



Summary of Deloitte's response to the Competition Commission's marketing and financial questionnaire

Non-confidential version

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Member of Deloitte Touche Tohmatsu Limited

SUMMARY OF DELOITTE'S RESPONSE TO THE COMPETITION COMMISSION'S QUESTIONNAIRE

1. INTRODUCTION

1.1 This paper should be read alongside Deloitte's response (the "**Response**") to the market and financial questionnaire from the Competition Commission ("**CC**") submitted to the CC on 20 February 2012. We are aware that the Panel will have voluminous material to read and digest in relation to the Inquiry. In order to assist the Panel in its review of the more detailed submissions contained in our Response, we therefore thought that it would be helpful to provide a summary of the key points.

1.2 This Paper therefore summarises our observations on the following six issues:

- (a) growth and competition in this market, based on Deloitte's growth experience;
- (b) the delivery of audit quality;
- (c) choice of auditor for large companies;
- (d) the provision of non-audit services;
- (e) the relationship between audit fees and concentration/market shares in the large company audit market; and
- (f) the profitability of Deloitte's core audit and audit related services business (together "**Audit Services**").

1.3 We hope that the evidence set out in this paper and the Response – complemented by direct evidence from FTSE 350 companies and their stakeholders – will help the Panel to gain a fuller understanding of the competitive dynamics in the large company audit market.

2. GROWTH AND COMPETITION

2.1 We have explained to the CC in our previous submissions¹ that our own growth experience indicates that, with appropriate investment, there is no material obstacle to building a large company audit practice. The Response sets out in more detail the manner in which we were able to expand our large company audit practice, and our continued efforts to compete strongly for new clients². We summarise the key points in this Paper.

¹ See page 1 of Deloitte's Initial Submission.

² See the responses to questions 22-26, 93 and 103 in the Response.

Deloitte's position in the late 1990s and the Andersen transaction

2.2 In the late 1990s, Deloitte's audit practice was only the sixth largest in the UK (with the position consistent for large companies and for the practice as a whole³). In 1995, Deloitte undertook five FTSE 100 audits, a far smaller number than any firm which is now a leading auditor of large companies. By 2001 we had increased this number to 12.

2.3 We undertook a deliberate strategy of growing our audit practice, including, in particular, our large company audit practice. We did so because we considered that this was a core activity in which we could build on our existing skills to develop a successful and profitable practice. A part of the growth in our audit practice resulted from the acquisition of the Andersen UK practice in 2002, however as can be seen in the table below a significant proportion of our growth was organic and resulted from the successful investment strategy which we pursued.

Table: Net growth in FTSE 350 audit clients 2001-2011

	Before Andersen transaction (2001)	Resulting from Andersen transaction (2002)	Organic Growth	As at February 2012
FTSE 250	29	20	19	68
FTSE 100	12	6	4	22
Total	41	26	23	90

Note: figures in the above table are net movements

This investment strategy was pursued with no guarantee that it would be successful. It was also undertaken in the knowledge that increasing our number of FTSE 350 clients would have a knock-on effect on the risk, both financial and reputational, borne by the firm as a whole⁴.

³ See further the response to questions 23 in the Response.

⁴ See further the response to questions 43 and 48 in the Response on the unavailability of professional indemnity insurance to cover in full the scale of a catastrophic loss which could arise following a failure of a FTSE 350 company.

Deloitte's strategy to grow its large company audit practice

2.4 In July 2002, immediately following the Andersen transaction, we adopted a "Strategy and Growth Plan"⁵. Its overarching goals included the following:

- (a) *"number 1 in overall growth";*
- (b) *"first or second in every service line";*
- (c) *"maintain exemplary risk management record";* and
- (d) *"sustained emphasis on quality".*

2.5 Within our audit business, the following objectives were set for our Audit Services practice:

- (a) *"focus on quality, integrity, independence and the effectiveness of our audit approach";*
- (b) *"this will provide us with faster growth than our competitors";* and
- (c) *"currently we are number three in the UK by revenues and FTSE 500 clients. Aim to become number two by revenues and FTSE 500 clients by 2005."*⁶

2.6 This strategy provided a springboard for Deloitte's growth. In 2004, we further updated our strategy, with additional clarity on our goals in statutory audit, seeking to improve on Deloitte's then current position as number three in FTSE 100 and FTSE 250 audit to become number two⁷. The audit strategy recognised that, in addition to growth from winning clients from other large firms, some of the planned growth in our FTSE 350 audit clients was likely to come from existing clients of next tier firms given the "flight to quality" by clients that was being observed in the post-Enron environment as well as from new entrants in new sectors, such as energy and resources.

2.7 Our strategy therefore focused on winning large company audits from competing firms and specifically adopted the following actions:

- (a) we placed a premium on partner reward for success in winning audit bids for FTSE 350 clients;

⁵ See document reference: DT-MFQ-23-2002 Post Andersen Board - presenv3 and the response to question 23 in the Response.

⁶ Ibid.

⁷ See document reference: DT-MFQ-23 Blue book strategy from 2004 and the response to question 23 in the Response.

- (b) [REDACTED];
- (c) we emphasised the client focus of all our partners, including those in leadership positions;
- (d) we made big efforts to clarify what we offered clients and to communicate this well at the information gathering stage of an audit tender;
- (e) we recruited and retained the “cream” of talent, both at graduate and senior hire levels, offering competitive remuneration in order to ensure we had the very best audit delivery teams;
- (f) we created a dedicated partner-led, bid support team to assist our audit partners in developing tenders (with annual costs of approximately [REDACTED]);
- (g) we exploited the distraction factor for PwC of its mergers with other large firms;
- (h) we worked with and supported the Deloitte international network, strengthening our global Member Firm audit network and our relationship with key Member Firms, to ensure that we were able to present a strong, consistent and cohesive global audit team to potential audit clients;
- (i) we expanded the range of our specialist skills and industry expertise and wove them into our audit approach so that we could demonstrate how the quality of our audit would be distinctive as a result of the greater breadth and depth of expertise available from our firm overall. Retaining our consulting practice was of great assistance in this respect;
- (j) we presented ourselves as the winning firm on the basis of our track record;
- (k) we developed a new approach to quality and risk management, embedding capability and responsibility for the delivery of quality and the management of risk within each service line (including audit) supported by strengthening of our central practice protection group (“PPG”), empowering service line leaders with support from PPG to design and build quality and risk processes appropriate to the services that they delivered to their clients; and
- (l) we emphasised our excellent claims record⁸.

⁸ See the response to question 44 of the Response.

International investment

2.8 Large companies tend to be more geographically diverse and more complex and such companies tend to want to appoint a single network as auditors worldwide. In response, the Deloitte international network has invested heavily in developing an integrated network of auditors in many countries. Much of the international investment was (and continues to be) particularly high risk but as we were (and remain) the second largest member firm in the Deloitte international network we were determined to commit the resources because we knew we would not be in a position to win FTSE 100 or 250 clients by merely focusing our investment on the UK⁹.

2.9 Our international network investment (to which the UK firm has heavily contributed) has included:

- (a) Priority Markets Investment Programme: in responding to the needs of a complex and cross border marketplace and in order to allow us to be able to serve our prospective and existing audit clients on a global basis, we have made (and continue to make) substantial investment (as a global network) in new geographical regions, by:
- (i) developing or acquiring local practices; and
 - (ii) operating as an integrated network with consistent quality, processes and methodology and consistent levels of judgement applied across all aspects of auditing major international companies, irrespective of where they operate.

As a global network DTTL is currently committing [REDACTED] over the next three years, FY13 to FY15, to further develop our capability in various markets, notably [REDACTED]. As the second largest firm in the network, the UK firm is contributing a significant proportion of this. This is the third phase of our Priority Markets Investment Programme, which we have invested in for many years; and

- (b) the development of quality control through building an integrated network with common policies, compliance requirements, independence and conflicts checks, etc. This investment has proved

⁹ A recent example of the Deloitte network's investment in new geographic markets is the recent acquisition of a local firm in Mongolia [REDACTED]

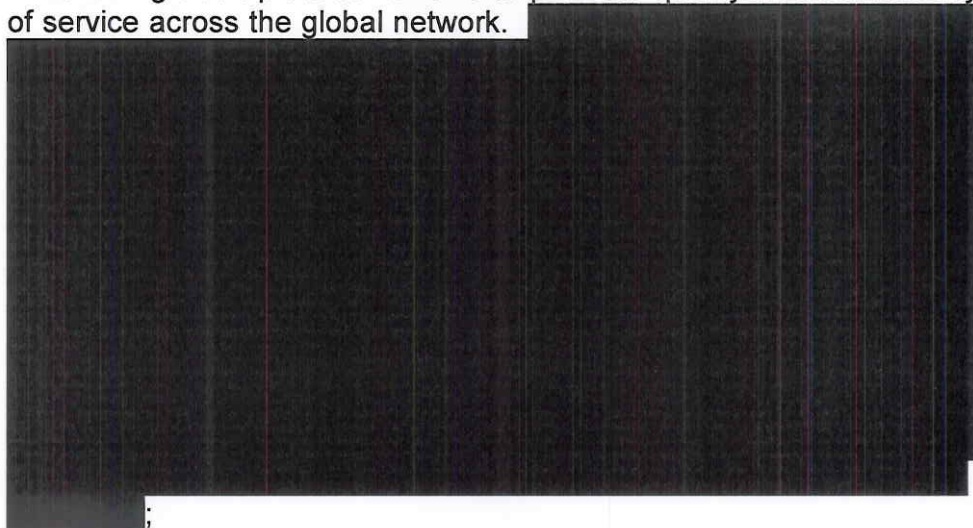
[REDACTED] DTTL is currently exploring developing a capability and is also moving resources into

essential in providing the requisite quality to our clients and in ensuring that resources can be allocated across the network.

