

## PwC Response to the Barriers to entry: International networks working paper

- 1 This submission sets out our initial views on the Barriers to entry: International networks working paper (the **International Networks WP** or the **Paper**). We provide a more detailed point-by-point response to some of the paragraphs in the Paper in the Annex to this response.
- 2 In this submission, we first set out our views on the Competition Commission's (**CC**) initial conclusions on the effect of the network on competition for the supply of audit services to the FTSE 350 in the UK. We then focus on three key themes that should be drawn from the Paper and that we believe the CC should take into account as it develops its thinking:
  - (a) international professional service networks have developed as a result of their constituent firms' need to respond to evolving customer demand;
  - (b) the four largest firms belong to larger and more experienced networks of member firms than mid-tier firms; and
  - (c) the risk of failure of the four largest firms or the networks in which they are members is overstated.

### The CC's initial conclusions on the possible effect of a network on competition

- 3 The focus of the CC's initial conclusions<sup>1</sup> is on the network as a barrier to entry and the conclusion in the final paragraph of this section is that the development of international networks is a good example of how smaller firms are excluded from tender processes. We discuss how far this may in fact be the case below but our principle concern is that there is an undue focus in the Paper on networks as a possible barrier to entry. This obscures the much more significant point that the development of strong international networks by the largest audit firms, and the efficiencies associated with such networks, are examples of the competitive process working well.
- 4 We are also concerned that by focusing on international networks as a barrier to entry, the CC has not considered the 34% of FTSE 350 companies that have no international element in their audit<sup>2</sup> and the 92% of respondents to the CC's Survey from companies with no international operations who did not consider a firm's international network to be important when choosing an auditor<sup>3</sup>. For the audits of these companies, the lack of an international network (or membership of a smaller network) would not be a barrier to entry.
- 5 The four largest audit firms expended considerable time and resources, and took risks, to contribute to the building of their networks. They continue to invest to contribute to the maintenance and improvement of the networks in which they are members. This was done (and continues to be done) to meet client requirements; each firm understands that if they and

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<sup>1</sup> Set out in paragraphs 128 - 132 of the Paper (all paragraph references are to the Paper unless otherwise stated).

<sup>2</sup> Table 8 of the Paper.

<sup>3</sup> See slide 39 of the IFF Survey Presentation (the **CC's Survey**) which was published on 26 July 2012.

the networks in which they are members did not do this their competitors would and business would be lost.

- 6 The CC states that 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*”<sup>4</sup>. This conclusion does not recognise that:
  - (a) Most of the attributes described in the paragraph (economies of scale, cohesiveness of the network, ability to employ higher quality staff) give rise to efficiencies that enhance competition. While the Paper refers to the possibility that such attributes may constitute a barrier to entry to firms that do not possess them, it does not acknowledge that these attributes contribute to the provision of an efficient, quality service that is responsive to client demands.
  - (b) There are four large firms which are all members of large and cohesive networks, which mean that the benefits of these efficiencies are passed on to their clients through the competitive process. This is specifically recognised by the CC which states that “*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.*”<sup>5</sup> However, the implication of this paragraph (and indeed the tone of the initial conclusions more generally) is that the CC considers this to be a negative so far as the competitive process is concerned.
- 7 It is unfair for the Paper to principally focus on the impact of the international networks from the perspective of expansion possibilities for the mid-tier firms, when the main market impact is the ability of the four largest firms to leverage off their membership of large networks to deliver efficient, competitive services that meet a growing client demand for international audit services. Indeed, the mid-tier firms have significant networks of their own which could form the basis of a further phased international expansion if those firms decided to invest in the way that the four largest firms have done. The mid-tier firms also have the option to merge or to encourage mergers of other firms within their networks should they wish to speed up the development of their networks.

#### **International coverage of network required to satisfy customer demands**

- 8 The CC correctly recognises that it is becoming increasingly important for an audit firm to be a member in a suitable international network to cater for the demands of large listed international companies<sup>6</sup> (this has been the case for some time now) and that a strong, credible international network is an important attribute for winning business<sup>7</sup>.
- 9 We agree with the CC that many of the networks are becoming increasingly integrated, specifically with respect to standardised methodologies, software and the level of monitoring

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<sup>4</sup> Paragraph 128.

