



BDO LLP

HEARING WITH THE COMPETITION COMMISSION

Investigation into the market for the
supply of statutory audit services to large
companies in the UK

13 FEBRUARY 2012



WHAT WE'LL COVER TODAY

- A summary of BDO's position
- An introduction to BDO
 - Our capabilities
 - BDO International
 - Our strategy and ambition
 - BDO UK
 - Our commitment to quality
 - Case studies
- Our observations on the Big Four's submissions
 - PwC's 'four pillars'
 - Adverse outcomes
- Some suggestions for the Competition Commission (CC)
- Potential remedies
- What would more competition look like?



OUR POSITION

- The Reference Market is not working effectively
- Features of it produce adverse effects on competition and harm clients and competitors
- Barriers to entry/expansion apply also to listed companies outside the FTSE 350
- Behaviour of key intermediaries is exclusionary
- Lack of choice is a real problem for some companies
- The Big Four reinforce their dominance by:
 - Acquiring firms within BDO's or GT's international networks
 - Using deep discounts to win or retain clients
 - Relying on claims of 'audit quality'
- Problems would increase if a Big Four firm left the market
- There is no 'silver bullet', but a combination of remedies is required



AN INTRODUCTION TO BDO



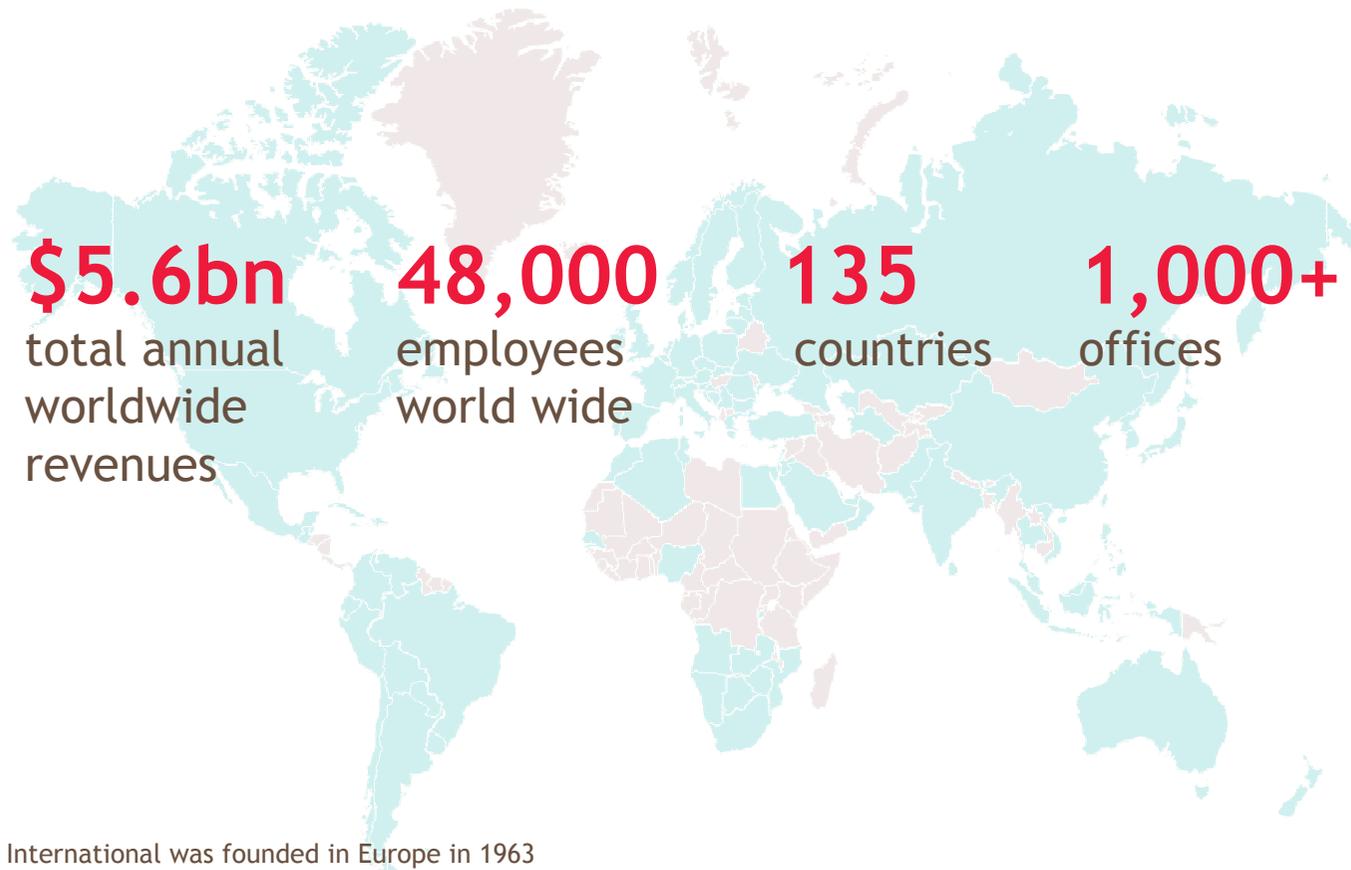
OUR CAPABILITIES

We can audit almost all companies

- Our network is large enough
- We have the necessary service offerings
- We have invested in quality and expertise
- Our quality is comparable to the Big Four
- Only the 35 or so largest UK listed companies are currently beyond our reach
- We provided services to 57 FTSE 350 companies in 2010/11

