Competition Commission Audit Services Market Inquiry

12 October 2012

Deloitte response to the Competition Commission's working paper "Barriers to entry: reputation and experience"

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1. Introduction and summary

1.1 Deloitte is grateful for the opportunity to comment on the paper published by the Competition Commission (the ***CC***) on "Barriers to entry: reputation and experience" (the ***Working Paper***).

1.2 This response is structured as follows:

(a) Experience and capability;

(b) Influence of alumni;

(c) Awareness of audit firms;

(d) The fragility of reputation;

(e) Companies' views of external pressures; and

(f) Conclusions drawn in the Working Paper.

1.3 We have already addressed some of these issues 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***) and our response to the CC's working paper on "Restrictions on entry and expansion" (the ***Barriers to Entry Working Paper***).

2. Experience and capability

Expertise

2.1 We agree with the Working Paper's assessment that expertise is a key factor demanded by audit clients[1]. However, The Working Paper fails to distinguish the difference between the importance of experience and the importance of expertise. Audit firms which display appropriate expertise can win audit engagements even where they do not have direct experience of auditing FTSE 350 companies in the same sector.

2.2 Deloitte has demonstrated this through its build up of expertise in financial services. Deloitte did not have pre-existing FTSE 350 audit experience with major retails banks or insurers to draw on, but was able to demonstrate the required expertise through other work and so win major clients such as Abbey National, Alliance & Leicester, RBS Group and RSA[2].

Existing relationships

2.3 The Working Paper correctly points out that one of the key ways of demonstrating expertise is through existing relationships[3]. It is important to note, though, that those relationships are not the exclusive preserve of the top tier firms: the leading mid tier firms have provided extensive evidence to the CC of their:

(a) substantial relationships with FTSE 350 companies:

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[1] Paragraphs 12-15

[2] See also Deloitte's response to the Barriers to Entry Working Paper, paragraphs 6.10-6.14

[3] Paragraphs 16-17

(i) *"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"*[4]

(ii) *"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."*[5]

(iii) *"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)."*[6]

(b) substantial audit relationships with large multinational companies:

(i) *"BDO said that it audited companies across the marketplace which were equivalent to companies in the FTSE 350"*[7]

(ii) *"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)."*[8]

(iii) *"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. The client base provided Mazars with a very deep and wide sector of expertise, covering three of the key sectors with distinguishing features: banking, insurance and energy."*[9]

(iv) *"Mazars also acted in 35 countries for a large bank [redacted] and its work for this client had enables it to invest in its banking capability in the UK market."*[10]

(v) Mazars *"has a substantial portfolio of major international clients for its regulated activities, performing audits for more than 500 listed companies worldwide."*[11]

2.4 It would seem that this work should give these firms good opportunities to demonstrate expertise even where they do not have pre-existing experience with a specific FTSE 350 company. The fact that existing relationships can be important in winning audit work is therefore not a barrier to entry in this market for the leading mid tier firms – rather it is an opportunity.

International networks

2.5 The Working Paper suggests that a separate 'reputational effect' may arise with respect to firms' international networks[12]. The Working Paper goes on to talk about how mid tier firms may be "perceived to be weaker"[13] with respect to their international presence.

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[4] BDO's response to the Issues Statement, paragraph 5.3.7

[5] Grant Thornton's response to the Issues Statement, paragraph 1.5(e)

[6] Grant Thornton's response to the Issues Statement, paragraph 1.7(d)

[7] Summary of BDO's hearing with the CC, paragraph 18

[8] Grant Thornton's response to the Issues Statement, paragraph 1.7(c)

[9] Summary of Mazars' hearing with the CC, paragraph 7

[10] Summary of Mazars' hearing with the CC, paragraph 10

[11] Mazars' Annual Report 2010/11, page 38

2.6 In fact, the Working Paper (and other working papers) fail properly to assess the extent to which concerns expressed by decision-makers are driven in fact by real differences between the capabilities of the networks of mid tier firms. The evidence before the CC is clear on the importance of deep capabilities across the international networks (not just the number of countries in which a firm has a presence). It is equally clear that the expert and informed buyers[14] in these markets go to pains to assess these capabilities. These decisions are based on far more than mere reputation.

2.7 That said, it is clear that mid tier firms have made substantial investments in their networks, and have indicated that they will continue to do so. We have addressed this issue more fully in our response to the CC's Barriers to Entry Working Paper[15].

3. Influence of alumni

3.1 The Working Paper states that *"Companies respond to a lack of information about audit quality by selecting auditors based on proxy measures such as relationships, familiarity and market norms. We note in this regard that many FTSE 350 FDs and ACCs are Big 4 alumni"*[16].

3.2 We have addressed in detail in our response to the Theories of Harm Working Paper and the working Paper on the "Nature and Strength of competition in the supply of FTSE 350 audits" (the ***Nature and Strength of Competition Working Paper***) the suggestion that company decision-makers lack information about audit quality – a suggestion that has no evidential basis. We address here the specific implication that decisions are based on bias towards top tier firms because of previous employment relationships.

