Deloitte.

Competition Commission Audit Services Market Inquiry

5 October 2012

Deloitte response to the Competition Commission's working paper "Firms' stated competitive strategies"

Deloitte response to the Competition Commission's working paper "Firms' stated competitive strategies"

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 "Firms' stated competitive strategies" (the ***Working Paper***).

1.2 This response comments on the following areas:

(a) The evidence showing the audit market is highly competitive;

(b) The differing capabilities of providers of audit services;

(c) Investment in winning and retaining FTSE 350 clients;

(d) The allegation of "low balling"; and

(e) Additional comments contained in an annex

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 market is highly competitive

2.1 The Working Paper notes extensive evidence of firms competing very strongly against one another. However, it does not appear to draw the obvious conclusion: that the market is highly competitive.

2.2 The Working Paper sets out at length the evidence that a wide range of players – including but not limited to the top tier firms – compete very actively for audit mandates. Submissions have been collated from BDO, Deloitte, EY, GT, KPMG, Mazars, PwC and PKF. (We note that Baker Tilly, although included in the CC's list of suppliers in the working paper "The suppliers of statutory audit services to large companies", is not represented in the Working Paper, but we believe that it similarly competes for these relationships). The Working Paper clearly demonstrates competition both within the top tier firms, and between the top tier and mid tier firms. For example, the Working Paper notes that:

> *"BDO in its audit strategy stated that 'there has been a considerable increase in competition in the market'*[1]
>
> *"In the audit service, [Grant Thornton's] target is to double FTSE 350 audit clients and fees."*[2]
>
> *"For the three largest firms, PwC considered there to be significant competitive pressure, with the other large firms maintaining contact with most of PwC's audit clients, including establishing shadow teams for some of PwC's audits. PwC noted that a client's management may inform PwC of the existence of targeting in order to exert competitive pressure on PwC regarding price and/or service."*[3]

[1] Annex to the Working Paper (the ***Annex***), paragraph 26

[2] Annex, paragraph 143

[3] Annex, paragraph 254

2.3 The evidence shows that many firms – again, including but not limited to the top tier firms – seek to make use of the opportunities that exist to demonstrate capabilities to FTSE 350 companies, both within and outside tender situations. The Working Paper explains that:

> *"All the firms have adopted in some form the strategic objective of increasing their market share and revenue and to that end have instigated arrangements to win new clients. The firms also have in place programmes to retain their existing clients and to increase the revenues generated from those clients."*[4]

2.4 Furthermore, the Working Paper identifies *"a recurring theme"* in the top tier firms' submissions: that of a *"persistent threat of an audit client going out to tender if fees are not reduced"*. This is consistent with our own experience and the evidence we have submitted to the CC. The Working Paper goes on, though, to say that *"the frequency of this threat occurring and the likelihood of a client following through is not apparent"*.[5] The implication is that because a tender does not occur in every case, the threat of tendering may not be credible and the market may therefore be operating less than competitively. On the contrary, the reason that a company does not in fact put its audit out to tender is because the incumbent auditor has adjusted its approach to maintain a competitive edge – that is, the market is operating well to deliver on companies' requirements in response to the credible threat to tender. This is well documented in the IFF survey conducted for the CC (the ***CC Survey***)[6]. We welcome the Working Paper's reference to *"informed customers"*[7] in this respect, since it is on the basis of their informed and expert nature that company decision makers are able to assess how best to achieve optimal outcomes for their companies.

3. Differing capabilities

3.1 In their evidence set out in the respective sections of the Annex, BDO and Grant Thornton make the point that different firms have differing capabilities to audit FTSE 350 companies.

(a) We note, for example, that Grant Thornton's evidence indicates that it sees Deloitte, KPMG and PwC to be its significant competitors with respect to listed companies – not any other firms[8].

(b) BDO's evidence states that *"the mid-tier firms all suffer from a lack of consistent quality within both their domestic and international audit practices"*[9].