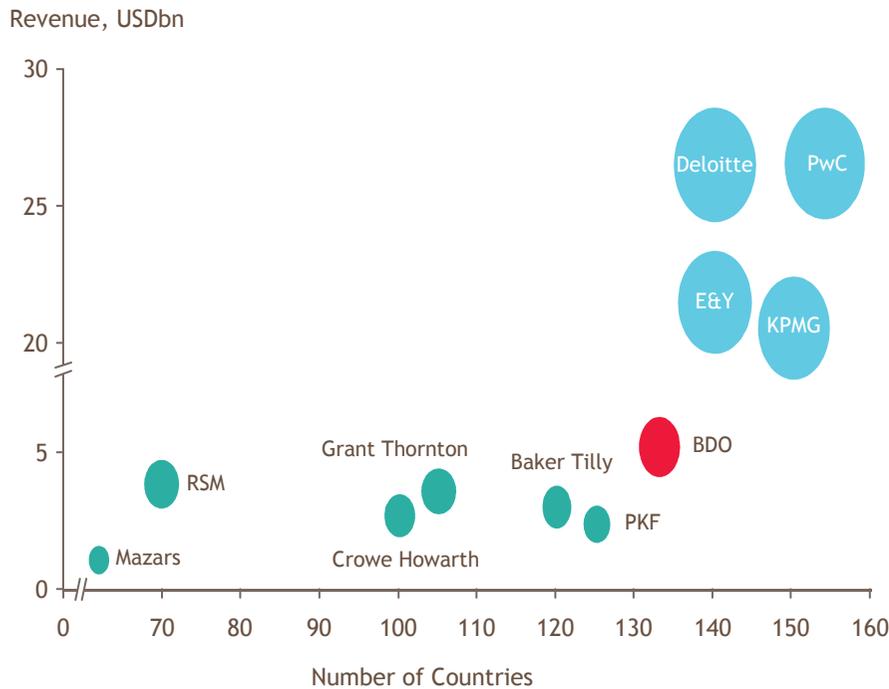
BDO INTERNATIONAL

Significant global reach



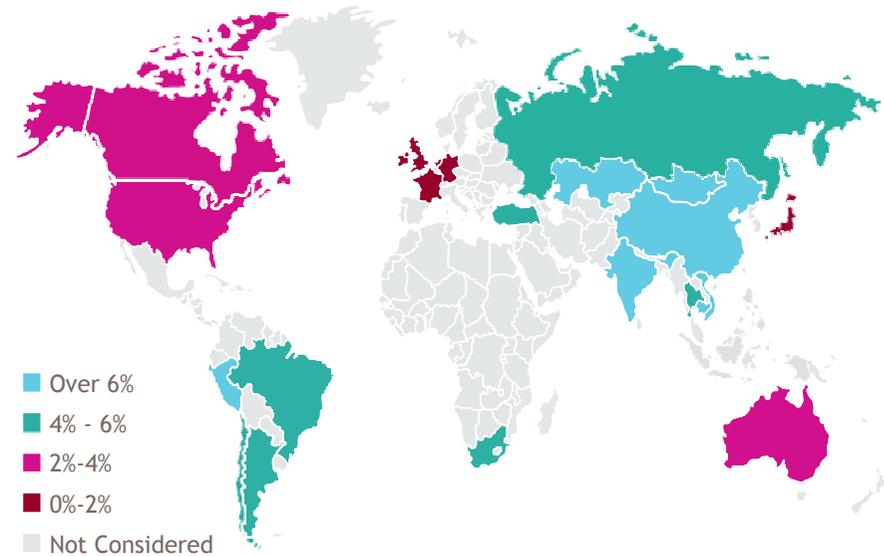
OUR STRATEGY AND AMBITION

We are the fifth largest accounting and advisory network globally



○ = employees

International market context
GDP growth forecasts show the importance of emerging markets¹

