge the CC to ensure that it takes proper account of the international nature of audit regulation.

\(^{202}\) See paragraph 1.5(d) of Grant Thornton’s response to the Issues Statement.

\(^{203}\) Paragraph 53(b) of the Working Paper.

\(^{204}\) See paragraph 6.4 et seq.

\(^{205}\) Paragraph 63 of the Theories of Harm Working Paper

\(^{206}\) See Deloitte’s response to the Theories of Harm Working Paper.
Partner rotation requirements

7.7 The third category of potential regulatory barrier discussed in the Working Paper is partner rotation requirements. The nature of the CC’s concern with respect to partner rotation requirements as a barrier to entry are not spelled out in the Working Paper. The CC sets out the regulatory requirements with respect to audit partner rotation but does not explain why this may be considered a barrier to entry and/or expansion. In practice partner rotation can have the opposite effect, as it can encourage companies to seriously consider a tender.

7.8 The CC rightly notes that the requirement has been put in place to support the public policy “good” of ensuring appropriate levels of independence: it is generally considered that this system works well.

Auditor liability

7.9 The fourth category of potential regulatory barrier discussed in the Working Paper is auditor liability. The Working Paper correctly notes that an auditor’s liability is an important feature of the market. It is also correct to observe that the regime allowing auditors to limit their liability by contractual means is not effective in practice, since companies are not willing to agree to such limitations.

7.10 Deloitte has noted the strong views on this subject of certain smaller firms, but the point does not seem to have been put so strongly to the CC by the larger mid-tier firms. We note also that unlimited liability is thought by certain companies (and possibly investors) to support audit quality. As Deloitte has explained, auditor risk is one feature of the market (although far from the only one) which allows companies and their investors to be confident that their auditor’s incentives are aligned with their own terms of the delivery of audit quality.

7.11 Deloitte has in the past engaged with policy makers in relation to liability reform and would be happy to do so again were the CC to conclude that it represented a material barrier to entry and/or expansion which was not outweighed by countervailing benefits.

Audit firm ownership

7.12 The fifth category of potential regulatory barrier discussed in the Working Paper is restrictions on audit firm ownership. The CC is correct to observe that a number of external commentators have suggested that the rules on audit firm ownership rules may constitute a barrier to entry, but it is also correct to note that the market participants (including those outside the top tier) have indicated that they do not consider it to be a barrier to their own expansion.

7.13 Once again, Deloitte would be happy to engage with the CC on this issue, but does not presently consider that the evidence compellingly shows that it is a barrier to entry and expansion in practice.

207 Paragraph 53(c) of the Working Paper.
208 Ibid.
209 Paragraph 53(d) of the Working Paper.
210 Ibid.
211 See paragraph 4 et seq of the summary of the hearing with Kingston Smith and certain other firms.
212 The ACCA also notes this view in its written evidence to the House of Lords Economic Affairs Committee: see page 36 of Volume 2 of the House of Lords Report.
214 Paragraph 53(e) of the Working Paper. See also paragraph 5.24 above. It is also possible that loosening restrictions on audit firm ownership could create additional conflict issues.
Rules on component auditors and joint audits

7.14 The sixth category of potential regulatory barrier discussed in the Working Paper is the rules on component auditors and joint audits.

Group audits

7.15 The CC does not explain in the Working Paper how the rules on component auditors in ISA 600 could constitute a barrier to entry and/or expansion.215

7.16 However, we are aware of the comments made by some firms that companies are being “misinformed” as to the requirements of ISA 600 – specifically, that they are being misinformed that “the ISA ‘requires’ the use of the same auditor for all companies within a group”.216 There is no basis for these comments.

7.17 First, the CC will have noted the expert and well-informed nature of buyers of statutory audit services. Every single one of the ACCs and CFOs interviewed by the CC in the context of the case studies is a qualified accountant and many have specific audit experience. It does not seem credible in those circumstances to consider that they are somehow being “duped” into taking action within their area of expertise that is not in the interests of their company.