Investment in quality

2.10 We have made (and continue to make) significant investment in quality including:

- (a) undertaking audit practice reviews to promote quality and consistency of service across the global network.



- (b) significant investment in staff mobility and secondments, such as:
- (i) hosting secondees from other Member Firms to develop their skills and knowledge;
 - (ii) having people on the head office/group audit team who have worked in the client's major overseas markets, or vice versa (which can serve to differentiate us from our competitors); and
 - (iii) strategic investments in relocating audit partners overseas to support Member Firms or to address specific client needs;
- (c) a significant expansion of our quality and risk community at a rate significantly greater than the growth of the firm. In addition to our central Practice Protection Group, we have:
- (i) dedicated, full time partners and staff with responsibility for quality and risk management in each of our service lines; and
 - (ii) other partners and staff with recognised quality and risk roles and responsibilities (in addition to their client serving roles and responsibilities).

¹⁰ See the response to question 101 of the Response.

The total size of the dedicated quality and risk community in the firm has grown from around █ people in 2001 to approximately █ today (excluding our central technical service line support teams such as NAA and GIOS referred to in 2.11 below);

- (d) other investments required to maintain a quality global audit practice capable of meeting the demands of FTSE 100 and FTSE 250 companies, including:
- (i) maintaining global industry networks (for example, training such as the financial services industry business school, update briefings and seminars, thought leadership and research);
 - (ii) funding by the UK firm of Member Firm's recruitment of quality audit partners (█);
 - (iii) clustering Member Firms to form stronger regions capable of delivering the required quality; and
 - (iv) █.
- (e) over the next three years we are investing █ in the UK audit practice to improve the audit delivery model (█), and to create the capabilities and capacity to grow the UK audit practice further.

Investment in technical competencies

2.11 We have also invested heavily in our technical competencies to enable us to respond to the complexities of accounting and auditing FTSE 100 and 250 companies, for example:

- (a) our investment in our National Accounting and Audit (NAA) department, a dedicated department within the Audit Service line which is responsible for ensuring that we are up-to-date with the latest developments in the UK audit regulatory framework. This department, which has grown considerably over the past 10 years, is resourced by qualified, professional audit staff and partners and today comprises: █ equity partners, █ non-equity partners, █ directors, █ assistant director, █ senior managers, █ managers and █ assistant managers. One part of the department deals largely with accounting and financial reporting matters and another part deals with audit related matters, including standards, reporting and methodology¹¹. The annual cost of this team is █ (plus profit share of █ equity partners); and

¹¹ See the response to question 104 of the Response.

- (b) significant investment in our new audit system that is currently being implemented¹⁴: Deloitte Member Firms are currently investing approximately [REDACTED] in new, bespoke audit software and systems, which will cost [REDACTED] per year to run globally. [REDACTED]

Investment in people

2.13 Consistent with our talent agenda, we have also invested significantly in our people through recruiting and retaining the “cream” of talent, both at graduate and senior hire levels so that we can offer our clients audit teams with proven high levels of technical skills and professional capabilities, including:

- (a) offering our people a highly competitive total reward package which includes flexible benefits, employer pension, and excellent working conditions and facilities;
- (b) investing in the provision of outstanding technical education for our people in the form of professional examinations and ongoing technical update training, in addition to the extensive “on the job” training that our recruits receive; and
- (c) ultimately, offering our people a challenging, rewarding, dynamic and supportive working environment and experience, providing opportunities to work on exciting and varied client engagements, with demanding and sophisticated clients, working with highly skilled and motivated partners and colleagues, and with hugely diverse career opportunities.

Investment in innovation and thought leadership

2.14 Finally, we have invested in innovation, thought leadership and targeting programmes designed to reach out to specific communities and peer groups, including (but not limited to):

- (a) investment in facilities for clients, including:

- (i) our [REDACTED] investment in the [REDACTED]

¹⁴ See further the response to question 103 in the Response.

[REDACTED]

(ii) a [REDACTED] investment to develop the [REDACTED]
[REDACTED];

(b) the Next Generation FTSE 100 and FTSE 250 CFO development programmes, [REDACTED]
[REDACTED];

(c) the Quarterly CFO Survey of major UK companies, capturing shifts in UK CFOs' opinions on valuations, risks and financing and a benchmark for gauging financial attitudes of major corporate users of capital. As well as being used by the Bank of England's Monetary Policy Committee and the Treasury, the CFO Survey is also used by very many audit clients and audit teams to allow them to benchmark their approach to balance sheet risk and capital structures with their peers;

(d) the Financial Controllers' Club, which holds regular seminars and events aimed at financial controllers and chief accountants;

(e) CFO Transition Labs, [REDACTED]
[REDACTED];

(f) Finance Leadership Team development programmes, [REDACTED]
[REDACTED]¹⁶, and

(g) Thought leadership programmes such as our annual Technology, Media and Telecoms Predictions publication.

2.15 Except for use of the [REDACTED], we do not charge clients (existing or targeted) for participation in these programmes or membership of the [REDACTED]. They are part of our investment in developing relationships and enhancing our reputation as a distinctive and innovative firm, adding tangible benefits and value to our clients. In total, we invest approximately [REDACTED] per annum in providing these programmes and initiatives;

2.16 The sustained investment strategy, described at paragraphs 2.8 to 2.15 above, has involved us taking risks and allocating profits to investment rather

¹⁵ See the response to question 26 of the Response.

¹⁶ See the response to question 93 of the Response.

than to partner drawings. This has been, and continues to be, a deliberate decision by our partnership, taken in the long-term interests of the firm.

Deloitte's current position

2.17 The result of this investment is clear. We now have the second largest number of FTSE 350 audit clients and the third highest level of audit revenues from this client base [REDACTED]

[REDACTED]). By investing significantly in our people, technology and processes, and, most importantly, by focusing on delivering high quality, highly valued audits, we have won more, and lost fewer, FTSE 350 audits progressively over the last decade than any of our competitors.¹⁷

¹⁷ See the response to question 23 of the Response and page 77 of PwC's response to the Issues Statement.

Table: Gains and losses of FTSE 350 audit clients by firm 2001-2011

Firm	Gross gains of FTSE 350 statutory audits 2001 to 2011	Net gains (losses) of FTSE 350 statutory audits 2001 to 2011
Deloitte	57*	+44*
PwC	28	+7
BDO	3	0
Grant Thornton	2	0
KPMG	19	0
Ernst & Young	15	-3
Andersen	1	-32**
Other mid tier firms	2	-5
Joint audit – big 4	1	-9
Joint audit – big 4 and mid tier	2	-2

* including 26 that were gained as a result of the Andersen transaction

** including 6 which were lost prior to or as a result of the transaction with Deloitte

NB: Figures are for Q3 2001 to Q3 2011

Deloitte's continuing strategy for growth

2.18 We continue to compete to grow our audit practice¹⁸. Our current strategy, adopted in July 2011, includes as one of its key objectives growing Deloitte's audit market share. A number of mechanisms have been specifically targeted in order to deliver this growth. These are:

¹⁸ See further the responses to questions 22-26, 93 and 103 in the Response.

(a) [REDACTED]

[REDACTED]

(c) [REDACTED].

2.19 A number of discrete targets have been set with respect to audit and our specific goal of ensuring that Deloitte becomes the audit firm of choice for clients, partners, staff and prospective employees by FY15. These include:

(a) *market share*: increasing Deloitte's audit market share by [REDACTED];

(b) *distinctiveness and quality*: being a clear leader in audit quality, based on client and regulator feedback;

[REDACTED]

[REDACTED]

2.20 The practical building blocks of our strategy to attract new client relationships²⁰ do not relate only to seeking out new relationships where an audit tender has already been initiated, but also to seeking actively to build relationships over time. Where an audit tender is announced, we have an intensive process to ensure that, if we decide to participate, we compete as effectively as possible for that mandate and that we demonstrate our capabilities to the client very clearly²¹. Prior experience of working with a company outside the statutory audit is valuable as the exposure to Deloitte that this opportunity facilitates allows the company to get to know the firm and the high quality of our people, culture, delivery and approach. It also allows us to gain valuable insight into the company, its culture, inherent risks, transactions, management style, etc - all key factors in allowing us to demonstrate effectively, during the audit tender process, how we will deliver a quality audit and be able to minimise the risks that a change of auditor may give rise to in the first year of the engagement. As part of this relationship

¹⁹ See further the previously submitted Deloitte UK Audit strategy four year plan from March 2011 ('Off the shelf': Reference B9: Deloitte UK Audit strategy four year plan March 2011).

²⁰ See the response to question 93 in the Response.