<sup>5</sup> Paragraph 132.

<sup>6</sup> Paragraph 113.

exercised by the network<sup>8</sup>. A priority for the PwC network of member firms is to provide clients with consistent quality and services globally, and as we have explained in detail,<sup>9</sup> the UK firm and other firms in the PwC network continue to make significant investments in supporting the development of the PwC network. For example, the PwC network works to promote consistent development across the network in all lines of service; the UK firm brings emerging leaders from South America, Africa, Asia and Europe together to work with Assurance teams in the UK for two years as part of PwC's World Experience Programme.

- 10 We agree with the CC that the opportunity offered by firms that are members in large international networks for their people to gain experience of working on audits of subsidiaries of large international companies and the possibility of secondments or transfers to other firms within the network, as described above, is an advantage in attracting high quality graduates and other personnel<sup>10</sup>.
- 11 As the CC recognises, a key indicator of the growing need for an international network is that the proportion of UK FTSE 350 company group audit fees that relate to work undertaken by the UK audit declined by 11 percentage points in the period 2006 to 2011<sup>11</sup>. Given the CC's analysis and this clear evidence, we disagree with the CC's suggestion that there is only "some" evidence of an upward trend in the level of non-UK audit work that is carried out as part of FTSE 350 audits<sup>12</sup> - the evidence is clear that, in aggregate, FTSE 350 companies have increasingly international audit requirements.
- 12 The CC also recognises that UK companies with no current overseas activities, but with expectations of expanding overseas in future, are likely to benefit from, and value, the existence of a strong international network<sup>13</sup>. We broadly agree with this and note that:
  - (a) despite the fact that in the CC Survey only 8% of respondents from companies with no international operations considered that a firm's international network was important when choosing an auditor;
  - (b) as soon as between 1 and 40% of the audit fee is accounted for by audit of a company's activities outside the UK the proportion jumps to 63%.<sup>14</sup>
- 13 The CC notes that the AIU 2012 annual report states that firms are increasingly using centralised processing centres or increasing the proportion of testing performed by junior staff to maintain profit margins<sup>15</sup>. These outsourcing centres and global software tools are an important part of meeting our customers' demands and of enhancing quality [X]. A significant amount of

<sup>7</sup> Paragraph 122.

<sup>8</sup> Paragraph 7.

<sup>9</sup> See paragraph 1.8(b) of our Submission and Response to Issues Statement (12 January 2012,) (our **Initial Submission**) and our response to Q15 of the Market and Financial Questionnaire (24 February 2012) (our **MFQ Response**).

<sup>10</sup> Paragraph 128(e).

<sup>11</sup> Paragraph 106 and Table 7

<sup>12</sup> Paragraph 112.

<sup>13</sup> Paragraph 115.

<sup>14</sup> See slide 39 of CC Survey.

<sup>15</sup> Paragraph 41.

competitive pressure is imposed on audit firms to price audit services competitively through innovations in the audit and efficiency savings; it would be more expensive for UK staff to carry out these tasks (and clients would be charged more for them). We are mindful of the AIU's annual report, and of the need for us to maintain quality while responding to competitive pressures in the market: the inherent tension between these factors is one that we believe is best managed by us.<sup>16</sup>

- 14 We disagree with the CC's suggestion that where financial savings are made through off-shore centres, the principal benefit appears to be in relocating work to lower-cost regions, rather than necessarily efficiency or quality gains<sup>17</sup>. There are efficiency gains and economies of scale to be made by sharing costs and spreading investments across member firms in a global network, as accepted by the CC in relation to the development cost of audit software platforms/tools.<sup>18</sup> [X].