7.18 Second, the case studies show very clearly that (a) decision-makers have a clear preference for component audits to be carried out by the group auditor, and (b) have good reasons for that view which are unrelated to the wording of ISA 600 (or any representations made by their auditor):

(a) Company B: the finance director states that:

“[He] wanted KPMG to audit the subsidiaries. Sometimes in the case of an acquisition there was a period where another firm finished an audit already underway, but in the main he preferred to use just one audit firm.”219

(b) Company C: the CFO states that he has

“a preference for one audit firm conducting audits of all subsidiaries. He said that the benefits of this were that it was easier to manage, to coordinate and control.”220

(c) Company I: the finance director explains that:

“The company used the same auditor for all its subsidiaries where a statutory audit was required. The FD thought that this had positive aspects from a coordination and communication point of view. The FD thought that the process was generally much easier with only one auditor, but this would not stop the FD changing a particular subsidiary’s auditor if there was a serious issue.”221

7.19 In sum, there is no foundation for the allegation that companies choose to have their group auditor conduct subsidiary audits other than for entirely rational reasons.

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216 Paragraph 8.1 of Grant Thornton’s response to the Issues Statement. See also paragraph 19 of the summary of Mazars’ hearing with the CC.
217 In the case of Company G, the relevant respondent was the Global Financial Controller, and in the case of Company J the Fund Accounting Manager, who similarly have an accountancy background.
218 See, for example, the ACC of Company C, the finance director of Company E, the ACC of Company F, the Global Financial Controller of Company G and the ACC of Company H.
219 Paragraph 9 of the Company B case study.
220 Paragraph 10 of the Company C case study.
221 Paragraph 8 of the Company I case study.
Joint and shared audits

7.20 The CC goes on to observe that “ISA 600 is silent on the matter of joint audits”\(^{222}\). It rightly observes that joint audit “is not common in the UK”\(^{223}\); the CC should be aware, though, that there is nothing that prevents companies from adopting joint (or, indeed, shared) audits.

7.21 The CC then goes on to speculate that joint audit “could be a way for mid-tier firms to gain experience or build reputation in the FTSE 350 audit market”\(^{224}\).

7.22 In fact, joint and shared audit are widely opposed by companies in the FTSE 350. The evidence in front of the CC to this effect is already extensive even though the question of remedies has not been actively raised:

(a) first, several companies participating in the CC’s case studies indicate (presumably unsolicited) their opposition to joint audit:

(i) **Company C**: the CC explains that the CFO:

“described joint audits as twice the coverage but half the value and considered the idea of better assurance was an illusion, as it was easy for issues to slip between the gaps in the firms.”\(^{225}\)

(ii) **Company G**: the global financial controller appears to indicate that one subsidiary of company G is jointly audited (although all details are redacted). Nonetheless, he appears to indicate that he finds this an unsatisfactory state of affairs:

“The GFC said that with regard to the joint audit of the [redacted] subsidiary, the challenge was making sure that there were no gaps or overlaps in the two audit firms’ work. He saw joint audit as an added complication rather than an added assurance.”\(^{226}\)

(b) second, the **Hundred Group** provided to the CC the results of a November 2011 survey of its members on the issue (inter alia) of joint audit. 100% of respondents indicated that they opposed mandatory joint audits\(^{227}\);

(c) third, **Oxera’s survey of investors** commissioned by BDO and Grant Thornton found that:

“There is little support among investors surveyed for joint or shared audit.”\(^{228}\)

In the case of both joint and shared audits, investors correctly identified the areas of concern:

\(^{222}\) Paragraph 53(f) of the Working Paper. The CC appears to concentrate on joint audit in this paragraph, rather than shared audit.

\(^{223}\) Ibid.

\(^{224}\) Ibid.

\(^{225}\) Paragraph 10 of the Company C case study.

\(^{226}\) Paragraph 15 of the Company G case study.

\(^{227}\) See page 4 of the Hundred Group’s submission to the CC.

\(^{228}\) Page ii of Oxera, *Investor views on market outcomes and potential remedies in the audit market* (the Oxera Investor Paper). For completeness, we note that Grant Thornton and the ACCA held a separate “Investor Round Table” (see http://www.accaglobal.com/content/dam/accaglobal/PDF-technical/audit-publications/ntl-ath-irtap.pdf) where similar sentiments were expressed: investors indicated their clear opposition to joint audit; they did not strongly oppose shared audit “if this is necessary to achieve the desired level of audit quality” (see page 6 of the paper). In fact, the evidence shows that those best placed to judge audit quality (ACCs and finance directors) are opposed to shared audit on quality as well as cost grounds.
Investors expressed some concerns about joint audits, including whether two audit firms would coordinate effectively, and whether two auditors would delay any investigations into auditor liability.  

“There are some concerns in relation to shared audits, including whether potential gaps in the responsibilities of each audit firm would emerge, and whether they would have any effect on changing the perceived status of non-Big Four audit firms.”