²¹ Ibid.

building approach, we have deliberately invested in [REDACTED]

2.21 It is clear from the responses to the Issues Statement and the site visit presentations that several accountancy firms, including mid-tier firms, compete very effectively for the provision of non-audit services to large companies including:

- (a) BDO explains that it provides non-audit services to 23 FTSE 100 companies and 34 FTSE 250 companies²²; and
- (b) Grant Thornton explains that it provides such services to 36 FTSE 100 companies and 66 FTSE 250 companies.²³

2.22 The success of mid-tier firms, such as Grant Thornton and BDO, in developing non-audit services with FTSE 350 companies should provide a compelling opportunity for these firms to win audit engagements for these clients as non-audit service engagements should enable their clients to gain a good understanding of the capabilities of these firms to deliver quality audits. Accordingly, if confident of this capability, one would expect those clients to invite them to participate in audit tenders for those companies.

2.23 Notwithstanding their demonstrable success in FTSE 350 non-audit services markets, it would appear that BDO and Grant Thornton have not been able to leverage the relationships they have gained through this work to convince their respective clients' Audit Committees that they have the depth of capability and quality required to deliver FTSE 100 (and more FTSE 250) audits. This is perhaps unsurprising given that BDO and Grant Thornton themselves concede that they are incapable of providing high quality Audit Services across the FTSE 350²⁴. In an intensely competitive market in which the largest four firms have invested significantly in developing the depth of capability and quality required to deliver their audits to companies across the FTSE 350, it appears that the mid-tier firms have been unwilling to take the risks that are inherent in investing in this market²⁵ and consequently have been unable to establish themselves as credible alternatives to the larger firms. We would encourage the CC to speak directly to FTSE 350 stakeholders to ascertain their reasons for not inviting mid-tier firms to tender

²² See paragraph 3.2.2 of BDO's response to the Issues Statement. We note also that the range of non-audit services provided by BDO, which is set out in Attachment 1 to BDO's response to the Issues Statement, covers all the categories set out in paragraph 3.12 of Deloitte's response to the Issues Statement.

²³ See paragraph 1.5(e) of Grant Thornton's response to the Issues Statement.

²⁴ BDO has conceded that approximately 35 of the largest UK listed companies are currently beyond its reach. See BDO's site visit presentation to the CC dated 13 February 2012. Likewise, Grant Thornton recognises that it is not in a position to provide audit services to almost 20% of the FTSE 350. See Grant Thornton's site visit presentation to the CC.

for their audits and, even more importantly, not appointing mid-tier firms as their auditors where such firms have been invited to tender.

Conclusion

2.24 Deloitte's growth of FTSE 350 audit clients was the result of a deliberate strategy. That strategy and the ability to compete effectively in the market required investment. Companies do not regard audit as a commodity product – they value and demand trusted open relationships with their auditors, which is critical to quality and the delivery of a robust audit. In order to deliver growth in our FTSE 350 audit business, profits, which could otherwise have been distributed to our partners, were reinvested in the business in order to secure longer-term goals and time and resources were expended to develop relationships with companies. Moreover, we adopted this strategy without any guarantee of success: we were aware that we faced highly capable competitors and that our growth strategy carried significant risk.²⁵

3. THE DELIVERY OF AUDIT QUALITY

3.1 We have addressed the primacy of audit quality in our previous submissions to the CC²⁶. The delivery of audit quality to a large company has many component parts, as we explain in detail in our Response²⁷. In particular, audit quality is not just delivering an audit that meets technical standards. It is far from simply the effective application of a mechanical process, or simply not making mistakes. It is multi-faceted, and absolutely reliant on the quality of contact between the auditor and the company and its stakeholders. We believe that engagement with the company, the ability to work effectively with its stakeholders, and our own responsiveness are key components of the delivery of audit quality, no matter how it is defined.

3.2 Quality is equally about demonstrating that:

- (a) the auditor has understood the needs of stakeholders;
- (b) the auditor has understood the issues and challenges that the company is currently facing, and might in the future face, and is able and willing

²⁵ We note that respondents to the CC's Issues Statement also generally agree that investment is required in order to compete effectively in this market. BDO, for example, states that the necessary capabilities "*all take time and significant investment over a long period*" (Paragraph 3.1.2 of BDO's response to the Issues Statement). However, we also note that BDO goes on to state that a firm "*would be reluctant to invest in acquiring [these capabilities]*" because of the uncertainty of success (Paragraph 3.1.3 of BDO's response to the Issues Statement). We find this statement to be a surprising characterisation of the relationship between investment and risk: Deloitte invested in the capabilities necessary to grow its FTSE 350 audit business without any guarantee of success – consistent with the approach taken to investment across many different industries.

²⁶ See, for example, paragraph 2.1 *et seq.* of Deloitte's response to the Issues Statement.

²⁷ See the response to Question 100 in the Response.

to offer insights and views to help the company in facing those issues and challenges;

- (c) the auditor's response is robust yet agile regardless of the complexity of the audit or the client's location; and
- (d) a commitment to personal ethics, corporate responsibility and transparency permeates everything the auditor does.

3.3 The Financial Reporting Council ("**FRC**") issued an audit quality framework in February 2008²⁸. In addition to this, as discussed in detail in the Response, we consider that the following elements are also important components of audit quality:

- (a) the application of professional scepticism and innovation;
- (b) a consistently applied and rigorous audit process and methodology, which is adaptable and responsive;
- (c) a partner-led approach with significant involvement from the very outset of the engagement;
- (d) the delivery of powerful insights in reports to those charged with governance; and
- (e) the appropriate involvement of specialists such as tax auditors, actuaries, valuation specialists, financial instrument specialists and industry experts.²⁹

3.4 As explained in the Response, we also have an intensive internal process (complementing external processes of which the CC is aware) to monitor and maintain audit quality across these dimensions³⁰.

The alignment of the auditor's incentives with those of investors

3.5 It is important to note that the auditor's incentives to deliver audit quality and a highly robust audit opinion are strongly aligned with the position of investors. This is because of the unique risks that arise in the conduct of a large company audit.

3.6 We have explained previously to the CC (discussed further in the Response³¹) the risks that an auditor bears – because the auditor's liability is uncapped, a failure to deliver a highly robust audit opinion could endanger the

²⁸ See <http://www.frc.org.uk/about/promotingauditquality.cfm>.

²⁹ See the response to question 100 in the Response.

³⁰ See the response to question 101 in the Response.

³¹ See the response to questions 7, 48 and 49 in the Response.

continued existence of the firm³². This risk is at its highest in relation to large companies, where the complexity of their business and the financial consequences of a company failure mean that the auditor has to take the utmost care in performing its task. It is because of these risks that Deloitte has invested, and continues to invest, in the people and systems that allow it to deliver audit quality at a very high level. The Deloitte network's investment of approximately █████ in our new audit systems is a case in point.

The discernability of audit quality

3.7 In our experience, the company stakeholders with whom we primarily interact – in particular Audit Committee chairs and members – are highly capable of discerning audit quality³³.

3.8 Audit Committee chairs and members are deeply conscious of their responsibility to test the auditor and ensure that investors are obtaining the full benefit of the auditor's work. We find suggestions³⁴ that these stakeholders find it difficult to discern audit quality, or that they benefit in some way from excess service at the expense of quality, surprising and utterly at odds with our experience, particularly in the light of the extensive and challenging engagement between Deloitte and most company stakeholders over the course of the audit cycle, and the sophistication and experience of these individuals. Indeed, we think that a suggestion that it is difficult for stakeholders to discern audit quality derives from a failure to engage adequately with those stakeholders. Proper engagement with stakeholders provides an opportunity to demonstrate capability and quality of offering. There would appear to be a clear connection between a failure to understand the demands of stakeholders and an inability to secure audit wins.

3.9 We note the observation by Grant Thornton in its response to the Issues Statement, which posits that there may be a distinction between the elements or outputs of the audit process that might be regarded as constituting audit quality by investors, and those that might be thought to constitute audit quality by company management³⁵. In particular, Grant Thornton seems to attempt to draw a distinction between client service and some more mechanical understanding of audit quality. This characterisation of audit quality is completely misconceived in the context of FTSE 350 audits.

3.10 We set out in detail in our Response the many points of our engagement with company stakeholders, including the various interactions with top management, the Audit Committee, its chair and other board

³² See paragraph 2.9 of Deloitte's response to the Issues Statement.

³³ Deloitte notes in this regard the work conducted by KPMG in relation to the qualifications of Audit Committee chairs; while Deloitte has not sought to verify KPMG's analysis, its results are consistent with Deloitte's experience. See Annex 1 to KPMG's response to the Issues Statement.

³⁴ See paragraph 3.1 to 3.4. of Grant Thornton's response to the Issues Statement.

³⁵ Paragraph 3.4 of Grant Thornton's response to the Issues Statement.

members, and attendance by the audit engagement partner at the board meetings at which the preliminary announcement and the annual report and accounts are discussed and at the AGM³⁶. This is in addition, of course, to the extensive “on the ground” engagement with company management and the company’s finance function throughout the audit cycle.

