The strategies of individual firms

1. This appendix reviews the individual competitive strategies of BDO, Deloitte, EY, GT, KPMG, Mazars, PKF and PwC.

BDO

Summary

2. BDO's intention was to become the leading audit practice in the mid-market, acquiring the largest share of AIM clients and increasing its presence in FTSE companies. BDO had adopted a one-firm strategy in its interaction with clients, developing 'one-firm linkages' between staff in each service line.

3. It considered itself and GT to be the only non-Big-4 firms capable of delivering high quality audit through an international network.

Revenue and margins

4. BDO's strategy for its audit business included increasing revenues from a £[✂] million in FY12 to £[✂] in FY 15 ([✂] per cent increase, CAGR [✂] per cent). This revenue was to be generated through an increased focus on financial services and 'managed clients and targets' and would also see the number of audit partners increase from [✂] to [✂].

5. New revenues would be sought from increasing the firm's share of AIM and LSE listed companies. This revenue growth would also be driven by all partners allocating at least [✂] per cent of their time to 'clients and markets' with the intention of increasing sales of all service lines.

6. BDO targeted margins within the audit practice for improvement through increased efficiencies. However, gross margins would only increase by [✂] percentage points to [✂] per cent by FY15. Efficiency in the firm's audit approach was being driven by technological developments, including the use of an Audit Practice Tool and methodology 'Audit 2010'. The network spent [✂] on developing the new audit software platform.

Pricing

7. Where a client had a manageable level of risk, BDO would set a price commensurate with that risk (subject to what the market would tolerate), but stated that they would not accept a high-risk client in exchange for a risk premium.

8. The firm produced guidance on fees which required partners to begin fee negotiations with an assessment of the cost to the firm and then to amend this based on a number of factors:

   (a) potential to leverage in other service lines;

   (b) whether the client has long-term audit relationships or switches regularly;

   (c) seasonality and resource availability; and

   (d) competitive strategies of other firms including whether key rivals have conflicts of interest.

Attraction and retention of clients

9. BDO designated key clients and targets as 'Managed Clients' and 'Managed Targets' for whom the firm developed client specific strategies. The strategies were developed by a client team which represented each of the firm's service lines. Target companies were identified on the basis of sitting in the firms 'market footprint', that they will generate significant fees or would enhance BDOs 'branded credentials'.

10. BDO believed that the Big 4 had an inherent advantage in the number of their alumni that were in positions of influence with respect of audit engagements and as part of its audit practice strategy was encouraging its partners to develop contacts actively.

11. BDO had developed a client listening programme, surveying its clients. The consolidated findings were then reviewed to assess any issues arising with the firm's client base.

Potential audit clients

12. BDO had targeted potential clients in niche market sectors such as [✂].The ability of BDO to find out about possible tenders before official commencement was dependent on the quality of its existing relationship with a client: if the firm had a good working relationship, it believed it would be aware before official announcement.

Increasing revenue from potential and existing clients

13. The firm had adopted the strategy of identifying 'managed clients' and targeting these for increased sales, with the intention that [✂] per cent of 'managed clients' should buy from three or more of BDO's services. A small number of 'managed target' clients were allocated to partners based on industry expertise and these partners were then responsible for putting together a team from across all service lines an pursuing any opportunities as they arose. For each 'managed target' the partner and their team would meet every [✂] months to discuss developments in the firm's relationship and any issues affecting the client. The effectiveness of the targeting process was assessed over a [✂]-year period. When meeting clients and targets, staff would produce a 'know before you go' briefing that lists the firm's interaction to date.

Services offered

14. BDO differed from the Big 4 by not having a consultancy service line and thus did not offer as broad a range of services to its clients but did provide other service lines including corporate finance and business systems advice. As part of BDO's drive to increase the audit practice's revenue, it was developing new assurance products to offer to the market.

People

Partner remuneration

15. Partners were remunerated in three bands or tranches; the first was a fixed amount, the second corresponded to the number of equity points (and thus the capital the partner has contributed), and the third was based on the individual's performance.[1] The number of equity points that a partner was allocated was dependent on the role the partner undertook.

16. Partners were appraised on a number of criteria, including their generation of revenue. There was, however, no minimum income level and audit partner's performance would not be based on cross-selling of other service lines.

17. Each partner must contribute [✂] per cent of first tranche profits as capital with an additional £[✂] per equity point.

Retention of partners

18. BDO believed that the Big 4 targeted its partners, with the firm losing one partner in the last five years to EY. [✂]. However, because of this, [✂].The firm's partnership agreement included non-compete clauses.

---

[1] The value of an equity point is based on distributable profit less the total value of the first and third bands of profit, divided by the total number of issued equity points.

19. BDO considered itself priced out of targeting Big 4 partners, though it stated that it had recruited three Big 4 partners in the past five years.

Experienced staff

20. BDO stated that as part of its strategy it had recruited a number of staff from the Big 4.

Graduate recruitment

21. The firm recruited both graduates and school leavers, as well as a scheme of summer placements, 90 per cent of which were converted to offers to join the graduate intake. The firm targeted 23 universities and attended 60 events nationally, and worked with careers services to provide skills sessions and presentations to students. Both graduate and school leaver programmes were supported by current trainees of the firm.

Alumni

22. BDO operated an alumni network as a ‘rich source of information and potential business relationships’ and acknowledged the potential of BDO winning work through the recommendation of alumni. The network had only recently been actively developed and the firm now employed a dedicated alumni officer to expand and oversee the network.

Reputation and brand

23. BDO focused its marketing activity on thought leadership and the creation of forums. Advertising was limited, with the firm considering that personal engagement was a more effective business development strategy.

24. Thought leadership publications were assessed to ensure that they demonstrated:

(a) understanding of a client's needs;

(b) the content of the publication is timely and relevant;

(c) that outputs were tailored to clients' preferences; and

(d) that they added value to the client.

25. The firm undertook research on brand awareness every year and noted that awareness of BDO had increased, particularly in London and the South-East. The firm also surveyed financial journalists to gain an appreciation of their views of audit firms.

Competitors

26. BDO in its audit strategy stated that 'there has been a considerable increase in competition in the market', which in part was driven by the Big 4 entering the mid-market. BDO noted that 'the mid tier firms all suffer from a lack of consistent quality within both their domestic and international audit practices. There is not the investment in knowledge or the strength in depth seen in the Big 4'. However, BDO considered that it was able to compete with its own strong central technical accounting team. BDO considered that GT was the only other non Big 4 firm which did not suffer from a lack of consistency in audit quality both in the UK and internationally.

27. BDO noted that the Big 4 are active participants in almost all tenders including non-FTSE 350 companies. In the current financial year BDO's records indicated that in only 7 per cent of its tenders was BDO told that no Big 4 firm participating in the tender, with the caveat that for almost half of this figure, BDO was not told the names of the other participants either.

Deloitte

Summary

28. Deloitte's strategy was to become 'the distinctive firm' with 'superior market and economic performance' and 'contributing to a sustainable and prosperous society'. Deloitte's audit strategy was to be the 'market leader in quality, innovation and efficiency of the core audit product'. [✂] in the market.

29. The firm had a broad range of strategies to attract and retain clients.

Revenue and margins

30. Deloitte considered that its ability to generate revenue was based on a number of factors:

    (a) macroeconomic conditions;

    (b) regulation—any change in the threshold for statutory audit, or on scope and responsibilities;

    (c) quality of people—determines the level of business won and retained, and the quality of the product/service;

    (d) network—strength and reputation; and

    (e) innovation.

31. The firm considered the following to be determinants of its cost base:

    (a) market conditions for talent;

    (b) grade mix—the balance of different skilled staff; and

    (c) innovation and technology—improvements in methodology were intended to enhance the quality of an audit, in part through simplifying required procedures, supported by appropriate technology and potentially off-shoring.

32. FTSE 350 audit clients made up 2 per cent of Deloitte's total client base by number. FTSE 350 audit clients generated 21 per cent of audit revenues. However, the gross margin achieved on FTSE 350 and non-FTSE-350 clients did not differ significantly, so their importance to the firm was primarily the scale of the revenue generated.

The service line's objective with respect to the quality was to deliver the highest quality in the most efficient way

Pricing

33. The profitability of audits did not include a risk premium. High risk clients were allocated a 'National Risk Partner' and would most likely be resourced with a more experienced team, who would undertake more work, which may lead to a higher price, but only to represent the increased resource cost.

34. The gross scale rate for FTSE 350 and Top Track 100 statutory audit and related services in FY11 was [✂] per hour, with a Revenue Recovery Rate (RRR) of [✂] per cent, generating a net rate of [✂].Within audit, there had been an [✂] percentage point decrease in RRR between FY06 and FY11, indicating increasing price pressure in setting fees. Across the whole firm this decline had not been as severe, with a [✂] percentage point reduction in RRR to [✂] per cent. However, a low RRR did not necessarily indicate a low net margin, merely that the market would not support the gross rate.[2]

35. In setting the firm's fee negotiation position, the firm approached the fee from several different perspectives. The firm would first look at a number of ratios comparing the size of the audit fee relative to a number of financial and non-financial metrics to establish if a proposed fee seemed realistic or acceptable to a client and consistent with other firms in the client's industry.

