STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Firms' stated competitive strategies

Introduction and summary

1. This paper analyses the submissions that firms have made regarding their competitive strategies to win clients and expand their businesses. The paper summarizes information provided by the parties in response to the Market & Financial Questionnaire (MFQ).

2. The paper covers BDO, Deloitte, EY, GT, KPMG, Mazars, PwC and PKF and is based on their responses to the MFQ (with the limitations that this implies). It does not cover material submitted by the parties in respect of individual client tender and price negotiations (which we are investigating separately).

3. Our review of the MFQs and various submissions made by the parties indicate that the parties believe that there is active competition within the market and that they each actively compete, but that this competition does not necessarily translate into frequent switching of audit firms. Whilst the specific modes of operation of the firms vary, each has undertaken broadly similar programmes of activities in order to compete in the market but to different degrees.

4. All the firms have adopted in some form the strategic objective of increasing their market share and revenue and to that end have instigated arrangements to win new clients. The firms also have in place programmes to retain their existing clients and to increase the revenues generated from those clients. Within the non-Big-4 firms, the level of active targeting within the FTSE 350 varies and full competition for audit engagements for all constituent members of the FTSE 350 is a long-term aspiration.

As such, it appears primarily the smaller end of the FTSE 250 that offer an immediate target for the mid tiers.

5. All the firms are moving towards what is typically referred to as a 'one-firm' strategy.[1] The emphasis of these strategies is to focus on approaching a client with the service offering that the firm as a whole perceives is most relevant to the client (and thus the most likely to lead to a sale), and contrasts with previous approaches of each service line approaching a client separately to sell its own products (and potentially antagonizing a client). Similarly, within the firms there appears to be an increased focus on developing industry sector teams to take ownership of clients and provide an integrated approach to clients. However, the firms' staff and revenues remain largely organized by specialist service line.

6. Whilst strategies across the firms are broadly similar, the level of detail in their submissions indicates that the largest firms can support and sustain more intense and prolonged programmes to attract clients.

7. The following sections consider each firm's stated strategies in several areas with a high-level comparison of firms':

   (a) revenue, pricing and margins: how the firm intends to increase revenues, the factors the firms consider in pricing individual audits and increase its profitability margins;

   (b) attracting and retaining clients: how the firm identifies and approaches potential clients and then how it attempts to ensure it retains them;

   (c) services offered: the non-audit services offered and specific 'value-added' assignments performed with the audit;

[1] Not all firms refer explicitly to this, instead firms exhibit traits of focusing on strategic interactions with clients overseen by a lead partner.

(d) people: how it recruits and remunerates its staff and partners and how it engages with its alumni; and

(e) reputation and brand: what the firms do to cultivate a reputation with purchasers of professional services.

Revenue, pricing and margins

Price pressure

8. Across the firms, there is a view that the recession and economic uncertainty has led clients to put increasing price pressure on their auditors. A recurring theme in the submissions from the Big 4 is the persistent threat of an audit client going out to tender if fees are not reduced, but the frequency of this threat occurring and the likelihood of a client following through is not apparent. However, the combination of informed customers and the competitive strategies of other firms may interact.

9. Because of this pressure on price, firms seek additional revenues by identifying new clients and supplying additional services to existing clients. However, because of the uncertainty in implementing fee increases, the firms place much greater emphasis on reducing costs and identifying efficiencies in their processes. This is discussed below.

10. [✂] was the only firm whose submitted documents included specific reference to increasing its prices as an element of its firmwide financial strategy (for the firm as a whole) alongside increasing revenue by increasing its market share. All the firms focus on improving margins, both by seeking efficiencies in individual engagements and in seeking more work throughout the year, particularly in off-peak periods to increase the utilization rate of staff and revenue. Three of the largest firms all make reference to using seasonal pricing, ie relaxing pricing targets outside peak periods. Some of the larger firms also refer to undertaking work at marginal cost if it is

perceived to have a strategic benefit, or similarly to second staff at the cost to the business.

11. KPMG believed that the mid-tier firms had used price as a differentiator when competing with the Big 4.[2]

Lowballing

12. There is a perception by non-Big-4 firms that periodically the Big 4 attempt to enter the market for smaller companies, undertaking the work at close to cost price.[3] The mid-tier firms' assessment of this 'lowballing' varies but it is perceived to be an attempt to increase firm revenue, either for promoting a headline figure for growth, or to try and recover the costs of employing underutilized staff.[4] PKF considered this pricing tactic to be a key factor preventing it from competing in some instances. There has been no written submission that firms are strategically lowballing to prevent smaller firms entering the market, rather that the firms vary prices seasonally, depending on the level of surplus staff.