3.11 We consider that the points of engagement above, and the robust scrutiny of our work that takes place in preparation for and at those meetings, gives Audit Committees and other company stakeholders a high degree of visibility of the quality of the product we deliver – very likely a higher degree of visibility than on the quality of other professional services provided to the company. While we are unable to comment on the degree of engagement offered by other audit firms, it would seem surprising that Audit Committee chairs (in particular) could consider that they were properly executing their duties without it.

3.12 In addition to scrutiny by the Audit Committees, the inspections by the FRC’s Audit Inspection Unit are publicly available providing third party scrutiny on the quality of our audit work and we provide public statements on our approach to audit quality in our annual Audit Transparency Report. The AIU’s findings on audit quality for individual clients are additionally made available to those clients’ Audit Committees. This is a direct quality feedback process that is unique to the UK.

3.13 We are supportive of any initiatives that seek to improve the quality and transparency of audit reporting by encouraging and facilitating enhanced engagement with key company stakeholders. For example, in our submissions to the European Commission (the “EC”) on the EC’s audit reform proposals, we have proposed that the audit report should be expanded so that there is more visibility on the extent of the work we have undertaken, which we believe will provide investors with useful additional information to assist in informing their investment decisions. Another area for further consideration could be for audit teams to meet with investors as part of the planning process to discuss those investors’ key concerns and to explain the key areas of judgement and focus of the audit. We would encourage the CC to explore the merits of any such initiatives in its dialogue with key audit stakeholders.

Audit quality in the early years of the audit engagement

3.14 In the early years of an audit relationship, there may be heightened audit risk³⁷. In part this is simply because the auditor will have a lower degree of intuitive understanding and may find it more difficult to exercise informed judgement about what might be unusual in the information it sees. However, we seek to mitigate that risk by devoting additional time and resources (generally at a senior level) in the early years of an audit relationship to

³⁶ See the response to question 84 in the Response.

³⁷ See paragraph 6.5 of Deloitte’s response to the Issues Statement and the response to questions 39 and 80 in the Response.

understanding the company's business. Doing this is critical to providing the degree of audit quality that is demanded by the company and its investors, and to managing Deloitte's own risk.

[REDACTED]

3.16 [REDACTED]

Our audit fees are set at a level that reflects the intense competition to win new audit relationships, consistent with the ability to generate a reasonable profit in the performance of our audit work over a reasonable period of time. Our pricing offers to prospective clients are made on the basis of the value to Deloitte of winning new audit relationships, irrespective of the identity of the incumbent auditor. Deloitte has won significantly more audit clients from other major auditors than from mid-tier firms: only three of our 31 FTSE 350 audit wins⁴⁰ in the ten year period from Q3 2001 to Q3 2011 were from mid-tier firms.

[REDACTED]

[REDACTED]

³⁸ Ibid. See also the response to questions 39 and 80 in the Response.

³⁹ See paragraphs 1.6.2 and 5.1.14 of BDO's response to the Issues Statement.

⁴⁰ Excluding former Andersen FTSE 350 clients.

4. CHOICE OF AUDITOR

4.1 The Issues Statement posits a concern that a lack of sector expertise or independence concerns could inhibit the ability of auditors to compete for and conduct audits for large companies, so limiting those companies' choice of auditor. As explained in the Response⁴¹, neither of these issues represents a material inhibition on Deloitte's ability to participate in tenders for new audit clients. We set out the main points below.

*Sector experience*⁴²

4.2 We explained in our Initial Submission that clients highly value sector-specific experience⁴³ and how we invest in the ability to compete for and conduct audits across the FTSE 350⁴⁴. Such experience allows Deloitte to perform a higher quality audit, since we are able to bring to bear insights on the market which (*inter alia*) allow us to make more informed judgments in the audit process. Industry/sector expertise and subject matter experts also ensure that our auditors have a much better understanding of the inherent risks within the industry or particular subject area, thereby ensuring enhanced quality in the audit – which is clearly of ultimate benefit to stakeholders. The same is also true where we are undertaking non-audit services – our sector experience provides additional insight to companies and increases the likelihood of the identification of risks which might not be visible solely through the audit.

4.3 We have conducted an analysis of our audit clients in the FTSE 350 by industry sector⁴⁵, based on companies' own industrial classification⁴⁶. That analysis indicates that there is no industry category in which Deloitte does not provide Audit Services to current FTSE 350 companies. We cover a broad range of sectors and are not over-concentrated in any one category. We therefore consider that we have the experience to enable us to win audit work and to deliver audit quality to the requisite standard in any sector.

Independence

4.4 In addition, observations as to the extent to which auditor choice may also be limited by conflicts of interest and/or independence concerns fail to take into account that these independence concerns can commonly be managed, in practice, such that they do not in fact represent an inhibition on bidding for and winning audit work.⁴⁷ The general rule (that covers the vast

⁴¹ See the response to questions 54 and 56-58 in the Response.

⁴² See further the response to question 56 in the Response.

⁴³ See page 17 *et seq.* of Deloitte's Initial Submission.

⁴⁴ See page 16 *et seq.* of Deloitte's Initial Submission.

⁴⁵ The analysis is performed for the companies' respective 2010 year ends, since not all 2011 annual reports are yet available.

⁴⁶ Full details are set out in the response to question 56 in the Response.

majority of situations) is that, where we are providing other non-audit services that impair auditor independence (and, of course, not all such services are impairing), we could not audit the financial statements for the year in which those services are provided. So, for example, if we are providing independence impairing services during calendar year 2011, we could not audit the 31 December 2011 financial statements, but if those services come to an end before the end of 2011, depending on the rules, we would not be precluded from being appointed as auditors for the 2012 financial statements

4.5 It is very rare for independence issues to prevent us from bidding for an audit appointment. We are not aware of any such issues arising for Deloitte in the last five years. There is one instance in the last five years where we declined to bid for an audit because of the nature of the consulting services that we provided. Given the relatively long term nature of the work that we were performing we concluded, with the agreement of the Audit Committee chairman, that it was not in the client's interest for us to participate in the audit tender.

4.6 Increasingly, the large, more complex companies are running their audit tender processes over a sufficiently long timeframe to allow as many firms as possible to participate, free of independence concerns.

Sufficiency of choice

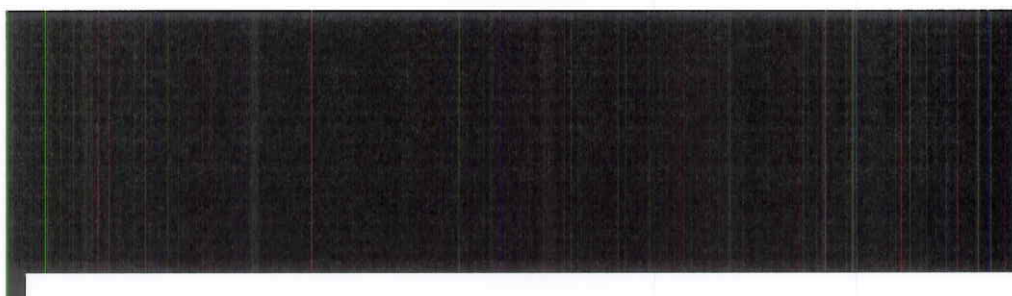
4.7 We are aware that some parties have made submissions to the CC that it should consider "choice" as an additional head of detriment in the market for large company audit⁴⁸.

4.8 We believe that there is no evidence that the current level of choice is insufficient. Nor is it evident that there is a failure to deliver good outcomes to companies and investors. To the contrary, the evidence does not indicate detrimental effects on large companies as a result of any failing of competition in the audit market. Four large audit firms compete strongly in this market and it is our view that all large companies can therefore invite enough credible audit firms to tender to supply their audits to maintain effective competition⁴⁹.

⁴⁷ See the response to question 54 in the Response.

⁴⁸ See paragraph 5.7.1 *et seq.* of BDO's response to the Issues Statement and paragraph 6.1 *et seq.* of Grant Thornton's response to the Issues Statement.

⁴⁹



Conclusion

4.9 It is clear from the above that neither sector experience (or lack thereof) nor independence concerns represent a real inhibition on our ability to participate in tenders for new audit clients. Moreover, we are not aware of any evidence that demonstrates that the current level of choice in the market is inadequate.

5. NON-AUDIT SERVICES⁵⁰

The provision of non-audit services to audit clients

5.1 It is correct to say that there are a small number of services which, in our experience, companies consider may be most efficiently performed by their auditor. The CC will be aware that the Auditing Practices Board (“APB”) consulted on the provision of non-audit services by auditors in 2009; its consultation responses strongly indicated that companies value having the choice of obtaining certain services from their auditor where regulatory rules permit⁵¹.

5.2 In the case of the FTSE 350, the vast majority of services provided by the auditor outside the core statutory audit are “audit-related services”⁵² – that is, services directly related to the audit itself, and designated as such by the APB Ethical Standard 5 (“ES5”)⁵³.

5.3 Outside audit-related services, the number of services which the auditor is considered by the audited company to be best placed to provide is, in our experience, very small indeed. We consider that only the following two services fall into this category:

- (a) *Class 1 prospectus work*: while not required to be performed by the auditor, it is generally rare for the auditor not to perform Class 1 prospectus work given the auditor’s knowledge of the company’s financial systems. This work commonly includes issuing a long form due diligence report on the track record of the business, a working capital report to assist the directors’ requirement to make a statement on the adequacy of working capital and an accountant’s report. The accountant’s report requires an accounting firm to provide a public “true and fair” opinion on three years of financial history and consequently it would be very costly and inefficient if this was provided by a firm which was not also the company’s auditor; and

⁵⁰ We note that non-audit services are outside of the reference market and would query why the CC is dedicating resources to the investigation of this market.