---

[2] It is not fully clear how the gross rate is determined, but is adjusted each year for inflation.

Prospective clients

36. The firm would also undertake a budget for the expected resource requirement for each element of the audit, and calculate a ‘gross’ charge based on fee rates. For international audits, other member firms would be consulted for their opinions on the number of hours budgeted for the respective international subsidiaries.

Existing clients

37. For existing clients and where there was no formal tender process, the previous year’s fees were revised by Deloitte on the basis of changes in scope and scale (which would be costed for the marginal resources required or released), inflation and whether a previously proposed fee covered the firm’s costs appropriately. A reconciliation of the year-on-year changes in the audit might also be presented to the client to establish that the fee was linked to audit work.

Existing and prospective clients

38. Issues that affected the scope or scale of the audit compared to the previous audit cycle would be considered in relation to the previous year’s audit fee (regardless of whether Deloitte was the incumbent auditor). The firm might make allowance in the desired fee if the timing of the audit work did not fall within a peak period, which led to an improvement in utilisation rates of staff. Finally, consideration of the expected market price would be made.

39. Fee negotiations were supported by a breakdown of the resources and associated costs incurred in the delivery of the audit by each of the client’s business units and subsidiaries produced.

40. Non-audit service fees were not negotiated at the same time as audit fees.

41. Deloitte noted that the negotiation process is at least two-step, with likely downward negotiation of the proposed fee both by the Finance Director or CFO and once agreement has been reached with management, a second challenge would come from the audit committee. Deloitte estimated that one in five of its clients had raised the prospect of going out to tender during fee negotiations over the course of the past six years.

42. Deloitte was aware of at least four clients in the FTSE 350 in the past six years which had required Deloitte as incumbent auditor to 're-tender' for the audit engagement, to decide whether to launch a full re-tender exercise.

Attraction and retention of clients

43. In the mid-2000s Deloitte created a dedicated 'bid-support team' and placed a 'premium on partner reward' for audit partners who won FTSE 350 audits, and ensured that partners were not fully allocated to client duties in order to allow flexibility to be available for tenders. Deloitte's strategies appeared to have been successful and the firm stated that in the past decade it has won more FTSE 350 audit clients than any other firm, notwithstanding the Andersen transaction.

44. Deloitte referred to two elements that form the basis for its strategy of pursuing new clients:

    (a) a governance structure for targeting and account development; and

    (b) tools to support teams to undertake the targeting.

Governance structures

45. For FTSE clients Deloitte had recently introduced the 'FTSE 100 portfolio management' programme to assist in managing the firm's portfolio of clients and services. For FTSE 100 clients, it was the firm's Executive, following discussion with

the relevant client, that decided whether to bid for audit engagements and other significant pieces of work and also how to respond to a potential change in the nature of the client relationship (such as a switch from a non-audit to audit role or vice versa) and manage regulatory requirements. The Executive were also responsible for ensuring that revenue was generated in a manner consistent with the firm's overall strategy for growth and service mix.

46. Outside of the FTSE 100, client relationships were overseen by a number of structures, including, for example, the relevant industry group, with day to day supervision from the Lead Client Service Partner (LCSP). The LCSP acts as a focal point for the firm across all service lines and was responsible for achieving increases in revenue from its service offering. In respect of any audit client, the audit partner was not responsible for increasing (nor incentivized to increase) non-audit revenues.

47. Deloitte had identified ten industry groups on which it intended to focus, and for each Deloitte had identified a number of specific objectives, both in the UK and in its overseas operations.[3]

Tools

48. The supporting tools used by Deloitte included a number of services which were provided to existing or target clients, which are intended to build brand awareness and goodwill towards Deloitte, and to contribute to best business practices and governance. Some of the initiatives that Deloitte offered include:

(a) invitation to Board members of listed companies to receive membership of the Deloitte Academy;

(b) financial Controllers' Club, which provides seminars for financial controllers; and

[3] Deloitte owns the Deloitte Swiss member firm and has a corporate finance and consulting joint venture with the Middle East member firm and an investment in the CIS firm.

(c) the next generation CFO programme.

49. Deloitte's designation of clients into industry groups had been to encourage specialization of staff. By developing client and industry knowledge, Deloitte's staff were able to apply industry knowledge to their clients and add value through services such as peer benchmarking. This strategy had been further embedded in its remuneration structure with one-third of its partners appraised (and remunerated) on the basis of 'market dimension', with specific objectives for interacting with their industry group. Despite this, the audit service line retains responsibility for assessment of audit quality which is a fundamental requirement for all audit partners.

50. If Deloitte identified that it did not have a client base or experience of a specific sector, it would target companies in the sector that it might provide non-audit services to, to develop corporate understanding and a working relationship with the client. The firm would also consider using the knowledge from other international member firms with experience in that sector. The firm might also consider recruiting specialist partners either from the market or possibly other Deloitte member firms, though these would not necessarily be working as statutory auditors. Deloitte's financial services practice is an example of this, having recruited senior figures in the banking industry, the FSA and partners from other member firms.

51. Deloitte would not expect to use an unsolicited tender, but its attempts to build relationships with potential clients were always with the ultimate hope of winning business through developing an increased awareness of Deloitte's service offering (which may in turn lead to a tender opportunity). Deloitte stated that it has records of attempting an unsolicited bid on two occasions in the past ten years in the FTSE 350, one for [✂] and one for [✂]. Both bids were unsuccessful.

52. Once Deloitte was notified of a tender opportunity, it stated that it would focus on a number of specific strategies:

(a) focus resources on preparing for meetings (40 per cent) and presentations (40 per cent) to decision-makers rather than preparing the tender document (20 per cent), which is referred to as '40:20:40';

(b) building an understanding of the target business and linking that into the proposed offering, tailoring content to the client's needs;

(c) demonstrating energy and enthusiasm to the client;

(d) identifying a suitable engagement team and matching staff with the client's style of working; and

(e) identifying strong audit managers to support the Partners and Directors.

53. When Deloitte surveyed its staff, of the 71 responses received, 43 (61 per cent) stated that they had no prior knowledge that a tender would occur before they received official notification. Of those who were aware, advanced notification was more likely where the firm was the incumbent auditor, or where the firm provided non-audit services, particularly with the finance department. No information on the amount of time in advance that Deloitte was aware of a prospective tender was provided.

54. In its submission, Deloitte identified 57 FTSE 100 companies and 60 FTSE 250 companies where it believed it was potentially conflicted on the basis of its or other Deloitte member firms' business relationships. However, in practice if it was perceived to be desirable (following discussion with the client) for Deloitte to pursue appointment as statutory auditor some of these conflicts could be avoided by ceasing to provide other services either immediately or in the medium term. APB Ethical Standard 5 allowed transition relief to an incoming auditor, so that the list of conflicts would potentially be shorter.

55. As part of its strategy refresh in 2011, Deloitte undertook a series of meetings between senior partners and ‘top executives’ of 20 ‘large’ and 8 ‘mid market’ clients (as well as a broader programme of client interviews) to appreciate better what clients sought from a professional services provider. The firm also undertook Client Service Assessments each year, and the results of these had fed into short guidance documents for Partners on clients’ expectations. This document also fed into the development of the firms’ strategy.

56. Client Service Assessments were undertaken with key clients to evaluate the firm’s performance. In 2011, surveys from 179 individuals were completed, of which 96 per cent indicated that their satisfaction with Deloitte was ‘Good’ or better. The firm would also periodically run a ‘defend’ programme, where audit partners were requested to review their relationships for a risk of tender and where issues were flagged, the partner responsible was asked to address the issues immediately.

Services offered

57. Deloitte was unique within the Big 4 of not selling its consulting arm in the early 2000s, although did explore this as a result of the increased sensitivity around the provision of non-audit services to audit clients. Deloitte had in the past decade made a number of acquisitions to develop further its range of services such as Burlington (Commercial due diligence) and Drivers Jonas (property consulting). However, in recent years the other Big 4 firms have rebuilt their consulting practices leading to a decline in market share.

58. Deloitte considered that the breadth of its service offering enhanced its audits by having the ability to resource audits with a much broader range of specialists to provide assurance on certain balances in a client’s financial statements.

59. Within audit-related services, Deloitte's offering included:

(a) interim reviews and quarterly reports;

(b) bank covenant compliance work;

(c) accounting advice;

(d) assistance with Financial Reporting Review Panel enquiry letters;

(e) other work for compliance with securities regulations or other non statutory audits; and

(f) independent assurance reports on non-financial performance.