3.2 This is consistent with our experience, and it appears also to be the view of FTSE 350 companies themselves, who make an informed choice between the wide range of audit firms which are competing for their business. They assess these levels of capability and make auditor appointment decisions accordingly.

4. Investment in winning and retaining FTSE 350 clients

4.1 The Working Paper sets out the various strategies adopted by firms in order to win and retain FTSE 350 audit clients[10].

---

[4] Paragraph 3

[5] Paragraph 8

[6] 91% of FTSE 350 companies perform a post audit review of quality and value every year, and 93% perform a review of price every year (slide 46 of the CC Survey). In parallel, FTSE 350 companies who have not switched in the last five years say that this is because they receive a high quality service (51%), receive good value of money (25%) or are happy as things are (21%) (slide 60 of the CC Survey).

[7] Paragraph 8

[8] Annex, paragraph 141

[9] Annex, paragraph 26

[10] Annex, paragraph 1 *et seq*.

4.2 It is clear that all firms adopt a wide range of tactics. That said, it is clear that some firms more actively target FTSE 350 company audit work than others. It should come as no surprise, then, that those who are more active win a larger share of this work. This is in no way an indication of a lack of competition. This can be seen throughout the CC's evidence base:

(a) The Working Paper identifies the following relevant points:

(i) Some of the mid-tier have focused primarily on other markets than the FTSE 350:

"BDO's intention was to become the leading audit practice in the mid-market, acquiring the largest share of AIM clients and increasing its presence in FTSE companies."[11]

"Mazars had adopted a strategy of increasing its share of the small and mid-cap market outside France to continue to build credibility to allow it potentially to enter the large company audit market."[12]

(ii) Some of the mid-tier appear not to have focused on the FTSE 350 at all:

"PKF only tenders for one or two FTSE 350 audits each year and does not put substantial resource into attacking the market beyond this."[13]

(b) The company case studies undertaken by the CC (the ***Case Studies***) similarly include evidence that the mid tier do not actively target FTSE 350 companies:

"There had been no approaches for any work from the Mid-Tier firms. The CFO said that he did not think that he had ever been approached by anyone from the Mid Tier."[14]

"The ACC had only one approach in the last 24 months from a Mid Tier firm (in the context of the company). A meeting was arranged but was cancelled by the firm and had not been rearranged".[15]

"The FD had informal discussions with mid-tier firms but did not think they were interested in the company's audit, although she did think they could do the work".[16]

(c) the CC Survey shows that mid tier firms are less proactive in approaching potential clients – both in the FTSE 350 and outside the FTSE 350. Grant Thornton and BDO are markedly more active than other non-top tier firms (especially as regards non-FTSE 350 clients) but still fall some way short of the top tier firms.[17]

4.3 We discussed with the CC at the hearing the investment that Deloitte makes in terms of the investment of partner (and other) time. We agree with the comment made by BDO at its hearing with the CC that the investment of time and effort is important, and more significant than monetary cost[18].

4.4 Finally, we are surprised that there is no mention in the submissions from the mid tier firms regarding investment to retain their current audit relationships with companies which are likely to grow into the FTSE 350. As we have explained, this would appear to be a promising strategy for

[11] Annex, paragraph 2

[12] Annex, paragraph 198

[13] Annex, paragraph 210

[14] Case study C, paragraph 32

[15] Case study F, paragraph 56

[16] Case study H, paragraph 32

[17] CC Survey, slide 82

[18] Paragraph 19 of the summary of BDO's hearing with the CC.

a firm wishing to expand its FTSE 350 audit client base, and one which would address the comments from certain firms that companies are not sufficiently aware of their capabilities[19].

5. Allegations of 'low balling'

5.1 We are aware of the allegations that we and other top tier firms deliberately target the clients of mid-tier firms with unusually low audit fees. This allegation is repeated in the record of GT's[20] and PKF's[21] evidence in this Working Paper. This is absolutely false.