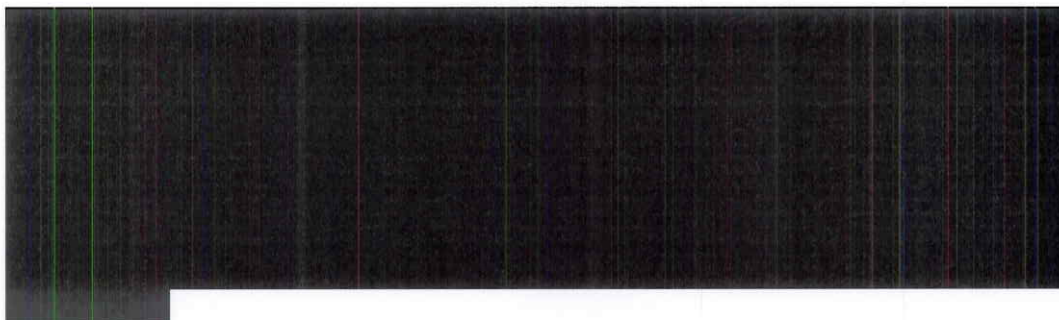
⁵¹ See ABP, *Audit firms providing non-audit services to listed companies that they audit*, 2009. See also the response to question 78 in the Response.

⁵² We detail these in the response to question 53 in the Response.

⁵³ See <http://www.frc.org.uk/images/uploaded/documents/ES%205%20final.pdf>.

- (b) *Comfort letters on bond raising*: again, while not required to be performed by the auditor, in most cases the auditor will perform this work. This is primarily because the firm providing such a letter is required to have completed procedures equivalent to planning an audit and/or completing an interim review of financial information, which would be a routine part of the audit engagement.

5.4 Neither of these services forms an important part of the non-audit services provided by Deloitte or any other provider to large companies as both services are required only sporadically by large companies.



5.6 However, as we have explained⁵⁴, except for these three areas of non-audit services, the auditor is in fact more limited in its ability to provide non-audit services than any other competing service provider, because of independence requirements⁵⁵.

The provision of non-audit services to other companies

5.7 With regard to the provision of non-audit services to other large companies (i.e. those which Deloitte does not audit), as explained in our response to the Issues Statement,⁵⁶ we have to compete hard – and on a level playing field – with the numerous providers of these services, many of whom are major global players, including global consulting firms and investment banks, as well as other accounting firms. They each have the opportunity to demonstrate the quality of their offering in the work that they do. It is the overall quality of the offering, regardless of the service in question, that helps to win non-audit work.

Conclusion

5.8 The market for non-audit services is highly competitive and multiple audit firms compete in that market successfully (together with very many more

⁵⁴ Paragraph 3.10 of Deloitte’s response to the Issues Statement.

⁵⁵ BDO’s appears to concur. See its observation that “the likelihood of [the] provision [of non-audit services by the auditor] is being cut back” by regulatory proposals. See paragraph 5.2.2. of BDO’s response to the Issues Statement.

⁵⁶ Paragraph 3.12 of Deloitte’s response to the Issues Statement.

other service providers). This is demonstrated by the significant FTSE 350 client connections of BDO and Grant Thornton in non-audit services.

6. THERE IS NO RELATIONSHIP BETWEEN AUDIT FEES AND CONCENTRATION

6.1 Our audit fees are determined through detailed negotiation with expert purchasers and reflect the competitive nature of the provision of Audit Services to large companies⁵⁷.

6.2 The factors that are taken into account by Deloitte in negotiating audit fees with clients and potential clients⁵⁸ include:

- (a) the scope and complexity of the work to be performed, including:
 - (i) our assessment of the risk profile of the company which may lead to additional work being undertaken⁵⁹;
 - (ii) any business acquisitions, disposals or restructuring and/or new regulations or requirements that have occurred in the previous period and may impact the fee;
- (b) the timing of the audit procedures, e.g. whether the team is working to compressed timetables in order to meet transaction or other deadlines or the audit is to be performed during off-peak periods; and
- (c) the benchmarking of the total audit fee of the company compared to its industry and sector peer group.

6.3 As we explain in our Response, fees for continuing audit clients will generally be renegotiated annually, reflect changes in the factors set out above⁶⁰, and involve a detailed process of negotiation with the company⁶¹. Each negotiation takes place against the background of the bespoke nature of the audit process – no two audits are the same and this is reflected in the approach taken to the fee negotiation process. The audit fee negotiation process is a serious, considered and governance-led process between senior executives and audit partners, with final negotiation and agreement by the Audit Committee.

6.4 Despite the detailed negotiation process and the level of analysis provided, it is still very common for an “agreed” fee position between the CFO (after reference to the Audit Committee chair) and lead audit partner to come under further downward challenge when the fee is formally presented to and

⁵⁷ See also paragraph 3.2 *et seq.* of Deloitte’s response to the Issues Statement.

⁵⁸ See the response to question 89 in the Response.

⁵⁹ See further the response to question 37 in the Response.

⁶⁰ See further the response to question 87 in the Response.

⁶¹ See further the response to question 88 in the Response.

discussed by the Audit Committee, particularly if the members of the Audit Committee have experience from other FTSE 350 boards (commonly Audit Committee members are members of more than one FTSE 350 board)⁶². The downward pressure is acute and is commonly expressed by the Audit Committee as:

- (a) an expectation of no inflationary increases; or
- (b) the need to find audit efficiencies (both by the company and the auditor); or
- (c) competitive market behaviour seen at other companies.

6.5 At various stages through the fee negotiations it has become increasingly common for the CFO and/or the Audit Committee to raise the subject of an audit tender in order to exert additional leverage in the negotiation process⁶³. This is often part of a client-driven benchmarking exercise to test the market. In short, the fee negotiation process is one of the most difficult aspects of a lead audit partner's responsibilities and reflects the intensely competitive FTSE 350 audit market.

The relationship between price and market shares/concentration

6.6 Given these factors, we have maintained the view that there is no statistically significant relationship between audit fees and market shares and/or market concentration. We are aware, though, that such a suggestion has been made in the Oxera study, carried out in 2006⁶⁴ and updated by the OFT⁶⁵ prior to its market investigation reference. Despite a critique of the robustness of Oxera's analysis by PwC in 2008⁶⁶, this analysis formed a significant part of the OFT's evidence base in making its reference to the CC. Moreover, while the CC has recognised that the Oxera study has been criticised, it indicates that it is one of the principal sources on which the CC's Issues Statement has been based⁶⁷.

6.7 We have conducted an in-depth econometric analysis of the determinants of audit fees. This has involved a detailed review of Oxera's econometric analysis, covering both its evidential basis and its methodology. Deloitte's analysis shows that there is no basis for Oxera's conclusions - that is, there is no basis for considering that there is a statistically significant relationship between the level of audit fees and concentration or market shares. Rather, as one might expect, the statistically significant relationships

⁶² See further the response to question 89 in the Response.

⁶³ See the response to question 91 in the Response.

⁶⁴ Oxera, *Competition and Choice in the Audit Market*, April 2006.

⁶⁵ See http://www.offt.gov.uk/shared_offt/freedom_of_information/audit-econometric-summary.pdf.

⁶⁶ PwC, *Competition and choice in the UK audit market: a review of the Oxera Report*, 2008.

⁶⁷ Paragraph 3 of the Issues Statement.

that can be discerned relate to indicators of audit complexity and risk. The results of our study are briefly summarised below.⁶⁸

The evidential basis for the Oxera analysis

6.8 The Oxera study is based on an analysis of the FAME database. The FAME database stores certain data on companies in the UK and Ireland, and is maintained by a private provider. We have undertaken a verification exercise of the FAME database⁶⁹. That exercise has established that there are gaps and inaccuracies in the data that fatally undermine its robustness as a data source:

- (a) in many cases, no data are provided, even where the data are in fact readily available from company reports. The table below sets out the level of data availability in the FAME database across only the key variables of auditor, audit fee and turnover:

Table: FAME data availability

	Sample	2011	2010	2009	2008	2007	2006	2005	2004	2003	2002
FTSE 350	342	100%	84%	81%	77%	73%	70%	65%	61%	57%	53%
FTSE Small Cap	261	100%	74%	62%	61%	59%	54%	51%	48%	46%	46%
FTSE Fledgling	135	100%	85%	67%	62%	58%	59%	58%	53%	53%	53%
Private companies	142	100%	77%	85%	79%	72%	68%	56%	52%	47%	34%

Source: Deloitte analysis

- (b) in many cases, inaccurate data are recorded – for example the recording of a USD amount for the audit fee, rather than a GBP amount; misreporting of revenues (particularly in the financial services and gambling industries); and misreporting of the auditor specified in the annual report. The table below shows the level of inaccuracy of

⁶⁸ A copy of the full Deloitte study (“Audit pricing analysis”) was provided to the CC on 27 February 2012.