60. Deloitte noted that interim reviews were in practice always carried out by the statutory auditor. Deloitte stated that around 10 per cent of FTSE 350 companies did not include an auditor's review with their interim results. Deloitte did not record revenue from audit-related services separately from the statutory audit in its financial system so were unable to provide a firm-wide analysis.

61. In response to client requests the firm also offered a broad range of permissible non-audit services to its audit clients, and considered that as an auditor it was best placed to undertake audit related services and provide a broad range of covenant compliance work, accounting advice, responding to FRRP letters. Deloitte noted that it was a client's audit committee that would decide what non-audit services an auditor can offer to its clients.

People

Graduates

62. Deloitte's graduate recruitment programme targeted 35 universities each year. In addition Deloitte offered internships and an industrial placement programme. Deloitte was ranked number 2 in the Times Top 100 graduate employer of choice survey.

63. Deloitte also operated a number of schemes for recruiting junior staff, including one to employ school leavers post A-Levels which included studying for an accounting qualification; a gap year programme that included eight months of paid work during the gap year, summer placements during university and an accelerated entry on to the graduate programme upon graduation.

64. [✂].

65. Junior staff had not previously received a bonus as an element of their remuneration (although they had received other awards), though this would be changing from September 2012.

Remuneration—partners

66. Deloitte had one class of equity partner, though individuals were assigned to one of four ‘equity groups’ based on their role. Within each group, partners would be allocated to a ‘band’, each of which was allocated a number of ‘profit sharing units’. Each equity partner pays £[✂] per allocated profit unit as a contribution to financing the firm The amount contributed is repaid on retirement from the firm.

67. Partners share profits based on each individual’s contribution and capability. Partners were not universally remunerated on the basis of generated income, but this might form part of their individual objectives. Deloitte’s audit service line specifically included a premium on partner reward for success in winning audit bids for FTSE 350 clients. Quality is a key criteria for assessment, where ‘a spotless performance will be expected from all partners’.

68. Deloitte also employed non-equity partners, who were not ‘members’ of Deloitte LLP and did not receive a profit share. Non-equity partners (as with other staff members)

received a performance related bonus that was linked into the firm's overall performance.

69. In the past five years, Deloitte were not aware of any statutory audit partners leaving to join another Big 4 firm. Deloitte identified one audit partner joining another (non-Big 4) firm. In contrast, over the same period, 20 audit partners left the firm to work outside of the professional services profession and 28 retired. Deloitte considered the 'experience of being a partner' to be sufficient incentive to remain with the firm. Deloitte perceived there to be a greater level of movement below partner level, with the majority of staff moving into industry.

70. Deloitte stated that external partner recruitment into the statutory audit business was at a 'very low level' and was at a rate of 'one or two per year'. In the last five years Deloitte had recruited one partner from PwC, specifically for his technical experience and to provide input into insurance client teams, but he did not lead any FTSE 350 audits himself. Deloitte had also recruited two PwC Directors into its partnership. Deloitte had recruited one partner from BDO, in Belfast to replace a retiring partner, who left Deloitte after two years. Of the 64 partners who had lead FTSE 350 audits, 63 were promoted to partner from within Deloitte or Andersen (or predecessor firms).

Alumni

71. Deloitte had 22,000 former members of staff in its alumni network, of which 9,000 previously worked in the audit service line. Most of these will have left the firm at a relatively junior level (eg after completing the three-year training contract). Deloitte uses the alumni programme to remain in contact with its previous employees. In some cases, alumni relationships develop into business relationships. However, Deloitte noted there were numerous examples where the presence of an alumnus in a senior position did not lead to Deloitte's appointment as auditor.

Reputation and brand

72. Deloitte UK intended to spend [✂] in FY12 on its brand which includes London 2012, 'Brand', 'Innovation' and Corporate Responsibility, of which [✂] relates to staff and office costs. Deloitte stated this expenditure was less than [✂] per cent of its revenue. Deloitte believed that its range of sponsorship was distinct from the other firms, and placed it closer to 'leading corporate'. Deloitte's sponsorships were each made with the intention of specific business objectives. Deloitte expected to spend a further £[✂] on marketing in FY12, of which half was non-staff costs.

73. The firm was appointed as official professional services provider for the 2012 Olympic and Paralympic Games, and as a requirement of this 'sponsorship', the firm committed to the provision of £[✂] of staff time over five years.

74. As part of its strategy to develop relationships with existing and target customers, Deloitte undertook a number of initiatives including:

(a) 'service line specific marketing collateral' which included technical briefings;

(b) thought leadership; and

(c) quarterly surveys of UK CFOs on issues around finance and capital.

Competitors

75. Deloitte did not have a dedicated team or work stream monitoring its competitors. However, the firm did consider the activities of competitors when designing its strategy (though it was keen to state that it was not a reactive document to competitors). On the completion of a competitive tender process, the firm undertook a debrief exercise, which captured what the client wanted and what different competitors were offering in the context of the winning bid. Deloitte would seek feedback on both successful and unsuccessful bids.

76. In its market analysis for its 2011 strategy refresh, Deloitte identified its principal competitors. In considering the larger mid-tier firms (ie GT and BDO), it noted that the firms had a similar geographic reach to the Big 4 but with a smaller scale.

77. [✂]

78. [✂]

79. [✂]

80. Deloitte perceived Mid-Tier firms only to be potentially significant rivals in the mid-sized and regional markets and required significant international growth before they can challenge for large international clients.

EY

Summary

81. EY had the most distinct operating model of the Big 4, with the UK firm part of an 'integrated global organization'. As part of the arrangements in the EY network, EY UK became part of a single operating unit, the EMEIA Area; and restructured its business into two distinct business units.

82. The EY global strategy is to build:

(a) 'A reputation for quality people, service quality and profession';

(b) 'A brand that attracts the best people and clients';

(c) 'The right relationships with all our stakeholders, including clients, regulators, investors, academics, media and communities, and our people'; and

(d) 'The leading share in our priority market segments'.

83. As noted, EY UK was managed as two business units that were integrated into the EMEIA area. Financial services were managed through the Financial Services Office, which formed part of a pan-European Financial Services Office with the remainder of the UK firm acting with the Republic of Ireland member to form a UK&I business unit. The two UK business units operated across all service lines and each had their own managing partner. The operation as European business units was intended to lead to senior staff and partners taking a broader appreciation of a service line or industry across EMEIA.

84. In the UK, EY had the smallest revenues of the Big 4. Submissions from some of the other Big 4 firms demonstrated a perception that the US firm had increased its own influence over the UK firm. However, EY states that this perception is incorrect

Revenue and margins

85. [✂]

86. EY's network had a long-term project to improve the efficiency of its audit methodology to identify a 'sufficient productivity gain' to offset cost and fee pressures.

Pricing

87. [✂]

88. [✂]

Attracting and retaining clients

89. [✂]

90. EY considered that by adopting its integrated global structure that it was better able to appeal to large international clients and that industry specialization was increasingly important for clients to allow benchmarking. However, EY did not target specific sectors for identifying prospective targets.

Existing clients

91. Each year the firm undertook an Assessment of Service Quality (ASQ) with its clients, the results of which were discussed at audit committee. The ASQ included a short online survey followed up with a meeting with a senior member of the firm who had not been involved with the audit. [✂].

New clients

92. [✂]

93. [✂]

94. EY did not prepare unsolicited audit tenders though it approached firms to develop relationships and explain EY's service offering.

95. [✂]

New and existing clients

96. [✂]

97. [✂]

98. Once a tender process had completed, EY would request feedback sessions directly with the Audit Committee Chair and the Finance Director if the firm was not successful.

Services offered

99. EY provided a variety of audit-related services, and considered that those which were required for compliance with a regulator (such as reviews of interim financial statements, reports on assets and grant certification) were realistically only able to be done by the statutory auditor. In a sample of ten clients, the proportion of fees received relating to audit related services ranged from [✂] per cent to [✂] per cent. With respect of non-audit services, EY considered as an auditor it was best placed to provide any services requiring an appreciation of the controls and processes of a client and where work may be undertaken in parallel to statutory audit work.

100. Since 2006, EY had restarted the provision of advisory services, following the disposal of most of its previous advisory business to Cap Gemini in 2000. [✂].

101. EY did not perform any pro bono work for its clients or any prospective clients.

People

102. There was one class of equity partner at EY, as well as a ‘small number’ of salaried, Associate Partners. In 2011 [✂].

103. All partners set agreed objectives with their counsellor and line manager and were assessed against them. As part of the annual performance review, the partners were [✂].

104. [✂].

105. EY's graduate recruitment programme covered 30 universities, with the firm recruiting 330 graduates. The firm also ran an internship scheme, with the firm making employment offers to 90 per cent of interns. The firm also operated a programme for school leavers.

Alumni relations

106. EY operated an Alumni programme, but did not state the extent, nature or strategic purpose of its operation.

Reputation and brand

107. EY sponsored a number of events and publications such as the ITEM Club, the CBI national conference as well as temporary gallery exhibitions.