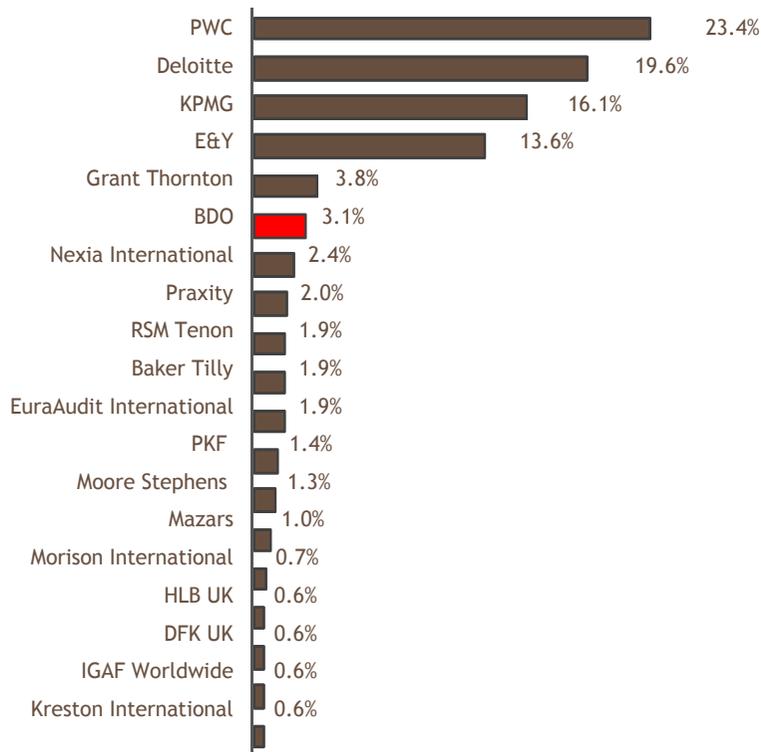


(1) Country average GDP growth from IMF forecast data for 2011-2016

MARKET SHARES IN UK & CHINA

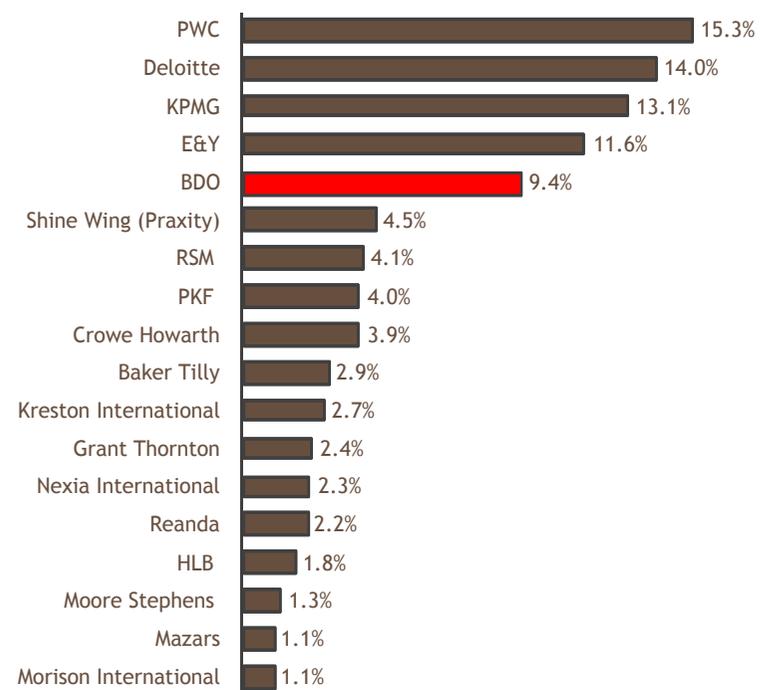
Contrasting markets

UK Market Share (2009-2010)¹



(1) IAB report December 2010 (based on fee income, all services)

China Market Share (2009-2010)²



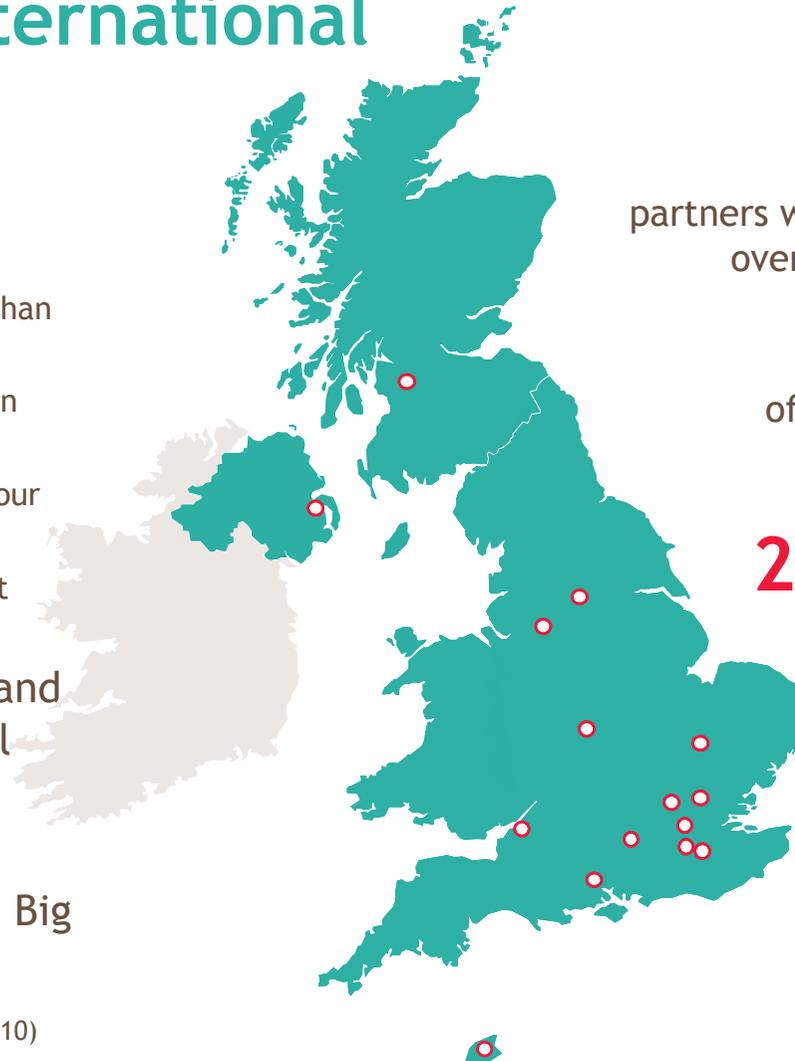
(2) IAB report, March 2011 (based on fee income, all services)

BDO UK

Cornerstone of BDO International

- Core mid market and significant PIE/larger corporate clients
- Significant client feedback¹
 - 96% of our clients would recommend us, more than those of any other accounting firm
 - We offer the best value for money and clarity on fees
 - We are better than the Big Four at listening to our clients
 - We are the only firm to have retained our client service score year on year
- Investment in brand, systems, people and growth areas funded by partner capital and bank debt
- Reward: top end of mid tier and differentiated proposition/model from Big Four