13. Perceived lowballing in off-peak periods may be driven by having a core client base consisting of a large number of clients with a December year end. The firms then set their resourcing levels to ensure they are able to service the peak created by these large clients, but as a result have underutilized staff at other times of the year and thus may seek engagements that cover the marginal cost of this time.

14. We will investigate if there is any quantitative evidence of this.

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[2] See paragraph 189 of appendix.
[3] That is that the audit fee charged covers only the direct costs of employing the audit team.
[4] As listed companies tend to have 31 December year ends, it may be that smaller companies with 31 March year ends and less demanding over audit timetable are an ideal way of maintaining utilization rates.

Staff costs

15. According to rival firms, KPMG pays staff working on smaller clients a lower salary, allowing them to price differentiate between different market segments. KPMG has not, however, referred to this strategy in its documents and stated that KPMG operated a pay policy based on geographical markets and the demand for labour in these markets. Salaries were based on six geographical markets and had no reference to the size of clients on which staff work.

Cost efficiencies

16. In maintaining and growing profit margins, all firms make reference to reducing their cost base, through identifying efficiencies in audit methodology (through standardization and automation including technology), which will lead to a reduction in the resource requirement for audits and increase the revenue generated per chargeable hour.

17. A significant development among the Big 4 has been the development of offshore processing centres to undertake some audit work.[5]

Attracting and retaining clients

Initiating and building relationships

18. All the firms seek to win work from new clients, or seek appointments as auditors for clients for which they already provide non-audit services, and the firms consistently refer to the importance of building relationships with clients before a tender situation occurs. These relationships may be built through introductions and periodic meetings between a partner and senior management at a potential client, or it may involve undertaking a number of non-audit engagements. The benefits of this approach are twofold: the first is making the firm, and potentially an audit team, known to the target

[5] [✂]

company and the second is that the firm is able to develop its own knowledge of the client's operations and business risks and use this in a subsequent tender.

19. The Big 4 firms audit companies generally, including FTSE 350, mid-cap and AIM listed companies, large and medium-sized private companies, private equity backed businesses, trusts, funds and charities.[6] Within the other firms, there is a greater emphasis on continuing to develop their presence in AIM and smaller listed companies, but with an intention to target some areas of the FTSE 350.

20. The most common principal strategies for developing a client's awareness of a firm and an appreciation for its service offering are:

(a) provision of non-audit services to develop relationships with key individuals;

(b) regular face-to-face contact with key client staff, regardless of whether any services are provided; and

(c) developing a strong reputation for quality and experience in the sector through work with companies in the same market as the target client.

Developing relevant experience and expertise

21. Historically, being the auditor of a rival company has sometimes been an issue for clients.[7] However, the firms almost all emphasized the importance of having experience in an industry to compete in it. Companies wish their auditor to have sector expertise, which gives them a competitive advantage, as follows:

(a) Technical accounting: the experience of auditing and advising other clients in an industry allows the firm to consider whether a proposed accounting treatment is not only consistent with financial reporting standards but also whether it is consistent with industry conventions.

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[6] Given the scope of the investigation the firms responses focus on the FTSE 350 where they actively target clients.

[7] A clear instance of this was in the USA in 1990 when Arthur Young who audited Pepsico and Ernst & Ernst who audited Coca Cola merged, and were forced to resign as Pepsico's auditor to avoid a potential perceived conflict of interest. www.nytimes.com/1990/02/24/business/ernst-drops-pepsi-for-coke-as-auditor.html.

(b) Auditing: by extension, familiarity with other companies in the same sector will increase the likelihood that an auditor has encountered an accounting treatment, or, for instance, a particular type of financial instrument, and will appreciate the most appropriate, efficient audit approach.

(c) Industry knowledge: a significant element of planning an audit requires understanding the business risks faced by a client, and whether these risks affect audit risk. By starting with a stronger grasp of the operations of similar companies and regulations, the firm is better able to identify motivations for the manipulation of financial statements. Examples of this might be where certain ratios or metrics may be used in the financial or specialist press to compare companies' relative performance.

(d) Added value: as part of its service offering, a firm with sector experience will be able to provide additional insights, either on technical accounting or benchmarking.