#### **The four largest firms are members in larger and more experienced networks**

- 15 We agree with the CC that the four largest firms are members in the largest and strongest networks and recognise that it may be difficult for the mid-tier firms to replicate these networks in the short to medium-term<sup>19</sup>. We accept that the greater the financial resource we invest in the PwC network, the better the network will be, which in turn will mean that it is better able to meet the demands of our global clients.
- 16 However, the strength of a network is not principally founded on the number of member firms in different countries: prerequisites to a successful network are the ability to offer large companies consistent quality across the network and the specific expertise and experience needed to audit those companies. The case studies and CC's Survey results support this position<sup>20</sup>. The behaviour of large companies in preferring large audit firms reflects the fact that the four largest firms have qualities, such as membership in superior networks and greater experience, which makes them particularly suited to audit large and international companies. Larger companies are also more aware of quality and the need for it to be consistent across the network. As the CC notes, 66% of FTSE 350 companies identified "*consistency of delivery world-wide*" as an "*important*" factor in assessing their audit quality<sup>21</sup>.
- 17 The larger mid-tier firms are members in significant, albeit smaller, networks which could form the basis of a further phased international expansion if appropriate investment decisions were made. For example, these firms and the smaller mid-tier firms could target:

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<sup>16</sup> See Section 6C and Annex 6 of our Initial Submission.

<sup>17</sup> Paragraph 41.

<sup>18</sup> Paragraph 74.

<sup>19</sup> Paragraph 128(a).

<sup>20</sup> Paragraphs 121, 125-126.

<sup>21</sup> Paragraph 121.

- (a) the 37% of FTSE 350 companies which have between 1 and 40% of their audit fee accounted for by audit of the company's activities outside the UK and who do not consider an international network as important when choosing an auditor<sup>22</sup>; and
  - (b) those companies which operate in particular countries but do not have a global operation such that the mid-tier firms could focus on specific geographical zones and groups of audit firm partners, with a goal of building their networks incrementally.
- 18 However, currently there is a lack of incentive for the mid-tier firms to invest in expansion due to the highly competitive nature of the market, which is already well-served by the four largest firms resulting in a minimal base of dissatisfied customers to target. As the evidence shows, prices and margins are at competitive levels due to fierce competition between the existing suppliers who react to effective competitive pressure exerted by large and global buyers. The mid-tier firms also have the option to merge, or to encourage mergers of other firms in their networks, in order to fast track such development but, as mentioned above, simply having an extensive network does not mean that the network has all the necessary attributes to compete.
- 19 Similarly, mid-tier firms could invest (as we have done) in offshore centres of expertise (e.g. audit processing facilities) without any significant cost disadvantage given a number of them already have substantial networks in existence to support and utilise such centres<sup>23</sup>.
- 20 The CC notes<sup>24</sup> that there are a small number of examples where the member firm of one network has merged with, or acquired, another local firm which was a member of a different network. Such mergers or acquisitions may lead to a gap in the representation of one of the networks, depending on whether alternative local firms or groups of partners can be found to fill the gap. The CC states that it is not clear from the available examples whether such switches between networks are driven by the switching firm's partners or by international motivation. The merger of one local firm with another will most often be driven by the merging firms' need to serve the evolving needs of clients (whether nationally or internationally). Any decision of a partnership will have to be approved by its partners<sup>25</sup> - and it therefore follows that if smaller firms choose to switch networks or join a network it is because the partners of that firm see it as the best available opportunity for them. Furthermore, in most jurisdictions an acquisition would be subject to obtaining approval, where applicable, from local competition authorities and such approvals are designed to ensure that the acquisitions do not result in anti-competitive effects.
- 21 We agree that by virtue of being a member of a network, firms will gain business from the international subsidiaries of other member firms' domestic clients and that this in turn may generate additional revenue for the network<sup>26</sup>. This is a client driven requirement reflecting the

<sup>22</sup> See slide 39 of CC's Survey.

<sup>23</sup> As noted by the CC in paragraph 86.

<sup>24</sup> Paragraph 35.

<sup>25</sup> Unlike a limited company, partnership firms do not have shareholders who may be interested in a sale to which management is hostile. To the extent that the firm's management was to propose a merger to which the partnership was hostile, the partners could defeat the proposal - and equally the partners would have to approve any proposed merger.