(1) Independent research carried out by Lighthouse Global (2010)



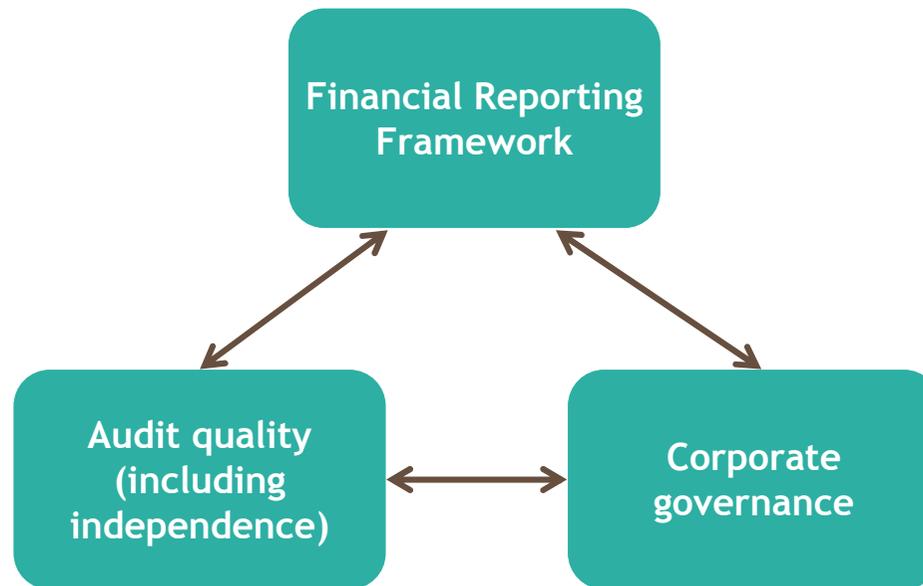
200
partners working with
over 2,300 staff