⁶⁹ Since the FAME database only stores a maximum of ten years’ worth of data on each company at any given point, Deloitte has not been able to use exactly the same dataset as that used by Oxera, but has performed the same exercise on the currently available dataset.

the FAME database for the FTSE 350 over the same three key variables – auditor, audit fee and turnover⁷⁰:

Table: FAME data inaccuracy for the FTSE 350 – percentage of errors made in FTSE 350 data

	2011	2010	2009	2008	2007	2006	2005	2004	2003	2002	Total
Audit fee	3%	17%	19%	19%	19%	19%	30%	29%	27%	24%	21%
Turnover	0%	1%	2%	1%	2%	1%	1%	1%	1%	1%	1%
Auditor	2%	6%	8%	9%	10%	10%	9%	9%	10%	9%	8%

Source: Deloitte analysis

6.9 Overall, our analysis shows that the data are incomplete and of poor quality. We note that Oxera does not indicate that any data cleansing was undertaken prior to its analysis; in its absence, we have significant concerns about the robustness of the resulting analysis. For the purposes of our analysis described below, where errors were identified in the dataset used by Oxera, we sourced information from companies' annual reports to correct the data and to ensure consistency across the period. However, given the poor quality of data for the companies that were at the top and bottom of the identified range, there are no doubt further, less prominent, errors that still exist within the dataset. It is worth noting that the level of inaccuracy is greatest in the earlier years of the database – including three of the years used by Oxera in their analysis. We welcome the CC's recently announced initiative to hold a discussion with the main parties to the Inquiry to discuss the concerns raised about the FAME dataset and explore possible ways to address these concerns.

The Oxera methodology

6.10 The Oxera analysis (and the subsequent update by the OFT⁷¹) supports the hypothesis that there is a positive and statistically significant relationship between audit fees and (a) auditor market share, and (b) market concentration (measured by Herfindahl Hirschman Index ("HHI")).

6.11 However, the methodology used by Oxera (and the OFT) is not robust. In particular, the two standard econometric methodologies they use (the fixed effects methodology and the random effects methodology) are not appropriate where the factors analysed include the previous period's audit fee (a factor that is included by Oxera and the OFT), since a factor of this type (a "lagged dependent variable") can bias the results. We note that the Oxera study was

⁷⁰ Although Deloitte has not been able to verify and correct other data points in the same way, the scale of corrections that have had to be made to these three core (and relatively simple) variables casts doubt on the accuracy of the other data contained in the database.

⁷¹ See http://www.offt.gov.uk/shared_offt/freedom_of_information/audit-econometric-summary.pdf.

published in 2006, the same year in which more robust methodologies were developed to avoid this problem. These methodologies are now well-established in the econometrics literature⁷² and have been applied in our review.

Relevant factors

6.12 We note also that the Oxera (and OFT) methodology appears to omit factors that, intuitively, might be thought to be potentially relevant to the audit fee. These include:

- (a) *audit risk*: the literature on audit fees indicates that audit risk is likely to be an important factor in determining the audit fee, due to the risk of legal action. Audit fee models in the econometric literature use debt to equity ratios, profits, and ratios of receivables/inventory to assets as proxies for risk. None of these were employed in the Oxera/OFT analysis. We have included these factors in our analysis; and
- (b) *company size*: the size of the audited company is commonly measured by reference to total assets as well as total turnover. This factor is not included in the OFT/Oxera modelling. We have included this factor in our analysis.

Results of the Deloitte analysis

6.13 The results may be summarised as follows:⁷³

- (a) the data show no statistically significant relationship between audit fees and either (a) auditor market share or (b) HHI levels; and
- (b) the only factors that are statistically significant are:
 - (i) the previous year's audit fee (which accords with intuition, since this will commonly be the starting point for negotiations);
 - (ii) total assets (an indicator of the company's size and potentially its risk and complexity); and
 - (iii) whether the company suffered a loss in the relevant year (which may be an indicator of audit risk).

6.14 These results accord with our expectations and also with the results found (using a different methodology) by PwC⁷⁴.

⁷² See for example, Cameron (2006), *Microeconometrics*, Cambridge University Press, pp. 673.

⁷³ The full results (and full details of the methodology) are set out in our "Audit pricing analysis" paper.

⁷⁴ PwC, *Competition and choice in the UK audit market: a review of the Oxera Report*, 2008.

Conclusion

6.15 In conclusion, the results of our analysis indicate that:

- (a) the Oxera/OFT analysis is not robust and cannot be relied upon;
- (b) there is no demonstrable causal relationship between concentration and audit fees; and
- (c) the data indicate that audit fees are driven primarily by the size of the audited company and the risk of conducting the audit.

7. DELOITTE'S AUDIT PRACTICE DOES NOT PRODUCE SUPER-NORMAL PROFITS

7.1 We assess our business performance (including profitability) on a firm wide basis. Below this level, we report at the level of four service lines: Audit, Tax, Consulting and Corporate Finance. While statutory audit work is primarily undertaken within the Audit service line, a significant contribution to the delivery of the audit is also made by specialists within other service lines, drawing on their particular expertise. For example, taxation specialists will very commonly be involved in the audit process in order to undertake a sufficiently detailed audit of the tax arrangements of audit clients⁷⁵.

7.2 The result of this is that the manner in which the CC seeks to understand the profitability of Deloitte's Audit Services on a standalone basis does not fit well with how we manage our business and assess our own performance.

7.3 Nonetheless, in order to address the questions raised by the CC, we have undertaken an exercise which attempts to assess the profitability of our Audit Services. However, the results are sensitive to a number of assumptions involving the allocation of costs. The key points of our findings are summarised in this Paper⁷⁶.

7.4 Our analysis indicates that:

- (a) the profitability of Audit Services has been less over the last five years than for Non-audit Services, which by itself provides some evidence that audit prices and profits are not excessive since (as discussed above and in our response to the Issues Statement⁷⁷) the provision of non-audit services occurs in multiple, highly competitive markets;

⁷⁵ Furthermore, certain services provided by the Audit service line do not relate to statutory audit – e.g. risk advisory services. See further the response to question 67 in the Response.

⁷⁶ See further the response to questions 64-69 in the Response.

⁷⁷ See paragraphs 3.11 - 3.12 of our response to the Issues Statement.

- (b) the profitability of Audit Services has varied significantly over the last five years, which serves to emphasise that profitability analysis needs fully to take into account:
 - (i) the macro-economic environment; and
 - (ii) the susceptibility of margins to changes in the volume of work, due to the high proportion of fixed costs in the business;
- (c) our Audit Services profitability is commensurate with that of other high quality professional services firms such as law firms. It is less than that of Magic Circle law firms and similar to that of Silver Circle law firms;
- (d) the premium returns of our Audit Services relative to that of mid-tier audit firms is commensurate with the premium that Magic Circle law firms are able to sustain over Silver Circle and other law firms; and
- (e) the substantial market and business risks of providing audit services are difficult to quantify but if successfully mitigated would result in correspondingly higher levels of profitability for those, generally larger, firms that are both willing and able to take on the higher risks associated with larger and more complex clients.

7.5 Together these results serve to demonstrate that the profitability of our Audit Services is not excessive and provides an appropriate level of return reflecting market and business risks and the quality positioning of our services in the audit market.

The appropriate measure of profitability

7.6 The competition authorities have a well-developed literature and jurisprudence in relation to the measurement of profitability⁷⁸ which suggests that an “internal rate of return” (“*IRR*”) or return on capital employed (“*ROCE*”) approach may commonly be the most appropriate way of assessing the relative profitability of a business or industry. However, the literature and jurisprudence recognise that there are certain businesses and industries for which these approaches are not appropriate. In particular, the CC’s guidelines state that:

“The Commission recognises the difficulty in measuring the cost of capital and its limited applicability to some industries, such as some markets for services and products with a high intellectual property value. In such situations the Commission may consider alternative

⁷⁸ See for example: OFT, *Assessing profitability in competition policy analysis*; and Competition Commission, *CC3 Market investigation references: Competition Commission Guidelines*, paragraph 3.81 *et seq.*

measures such as the return on sales or other relevant financial ratios."⁷⁹

7.7 Our business, and the market for the audit of large companies more broadly, is such a case. There are several reasons for this:

- (a) in the case of a professional service firm such as Deloitte, the tangible fixed assets of the business – such as property or information technology – form a relatively small proportion of the total value of the business. Intangible assets such as brand and intellectual capital invested in the workforce are much more significant;
- (b) we are aware that the CC has given consideration to the circumstances in which items such as brand or intellectual capital may constitute intangible assets⁸⁰, but these are difficult to apply in the present case because the brand and intellectual capital are not only intrinsic to the service offering of Deloitte, but are also part of the off balance sheet capital that we have built up over time; and
- (c) it is very difficult to establish the appropriate weighted average cost of capital in relation to a business such as Deloitte's. As a partnership, we have no traded equity from which a beta value, representing the risk element attaching to the capital investment, may be estimated. Furthermore, the traditional capital asset pricing model generally captures only systematic risks and not the specific risks that characterise partners' investment in a large audit firm.

7.8 For all of these reasons, this appears to be the type of case contemplated by the CC in which an analysis based on a measure such as return on sales may be most appropriate.