108. EY undertook advertising to 'support a specific marketing programme or theme'. The range of EY's thought leadership was delivered through private briefings, CFO and Financial Controller forums, workshops, access to Ernst & Young online and publications.

109. [✂].

Competitors

110. [✂].

GT

Summary

111. GT's competitive strategy for the FTSE 100 and parts of the FTSE 350 could be summarized as being based upon building 'awareness, relationships and credibility through non audit services and then leverage into the audit market' in the medium to

long term. GT actively identified potential clients with whom it sought to develop relationships and also those companies which it did not believe that it had the sector expertise to audit in the short term (so as to focus its resources strategically).

112. GT's intention is improve its institutional acceptance and by FY16 to have sustainable relationships with [✂] per cent of the FTSE, and [✂] its presence in the FTSE 350 (and very large private company) market, [✂]. This strategy is based on increasing its non-audit offering and developing long-term relationships with a smaller number of companies, but with a larger level of revenue, [✂].

113. GT also targeted large companies that have a large number of subsidiaries where bundles of those subsidiaries might be audited by a different auditor to the group audit (shared audit), in order to display international coverage.

Revenue and margins

114. In its 'Growing as one firm' strategy, GT intended by 2015 to have increased firm revenue by £157 million (46 per cent) with audit revenue increasing by £34 million. £95 million of this growth would be from private and small listed companies, with revenues from large listed clients increasing by £39 million (205 per cent) to £58 million.

115. The strategy also targeted improving the gross margins of the firm from 44 per cent in 2010/11 to 48 per cent in 2014/15. GT disclosed the composition of the planned improvement in margin but not their actions intended to achieve this.

116. GT's 2008 to 2012 Assurance Strategy identified that gross margins across different offices varied by up to [✂] percentage points. In an attempt to improve margins, audit engagement costs were targeted to be reduced by [✂] per cent for all

engagements and for there to be an improvement in the balance of senior staff on audits through an improved 'Director/Partner Leverage Model'. Whilst GT had a ratio of 1 Director for every four Partners, it was noted that the Big 4 have a ratio closer to 1:1.

Pricing

117. GT in its MFQ response stated that it priced audit fees based on a number of factors relating to the client including:

(a) the risks of the audit including the ability of the client to continue to be a going concern, the complexity of accounting and reporting requirements and its profile;

(b) market rate, the current fee, fees charged to similar businesses or that proposed by a competitor;

(c) the quality of the service provided and the level of current client satisfaction;

(d) the importance of the client in terms of brand association, profile raising or sector focus;

(e) how secure the relationship is and any recent changes in decision makers;

(f) the ability to re-engineer the audit approach and propose an innovative solution;

(g) the length of tenure; and

(h) the likelihood of the client growing.

118. GT gave no information on example pricing decisions in the MFQ.

Attraction and retention of clients

Potential audit clients

119. For large company audit (FTSE 350 and large private), GT identified the sectors in which it thought it could actively compete, which is where it considered to be where it has credible sector expertise. GT attempted to develop relationships with target clients through sector teams undertaking research on issues faced by the target

company, arranging client meetings with appropriate service line representatives and providing advice with subsequent follow up actions. The firm monitored the level of target client interaction.

120. GT did not make unsolicited approaches to companies with respect of performing statutory audit, unless there is a formal tender process.

121. As a medium- to long-term strategy, GT was ‘promoting shared audits’ to gain more large company audit experience. GT had identified companies with more than 500 subsidiaries with total audit fees of £10 million or more. GT was not, however, applying this strategy to banks and financial services companies, due to the scale of highly specialized knowledge required. It was not clear to what extent this strategy had been actively pursued to date.

Increasing revenue from potential and existing clients

122. GT targeted sales to individual clients through a number of standardized documents. Internal strategy was driven by ‘Account plans’ which GT prepared for both new and existing clients. Each client/target had an owner and an identified service team with named individuals. The Account plan included existing fees by service line and an identification of potential recurring and non-recurring fees available, as well as the value of other non-audit services provided by other firms. A SWOT analysis was performed on the both the client/target and the firm’s relationship with the client. A series of actions were also identified, such as invitations to functions. However, the level of detail of the two account plans submitted by GT differed. GT state that it has firm guidelines in place to ensure that it complied with Ethics Standards in regard to provision of non-audit services to entities that it audits.

123. Other internal documents submitted included an example Business Development Strategy, which included action points, such as inviting client staff to ‘Masterclass’ events, where topical business issues are debated, focused meetings on matters such as governance in the FTSE 350, and meetings with senior staff which provided advance warning of a potential audit tender opportunity.

124. GT also produced a ‘Pipeline measurement report’ that captured the number of identified target clients, the potential recurring and non-recurring expenditure, as well as monitoring the number of incidences of contact between GT and the target companies over time. In the three months to January 2012, GT staff met with 15 per cent of its active target clients, with 240 meetings with targets held in January 2012 alone.

125. Externally, agendas for meetings with clients to discuss the business issued they are facing and consider ways in which GT could help were produced in the style of a prospectus with customized content for that client whilst including brand information such as GT’s ‘Global Highlights’ and a list of large corporate clients. Other external facing documents included presentations that emphasized the relationship GT had developed with the client over a number of years with specific examples of what different team members have contributed across the various service lines.

126. GT’s strategy in ‘national markets’ includes winning a ‘portfolio of flagship clients’, whilst also identifying the need to keep a strong presence in regional markets. With its existing clients, GT’s strategy was to ‘focus on clients’ issues and future plans rather than pushing service lines’, so that only relevant services were offered to clients.

127. GT identified the greatest risk to retaining an audit client was where there is a change in the decision makers for audit services, and particularly where the new decision maker had no experience with GT. Further, GT believed that when a company was acquired by private equity or a sovereign wealth fund, there was a greater inclination to appoint a Big 4 auditor. GT's principal strategy against this was to maintain regular client contact to strengthen the relationship.

Services offered

128. GT offered a variety of services to its audit and non-audit clients. Its strategy was to 'integrate ... services across service-lines to meet company-specific needs', essentially presenting GT as one firm, rather than a number of individual service line silos and as noted in paragraph 126, GT was attempting to move towards a company driven approach in targeting further sales. Where a service is provided to an audited entity this is always done in accordance with the firm's independence policies and the Ethics Standards.

129. GT had some large non-audit clients and it had identified, expanding non-audit as a way of obtaining ad hoc high-margin work that interests staff, and increased the firm's profile.

People

Graduates

130. GT invested in its graduate recruitment campaign, winning the RAD 'Best Graduate Campaign 2011'. GT targeted most of its budget on what it identified as 'tier one' universities ([✂]) with a lower presence at other universities. GT sent current graduate trainees who are alumni of tier one universities to various recruitment events. The firm also paid final year university students to work as brand

ambassadors and receive a performance related bonus based on the number of applicants from that university.

131. GT monitored statistics on recruitment from all universities to establish the effect of different approaches on application rates. GT also sponsored a number of university societies at non-‘tier one’ universities to ‘build the brand with students who are not necessarily interested in a career in accountancy’.

Experienced staff

132. The firm actively recruited staff to join its advisory team, targeting employees from other firms and in industry who had current experience of working with large companies to establish an experience base.

Alumni relations

133. Former partners received an alumni magazine twice a year. GT held a number of annual alumni events centred on its regional offices to maintain contact with alumni.

Remuneration—partners

134. As of 1 July 2010 GT had one class of equity partner, referred to as ‘full share’ partners. Their entitlement to share in the firm’s profit was determined by their allocation of ‘units’ (which across the firm account for 75 per cent of distributable profit), with additional profit determined by performance based allocations from National Discretionary Award Pool (the remaining 25 per cent of distributable profit).

135. Partners must contribute either £225,000 or £250,000 dependent on the number of ‘units’ allocated. Interest on partner capital contributions is paid at Bank of England Base Rate plus 5 per cent.

Remuneration—staff

136. GT's Assurance strategy was to 'attract and retain quality people', though no detail was given on how this approach has specifically been implemented. Average hourly cost by grade was:

TABLE 1 **GT average hourly employment cost**

	Average hourly employment cost 2011/12 £
Partner	101.27
Director	70.36
Manager	33.69
Senior	30.29
Assistant	15.85
Associate	17.75

Source: GT

Reputation and brand

137. GT identified developing *thought leadership* as a theme of its assurance strategy to win clients, as it considered this work to be a 'hallmark of a leading professional services firm'. GT used market intelligence to identify target sectors. GT's commentary on the Budget was provided as an example of GT obtaining significant national press coverage.