**Independence rules on client size**

1.1 The seventh category of potential regulatory barrier discussed in the Working Paper is independence rules on client size. The Working Paper posits the possibility that the rules on client size (i.e. the limitations on the proportion of fees a firm may receive from one client) could in theory constitute a barrier to entry and expansion.

7.23 We note that no firm has indicated that this is the case, and we believe that the CC is likely to be correct in its preliminary conclusion that “these regulations would be unlikely to affect the ability of non-Big 4 firms to tender for FTSE 350 audits other than the very largest clients.” We note in any case that there are generally considered to be good public policy reasons for these rules and we are supportive of them for these reasons.

**Other independence requirements e.g. banking relationships**

7.24 The seventh potential regulatory barrier discussed in the Working Paper is other independence requirements, particularly in relation to banking client. It is correct to observe that the independence rules with respect to banking relationships may present a more significant barrier to switching (for both the firm and the bank) than for other clients. Deloitte would be happy to engage in dialogue as to mechanisms for mitigating any such additional effect, but the CC will also be aware of the public policy reasons for such rules.

**Requirement for the audit committee to approve change of auditor**

7.25 The ninth potential regulatory barrier discussed in the Working Paper is the requirement for audit committees to approve a change of auditor. The Working Paper states that “some commentators have suggested that the conservative nature of audit committees acts as a further barrier to mid-tier firms winning FTSE 350 audits.” In fact, as far as we are aware, this allegation has mainly been made in the submissions to the CC by certain mid tier firms (rather than by independent commentators).

7.26 This suggestion does not do justice to the members of audit committees and ACCs in particular. The evidence shows that they are highly expert and dedicated people, with strong insight into the actual quality delivered by audit firms.

7.27 We note that the customers of the audit – the investors – wish to retain the role of audit committees in this respect: Oxera’s interviews with investors revealed that:

“None wishes to see a radical change in the role of the audit committee as the agent of shareholders in selecting and monitoring an auditor.”

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229 Paragraph 3.2.4 of the Oxera Investor Paper.
230 Paragraph 3.2.4 of the Oxera Investor Paper.
231 Paragraph 53(g) of the Working Paper.
232 Ibid.
233 Paragraph 53(h) of the Working Paper.
235 See paragraph 3.2.2 of BDO’s response to the Issues Statement.
236 See paragraph 6.4 above.
Non-audit services

7.28 The final potential regulatory barrier discussed in the Working Paper is the rules on the provision of non-audit services by a company’s auditor. The Working Paper states that the OFT raised the issue of whether the rules on provision of non-audit services lead to a situation where “a significant proportion of FTSE 350 companies find that one or more of the Big 4 audit firms is conflicted out”238.

7.29 We have explained to the CC that this is not correct239. It is very rare for independence rules to prevent us bidding for an audit appointment. We are not aware of any occasion in the past five years where this was the case240.

7.30 The general rule (that covers the vast majority of situations) is that, where we are providing non-audit services to a company that would impact auditor independence (and not all non-audit services fall into that category), we could not audit the financial statements for the year in which those services are provided. Companies will generally manage their tender processes to ensure that this does not inhibit firms from bidding.

7.31 To be clear, it is the company and not Deloitte who decides the roles we will play or bid for. Any attempt to “game” a FTSE 350 company by declining the audit role in order to undertake non-audit work would elicit a very negative response from the company which would endanger the prospects of any future work of any nature241.

8. Auditor clauses in loan agreements and pressure from advisors

Auditor clauses in loan agreements

8.1 Deloitte has explained to the CC that it opposes the inclusion of contractual limitations on companies’ choice of auditor and believes that such clauses should be prohibited242.

8.2 The Working Paper states that “it is particularly difficult to ascertain the extent to which such clauses and vetos are justified by a real (rather than perceived) difference in quality between the Big 4 and non-Big 4 firms”243. Deloitte is clear that there is a difference in quality between its audit work and that of non-top tier firms. While several mid-tier firms have appreciably improved their offering over the past several years, we believe that that gap remains, particularly because they have chosen to invest in other priorities, including non-audit services244. Nonetheless, we do not believe that these clauses are helpful, and we support their removal.

Other forms of pressure from advisors

8.3 The Working Paper notes that allegations have been made that other advisors may put pressure on companies not to use non-top tier firms245. It notes also that these allegations “are by nature...”246.