Non-audit work as an introduction

22. The need for a prospective auditor to demonstrate sector credentials therefore requires initial entry to a sector either through previous audit or non-audit work. For firms without this audit experience, non-audit work can therefore be used as a way of developing a professional relationship with a company and increasing the likelihood of being invited to tender for audit should the opportunity arise. Such engagements develop personal relationships and the firm's understanding of a company's business, which could then be employed in preparing a formal tender at a later date. Further, when undertaking this work for other companies, the firm develops a more holistic appreciation of a sector which may give rise to the opportunity to provide 'value added; insights to a prospective client.

23. Several firms refer to arranging or attempting to arrange meetings with staff at prospective clients to offer information. However, Mazars noted that it had struggled to gain access to key decision-makers and influencers of companies where they did not have an existing connection, whilst PKF only tendered for one or two FTSE 350 audits each year and did not put substantial resource into attacking the market beyond this.

24. In circumstances where approaches are not responded to, an enhanced programme of sponsorship or thought leadership publications might be used to improve the receptiveness of target company staff to approaches from the firms.

Alertness to opportunities and 'bid readiness'

25. The firms as a whole did not generally receive advance warning of a tender (other than where they were the incumbent), but it appeared that the Big 4 had an increased emphasis in monitoring potential 'trigger points' in a company or acting to promote such an event. These events might be the breakdown in the relationship between management and the company's auditor, or any change in key staff, including particularly where a new FD or ACC is either an alumnus or has had a previous commercial relationship with the firm. Fundamentally, however, capture of this information, through whatever channel, depends on a close ongoing relationship with staff across a client company.

26. None of the firms stated that they made unsolicited approaches to new clients on a frequent basis. Some of the largest four firms indicated that they had used them on occasion but had not been successful in winning audit engagements in their own right. However, these may inform companies of what other firms could provide and at what price. Where a tender exercise has taken place shortly after an unsolicited bid, is not clear whether this bid had this affect.

27. On initiation of a tender, the firms all gather background information on a target company and its operations, environment and risks, but the level of detail and granularity that the firm is able to present again depends on a pre-existing knowledge and appreciation of a company's activities. The sophistication of the mechanisms used when anticipating and subsequently preparing a tender appears anecdotally to vary. For the Big 4, dedicated bid-support teams compile data throughout the year for identified targets, and periodic 'practice' tenders might be carried out internally for the largest clients.[8]

28. Non-Big-4 firms in their submissions appear not to have dedicated central bid support teams. However, BDO does maintain a standing file of intelligence on specific target companies outside a tender process, which the other mid-tier firms do not refer to in their submissions. Non-Big-4 firms do, however, maintain a pipeline of possible clients, with assessments of the likelihood that an engagement would be won, with increasing activity as the prospect of a viable tender opportunity arose.

29. BDO, Deloitte, EY, KPMG and PwC referred to assembling shadow teams and making their presence and potential to service a prospective client known.[9] Such teams are not full audit teams, but rather designated individuals within the firm given the task of building and developing relationships with a specific company, drawing on available firm resources. They exist outside any announced tender process, and allow the firm to advertise to a target company a team of named individuals with specific experience and skills. Accordingly, they are a way for a firm to demonstrate to a company its capability, and may be a way of destabilizing the current incumbent. It is also a strategic competitive tool, developing knowledge and understanding of a company before any tender opportunity arises. It is not clear to us how many shadow

[8] See relevant sections of the appendix on attracting and retaining clients.
[9] See relevant sections on 'attracting and retaining clients' in appendix.

teams a partner or other staff may be associated with, and how many are in place across the firms.

30. Only BDO of non-Big-4 firms referred to the use of standing shadow teams. This may be due to a lack of available staff resource.

Managing customer relationships

31. The firms each operate several strategies for managing client relationships. The most commonly referred to is the use of annual surveys and interviews with clients on the conclusion of an audit. The extent to which these are mandated by the firms may vary (and is affected by the willingness of partners to conduct them). They are generally compulsory for large clients. Some of the Big 4 refer to partners not involved in delivering a given audit undertaking the interviews of key clients or collecting client feedback centrally. Where issues are identified on receipt of the survey or interview, partners must deal with these in the next year's audit approach. In extremes, this may lead to a replacement of members of the audit team. The firms collate these findings and share common trends across their staff and partners.

32. Fee negotiations for each year's audit form a key element of the firms' strategies for retaining clients and one which requires the need to balance the firm's desire to increase revenues and margins and price pressures of clients. Typical negotiations for year-on-year changes in fee will focus on incremental changes in the client's activities, though some clients (particularly larger ones) will demand a full resource breakdown across national and international business units. Strategies for revenue and margins are discussed above in paragraphs 8 to 16. (One key factor dealt with in a fee negotiation is the impact of other firms informing clients what their audit fee might be if appointed, in an attempt to provoke a tender.)

