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Competition Commission Audit Services Market Inquiry

12 October 2012

Deloitte response to the Competition Commission's working paper "Barriers to entry: international networks"

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1. Introduction and summary

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

1.2 This response comments on the following areas:

(a) The reasons for developing an international network;

(b) Views on the possible effect of a network on competition.

1.3 We have already addressed some of these issues in our response to the CC's working paper on "The framework for the CC's assessment and revised theories of harm" (the ***Theories of Harm Working Paper***) and our response to the CC's working paper on "Restrictions on entry and expansion" (the ***Barriers to Entry Working Paper***).

2. The reasons for developing an international network

2.1 The Working Paper sets out some comments on the reasons why firms may develop an international network. For example:

"*membership of a network may affect the level of competition in a market and the level of profit that a member firm may be able to extract*"[1]; and

"*increasing the proportion of testing performed by junior staff to maintain profit margins*"[2] in relation to centralised audit processing centres (usually based overseas).

2.2 These comments bring to mind the suggestion in the Barriers to Entry Working Paper that firms have engaged in discretionary, strategic actions to lower their marginal costs thus raising barriers to entry[3]. We have already submitted a response to the arguments contained in the Barriers to Entry Working Paper[4], and explained in detail that (a) these investments are not in any way designed to increase barriers to entry, and (b) are not discretionary – they are a necessary response to the demands of Deloitte's clients. The CC's characterisation of firms' incentives is divorced from the realities of the market.

2.3 Given Deloitte's clients' requirements for both (a) good value and, above all, (b) high quality, these investments and improvements in an international network have been a necessary response to client demands. As clients have become more complex, sophisticated, regulated and international over time, it has been incumbent on their auditors to keep up with these developments by ensuring that their systems and methodologies continue to deliver high quality audits, and to deliver those audits efficiently.

2.4 As emphasised in our response to the Working Paper "Evidence relating to the selection process: tendering, annual renegotiations and switching" (the ***Selection Process Working Paper***)[5], the processes employed by companies to appraise their auditors are thorough and detailed. They provide an opportunity for the companies to identify areas where improvement is required or

[1] Paragraph 129

[2] Paragraph 41

[3] Paragraphs 31 and 33 of the Barriers to Entry Working Paper

[4] Paragraphs 5.20 to 5.25 of the Deloitte response to the Barriers to Entry Working Paper

[5] Paragraph 7.7 of the Deloitte response to the Selection Process Working Paper

desired, to examine the audit plan for the following year, and to challenge and agree the efficiency improvements proposed. Such efficiency savings that have been and may be achieved in the future through improvements in international working practices will therefore be passed on to clients.

2.5 The Working Paper's implications are therefore without evidential basis, and they are made without reference to the increasing demands from companies for high quality service, delivered efficiently, on an increasingly international scale. Investments in an international network are undertaken because companies demand that auditors are able to perform audits of their international operations at a uniformly high level of quality. Competition between firms ensures that any cost savings achieved through enhanced international integration are passed through to companies. Companies therefore benefit from the investments that are being made by all firms in developing their international capabilities.

3. The effect of a network on competition

3.1 The Working Paper states that:

> *"In our initial view, it does appear that international networks are a good example of the virtuous / vicious circle identified in our Restrictions on Entry and Expansion working paper. Those with large, established networks may compete for and win the audits of large companies, with any success reinforcing the strength of the network and making it more attractive to potential future customers. Those without such a network are likely to be excluded from tender processes where there is expected to be a significant level of international audit work, and so the risk of any investment in network expansion is increased."*[6]

3.2 This fails to take into account the actual position of the mid tier firms. The evidence in the Working Paper shows that a number of mid tier audit firms have large international networks: "*Where all the four largest networks are present, both BDO and GT show a broadly similar level of international coverage"*[7]. Furthermore, the coverage of the all networks has been growing, and, significantly, as the Working Paper notes, '*these increases were particularly significant for the smaller networks'*[8]. This convergence of coverage is at odds with the view in the Working Paper that larger networks inevitably get stronger at the expense of smaller ones and therefore refutes the argument that smaller firms are constrained in their ability to expand internationally through a '*vicious circle'* .

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

(a) BDO:

(i) *"Contrary to recent comments made by some Big Four firms, BDO, GT and other firms have made significant investments in recent years in broadening and strengthening their international networks. For example, BDO's UK firm invested substantially in BDO's Indian network firm and more recently has invested in expansion in the Middle East."*[9]

(ii) *"BDO continues to invest in its network."*[10]

(iii) *"BDO believes that the BDO network is large enough to audit almost all companies."*[11]

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[6] Paragraph 132

[7] Paragraph 93

[8] Paragraph 89

[9] Paragraph 5.1.10 of BDO's response to the Issues Statement

[10] Paragraph 6.2 of BDO's response to the Issues Statement

(iv) *"Over the last two years we have committed resources to strengthening and further improving [our network's] operation and management. Actions include the global launch of a new audit methodology tool and continued investment in our corporate finance office in Dubai and our Indian member firm."*[12]

(b) Grant Thornton:

(i) *"GTI had made a significant investment in the last ten years in its international organization and now spent approximately $60 million a year on its international infrastructure. It had made significant investment into creating a more cohesive organization, for example it had established international practice heads, a global board of governors and the major firm CEOs met on a quarterly basis to discuss international strategy."*[13]

(ii) *"Grant Thornton has the necessary international capability to audit the large FTSE 350 companies. Grant Thornton is a member of Grant Thornton International, a network of accounting and audit firms present in more than 100 countries, including all of the major business hubs across the world; in aggregate member firms employ over 30,000 staff"*[14]

3.4 These are important steps, which have substantially increased the footprint of the largest mid tier firms. Although we do believe that there remains a difference in capability in key jurisdictions between Deloitte's network and that of the largest mid-tier firms, we believe that the capability gap is decreasing over time, directly in contradiction to the Working Paper's conclusion of a *"vicious circle"*.

3.5 The evidence of the mid tier firms shows that they consider their networks to be comparable to those of top tier firms: there is no evidence that they have submitted to the CC supporting a view that the need for an international network constrains their ability to win FTSE 350 audits.

3.6 Moreover, that it is possible to grow a competitive practice from a position of relative weakness with meaningful but achievable investment is consistent with our own recent experience. Since 2005, Deloitte has almost doubled total revenues from its Swiss business, from a position where it was only the fifth largest market player. In that period, its audit revenues have grown from CHF [✂]m in FY06 to CHF [✂]m in FY12. Deloitte has won the audits of major Swiss businesses such as Givaudin, Orascom, SR Technics, Nyrstar, BNP Paribas, Candax Energy, WWF International, Kempinski Hotels, Publimo Group[15].

4. Conclusion

4.1 Our view, which is backed up by the experiences and evidence of the mid tier firms, is that the major mid tier firms all belong to large, established and growing international networks. No firm has submitted to the CC that investment in its international network is a barrier to its growth with respect to FTSE 350 audits. It is incorrect to conclude, therefore, that international networks are a barrier to entry that prevent mid tier firms from competing against top tier firms for FTSE 350 audits.

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[11] Paragraph 2.3 of BDO's response to the Issues Statement

[12] Page 11 of BDO's Annual Report 2010

[13] Paragraph 2 of the summary of Grant Thornton's hearing with the CC

[14] Paragraph 1.5(a) of Grant Thornton's response to the Issues Statement

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