237 Page iii of the Oxera Investor Paper.
239 See paragraph 4.4 et seq of Deloitte’s summary of its response to the CC’s market questionnaire.
240 Deloitte has explained that in the case of , we discussed with the company whether they would wish us to participate in the tender. Those discussions led to the mutual decision that we would retain our non-audit role for the company. See further paragraph 4.5 of Deloitte’s summary of its response to the CC’s Market Questionnaire.
241 See further footnote 240 above in relation to the decision to continue undertaking non-audit work for .
242 See page 27 of Deloitte’s initial submission to the CC.
244 See paragraph 6.24 above.
hard to substantiate. This is because there is little evidence to back up such allegations, and ample evidence to the contrary. In particular:

(a) the CC Survey evidence indicates very clearly that “investor perceptions and financial institutions expect a Big Four auditor” was an absolutely immaterial factor in decisions to limit tenders to top tier firms only – being raised only by 2% of FTSE 350 respondents; and

(b) the case studies similarly indicate no pressure from these constituencies, as we have detailed in section 3.16(c).

9. Conclusion

9.1 The CC has set out a very wide range of potential barriers to entry in the Working Paper. In practice, we believe that there is little evidence that any is significant.

9.2 It is critical that the CC takes more than a theoretical approach to the issue of barriers to entry and expansion. Those agitating for action from the CC are firms who already possess significant capabilities and have indicated that they are able to invest strongly in their audit practices. We have no reason to doubt what they say. We believe that with continued and achievable investment – targeted in particular at the capabilities demanded by FTSE 350 companies from their auditor – there is no reason why they cannot be successful in this market.

9.3 To summarise our views:

(a) it is critical that the CC properly recognises the realities of the market when assessing the extent of any purported restrictions on entry and expansion. A theoretical exercise in assessing barriers to greenfield entry would not reflect market realities. In practice, mid tier firms have already invested significantly in the capabilities necessary for audit of FTSE 350 companies in the UK;

(b) in assessing possible expansion strategies, much of the work to date appears to have concentrated on winning more FTSE 350 clients from their existing auditors by way of tender processes. In fact, given the fluid nature of the FTSE 350, an equally – if not more – effective way of growing a firm’s FTSE 350 audit client base is to seek to retain clients as they grow and join the FTSE 350. A firm is particularly well-placed to demonstrate its capabilities to a company of which it is already auditor – addressing the concern expressed by mid tier firms that some companies may be insufficiently aware of their capabilities. Deloitte’s analysis of the fluidity of its FTSE 350 client base indicates the opportunities that arise through this strategy: a “half-life” analysis indicates that of Deloitte’s clients in the FTSE 350 in one year, only half would still be Deloitte clients in the FTSE 350 just 6.6 years later;

(c) there is no evidence that mid tier firms are at a cost disadvantage when tendering;

(d) search, tendering and switching costs are not such as to inhibit companies from taking steps when they consider that they may not be achieving the optimal value/quality outcome. On the supply side, no firm has indicated that the costs of participating in tenders inhibits it from responding to invitations to participate;

(e) Deloitte has never invested in order to raise its competitors costs or make their expansion more difficult. It has, of course, invested, in response to client demands, to make its audits more efficient and of higher quality. This has clear benefits for customers;

\(^{246}\) Paragraph 56 of the Working Paper.

\(^{247}\) Page 56 of the CC Survey. Notably, this figure was lower for FTSE 350 respondents than for non-FTSE 350 respondents.
(f) advertising costs are immaterial in this market: Deloitte is not aware of any advertising spend in the past five years that is attributable to its audit practice – still less to its audit of FTSE 350 companies;

(g) reputation does not have to act as a *proxy* for quality in this market: the high level of visibility of audit quality on the part of finance directors and audit committee chairmen (*ACCs*) means that it is a *function* of quality;

(h) we believe that mid tier firms have made significant investments in audit quality, although Deloitte believes that its audit quality remains higher than that of mid tier firms;

(i) similarly, while Deloitte believes that its network possesses more strength in depth than that of mid tier firms, it notes the investment that they have made and believes that further investment is within their means should they choose to do so;

(j) we are not aware of any evidence that regulatory barriers are significant in this market; and

(k) Deloitte would be happy for restrictive clauses in loan agreements to be outlawed. The evidence shows that alleged informal pressure to select only top tier firms does not play a significant role in auditor appointment decisions.
Annex 1

1. Comments on the Oxera entry model

1.1 In this appendix we comment on the Oxera model for entry into auditing FTSE 350 companies. Our main concern is that the Oxera model does not reflect the way in which audit businesses are in practice developed in two important ways:

(a) Audit client retention. Oxera focuses on an investment strategy that appears to exclusively target new clients. This ignores the strengths of mid-tier audit firms. Mid-tier audit firms already have as their existing clients companies that are likely to grow into FTSE 350 companies. This means that mid-tier audit firms can maximise their likelihood of success, while minimising their ‘investment’ costs by also focusing their efforts on retaining their existing high growth clients.