<sup>26</sup> Paragraph 128(c).

desire of clients to have access to a joined-up, coherent and high quality network to meet their requirements.

- 22 However, we disagree with the CC when it suggests that international networks appear to be an example of the “*vicious circle*” identified in the CC’s Restrictions on Entry and Expansion paper<sup>27</sup> as this is not the “*vicious circle*” as described in that working paper. The “*vicious circle*” suggested in that paper was that barriers might relate to a perception of lack of ability rather than a reality. In the case of international networks, it is clear on objective measures that the mid-tier networks lack the resource, experience and expertise of those of the four largest firms. The incentive for the mid-tier to invest in order to compete more efficiently with the four largest firms is linked to the market’s views on the performance of those four firms. If the four largest firms were to under-perform, then the incentive for investment increases and mid-tier firms would be expected to target specific countries and groups of partners and build incrementally.

#### **Risk of failure of one of the four largest firms is overstated**

- 23 In paragraphs 148-150, the CC sets out a theoretical set of circumstances which might lead to the collapse of one of the four largest firms. We find these paragraphs highly speculative and it is unclear as to why this purely hypothetical circumstance is being described. While it is not suggested in the Paper, we would be extremely concerned if the CC were to consider any adverse effect on competition (**AEC**) finding on the basis of such hypothetical projections: as far as we are aware, there has never been a previous AEC finding relating to a hypothetical future counterfactual, and we do not believe such a finding would be within the scope of the CC’s statutory jurisdiction.<sup>28</sup>
- 24 As we have explained in detail,<sup>29</sup> in our view the likelihood of failure of a large firm is remote, in part as a consequence of the regulatory regime having been strengthened considerably in recent years to reduce the risk of audit firm failure and exit. While we accept that - given the unlimited liability risk we face - the risk of audit firm failure and exit from the market can never be completely eliminated, the inherent strength of the networks in which the largest firms are members makes the recurrence of events such as those that led to the demise of Arthur Andersen significantly less likely. Notably, audit firms have responded to those events by increasing their internal quality controls and risk mitigation efforts - resulting in far better control of risks than historically was the case.<sup>30</sup>

<sup>27</sup> See paragraph 132 of that paper.

<sup>28</sup> As section 134(1) of the Enterprise Act 2002 makes clear, on receipt of a market investigation reference, the CC is required to decide “*whether any feature, or combination of features, of each relevant market prevents, restricts or distorts competition in connection with the supply or acquisition of goods or services in the United Kingdom or a part of the United Kingdom*”. The test is clearly drafted to refer to current market features, and not hypothetical features of a speculative possible future market, in considering this AEC test. By analogy with merger control, the CC is required to consider the most likely counterfactual in assessing whether there has been a substantial lessening of competition, but it could not base a prohibition decision on a theoretically possible but highly unlikely future failure of a key market competitor.

<sup>29</sup> See our response to Q48 and Q110 of the MFQ Response.

<sup>30</sup> This has resulted in considerable reductions in the level of audit related litigation (see paragraphs 6.63-6.67 of our Initial Submission).

- 25 The two events that are the most likely to risk triggering a large firm failure are:
- (a) a criminal prosecution or other action that might lead to a cancellation of the audit licence of an audit firm; or
  - (b) a civil claim of such magnitude that the potential liability would be sufficient to threaten the existence of the audit firm.
- 26 As we have previously explained,<sup>31</sup> we believe the above events are highly unlikely to lead to a major network failure or exit [§<].
- 27 We note the CC recognises the informative examples of what happened following recent significant audit problems experienced by firms in the PwC network in Japan and India (as highlighted in the Paper<sup>32</sup>): despite these both being significant jurisdictions, and the Indian firms in question being full member firms of the PwC network, there has been no long-term detrimental impact on the viability and success of the PwC network or on the UK firm.

PricewaterhouseCoopers LLP

24 October 2012

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<sup>31</sup> See our response to Q48 and Q110 of the MFQ Response.  
<sup>32</sup> Paragraphs 139-144.