5.2 Deloitte competes actively and equally for all audit mandates, regardless of the identity of the incumbent auditor.

5.3 Evidence that Deloitte does not particularly target the clients of mid-tier firms with lower prices can be seen in the relative RRRs between 2006 and 2011 for the first year of the audit relationship: audits won from mid tier firms in fact show a 2% higher average RRR ([✂]) compared with audits won from top tier firms ([✂]).

5.4 The Working Paper also sets out a specific allegation that top tier firms strategically low ball to win the audits of companies with non-31 December year ends. It is correct that Deloitte may discount its rates for companies whose audit work can be undertaken in non-peak periods; however, this is a sign of a market operating well to meet client demands in peak periods while retaining efficiency. In particular, there is no evidence of specific targeting of mid tier clients with non-31 December year ends. Between 2001 and 2010, of the 205 switches between the top tier auditors, 51% had 31 December year ends, and of the 30 switches from mid tier to top tier auditors, 50% had 31 December year ends (i.e., the ratio is the same).

6. Investments in 'marketing' to enhance reputation

6.1 The Working Paper sets out certain observations on firms' *"marketing strategies"*[22]. Deloitte's investment in *"marketing"*, as that term is commonly understood, with respect to its audit practice (including items cited by the CC such as sponsoring awards) is negligible and is not a relevant competitive dynamic. The nature of the buyers in this market means that their decisions are conditioned by the ability to demonstrate that the firm will deliver quality and value, not sponsorship of an award ceremony. We have seen no evidence published by the CC that would suggest otherwise.

6.2 Furthermore, the Working Paper is wrong to characterise thought leadership activities as a species of marketing[23]. They are an investment in the intellectual capital of the firm which is a necessary part of competing effectively in a fast changing market. Deloitte shares this intellectual capital with its clients and more widely as part of its commitment to its public interest role.

7. Conclusion

7.1 The Working Paper demonstrates very clearly a pattern of competitive behaviour from all firms in this market. The firms are obliged to compete hard to win audit relationships and to retain those relationships in the face of the detailed assessment of their performance which companies undertake and the competitive activities of their peers.

---

[19] See further paragraph 1.4 of Deloitte's response to the Barriers to Entry Working Paper.

[20] Annex, paragraph 142

[21] Annex, paragraph 222

[22] Paragraph 42 *et seq*.

[23] Ibid.

Annex 1

Responses to points of detail

¶	Working Paper wording	Comment
30	'Only BDO of non-Big-4 firms referred to the use of standing shadow teams. This may be due to a lack of available staff resource'.	It is incorrect to assume that Deloitte have 'shadow teams' standing by, waiting for a FTSE 350 audit client. We identify specific partners and teams to target specific FTSE 350 clients, but during the targeting period they are very much utilised on other engagements. The reference to 'a lack of available staff resource' implies the CC considers Deloitte to have excess underutilised resource. In fact, utilisation of audit partners has been at [✂] on average over the past seven years (and [✂] excluding holidays from the calculation).
Annex 10	'BDO believed that the Big 4 had an inherent advantage in the number of their alumni that were in positions of influence with respect of audit engagements'	We refer the CC to our response to The Theories of Harm Working Paper in which we set out the significant volume of evidence regarding the informed nature of purchasers.
Annex 32	'...the gross margin achieved on FTSE 350 and non-FTSE 350 clients did not differ significantly,'	We refer the CC to our Other Business Information Submission which includes the relative gross margins for FTSE 350 audit ([✂] on average between FY06 and FY11) and non-FTSE 350 audits ([✂] for the same period).
Annex 54	'In its submission, Deloitte identified 57 FTSE 100 companies and 60 FTSE 250 companies where it believed it was potentially conflicted on the basis of its or other Deloitte member firms' business relationships. However, in practice if it was perceived to be desirable (following discussion with the client) for Deloitte to pursue appointment as statutory auditor, some of these conflicts could be avoided by ceasing to provide other services either immediately or in the medium term.'	Our view is that 'almost all' rather than 'some' of these conflicts could be avoided by ceasing to provide other services.