138. GT monitored client satisfaction surveys, media feedback and brand awareness to establish if its strategies had any impact on the awareness and receptiveness of the market to its services. This monitoring of the market indicated that between 2008 and 2010 the number of purchasers of accounting services for large companies that were aware of GT, had increased 19 percentage points to 41 per cent of respondents. Similarly, the proportion of GT clients that stated that they would recommend GT had increased 16 percentage points to 90 per cent in the period 2008 to 2011.

139. Active development of the GT brand had been focused through the identification of specific sectors to specialize in, which GT can then leverage from in its marketing and further developing the firm's experience in those sectors. GT appointed eight National Sector Leaders who acted as the firm's 'voice and face' in eight sectors, with the intention of developing an identifiable profile in that sector. GT noted that it was aware of the FRC's findings that mid-tier firms did not demonstrate strong sector expertise and is acting to challenge this.

140. Other brand awareness activities included the sponsoring a number of publications, awards and events, such as the Top Track 250 league table and 'Mid-Cap business of the year' award and in 2012 GT was embarking on a national advertising campaign, which it had not previously done to the same degree.

Competitors

141. GT provided an analysis of its direct competitors, identifying also competitors which it considers 'significant' in a number of segments. GT considered Deloitte, KPMG and PwC to be its significant primary competitors for listed companies and non-audit work. The only area where EY was seen to be a significant competitor was in large private companies. GT identified Baker Tilly, BDO and PKF as significant competitors in 'other entities' but did not consider Mazars to be a primary competitor in any segment.

142. GT believed that the Big 4 aggressively targeted smaller clients during downturns to secure work at marginal cost, before increasing fees again, with a lag before small firms switched back to the Mid Tier. GT's response to the Big 4 had been to:

(a) emphasize the comparable audit quality;

(b) highlight GT's experience in sectors;

(c) promote GT's shorter decision chains;

(d) recruit experienced professionals in its advisory service to develop connections with large companies; and

(e) use advisory work (126 FTSE 350 clients) to develop sustainable relationships with SMTs.

Target

143. By FY2016, absent any regulatory intervention, GT's aim was to halve the number of FTSE 350 advisory clients, but triple the average fee (currently [✂]). In the audit service, its target is to double FTSE 350 audit clients and fees.

KPMG

Summary

144. KPMG presented itself as a firm whose success was dependent on its reputation and ability to add value to its clients. Furthermore, the firm identified five strategic imperatives (clients, expertise, organization, partners and people, and its communities) which it considered made it ELLP 'the best firm to work with'.

145. The strategy of the UK Audit function was to 'build and sustain our reputation as the best firm to work with by providing high quality and insightful assurance to our clients and constituencies with forward-thinking professionals. In the UK our ambition is to have an innovative, dynamic and value enhancing Assurance Practice'. The UK Audit Function had objectives relating to quality, market ambition, broadening its service portfolio, improving its core product (audit) and people.

Revenue and margins

146. KPMG believed that its margins had had increased pressure, from both clients demanding more from their auditor, or at a lower price, and also from an increased level of work to satisfy professional requirements, such as assessing the viability of

audit clients as going concerns. KPMG thought that the level of work that needed to be undertaken to complete an audit was heavily prescribed by auditing standards with the extent of testing determined by the scale and activities of the client.[4]

147. KPMG had aimed to improve the cost efficiency of audit work. Whilst cost efficiency was not the primary objective of KPMG's eAudit software, the introduction of this had allowed the parcelling of work streams to allow different teams to work in parallel, increased standardization of the nature and level of testing, and the degree of automation over certain tasks. Another initiative had been to take advantage of the ability to parcel up work streams to allow the use of the KPMG Global Services and Resource Centres, part of the benefit of which is to allow work to be conducted at a lower cost per hour. These are discussed further in the international network paper.

148. KPMG observe margins by analysing changes in audit fee levels. [✂].

149. One element of margins that had been identified by KPMG as a risk was the 'increasing demands of our Regulators', noting that 'more potential client chargeable time is being spent liaising with and managing the Regulators'.

Pricing

150. KPMG's audit pricing was 'client specific', with a need to remain competitive with the caveat that this client specific focus needed to provide 'enough return to justify the employment of high quality but 'nevertheless reflect the price challenges that existing and potential audit clients pursue in addressing their own cost pressures, particularly in response to the difficult economic environment which has prevailed in recent years and continues to prevail'. Pricing was driven in the first instance through a budgeting process of identifying the expected number of hours by grade, multiplied by their

[4] Specific audit responses to significant risks are driven by the nature of the client but are required under ISAs.

respective scale rate. KPMG then compared the ‘gross cost’ to the figure it is believed would be the market rate, to calculate a recovery rate and also the recovery per hour of the engagement. This hourly rate was compared with the firm’s benchmark, discussed below. However, when tendering for a new audit, there might not be sufficient information to enable a detailed assessment of costs and therefore estimates of resourcing would be more focused on comparative benchmarks for similar businesses.

151. The nature of pricing and fee negotiations varied by clients, with some clients accepting a standard uplift, or freeze, others negotiated on the previous year’s fee amended by changes in scope, with others demanding a full zero-based approach for all components and locations.[5] For large international clients, the fee negotiation could ‘take weeks or even months to conduct’.

152. Pricing for significant clients would be discussed with pricing panels or other internal soundings between the engagement partner and the firm’s management to ensure appropriateness of pricing in individual fee negotiations and sharing of best practice.

153. As with the other large firms, KPMG had a substantial peak in demand for audit staff in [✂] to service the needs of clients whose accounting period matched the calendar year. As a result, utilization rates of staff were higher during peak periods. To maintain utilization rates, some pricing decisions would be based on the need to sell staff time and thus work may be priced closer to marginal cost during off-peak periods. KPMG’s benchmark of revenue generated per hour of staff time was [✂].Depending on the level of work coming into the firm, it might decide not to undertake work if it perceived that there would be an opportunity cost of employing resources on a less profitable assignment.

---

[5] A zero-based approach would be a calculation of necessary resources without reference to previous years’ engagements.

154. For KPMG, the level of risk attributed to a client affected price but only with respect of the increased level of work needed to mitigate that risk, rather than charging a specific risk/reward premium.

155. A change in pricing model in the industry is monitored as a Board level risk because of the pressure on quality and potential loss of clients.

Attracting and retaining clients

156. KPMG stated that the 'key drivers to ensure client retention are maintaining and ensuring client satisfaction levels through innovative and proactive client service. This involves the delivery of high quality audits in an efficient manner and to deliver insights and value adding ideas as a by product from the audit'.

157. The critical success factors that KPMG identified for its audit business included high staff quality, specialist expertise, its network, efficient and standardized approaches, the strength of its 'bench', extensive experience, knowledge and understanding of a client's business, appropriate working relationship with the client at all levels of seniority, strong quality assurance processes. Here KPMG identified that it was able to replace any individual on an audit with an equally skilled person within a short timeframe.

158. KPMG believed there were no clients that it could not audit and, whilst there were some clients where non-audit work was currently being undertaken by KPMG which was not compatible with the role of the auditor, it did not believe that it would be conflicted from undertaking the audit given a reasonably short period of notice. However, certain business relationships, for example in terms of its banking and finance providers ([✂]), could be more difficult to resolve in the short term.

159. KPMG thought that the key to retention of client was through maintaining and improving client satisfaction levels by offering ‘innovative and proactive client service’. KPMG suggested that during fee negotiations clients might threaten to switch audit firm or tender the audit, but did not necessarily go through with this. In a number of instances, KPMG reduced their fee to avoid this risk. In some instances, price had been driven by the intervention of prospective tenders from rivals, forcing price down, such as in the example of [✂].

160. The identification and targeting of new clients was driven at several levels. KPMG International identified a number of very large international companies for member firms to target through ‘agitation targeting’ where partners actively approach targets to encourage companies to consider revising their audit arrangements whilst promoting KPMG’s service offering.

161. KPMG Europe LLP, the UK firm’s parent also operated the ‘Top Tier programme’ that identifies additional potential targets, which may be approached with either targeted campaigns or long-term positioning.

162. Each business unit also operated a ‘top [✂] programme’ of large listed or mid-market clients that were monitored. Within the firm, internal strategy was to remind partners (and staff) of the ‘need to actively pursue business development opportunities’.

163. However, whilst the firm may adopt a proactive approach to courting clients, a full unsolicited tender was relatively unlikely:

> On occasion, when we do have sufficient information and relationships with a company to suggest a meaningful alternative audit approach, we may provide an informal and indicative alternative proposition to a company as a means of enticing an audit tender. However, we do

> constantly make approaches to clients to encourage target clients to issue a competitive tender [...] However, it would be rare for us to submit unsolicited full audit proposal bids to FTSE 350 companies given the nature and extent of information that is required to prepare a meaningful audit bid.