(b) Gaining FTSE 350 experience. An important part of an audit growth strategy is likely to be extending the provision of non-audit services to FTSE 350 clients. This is not included in the Oxera entry model but supports the development of experience and understanding of FTSE 350 clients which in turn will increase the likelihood of success at audit tenders. In addition, the sale of non-audit services which can be worked on by staff that are to some extent fungible across both audit and non-audit services increases overall utilisation and revenues which then mitigates the cost of investing in higher quality partners and staff.

1.2 We comment below, first on the requirements of a FTSE 350 audit and then set out how an entry strategy based on not just competing for new clients but also retaining existing clients would be consistent with these requirements. We then comment in more detail on Oxera’s model.

2. The requirements of a FTSE 350 audit

2.1 In order to win audit engagements with FTSE 350 clients audit firms must offer and provide the quality of services demanded by these clients. This requires a number of necessary skills and capabilities which, as we previously indicated to the Competition Commission in Deloitte’s Initial Submission, include the following.

Key requirements of a FTSE 350 audit

1. Highly skilled and professional partners and staff with specific industry experience
2. Comprehensive conflicts and independence systems and controls
3. Sophisticated, innovative and flexible audit technologies and methodologies
4. Access to dedicated technical expertise
5. Challenging and robust quality review processes
6. An integrated quality, risk management and compliance framework
7. A demonstrable track record of delivering quality and acting with integrity and objectivity
8. Ability to devote adequate resources at required times
9. Access to an international network
10. Full client service offerings across a broad range of disciplines
11. Appropriate levels of risk financing, with access to sufficient levels of capital and professional indemnity insurance.

2.2 The necessity for the skills and capabilities listed above has been broadly confirmed by the Survey of the FDs/CFOs and ACCs commissioned by the Competition Commission. In particular, the factors considered to be important in assessing the quality of the audit most often cited by the respondents included: efficiency of the audit process, ability to detect misstatements, independence of the audit firm, high degree of challenge, reliability and usefulness of audit report and consistency of delivery worldwide (Competition Commission Survey, July 2012).

2.3 The mid-tier firms (BDO and Grant Thornton) have asserted that they already possess the necessary attributes for delivering most FTSE 350 audits. The Competition Commission has noted that ‘Other auditors responded that they could audit companies across a broad range of (FTSE 350) sectors’. This is also to some extent confirmed by the responses of FTSE 350 Finance Directors and Audit Committee Chairs in the Competition Commission Survey and in the Case Studies. Of those FTSE 350 companies that had tendered their audit in the last five years, some 30% had invited at least one mid-tier firm to tender. Similarly some three out of ten firms interviewed by the Competition Commission believed that a mid-tier firm could audit its accounts.

2.4 Consequently, an obvious entry strategy for mid-tier firms is to focus on the key requirement that may most self-evidently be deficient. This requirement is the demonstrable track record of delivering quality and acting with integrity and objectivity and it can most easily be enhanced by retaining their high growth clients that are aspiring to enter the FTSE 350. By virtue of being existing clients, it will be easiest to demonstrate to them a track record for quality and as such clients enter the FTSE 350, so this track record will become visible to other FTSE 350 companies.

2.5 It should be noted that the requirements for a FTSE 350 audit do not include advertising or other promotional costs to support an audit firm’s branding.

3. The market opportunity

3.1 The FTSE 350 is not a static set of companies. The Competition Commission in its market definition has considered the current and recent participants of the FTSE 350; some 542 in its Market Inquiry dataset. However the Competition Commission appears not to take into account the significant number of companies that are aspiring members of the FTSE 350.

3.2 As at December 2010, 186 companies (53%) had been in the FTSE 350 for less than 10 years and 116 (33%) for less than 5 years. In other words, in 2005, there were some 116 companies not in the FTSE 350 that were shortly about to become part of the FTSE 350. Moreover, as noted by the Competition Commission in its Market definition working paper, the mid-tier forms have higher market shares outside the FTSE 350; together, some 11% of other listed companies.

3.3 PKF have described such a “retain strategy” in their hearings with the CC, noting that as clients grew, this provided the auditors with an opportunity to grow with them and build a portfolio of progressively larger firms.