3.3 There is no basis for these allegations of bias, and such bias certainly cannot be inferred from the mere fact of previous employment[17]. Given that the Big 4 are the major recruiters and trainers of chartered accountants in the UK, the fact that many of these people have a Big 4 background is nothing more than a truism.

3.4 We completely disagree with these allegations which seem to us to be a direct criticism of the integrity of some of the UK's leading business people. FTSE 350 CFOs and ACCs will not and do not take important commercial decisions on the basis of loyalty to a previous employer.

3.5 We find these allegations particularly surprising given the detailed evidence that is in front of the CC about the concrete factors – squarely related to quality and value – that are taken into account in auditor appointment and appraisal decisions[18].

4. Awareness of audit firms

4.1 To the extent that the evidence suggests that companies may be less aware of the capabilities of mid tier firms, the evidence shows that mid tier firms make less significant efforts to make sure that FTSE 350 companies are aware of those capabilities. Audit relationships have to be sought and won actively – as you would expect in a well-functioning market. The Nature and Strength of Competition Working Paper makes it clear just how active that competition is.

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[12] Paragraphs 19-22

[13] Paragraph 22

[14] See section 7, below

[15] See paragraph 6.17 of Deloitte's response to the Barriers to Entry Working Paper

[16] Paragraph 74

[17] We note, as did PwC in its Response to Third Party Submissions (at footnote 104), that most of our alumni spent only a few years of their career with Deloitte, and in particular this was usually at the very beginning of their career. Whilst we dismiss the 'loyalty to a previous employer' argument completely, we also find it strange that a period of previous employment at one of the top tier firms could result in loyalty to the 'Big 4' as a whole.

[18] See, for example, paragraphs 30-89 (tender process) and paragraphs 135-174 (renegotiations) of the working paper "Evidence relating to the selection process: tendering, annual renegotiation and switching"

4.2 The Working Paper references the Company C CFO, who *"did not think he had ever been approached by anyone from the Mid Tier."*[19] There are additional examples from the Case Studies:

> *"There had been no approaches for any work from the Mid-Tier firms"*[20]
>
> *"The ACC had only one approach in the last 24 months from a Mid Tier firm (in the context of the company). A meeting was arranged but was cancelled by the firm and had not been rearranged".*[21]
>
> *"The FD had informal discussions with mid-tier firms but did not think they were interested in the company's audit, although she did think they could do the work".*[22]

4.3 In addition, the IFF survey conducted for the CC (the ***CC Survey***) shows that mid tier firms are less proactive in 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.[23]

4.4 This is no barrier to entry: there is nothing in the evidence before the CC to suggest that mid tier firms could not more effectively target their efforts on FTSE 350 companies (as they currently target them on other sectors such as private companies, AIM companies or public sector bodies).

5. The fragility of reputation

5.1 The Working Paper makes the statement that *"Because reputation is only a proxy for accurate information on quality and capability it may over time depart from reality."*[24] This remarkable statement has no basis in the evidence before the CC.

5.2 As Deloitte has explained, its reputation is no more than the sum of the direct observations of its clients as to the quality it delivers: if Deloitte ceases to deliver that quality, its reputation will suffer in short order. Nothing we have seen in the course of this investigation – and nothing in our own experience – can lead to any conclusion to the contrary.

5.3 In particular, companies *do* have access to accurate information on quality and capability, as the CC's own evidence shows: the evidence of the Nature and Strength of Competition Working Paper (drawing in turn on the evidence in the company case studies undertaken by the CC (the ***Case Studies***) and the CC Survey) shows that decision-makers ensure that tendering, appraisal and reappointment processes are structured to make sure that they obtain detailed information on the capabilities of firms. The decision-makers are well-placed (as the Nature and Strength of Competition Working Paper correctly notes) to assess that evidence and act on it to make fully-informed decisions.

5.4 We fail to understand how the evidence set out in this Working Paper – or, to an even greater extent, the totality of the evidence in front of the CC – can have allowed this conclusion to be reached.

6. Companies views of external pressures

6.1 We have explained that decision-makers within companies make their auditor appointment, appraisal and reappointment decisions on the basis of observed capabilities, not so-called

[19] Paragraph 42(b)

[20] Case study C, paragraph 32

[21] Case study F, paragraph 56

[22] Case study H, paragraph 32

[23] CC Survey, slide 82

[24] Paragraph 76

"proxies". Furthermore, there is no suggestion in any of the evidence that the CC has gathered that any third party has put pressure on company decision-makers in those decisions. Indeed, many decision-makers are clear in their evidence to the CC that no such pressure has been applied:

(a) 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[25];

(b) The Oxera survey indicated that the opinion of external stakeholders (company's bankers, corporate brokers, credit rating agencies and lawyers) in audit selection is seen as relatively unimportant by the ACCs[26];

(c) Case Studies (as noted in the Working Paper)[27]:

(i) Company F: the finance director explains that: *"There was no external pressure to change the previous [mid-tier] auditor."*[28]

(ii) Company H: the ACC states that he: *"had not faced pressure from outside the company to continue using a Big 4 firm."*[29]

(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."*[30]

(iv) In addition the these examples, the FD of Company I (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 (many such quotes are featured in the Working Paper), 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.