164. Additionally, the firm monitored changes in senior staff of FTSE 350 companies, [✂].

165. Prior to engaging in any tender activity KPMG would 'seek to gather information regarding the current audit arrangements (eg timing of work, team size, locations covered, deliverables in addition to the audit opinion, etc) and information in relation to the potential audit client itself'. This information was gathered to:

> articulate a compelling and value adding alternate audit proposition, demonstrating a thorough understanding of the client's business and the risks it faces and instilling the confidence that the audit will not only be conducted to the highest standards but also in the most efficient manner.

166. The firm's Head of Audit met the Head of Sales on a monthly basis to discuss the level of business being achieved by the audit firm, indicating that generating revenue was one of several constant objectives of the Head of Audit. Further, partners were expected to spend up to [✂] per cent of their time on marketing and business development.

167. Between 2006 and 2010 the KPMG Audit Committee Institute surveyed its members 'to better understand the challenges and issues facing audit committees'. In 2010 and 2011 KPMG itself surveyed finance directors to establish what they were looking for from auditors to better focus their offering. The firm also subscribed to brand

surveys to establish its relative strengths compared with other firms and sought client feedback from key stakeholders to identify how to modify its approach. In 2011, 86 per cent of audit partners initiated client satisfaction surveys, which led to 916 responses that the firm could consider.

Services offered

168. KPMG saw innovation in audit, as a ‘variation on a theme’ with more feedback on systems and controls and a ‘more vibrant and exciting way of presenting audit findings’ and further [✂].Innovation in delivery was driven by how clients operated. KPMG was keen for there to be innovation in the format of the audit report, tailoring to circumstances of companies of different sizes but were not able to do so since the wording of auditors’ reports was narrowly prescribed by regulations and standards.

169. In addition to statutory audit services, KPMG’s audit practice had developed a number of assurance products that it could offer to its non-audit clients such as the ‘Maximum Assurance initiative’ and ‘Extended Assurance offering’.

170. The specific assurance products that KPMG’s audit functions offered to its clients have been developed and included:

(a) accounting and advisory;

(b) extended and internal controls;

(c) future and business combinations;

(d) regulatory and contractual;

(e) resource;

(f) revenue and data;

(g) sustainability; and

(h) tax assurance.

171. KPMG acknowledged that the knowledge gained from statutory audit provided the firm with a great deal of insight into a client's business and allowed the firm to deliver audit-related and some other services, subject to independence and regulatory considerations, where the client might benefit from KPMG's pre-existing understanding and ultimately add value.

People

172. KPMG identified the development of a broader range of assurance activities provides a broader working experience for its audit staff, whilst also utilising knowledge acquired in the course of statutory audit.

Remuneration—partners

173. Partners were remunerated from the distributable profit of the firm and comprised two elements: a base component, and a performance-related element. In 2011, [✂] per cent of distributable profits were paid as the base component (2010: [✂] per cent). The base component was linked to a standard pay spine based on four categories of partner role and the value of the base component for an individual would remain steady subject to retaining the same role, whilst the performance related element was driven by a combination of an individual's and the firm's performance.

174. Audit partners were not remunerated on the basis of sales of non-audit services to audit clients.

Remuneration—staff

175. KPMG monitored the market for staff by subscribing to 'keypad data' survey on salaries. KPMG stated that its newly qualified staff were paid a 'market leading'

annual payment[6] but there remained a high turnover at qualification and the firm faced competition from inside and outside the audit industry.

176. All staff were eligible to receive a performance-related bonus, subject to 'stretch' principles whereby, for example 'Outstanding' performers would receive a higher bonus than 'Effective' performers. The proportion of an individual's remuneration based on performance increased with seniority: for 2011 graduates on average received [✂] per cent of their remuneration as a performance-related bonus, whilst Managers received [✂] per cent and Directors [✂] per cent.

Recruitment

177. Within the Audit practice, over the eight years to 2011, one audit partner joined KPMG from another Big 4 firm, and one audit partner left to join a Mid-Tier firm and even when considering audit directors, movement in and out of the firm was 'very limited'. KPMG stated that 'nearly all' of its audit partners were 'home grown', that is, that the partners had been at the firm for many years. When the firm had to recruit externally at director or partner level it was to address specific gaps in its team of approximately 250 Responsible Individuals and has typically been caused by regional skill shortages where staff have not been willing to relocate or in sectors where there has been rapid growth. KPMG previously considered buying other firms, but decided against this strategy on the basis of 'cultural fit' and 'quality'.

178. Recruitment of graduates was described as a rigorous multi-stage process with various levels of filtering including psychometric assessment before interview by a Partner; candidates were subject to 'strict academic requirements', requiring a 2.1 and ABB at A-level. KPMG stated that staff quality at a junior stage was important due to the difficulty in recruiting high quality audit staff later in careers, stating that

---

[6] Which includes salary and bonus.

‘without a high quality intake at this level it is difficult to substantially change ... capability’.

179. KPMG supplemented its recruitment programme for graduate trainees by offering summer internships to university students, with 90 per cent of penultimate year interns subsequently joining the graduate intake. The firm also partners with three universities, and funds students through an accountancy degree and provides employment upon graduation as entry-level trainees in the firm’s Audit function. The programme lasts for six years overall, where KPMG also funds a professional accountancy qualification alongside the university degree.

180. In 2012 KPMG was starting an apprentice scheme within Risk Consulting to take school leavers to train for the AAT qualification, which allows an accelerated route to qualification with a CCAB body.

Alumni

181. KPMG operated an alumni programme for 25,000 former employees and operated a social networking website as well as offering alumni the opportunity to receive technical updates and access to online seminars. KPMG stated that promotion of the network was partly because they were aware that alumni may go on to be future purchasers of professional services and also because they could use the views of alumni for market intelligence.

Reputation and brand

182. KPMG perceived the value of its brand to be driven by its reputation for quality and this quality was driven, inter alia, by having top quality staff.[7] Any activities such as sponsorship and advertising were for the purposes of making others aware of that

[7] KPMG submission to CC, section 8.

reputation. KPMG considered that association with trade bodies and events for instance would allow potential clients to become aware of the firm's work and in some instance meet its staff. Audit specific advertising was rare and typically low-value and focused.

183. Similarly, KPMG considered that thought leadership demonstrated that the firm had an awareness and knowledge of issues facing potential clients in different sectors and was of 'most importance in demonstrating and communicating our commitment to value and excellence' and 'may contribute at the margin' to winning new clients.

184. KPMG sought to differentiate itself through the quality of its service provision:

(a) quality of its opinions to stakeholders;

(b) insight arising from its audit which is fed back to management and the Board throughout the audit; and

(c) quality of its reporting to the management team and Audit Committee.

185. KPMG gave the example of declining to participate in the tender for the audit of [✂] (for which it was auditor) as the firm felt unable to undertake an audit of a suitable quality (given their knowledge of the scope required) for the reduced audit fee that [✂] sought. However, it was not clear whether the opportunity cost of the engagement was of equal or greater bearing in deciding not to participate.

Competitors

186. KPMG believed that the ability of a rival firm to grow in the large company market depended on its willingness to 'effectively invest in quality, across its different facets',

with investment based on time and effort rather than large capital outlays. It cited Deloitte as an example of this.[8]

187. KPMG's assessment of the other market participants was that the other firms have actively competed on price, with formal and informal tenders being lower than existing audit fees. Further, the apparent fee strategy of each firm varied by the sector of a prospective client.

188. [✂].

189. KPMG believed that [✂] and [✂] were both attempting to increase market share and improve margins through standardization of audit work. Further in the case of [✂], KPMG believed that it has received a 'subsidy' from its network to allow it to compete more aggressively on price to win market share and was also using its network's outsourcing arrangements to improve margins.

190. [✂].

191. With respect of recruitment, KPMG believed that over the last five years [✂] had tried to recruit junior partners, [✂] and senior managers from other firms to boost resource profile, mainly in northern offices, whilst over the last decade [✂] targeted [✂] staff who were senior but had hit a ceiling in their career progression.

192. KPMG found that there were a number of companies that tendered but retained the incumbent auditor.

---

[8] KPMG main submission, paragraph 309.

Mazars

Summary

193. Mazars was a relatively new entrant to the UK audit market, and had a heavy focus on servicing French clients (19 of the 20 largest clients in the global firm were French companies). The firm saw the Barnier EC proposals on joint audits of large PIEs to be a major opportunity for the firm. It would be a familiar operating model to that employed in France. The firm's principal strategy was to attempt to gain a foothold in listed companies by targeting small and mid-cap clients with audit services, whilst supplementing this with non-audit work for larger clients.

194. The UK firm is part of an integrated global firm (in contrast to other large firms which are members of international networks), though its global presence is significantly smaller than some other non-Big-4 firms, with a presence in only 69 countries, compared with 100 or more for the other firms. Mazars did not have any FTSE 350 audit clients and as a result they could not provide as much information to us as other firms.