## ANNEX

In this Annex we provide a more detailed response to some of the points in the Paper and identify important mistakes that the CC has made. We have highlighted only those points about which we feel most strongly; where we have not commented, this should not be interpreted as implying agreement with the conclusions drawn in the International Networks WP. For ease of reference, we use the same paragraph numbers below as those used in the Paper.

### 1 Introduction

- 1.1 **Paragraph 3:** For avoidance of doubt, we note in relation to paragraph 3(c) that member firms, or at least those of PwC, do not set standards in the context of auditing standards as promulgated by regulators. [☒]

### 2 The structure of an audit firm network

- 2.1 **Paragraph 15:** The territory specific requirements that it is suggested might be needed in the UK are actually not optional and must be included.
- 2.2 **Paragraph 33:** We disagree with the suggestion that the group auditor can overcome independence concerns by re-performing the work of the component auditor; this is not the case. Both the group and component auditor must conclude that they are independent. If not, they are not able to undertake the work. ISA 600 clearly states: "*The group engagement team cannot overcome the fact that a component auditor is not independent by being involved in the work of the component auditor or by performing additional risk assessment or further audit procedures on the financial information of the component*". Concerns over competency can be overcome in the manner described but not independence.
- 2.3 **Paragraphs 34-38:** The CC notes that historically UK and US firms created overseas offices and firms to service their domestic clients' international operations which in some instances were driven by a single client. We agree with this point. However, the CC goes on to say that had the requirements of ISA 600 been in place, this route of expansion might not have been allowable - although if the new branch office or firm shared in the profits of the 'parent' firm, this might not be an issue (paragraph 34). In fact, it is the ethical standards issued by the International Ethics Standards Board for Accountants (IESBA) that address independence of auditors - and the requirements of ISA 600 are premised on these underlying requirements. Thus, it is incorrect to say that ISA 600 would have potentially precluded expansion.
- 2.4 We question what evidence supports the House of Lords Select Committee on Economic Affairs quote at paragraph 38. If firms choose to join one of the largest networks, it is because the partners at the firm in question decide it is a good business opportunity. Furthermore, in most jurisdictions, including those given as examples of notable acquisitions, an acquisition would be subject to obtaining approval, where applicable, from local competition authorities, and such approvals are designed to ensure that the acquisitions do not result in anti-competitive effects.

### 3 Function of networks

- 3.1 **Paragraph 43:** [X]
- 3.2 **Paragraph 50:** [X]
- 3.3 **Paragraph 52:** [X]
- 3.4 **Paragraph 54:** Contrary to the CC's suggestion, if a member firm is appointed as group auditor to an international company, then this may require other member firms to cease offering some non-audit services (NAS) where the provision of such services would breach the relevant independence rules. However, it would not require other member firms to cease offering NAS altogether. Where firms act as auditor they typically continue to provide a range of NAS while complying with independence rules and the policies of the relevant companies.

### 4 The role of the network in setting audit methodologies and standards

- 4.1 **Paragraph 59:** We suggest amending this paragraph to reflect the requirements of ISA (UK&I) 600 "*The UK auditor of the consolidated financial statements of a parent and its subsidiary undertakings must adhere to the requirements of Clarified ISA (UK&I) 600 'Special Considerations—Audits of Group Financial Statements (including the work of Component Auditors)'. The 'group auditor' does not need to audit all the components of a group, but needs to obtain sufficient appropriate audit evidence that the consolidated financial statements are free from material misstatement at the group level.*"
- 4.2 **Paragraph 60 (footnote 24):** This footnote could be misleading without additional context to explain why it is appropriate for a higher level of materiality and a lower level of testing to be applied when auditing component financial information for the purposes of a group audit as opposed to a statutory audit of the entity's financial statements. We suggest amending the wording to that shown here.<sup>24</sup> "*If a statutory audit is not legally required (or requested) in an overseas subsidiary, a greater level of materiality might be used by the component auditor, to provide assurance to the group financial statements and reduce the overall level of audit testing, because the materiality applicable to the group financial statements will normally be higher than would be appropriate for stand-alone statutory financial statements of the overseas subsidiary.*"
- 4.3 **Paragraph 61 (footnote 25):** The intended meaning of this footnote is unclear. If the intended meaning is that not all components require work to be performed in support of the group audit opinion then the footnote should be linked to the first sentence of paragraph 60. Alternatively, if the intended meaning is that the nature of work that is conducted on a component need not be an "audit" (i.e. it could be a "review" or "specified audit procedures") then this should be clarified. The current linkage to the sentence on the level of detail and subsequent scrutiny is incorrect.
- 4.4 **Paragraph 62 (footnote 26):** The reference to paragraph A35 of ISA 600 in this footnote could be misleading without appropriate context. Paragraph A35 discusses how a group auditor may