33. Existing clients are also targeted with some of the programmes discussed above in relation to new clients and the overall brand development of the firm discussed below.

Services offered

34. All the firms offer a variety of non-audit services to their clients. All referred to making any decision to sell non-audit services to audit clients based on the APB's ethical standards. The anecdotal examples on the relative proportion of fees generated from non-audit services indicate that the level can vary.[10] Other than some audit-related services, all the firms stated that prices for audit and non-audit services were not negotiated at the same time.

35. The range of services offered varied across the firms. All the firms have an audit/assurance and tax practice and will then have different groupings of service offerings. Whilst EY, KPMG and PwC had largely divested their consultancy arms, these have since been redeveloped by the firms, albeit with a focus on operational consultancy rather than IT implementation (as undertaken by the predecessor consultancy arms). The smaller firms offer a narrower range of services, but do not have any significant gaps in their service lines. Differentiation comes from the breadth of specialist services, such as actuarial services, HR and payroll consulting and property consultancy. Some of the firms have developed niche consulting practices (such as PKF's hotel consultancy).[11] BDO has instituted a programme of developing its non-audit assurance practice, to offer the market a broader range of assurance products to provide direct evidence of the calibre of its staff to non-audit staff.

[10] See also paper on provision of non-audit services.
[11] Paragraph 217.

People

36. The audit partners within the partnership of each firm are largely composed of members who have worked at the firm for the duration of their professional career, and this is particularly the case for the Big 4 firms. There is relatively little movement within the membership of the partnerships beyond retirement and replacement. A small number of partners periodically leave to go into industry or on secondment to other member firms within a network, but there is almost no movement of partners between the firms. Due to their smaller size, the partnership of non-Big-4 firms will have a greater proportion of 'inward transfers' from other firms compared with the Big 4.

37. There is an acknowledgement from the non-Big-4 firms that they cannot compete with the Big 4 with respect to remuneration and to a large extent the possible client portfolio when attracting partners.

38. The data provided by the Big 4 firms indicates little movement of staff and partners from their firms to mid-tier firms. Furthermore, one of these firms ([✂]) said that the partners targeted for recruitment by the mid-tier were those who had achieved a level of seniority, but who were unlikely to progress further in their current firm. The same could also be true for staff, though lifestyle factors might be relevant as well.

39. In an attempt to keep partner remuneration competitive, one firm ([✂]) stated that it had to restrict the growth of its partnership to prevent profit shares shrinking, but as a result believed that this could be a constraining factor on capital if the firm wanted to grow. This would, however, indicate that smaller firms may be unwilling to accept lower remuneration in the short term to try and capture a greater market share.

40. At a more junior level, all the firms offer graduate training schemes, and increasingly more firms are introducing schemes for school leavers. It is not clear if recruiting school leavers instead of graduates is seen as a way of reducing the average cost of staffing an audit. A number of the firms also sponsor students through accredited university courses with accompanying paid summer work placements and a job offer on graduation subject to performance.

41. The overall level of focus on graduate recruitment varies, with the number of universities visited by a firm broadly linked to the size of firm. GT provided some innovative examples of how it undertakes its graduate recruitment, including the use of students who have interned at the firm being paid to recruit actively on campus.

Reputation and brand

42. The firms differ in their views of what activities are considered to develop their brand and reputation and which merely publicize this pre-existing reputation. All, however, engage in marketing through programmes of thought leadership and sponsorship of events and awards. At GT thought leadership is an area of active development.

43. There is some significant differentiation in this marketing activity, with some firms sponsoring national cultural institutions (in part to use the facilities for client entertainment) and in the case of Deloitte, the London 2012 Olympic and Paralympic Games. Whilst all the firms may provide technical briefs circulated to potentially interested recipients across an industry, larger firms are able to attract key client (and target client) stakeholders with additional facilities such the Deloitte Academy,[12] or development programmes for CFOs and other finance staff.

[12] The Deloitte Academy offered guidance to boards and individual directors. Deloitte said that it came about in response to the demands, challenges and increased accountability for those who managed and governed.

44. Some elements of thought leadership, such as technical and industry briefings, may be sent to company staff as a more passive way of developing the firm's reputation with individuals who may have some influence in purchasing professional services.

45. All the firms undertake sponsorship of industry sector events and awards, though again, this varies with the scale of the firm.