195. In the recent past, the firm managed to achieve targets for growth in revenue in non-audit, but not in audit work.

Revenue and margins

196. In Mazars' submissions, its primary strategy to improve profitability was to improve efficiency, with no stated intention to increase fees, which may be a competitive strategy to avoid becoming less attractive to clients on the grounds of price. Mazars hopes to drive efficiencies through improved staff utilization rates, new IT audit tools and improved audit approaches.

Pricing

197. In setting fees for services, Mazars attempted to determine the resource requirement for an engagement and calculate the associated costs using scale/charge-out rates. It was the firm's strategy to attempt to recover [✂] per cent of charge-out rates for staff, though may go to [✂] depending on the desirability of the relationship and the utilization rates of staff.

Attracting and retaining clients

198. Mazars had adopted a strategy of increasing its share of the small and mid-cap market outside France to continue to build credibility to allow it potentially to enter the large company audit market. Mazars strategy when targeting clients involved putting together a standard information pack including general background as well as 'analysis of key shareholders', which would then feed into a bespoke plan.

199. Mazars did not have a source of information regarding when FTSE 350 companies would tender for an auditor. The firm did not submit unsolicited bids to FTSE 350 companies as they did not believe they would be effective.

200. The firm had been proactive in attempting to contact the FTSE 350, one example being after the firm had won an award for 'audit firm with best service' it wrote to 'key targets' in the FTSE 350 with a bottle of champagne but received no responses which resulted in a meeting. The firm found instead that use of its existing contacts to obtain access to key stakeholders had been more successful at generating meetings, but given that all firms did this, there has been little perceived gain.

201. Mazars considered that its globally integrated structure was the optimal structure to win international clients as it allowed a greater sense of consistency across its global operations. As an extension of this global structure, the strategy for targeting Public

Interest Entities was determined centrally at a global level for the reason that Mazars should act as one firm. The firm also focused on operating on the basis of industry sectors delivering across service lines, rather than each service line going individually to market.

202. The firm did not undertake systematic client satisfaction surveys but used client care interviews for its largest clients.

203. Mazars had been forced by a client [✂] to lower its fees in order to retain the engagement.

Services offered

204. Mazars provided a variety of services to its clients. However, it stated that the level of non-audit services that it provided to audit clients was one of the lowest in the profession, but did not provide data to set this in context. Mazars offered a range of advisory/consulting services but in its submitted strategy documents, the firm states it is investing in Business Advisory services and developing a broader assurance practice.

People

205. Mazars had a two-tier partnership structure, with some partners also being members of a central network firm. Partners who are members of the global firm ('CARL Partners' and share in international profits) contribute between £[✂] and £[✂] of capital. Other partners contribute either £[✂] or £[✂] of capital. The firm intends to increase the number of CARL partners.

206. The loss of partners to the Big 4 is relatively low despite Big 4 partners earning two or three times more. Mazars perceived the greatest risk of loss of staff was around

partners who have niche or specialized industry knowledge and may be targeted by other Mid-Tier firms.

207. Mazars attracts some Big 4 partners when they retire or approach retirement, but Mazars was unable to pay salaries or offer experience similar to Big 4 for public interest entities, but can for Owner/Manager Businesses (private companies).

Competitors

208. Mazars perceived the Big 4 to be able to use their existing client base to their advantage such as being able to offer free benchmarking against other clients in the sector (at presumably little or no cost to the firms). The firm considered its larger clients to be at a greater risk of switching to the Big 4. This was particularly an issue for companies with international subsidiaries where Mazars did not have a member firm.

PKF

Summary

209. PKF was managed partially on a regional basis and partially on a service line basis, which contrasted with the other firms, which are predominantly organized by service lines.[9,]

210. PKF only tenders for one or two FTSE 350 audits each year and does not put substantial resource into attacking the market beyond this. PKF believed that the Mid-Tier firms present in the FTSE 350 were due to clients moving into the FTSE 350 rather than Mid Tiers being appointed out of choice.

---

[9] Some service lines such as corporate finance and management consulting are managed as service lines in their own right, whereas assurance and tax are managed on an office by office basis. Neither assurance or audit are reported separately internally for management accounts purposes.

Revenue and margins

211. PKF's Audit and Assurance Business Plan included the following points:

(a) retaining the firm's position as a top eight audit firm;

(b) expanding PKF's share of the listed audit market; and

(c) increasing fees above inflation (a target increase of 3.5 per cent).

Pricing

212. The firm's price negotiation strategy was based on three factors:

(a) desire to win or retain a client;

(b) experience of the client (such as the likelihood of overruns and quality of draft accounts); and

(c) timing of audit relative to peak demand.

213. The firm's assessment of the risk of a client fed into the pricing of an audit. However, PKF did not state if this is a risk premium or as a recovery of increased audit procedures.

Attraction and retention of clients

Potential audit clients

214. PKF monitored a pipeline of potential new clients, and attempted to engage in contact with them until it decided there was not a realistic possibility of being selected to provide services. PKF did not provide information to indicate how it identified potential clients and how long a client might be courted before removal from the pipeline.

215. With respect of seeking larger clients, PKF stated that the current situation with respect of auditor liability did not discourage it from seeking larger audit engagements, but that the ability to limit liability would 'enhance our appetite' to audit

larger businesses. PKF noted that to take on more than four FTSE 350 clients would require recruitment of additional staff. However, PKF's peak period of April to July would dovetail with new clients with a December year-end.

216. PKF had particular experience in mining and investment trusts and it considered that winning further work in these industry sectors would be easier than in other sectors where it did not.

Increasing revenue from potential and existing clients

217. PKF did not provide a specific response on this area.

Services offered

218. PKF offered a range of service lines. However, within those service lines, PKF appears to include some specialisms, such as within the management consultancy service line, PKF advertises 'hotels consultancy' and PFI/PPP consulting, both of which are relatively niche products. PKF acknowledged that its range of consultancy services is not as broad as the Big 4.

People

Partners

219. PKF had two classes of equity partner, 'full profit sharing' and 'fixed share'. [✂].

Graduate recruitment

220. PKF acknowledged that the remuneration (including non-pay benefits) offered by some of the Big 4 to their graduate trainees may be a little more than that offered by PKF. In promoting the firm, PKF emphasized the wider range of client experience it could offer to trainees through working on smaller audits compared with working on

one large FTSE 100 client. The firm had established ‘links with some universities’, but the nature and extent of those links were not clear.

Reputation and brand

221. PKF’s sponsorship and advertising spend was ‘very limited’ with individual investments of £1,000 to £10,000.

Competitors

222. PKF did not submit any significant comment on its competitors other than that the firm on occasions struggled to compete with the Big 4 on price because of a ‘propensity to ‘lowball’ on price’, which PKF perceived to be a strategy to utilize excess staff resources and generate revenue at low or no margin to generate revenue growth. The firm noted that the Big 4 have significant business development teams for developing client relationships.

PwC

Summary

223. PwC stated that: ‘Our ambition is to become the iconic professional services firm, always front of mind, whenever professional services are mentioned’. To this end, PwC seeks to be recognized as leading its profession and to achieve stretching revenue growth targets by providing universally high quality services to its clients and a distinctive proposition for its people. The firm supported this approach with a broad range of client interactions and sponsorship and association with events and publications. PwC had, like other firms, developed a ‘one firm’ strategy, to enable its vision of PwC as ‘a powerhouse of a commercial enterprise that does the right thing for our clients, our people and our communities’.

224. In accordance with UK contract law, PwC had previously attempted to seek agreement with its audit clients to limit its liability under the provisions of the Companies Act 2006, but this did not prove persuasive to its clients and it had decided not to pursue this further.

Revenue and margins

225. [✂]. In FY09 there was also a firm wide profit target of increasing profit per partner from £0.8 million in FY09 to [✂] in FY12. [✂]. FY11 firm-wide profit per partner was £763,000,[10] despite turnover growth of 9 per cent between FY09 and FY11.[11] This can be explained by a 7 per cent decrease in firm-wide profit,[12] reflecting pricing pressures and increasing costs.

226. [✂].

227. The firm stated that its large investments, relating to core IT, or audit systems such as the audit software Aura, are appraised on the value added to the business, their contribution to PwC's competitive position and their enhancement of quality of service. PwC states that like many IT projects, the benefits to PwC are, as well as increased quality, improved efficiency and competitiveness.

Pricing

228. [✂]. In PwC's experience, there is a detailed discussion every year between the company and its auditor on the scope and fee for the upcoming audit. PwC stated that fee negotiation is a dynamic process and every client is different with different

---

[10] PwC UK Annual Report 2011, p30.
[11] Percentage difference between 2009 and 2011 turnover figures in PwC UK Annual Report 2009, p4; PwC UK Annual Report 2011, p30.
[12] Percentage difference between 2009 and 2011 figures for profit available for division among members in PwC UK Annual Report 2009. p35; PwC UK Annual Report 2011, p35.

factors impacting the fee negotiation each year. PwC stated that fee negotiations would usually take into account the following factors:

(a) setting a competitive fee and providing value for money;

(b) changes in scope year-on-year including within the client's operating environment;

(c) a change in the level of risk in classes of transactions or balances;

(d) new accounting and/or auditing standards;

(e) inflation; and

(f) efficiency improvements.