Profitability

7.9 The table below presents the net revenue, and gross and net margins (as a percentage of net revenues) for Audit Services, sub-categorised into the FTSE350 and other audit clients, in addition to equivalent information for Non-audit Services. The net margins by Service Lines (and therefore for the Audit and non-audit services) are not measures used in the management of our business. These net margins have been estimated by allocating the various costs constituting overheads between Audit and non-audit Services, and

⁷⁹ Competition Commission, *CC3 Market investigation references: Competition Commission Guidelines*, paragraph 3.85.

⁸⁰ See, for example the CC's report on the *Supply of banking services to small and medium-sized enterprises*, Chapter 6 and the CC's report on *Store card credit services*.

between the FTSE350 audit clients and other audit clients as described in the Annex to this Paper.⁸¹

Table: UK firm revenue and margins for Audit and Non-audit Services, FY 2006-2011

	2006	2007	2008	2009	2010	2011
Net Revenue (£ million)						
Total						
Audit Services						
<i>FTSE 350</i>						
<i>Other Audit</i>						
Non-audit Services						
Gross Margin (%)						
[Data in table redacted]						
Total						
Audit Services						
<i>FTSE 350</i>						
<i>Other Audit</i>						
Non-audit Services						
Net margin (%)						
Total						
Audit Services						
<i>FTSE 350</i>						
<i>Other Audit</i>						
Non-audit Services						


7.10 It is notable that Deloitte UK earns [REDACTED] of its total annual fee income and [REDACTED] of our gross profit from FTSE 350 audit clients.

7.11 The factors underlying the changes observed in the table above in net revenue and gross margin for these service categories are explained in [REDACTED]. In summary:

- (a) both Audit and non-audit services have been affected by the adverse economic conditions since late 2007;

⁸¹ As noted previously, this detailed allocation of overheads is not undertaken for the management of the business, and we would welcome the opportunity to discuss with the CC the metrics that have been used at this stage to apportion overheads.

- (b) the divergence in the growth rates observed, and the fact that Audit Services net revenues maintained positive growth throughout this period, is likely to reflect the extent to which Audit Services possess some counter-cyclical factors;



7.12 The gross profit margin for Audit Services has varied between [REDACTED] and [REDACTED] over the period, while that for non-audit services has fallen from [REDACTED] in 2006 to [REDACTED] in 2011. This overlap of the range of gross margins achieved provides some evidence that audit prices and profits are not excessive since the provision of non-audit services occurs in multiple, highly competitive markets.

7.13 There has also been some convergence between the gross margin performance of Audit Services and non-audit services over the period for which data is available. The gap between gross margins for Audit Services and non-audit services was [REDACTED] percentage points in 2007 and [REDACTED] percentage points in 2011. Given this data covers only part of an economic cycle, it is not possible to conclude whether the narrowing and convergence of gross margins reflects a trend or a cyclical pattern.



Benchmarking Deloitte profitability

7.14 Since it is not possible to compare Deloitte's returns against a theoretically appropriate cost of capital, the most useful assessment of the reasonableness of our profitability is to set our profitability against that of appropriate comparators.

7.15 Comparators should be selected on the basis of the following criteria:

- (a) the comparators' business characteristics are as similar as possible to those of Deloitte;
- (b) the comparators should, as far as possible, face similar commercial and financial risks (since, in the long term, returns should compensate for risks); and
- (c) the market in which the comparators operate should be demonstrably competitive, to the best of our understanding.

7.16 However, Deloitte's net margins can only be compared directly against those of other partnerships, including the other major auditors, mid-tier firms and law firms. This is because net profit margins for partnerships cannot be compared directly with the equivalent figure for limited companies, because such a comparison would not take account of the fact that partners are remunerated entirely out of profits and do not draw any salary or other remuneration (unlike their equivalents in a limited company).

7.17 Due to the likely focus on comparators operating outside the reference market, we present comparisons of net margins and profit per partner against UK-based law firms and net margins against mid-tier audit firms. We would note, however, that differences between the net margins earned by the major auditors do exist, highlighting differences in the business models between them (in particular, the relative proportions of equity and salaried partners). Average profit per partner is a more valuable measure of profitability of the major auditors. The average profit per partner of the other big 4 firms is similar or lower than that achieved by Deloitte.

7.18 We recognise that profit benchmarking could be extended to include other professional services firms that are not organised as partnerships. However, as mentioned above this presents the challenge of adjusting for the partnership model. We would welcome the opportunity to discuss this challenge in more detail with the CC.

Benchmarking against UK-based law firms

7.19 We have split the comparator group into three parts so as to provide more granularity on the comparator set. As the figures below show that, regardless of whether measured using net margins or profit per partner:

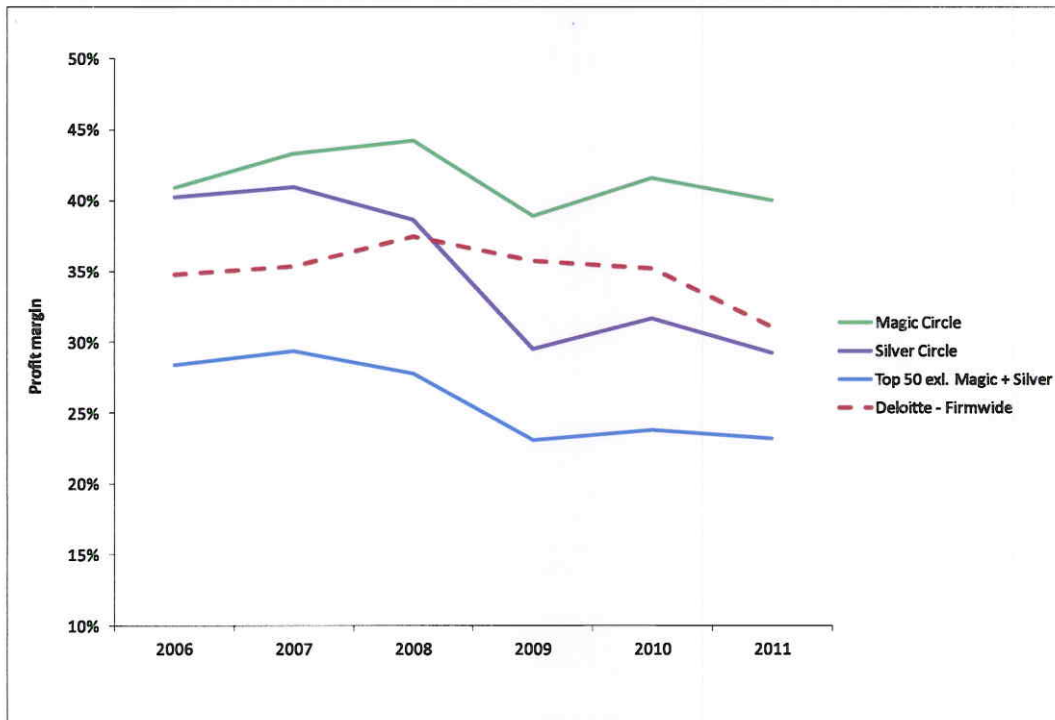
- (a) the profitability of Deloitte (and therefore also the other Big 4) overall lies below that of the Magic Circle law firms
- (b) profits of the Silver Circle law firms are higher than those of Deloitte in 2006 to 2008, falling below in 2009 to 2011; and

(c) 

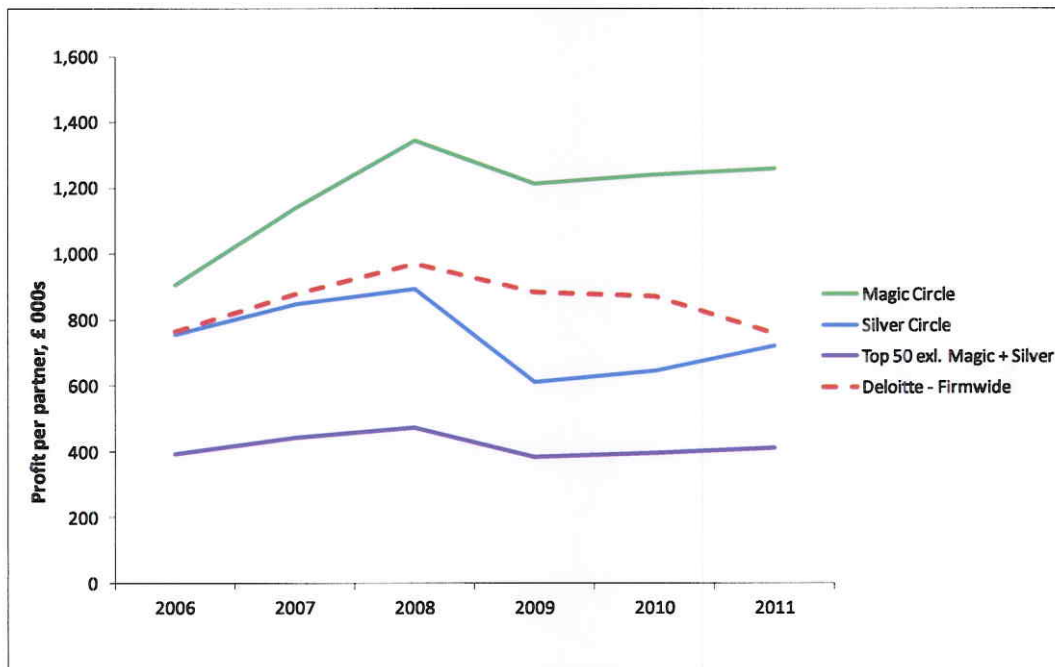


⁸² Reasons for the dip in net margins for audit services and the FTSE350 clients in 2007 are set out in our response to Q65 of the Response.