6.2 We note the Working Paper refers to the response to question C6 in the CC Survey[31] which indicates the reputation of the audit firm with investors, corporate brokers, analysts or external advisers was cited as being important in deciding to appoint or reappoint a statutory auditor. However the Working Paper fails to include the following observation from the CC Survey: *"More than half of FD/ CFOs and ACCs stated that 'pressure from shareholders, bankers, lawyers or analysts' would be a likely trigger that would make their company consider switching auditor (question C6) – however, this theme did not emerge as reason for recent switches at question C1. The responses to question C1 that could not be coded to any of categories shown in this slide were examined further to see if companies were subject to such pressure – no such responses were found."*[32]

6.3 In addition, the CC Survey also reports that only 2% of FDs and only 2% of ACCs cited 'requirement of lenders/banks' as a reason for not formally considering a firm outside the Big 4.[33]

[25] CC Survey, slide 85

[26] Oxera (2006) Table 3.1

[27] Paragraphs 59, 60 and 62 respectively

[28] Case Study F, paragraph 18

[29] Case Study H, paragraph 75

[30] Case Study J, paragraph 30

[31] Paragraph 57

[32] CC Survey, slide 62 (notes)

[33] CC Survey, slide 85

6.4 In conclusion, the evidence shows that the decision-makers are not influenced by third parties, and so can make their auditor appointment, appraisal and reappointment decisions on the basis of their own assessment of the real capabilities of firms.

7. Conclusions drawn in the Working Paper

7.1 We have addressed above some of the constituent elements of the Working Paper. Of the greatest concern, though, are the conclusions. The conclusions drawn at the end of the Working Paper are in no way substantiated by the evidence that the Working Paper sets out (or, indeed, any evidence that any other working paper sets out).

7.2 In particular, the CC alleges that it is *"difficult to judge the quality of an audit"*[34] and that *"quality cannot be observed until after the audit has occurred"*[35]. There is no basis for this contention in the evidence in the Working Paper or elsewhere. It is absolutely wrong that companies make selection decisions based on proxies for quality such as reputation and experience. All the evidence shows that companies (a) seek detailed information, (b) assess it carefully, (c) are well-placed to assess it accurately and (d) make decisions accordingly, in auditor selection processes. Indeed, in the Nature and Strength of Competition Working Paper the CC concludes that FTSE 350 CFOs and ACCs are "highly-qualified"[36], "experienced"[37], "sophisticated"[38] and "knowledgeable"[39] purchasers of audit services. The CC correctly notes that:

(a) they almost universally have an accounting – and commonly an audit – background;

(b) ACCs are often former audit partners or CFOs; and

(c) ACCs also commonly hold multiple audit committee positions[40].

7.3 Each of these characteristics means that CFOs and ACCs are both (a) knowledgeable about what factors are important in assessing the capabilities and performance of the current or a prospective auditor, and (b) well-placed to assess the evidence in relation to those factors.

7.4 The Working Paper notes that reputation may be deserved, but does not investigate this issue anywhere in this Working Paper or in any other part of its work that we have seen. It notes instead that *"reputation may depart from reality"*[41]. As explained above, there is no basis for this contention, and we find it remarkable on the basis of the evidence that is in front of the CC.

7.5 In summary, we can see no evidence to support the notion that there is a 'virtuous circle' for top tier firms or a 'vicious circle' for mid tier firms, still less that any such phenomena may be negatively impacting competition in the market for audit services. Mid tier firms have sufficient expertise and experience to tender effectively for many FTSE 350 audits, they have the wherewithal to make approaches to FTSE 350 companies, and there are no external pressures or restrictions preventing FTSE 350 companies from appointing a mid tier auditor. Above all, the purchasers of audit services are fully qualified and have all of the tools available to them to make informed decisions on which auditor to appoint, how that auditor has performed, and whether to reappoint that auditor or put the audit out to tender. Any suggestion to the contrary has no basis in the evidence.

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[34] Paragraph 73

[35] Ibid.

[36] Paragraph 74 of the Nature and Strength of Competition Working Paper

[37] Ibid.

[38] Paragraph 76 of the Nature and Strength of Competition Working Paper

[39] Paragraph 75 of the Nature and Strength of Competition Working Paper

[40] (a), (b) and (c) all Ibid.

[41] Paragraph 76