229. PwC's pricing negotiations typically involve several layers of the client's management and ultimately the client's Audit Committee. The negotiations are led by the engagement partner, who bases the negotiation on scope changes from the prior year, the factors identified in paragraph 228 above and the resulting budgeted resource expected to be required for the audit. Charge-out rates are applied to the resource requirement and expected recovery rates are calculated to assess the likely economics of the assignment and underpin the fee negotiation. The partner would consider, among other factors, an analysis of the previous year's fee. Depending on the requirements of the client, a detailed breakdown of the audit fee/hours would be produced and/or benchmarking would be undertaken with comparator companies for discussion during the negotiation. Underlying charge-out rates were set on the basis of the costs of each grade of staff [✂].

230. [✂].

Attracting and retaining clients

New clients

231. PwC operated a number of programmes focused at increasing market share:

(a) Tanks on Lawns—started in 2007 targeting a small number of 'brand defining clients' to grow the audit practice. The targets were all FTSE 100 companies who in the next three years, were likely to hold a competitive audit tender which PwC had a reasonable likelihood of winning. The initiative required the establishment of a 'shadow team' who actively developed working relationships with senior management. In 2009, this was expanded to include the FTSE 350.

(b) Mid-cap programme—to increase PwC's share of this market, staff and partners were reallocated to the London Mid-Tier business unit and the sales 'pipeline' was formalized and monitored more 'vigorously'.

(c) Velocity—a firm-wide sales and relationship development skills training programme, as it was acknowledged that Deloitte's growth would lead it to overtake PwC.

(d) Net 635—initiated in Autumn 2010 to replace Tanks on Lawns to increase audit revenues by [✂]. At the end of FY11, the programme was broadly on track.[13]

232. In addition to charitable pro bono work, PwC on occasion undertook work for free on behalf of potential client companies. One example was in performing a review of accounting policies for [✂], including comparisons to competitors, with the intention of showcasing PwC's capabilities and developing a closer relationship between the prospective audit team and the potential client staff.

233. PwC stated that it had not made unsolicited bids to FTSE 350 companies, as typically these stand very little chance of success. PwC indicated that targeting tends to be a gradual process to build relationships and establish a good track record with a company. PwC had, on occasion used 'cold bids', which it defined as being an uninvited unilateral tender issued after developing a working relationship with the target or on the identification of a 'trigger event' such as a change to the board or

[13] PwC Reply to Issues Statement, paragraphs 4.29–4.39.

audit committee, the rotation of the incumbent lead audit partner or a merger or acquisition. PwC does on occasion also use unsolicited bids for non-FTSE 350 companies where it has no, or a limited, prior relationship with the company. After a relationship had been established with a target, other activities might include submitting documents on how PwC would adopt a different audit approach to the incumbent. A recent strategy had been to offer secondments (both free and charged) to target companies.

Existing clients

234. The firm had undertaken various market surveys to understand the concerns of stakeholders in relation to the firm's brand health and reputation. Other surveys focused on the purchasers of audit services to allow PwC to understand their concerns about the current reporting and audit framework and to improve its offering.

235. PwC undertook a number of different tools for monitoring their relationship with clients, such as the annual Audit Relationship Risk Diagnostic which must be completed by all audit lead partners, [✂].

236. PwC also collected client feedback and encouraged partners to respond actively to it, with PwC providing, by way of illustration, four examples of large companies quoted as saying that they believed PwC has taken onboard their feedback. Feedback across the firm was collated and analysed with key messages then communicated back to the partnership as a whole.

Existing and new clients

237. PwC used a variety of activities to develop its relationship with clients and targets including:

[✂].

Services offered

238. [✂].

239. In FY11, PwC's FTSE 350 audit clients generated [✂] in audit fees plus [✂] of non-audit services, whilst FTSE 350 non-audit clients generated [✂] from non-audit services, indicating that there is little disincentive with respect of revenue not to pursue a FTSE 350 company as an audit client.

240. PwC provided an analysis of the relative hours spent on audit-related services for a sample of ten FTSE 250 clients where PwC was the statutory auditor. In this sample, the proportion of hours relating to audit related services ranged between 6 per cent and 18 per cent with a median of 12 per cent.

241. PwC provided two illustrative examples of shareholder and audit committee views on the level of non-audit fees relative to the audit fee along with that of the Hundred Group of Finance Directors, who noted: 'with appropriate safeguards in place, the quality of both the external audit and other specific non-audit services can be enhanced if undertaken by the auditor without impact on independence, and at lower cost'.

People

242. [✂].

243. Partners were remunerated for their work in the UK from the UK firm's distributable profits. Each partner had a 'target' level of income (remuneration) set each year. This remuneration was comprised of three components:

(a) role—[✂] per cent;

(b) firm's profits—[✂] per cent; and

(c) individual performance—[✂] per cent.

244. PwC believed that its ‘competitive offering to partners’ in respect of remuneration, development and support and the quality of clients and projects is the main incentive for partners to stay with the firm.

245. In the period 2005 to 2011, and in addition to internal promotions to partner, PWC recruited five partners into Assurance, three of which were from EY. In 2012, PwC recruited four partners across the firm, one from KPMG and the remainder from EY. Two of the four will work in audit.

246. In 2011, from outside PwC’s Assurance practice six partners left PWC—three to Deloitte, two to KPMG and one to EY. In the last three years PwC was not aware of any partners leaving to join Mid-Tier firms.

Graduate recruitment

247. PwC’s graduate recruitment programme resulted in 12 per cent of applicants receiving an offer letter. All potential recruits must achieve a minimum of 300 UCAS points at A-level (BBB) and a 2.1. In 2011, the top five sources of PwC’s 800 graduate recruits by number were the Universities of Nottingham, Durham, Warwick, Manchester and Oxford. The cost of the graduate recruitment programme was [✂] in FY11, excluding line of service time, and salary costs for intern programmes. PwC had been named by The Times as the best Graduate Employer for eight years running.

248. PwC also sponsored 50 undergraduates each year at the University of Newcastle to study for a degree, to qualify towards their ICAEW and undergo business placements. A similar programme at the University of Reading was in development.

PwC's Professional School Leavers Programme allows 100 students to join straight from school and study for the ICAEW qualification in four years. The firm also sponsored around 100 university clubs, societies or employability initiatives.

249. PwC's strategy is to attract and retain the best people by providing excellent training, allowing the opportunity to work with leading companies and ensuring the highest professional standards. It sought to retain individuals who it believed had the ability to become partner, by ensuring that their careers progressed constructively they felt valued and that they were remunerated 'in line with market expectations'.

Alumni relations

250. PwC had contact details of 30,000 former employees, including former partners, though stated that it did not hold current employment details for all individuals. Membership of the alumni network allowed access to thought leadership, publications, news about other alumni the PwC alumni LinkedIn group. A number of drinks receptions and dinners were held for different groups of alumni. PwC did not state what strategic value the firm placed on operation of the alumni programme.

Reputation and brand

251. PwC viewed its brand success as being measured by the overall performance of the business, but also undertook its own brand health survey every two years, focusing on purchasers of professional services in large firms including Audit Committee Chairmen.[14] PwC undertook a wide variety of thought leadership at all levels of the business, from global to national, sector specific pieces and which formed ongoing programmes and themes of work. PwC saw thought leadership as being a way of developing its brand, reputation and market positioning and leading thinking on issues relevant to stakeholders. The firm also saw thought leadership as a way of

[14] The work is outsourced to a research company and no reference to PwC's involvement is made.

strengthening relationships with clients and developing the intellectual capital of the firm.

252. The firm also developed its brand through association with various ‘communities affairs’ programmes.

Competitors

253. PwC described the competitive strategies of the other three largest audit firms. It did not cover the mid-tier firms:

> “on the basis that although certain mid-size audit firms provide competitive pressure at the lower end of the FTSE 350, […], [they] are not typically selected by large companies. This is because, according to the views of many external commentators, regulators and the large companies themselves, they lack the capabilities and attributes necessary to audit most large companies. Furthermore, despite the opportunity to do so, we see no serious investment by these firms to develop these attributes”.

254. For the three largest firms, PwC considered there to be significant competitive pressure, with the other large firms maintaining contact with most of PwC’s audit clients, including establishing shadow teams for some of PwC’s audits. PwC noted that a client’s management may inform PwC of the existence of targeting in order to exert competitive pressure on PwC regarding price and/or service. PwC provided five example companies with quotes from client staff where the other three largest firms had contact with an audit client. Other tactics and practices employed by the other

large firms included making ‘cold’ offers to undertake the audit for a lower fee.[15] PwC considers these tactics were broadly consistent with its own.

[15] PwC Response to Issues statement, section 4D.