Graph: Comparison of Deloitte and law firms' net profit margins [Table partially redacted]



Graph: Comparison of Deloitte and law firms' profit per partner [Table partially redacted]



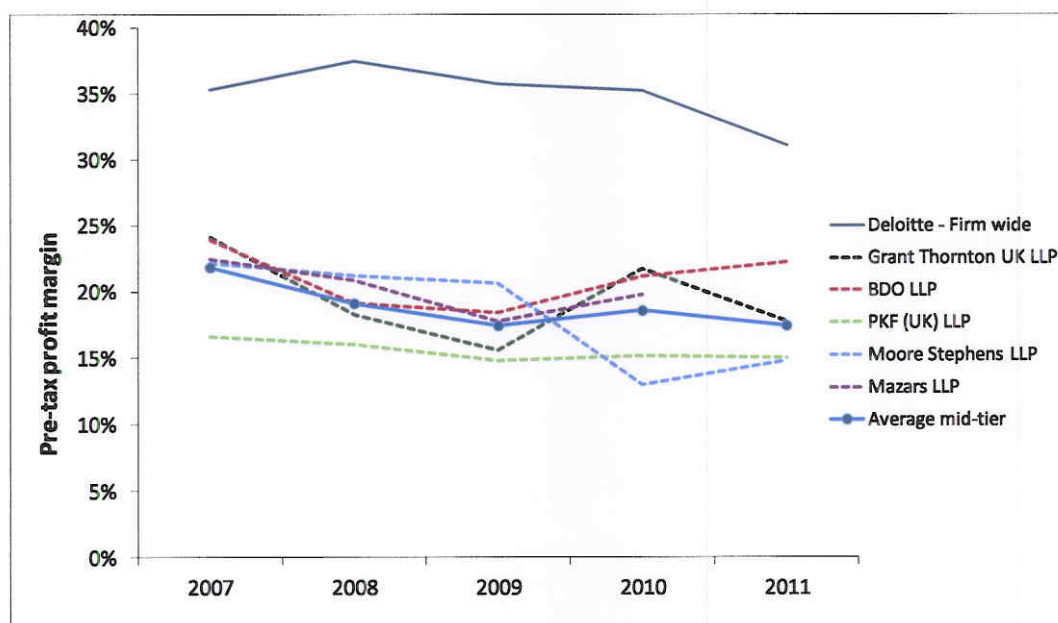
Source: Deloitte analysis of internal data and data obtained from Legal Business

7.20 The second pattern to note from these comparisons is the hierarchy in the returns achieved by the Magic Circle and the Silver Circle, with those for the Magic Circle being significantly above those of the Silver Circle and, in turn, above those of the next tier of law firms. This shows that, in competitive markets, where service providers are able to – and do – distinguish themselves on the quality of service provided to clients, this is reflected in the returns they achieve.⁸³

Benchmarking against mid-tier audit firms

7.21 The graph below shows Deloitte’s total firm and [redacted] net margins, alongside those reported for a number of mid-tier firms. As this shows, in a pattern consistent with that observed for the law firms, our returns are above those of the mid-tier operators included in this analysis.

Graph: Comparison of Deloitte Firm wide and [redacted] profit margins with mid-tier audit firms’ profit margins⁸⁴ [Table partially redacted]



Source: Deloitte analysis of internal data and data obtained from Perfect Information

7.22 Just as the Magic Circle law firms achieve higher returns than other law firms, as a result of their premium quality, so it is the case that we earn premium returns relative to mid-tier audit firms. The differences in net margins reflect a number of factors including:

⁸³ It may also generate a virtuous circle that higher quality of service generates higher margins and enables those higher quality operators to grow.

⁸⁴ It should be noted that the net profit margins for the mid-tier firms are for the total firm, rather than Audit Services only. Baker Tilly UK Audit LLP has not been included in the analysis as data points were available for FY09 and FY10 only. However these were in line with the profit margin for Mazars LLP.

- (a) the nature of the clients served, and in particular the risks entailed in serving those clients (see below);
- (b) the quality of service offered;
- (c) the skills and expertise of the personnel and their efficiency of delivery; and
- (d) the risks taken in making the investments necessary to grow our Audit Services.

The differential returns therefore reflect the outcome of normal and effective competition across all segments of the audit market.

Profitability and risk

7.23 It is important to note that the above comparisons do not seek to quantify the effect of the higher risk profile of our audit practice. We explain in greater detail in the Response the nature and extent of that risk, and our very intensive risk management process⁸⁵. In particular, we face unlimited liability (which cannot fully be covered by insurance⁸⁶) in respect of our audit work.

7.24 That risk is exacerbated in relation to the audit of large companies, for two reasons:

- (a) the complexity of the businesses of large companies, which requires much more detailed assessment than relatively simpler, smaller businesses. While size is not an invariable indicator of complexity or risk, it is generally the case that the business of large companies is more complex from an audit point of view than that of smaller companies⁸⁷; and
- (b) the consequences of company failure are greater in quantum. Where that failure was attributable to auditor negligence, the resulting damages claim could imperil the continued existence of the audit firm⁸⁸.

7.25 Some additional risk premium ought therefore to be factored in to the analysis of the appropriateness of profitability of large company audit, given the necessary relationship between risk and reward. We have not at this stage attempted to quantify the risk premium that is appropriate to large company audit. We are aware that Oxera has sought to quantify the possible uplift to appropriate returns from audit by comparison with returns from a

⁸⁵ See the responses to questions 34-43 in the Response. See also paragraph 2.9 of Deloitte's response to the Issues Statement.

⁸⁶ Deloitte has robust insurance arrangements in place, as explained in its Initial Submission (see page 25), but these are necessarily limited in quantum.

⁸⁷ See, for example, paragraph 4.19 of the OFT's market investigation reference decision.

⁸⁸ See further paragraph 2.9 *et seq.* of Deloitte's response to the Issues Statement.

diversified investment benchmark⁸⁹, but further work would need to be done to test fully the appropriate uplift for large company audit in particular.

Conclusion

7.26 Our profitability assessment leads to the conclusion that the profits earned by Deloitte from the provision of Audit Services are not excessive and provide an appropriate level of return reflecting market and business risks and the quality positioning of our services in the audit market. This finding is consistent with our analysis of audit fees which has demonstrated that these fees are set in accordance with cost drivers such as corporate scale, complexity and risk – and not as a function of the market share of the major audit firms.

8. CONCLUSION

8.1 As discussed in detail in the Response and in our previous submissions, we consider that the evidence shows that the market for the provision of statutory audit to large companies is highly competitive and delivers efficient outcomes in terms of price, quality, service and innovation for the benefit of consumers.

8.2 The investors and Audit Committees of FTSE 350 companies require their auditors to be able to provide a consistent level of support delivered at a consistently high quality in all of the territories across the globe in which they operate. They expect their auditors to be innovative and to provide insights to their business as part of the audit deliverable. Audit Committees demand value for money and, in their role as expert and challenging buyers of Audit Services, they are readily able to discern quality and to evaluate the merits of an audit offering. These requirements and expectations are not easy to meet. Audits of FTSE 350 companies are complex and highly technical services. They are also risky: the failure of a FTSE 350 could have catastrophic consequences for the audit firm.

8.3 We have recognised these requirements and expectations and, over many years, have made, and continue to make, the necessary investments (without any guarantee of success) to build-up the capabilities needed to meet these requirements and expectations. Our successes in winning FTSE 350 audits have not been delivered to us on a plate: we have fought hard at considerable cost and risk to expand our client base over the past 15 to 20 years and we continue to strive hard to provide audits of the highest quality to existing clients and to build new relationships. Winning FTSE 350 audit clients requires sustained investment and focus on relationship development – they are not gained overnight. We should not be penalised for our hard-earned success solely because other firms, who have had the same opportunities as us to expand, have not been prepared to make the

⁸⁹ Oxera, *Ownership rules of audit firms and their consequences for audit market concentration*, 2007.

investments needed or to take the risks required to demonstrate their audit credibility to FTSE 350 clients.

8.4 We welcome continued engagement with the CC in relation to the issues covered in our Response and summarised in this Paper. We would be very happy to discuss any of these issues directly with the CC at any time.

8.5 In particular, given our expectation that econometric analyses are likely to be of significance in the CC's investigation, we would welcome early engagement on the econometric methodologies that the CC is minded to employ before the CC embarks on what is likely to be a lengthy and complex work programme.

8.6 In addition, we would continue to urge the CC to engage directly with FTSE 350 companies and their stakeholders to seek their detailed views on the matters raised in the CC's Issues Statement and in the CC's questionnaires.

Annex
Allocation of Overheads

[methodology redacted]