gain an understanding of a component auditor. While this includes understanding the results of the network firm's quality control monitoring system this is but one factor that is considered in determining the appropriate level of involvement of the group auditor in reviewing the sufficiency and appropriateness of the component auditor's work.

- 4.5 **Paragraph 68:** The existence of a common quality assurance platform enhances the quality of audit engagements conducted across a network. It may impact on the resource requirements of the group auditor but audit engagements vary and the resource requirements and work effort deemed necessary to evaluate the work of the group auditor and each of the component auditors will depend on the specific engagement circumstances.
- 4.6 **Paragraph 69:** The first sentence of this paragraph is not accurate. There are no circumstances where reliance solely on a network's quality assurance arrangement is sufficient. ISA 600 requires the group auditor to evaluate whether the audit evidence obtained by the component auditor is sufficient and appropriate.
- 4.7 **Paragraph 70:** We confirm that we provided the CC with an example where we had used an audit firm outside our network and that working with a non-network firm incurred a "*significant addition to the local audit firm's fee*". However, we disagree with the suggestion provided at the end of paragraph 70 that because the increase in group fee was relatively small, it is just as efficient to use a non-network firm for component audits. The increase in the group fee was relatively small in the example we provided [X]. [X] a 2% increase is significant in the context of the component audit work itself – an increase at this level for a number of components would soon add up.

## 5 The international coverage of networks

- 5.1 **Paragraph 93:** In providing an initial conclusion, the CC understates the evidence that it has found distinguishing the four largest networks from those of the mid-tier firms. GT and BDO are only present in 76% of the countries where all the four largest networks are present (paragraph 91 of the Paper), which clearly shows that their level of international coverage is not "*broadly similar*" to that of the four largest firms, but significantly lower.
- 5.2 **Paragraph 95:** That the mid-tier networks are not similar to the networks in which the four largest firms are members is clearly acknowledged by the CC in the conclusion that "*[t]here are two identifiable tiers of networks*" being those of the four largest firms on the one hand and of the mid-tier on the other. Not only do the mid-tier networks have fewer staff in each firm and location, but the staff are likely to be less experienced given that the client portfolios of mid-tier firms consist of smaller and less complex companies.<sup>33</sup> The evidence does not support any suggestion that the mid-tier firms are comparable in size or quality with those of the networks in which the four largest firms are members.

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<sup>33</sup> Paragraph 37 of the Firms' Stated Competitive Strategies working paper states that "*there is an acknowledgement from the non-Big Four firms that they cannot compete with the Big Four with respect to remuneration and to a large extent the possible client portfolio when attracting partners*".

## 6 The network and the potential exit of a major auditor

6.1 **Paragraph 141:** [X]

6.2 **Paragraph 144:** Stating that: "*if the firms had been full members*", wrongly suggests that the PwC Indian member firms in question were not full members of the PwC network during the relevant period. This should be corrected. The Indian firms are (and were) full members of the PwC network, whereas ChuoAoyama (in Japan) was a network firm and not a member firm. Therefore any suggestion that this example of a large network surviving damage to its reputation in a particular jurisdiction is less significant because the firms in question were not full members is misplaced. The reality is that despite the PwC India firms' status as members of the PwC network, there has not been significant long term detriment to the wider PwC network as a consequence of the events in India.