4. Implementing the ‘retain strategy’

4.1 Retaining aspiring FTSE 350 companies, in the same way as competing for new FTSE 350 clients, will require some investment in additional resources. In particular, it will be necessary to acquire audit partners and senior audit managers of the quality required by FTSE 350 companies. However, the ‘retain strategy’ is likely not just to be more successful than competing for existing FTSE 350 clients but also more cost effective.
(a) The incremental costs of an audit partner and senior audit manager of the quality required by FTSE 350 companies can be set against the revenues of existing audit clients. This reduces the investment costs relative to the costs of competing in tenders.

(b) Successful retention also has the advantage of avoiding the need to compete in tenders for a replacement audit client;

4.2 It is important to note that a new ‘FTSE 350 quality’ audit partner would not be wholly engaged in delivering audits. Such a partner would be expected – especially outside the audit ‘busy season’ – to compete for non-audit services from FTSE 350 companies (to be clear, this would not include non audit services for their own audit clients). This would both build the track record of the mid-tier firm as well as provide incremental revenues during the growth period for the retained audit clients. For example, Mazars noted that it has been actively seeking to enhance their market positioning by spending “time, effort and money in promoting Mazars’ capability in the FTSE 350 market, primarily through non-audit work.”

5. Comments on the Oxera entry model assumptions

5.1 We have set out below more detailed comments on some of the specific Oxera assumptions in their entry model.

<table>
<thead>
<tr>
<th>Assumption</th>
<th>Oxera model</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment time horizon and payback period</td>
<td>• Overall investment horizon: 20 years</td>
<td>• Given the length of the investment period, considerable efforts would be made to manage investment costs through seeking other incremental sources of revenues, including non-audit services.</td>
</tr>
<tr>
<td></td>
<td>• Initial investment period: 7-10 years, during which clients are incrementally acquired (1-3 clients / year)</td>
<td>• The principal investment required is higher quality audit partners and audit senior managers to demonstrate strength in depth of the senior staff expertise rather than advertising and promotional costs.</td>
</tr>
<tr>
<td>Investments required</td>
<td>• 2-3 £m/year (or £10-30m)</td>
<td>• Further investments may be necessary to develop specific capabilities (e.g. regional presence, technical skills or specialist skills such as tax). This may be achieved for example by expanding of FTSE 350 non-audit services to gain increased exposure/understanding of FTSE 350 clients</td>
</tr>
<tr>
<td></td>
<td>• The costs include advertising and promotion (information campaign) and tendering.</td>
<td>• Some of the incremental costs will be covered by the margins achieved on the higher fee rates (for both NAS and audits) that will follow from deploying higher quality staff.</td>
</tr>
<tr>
<td>New partners per client</td>
<td>• 3 partners / 10 clients</td>
<td>• Investment costs can be managed by gaining leverage on a new partner’s time. This is likely to involve non-audit services and mentoring/developing existing g staff.</td>
</tr>
<tr>
<td>New partner compensation</td>
<td>• 0.35-0.45 £m/year, depending on the stage</td>
<td>• New partners may cost around £m+ (but since they replace existing partners, the incremental</td>
</tr>
</tbody>
</table>

254 Paragraph 14 Mazars hearing summary 14th March 2012
<table>
<thead>
<tr>
<th>Assumption</th>
<th>Oxera model</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenues from new / retained clients</td>
<td>£0.75m/year (FTSE 250) – £3.5m/year (FTSE 100)</td>
<td>• The Oxera model assumes that the new partners only focus on winning new clients. In practice, they are likely to bring in revenue from a mix of sources, including “retained” clients, new / existing clients and non-audit services.</td>
</tr>
<tr>
<td>Profit margins</td>
<td>Operating margin: 40%</td>
<td>• Operating margin differs between audit revenue and non-audit revenue, but is generally lower than 40%.</td>
</tr>
<tr>
<td>Likelihood of failure</td>
<td>35%-50%</td>
<td>• Unless clients tender, there is low risk that auditor would lose their growing client as they enter the FTSE 350. The Competition Commission Survey did not identify moving into the FTSE 350 as by itself a significant reason to switch auditor.</td>
</tr>
<tr>
<td>Increased liability risk</td>
<td>1%-4.5%</td>
<td>• It is not clear how Oxera implemented the increased liability risk, but the ‘retain strategy’ should reduce the liability risk relative to competing for new clients.</td>
</tr>
</tbody>
</table>