15
offices across
the country

20,000
clients

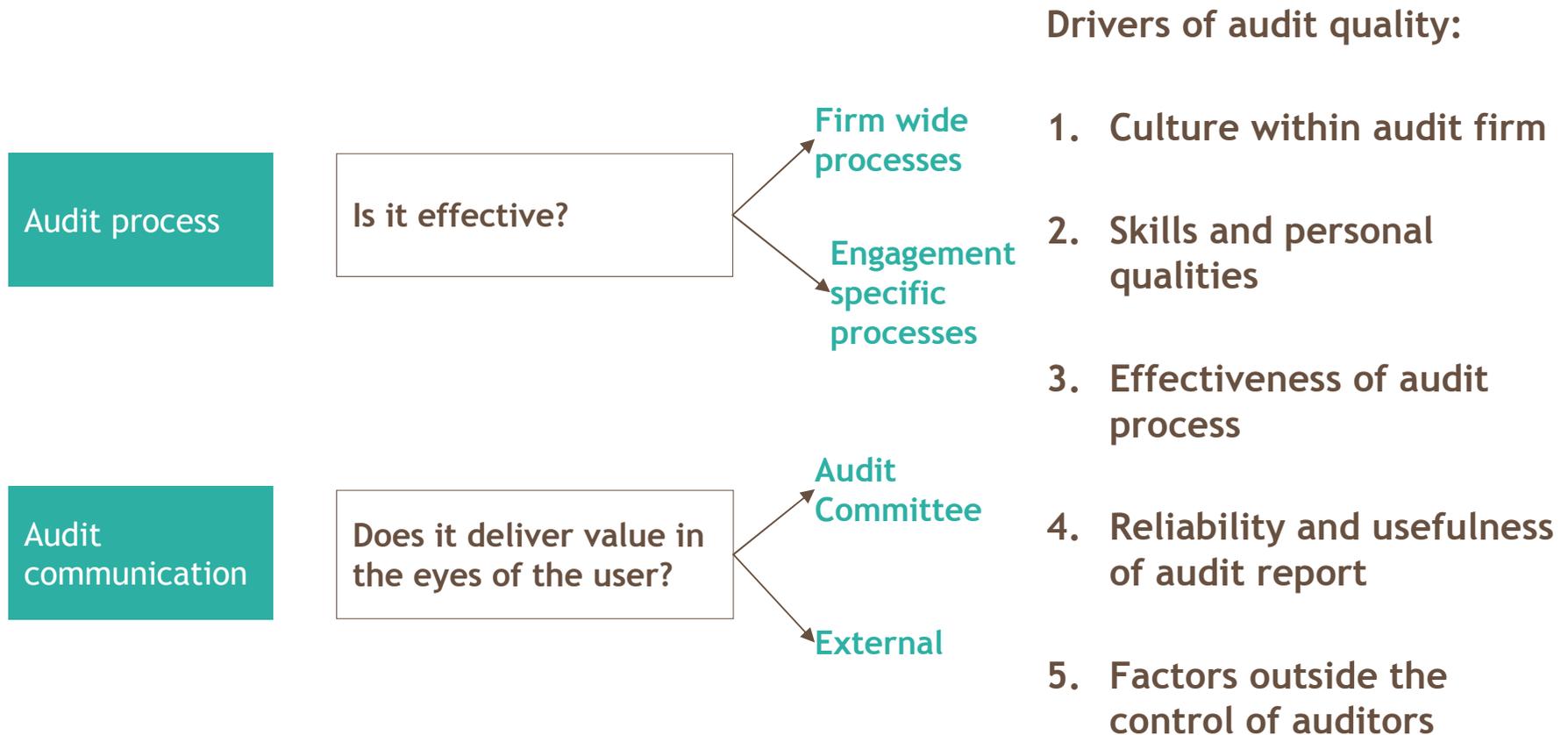
AUDIT QUALITY IN CONTEXT

Reliable and effective reporting of financial performance



WHAT IS AUDIT QUALITY?

The FRC's Audit Quality Framework



OUR QUALITY FRAMEWORK

Quality embedded in all that we do

FRC'S DRIVERS OF QUALITY	QUALITY	FIRM-WIDE FACTORS	INDIVIDUAL ENGAGEMENT FACTORS
Culture of the firm	Values and Ethics	<ul style="list-style-type: none"> • Our values: <ul style="list-style-type: none"> • Honesty and integrity • Mutual support • Strong and personal client relationships • Taking personal responsibility • Our culture • Our leadership 	<ul style="list-style-type: none"> • Partner engagement • Acceptance and continuation • Independence • Ethical requirements
	Transparency	<ul style="list-style-type: none"> • Our governance • Our public reporting • Our public policies 	<ul style="list-style-type: none"> • Open contracting • Communication • Listening programmes
Skills and personal qualities of our people	Empowerment	<ul style="list-style-type: none"> • Knowledge sharing • Promotion and reward policy • Our people's commitment • Commercial and personal skills training 	<ul style="list-style-type: none"> • Performance evaluation • Project management • Review and consultation
	Competence	<ul style="list-style-type: none"> • Our recruitment • Our technical training • International strength in depth • Breadth of specialist skills 	<ul style="list-style-type: none"> • Engagement, planning, performance and conclusion • Sector knowledge • Professional scepticism
Effectiveness of process and audit reporting	Process	<ul style="list-style-type: none"> • Our global audit methodology • Our global audit process tool • Our quality control • Our infrastructure 	<ul style="list-style-type: none"> • Risk based • Specialist support • Internal technical support • Depth and clarity of reporting



OUR COMMITMENT TO QUALITY

- Quality framework
- Audit quality control procedures, including:
 - Cold reviews
 - EQCR and technical review
 - Consultation process
- Partner quality appraisal and impact on earnings
- Promotions through knowledge sharing, *audit.insite* and Technical Standards Group
- Investment in APT (Audit Process Tool) and methodology
- Global frameworks/sharing eg *BDO connect*, risk and quality policies
- BDO International accreditation/quality reviews
- Active participation and involvement with regulators and policy groups



CASE STUDIES

REDACTED



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OUR OBSERVATIONS ON THE BIG FOUR'S SUBMISSIONS



THE BIG FOUR'S SUBMISSIONS

Our observations

PwC propose 'four pillars' to say there is no problem:

1. Large companies require specific skills and attributes which only the Big Four possess
2. There is fierce competition between the large audit firms
3. Large companies are extremely effective purchasers
4. The market operates efficiently and there are no adverse outcomes

This presents their case clearly, but we have observations on each of these claims

1. “LARGE COMPANIES REQUIRE SPECIFIC SKILLS AND ATTRIBUTES THAT ONLY THE BIG FOUR CAN PROVIDE”

Firms outside the Big Four can audit large companies

- FTSE 350 companies are diverse; market cap does not equal complexity of audit
- BDO audits companies that are comparable in size and complexity to FTSE 100/250 companies
- BDO has equivalent specialists to the Big Four eg tax, valuation, sector expertise

Investment

- Big Four created by merger and Arthur Andersen collapse, not investment
- Mid-tier firms face barriers the Big Four never had
- There is little evidence on the size of the Big Four’s investments, or on type of investment - training, marketing, IT systems, staff remuneration?
- BDO also invests and would invest more if market were more open and tendering occurred more frequently
- Big Four’s acquisition of network firms in key locations reverses investment by BDO/GT



2. “THERE IS FIERCE COMPETITION BETWEEN THE BIG FOUR”

Four is not enough in this market

- Not all of the Big Four are credible alternatives for companies in all sectors
- Conflict rules mean companies have choice of less than four firms

Four is not the natural outcome of competition

- Mergers and collapse
- No evidence that economies of scale leave room for only four firms (CC could investigate this)

Differences among Big Four should not be overstated

- Reputation barrier (‘IBM effect’) applies to Big Four as a group

Frequent tendering would not be inefficient

- Some switching and learning costs (but not prohibitive)
- But optimal frequency can’t be once every 30 to 40 years



2. “THERE IS FIERCE COMPETITION BETWEEN THE BIG FOUR” (CONT’D)

FTSE 350 is not necessarily a relevant economic market

- Different markets by sector and size within the FTSE 350
- Targeting of other firms’ clients occurs below FTSE 350
- ‘Churn’ as companies enter/leave indexes is not the same as switching

CC can analyse degree of competition between Big Four through price-concentration analysis

CC can analyse existence and effects of deep discounting

- Use of market power
- Non-audit services
- Pricing over extended periods

CC can analyse profitability - metrics used by Big Four to argue that profitability isn’t excessive are inadequate



3. “LARGE COMPANIES ARE EFFECTIVE PURCHASERS”

Not the usual business to business market

- Shareholders, not company management, are the real customer and lack power
- Audit committee are surrogate purchaser/trustee for shareholders
- Shareholders do not exercise scrutiny through the board/audit committee
- The true customer does not pay the audit firm

Asymmetries in purchasing

- Superficial measures of audit quality

Tender ‘threat’ does not equate to open market competition

Familiarity and conservative bias in audit committees and other market participants

- Alumni
- Relationships
- ‘IBM effect’

Exclusionary behaviour by intermediaries

- Banking covenants
- Informal exclusion



4. “THE MARKET OPERATES EFFICIENTLY AND THERE ARE NO ADVERSE OUTCOMES”

Lack of innovation

- Distinguish efficiency from innovation
- ‘The expectation gap’
- Changes in corporate communications
- ‘Going concern’
- Narrative reporting

Reduced choice

- Conflicts of interest/independence rules

Audit quality

- Corporate failures
- Audit failures
- Regulators’ findings
- Big Four overstate point that they have the right incentives because their reputations can be easily destroyed

Independence

- Perceived lack of independence



PRICING

- Evidence to date of a ‘Big Four’ premium:
 - LSE¹
 - Oxera²
 - Cardiff Business School³
- Relationship with deep discounting
- Are prices transparent or not?
- Non-audit services
- Big Four claims that discounts reflect cost savings seem implausible (the CC can analyse this)

(1) Enterprise Report: Concentration, Auditor Switching and Fees in the UK Audit Market (2008)

(2) Competition and Choice in the UK Audit Market, prepared for the Department of Trade and Industry and Financial Reporting Council (2006)

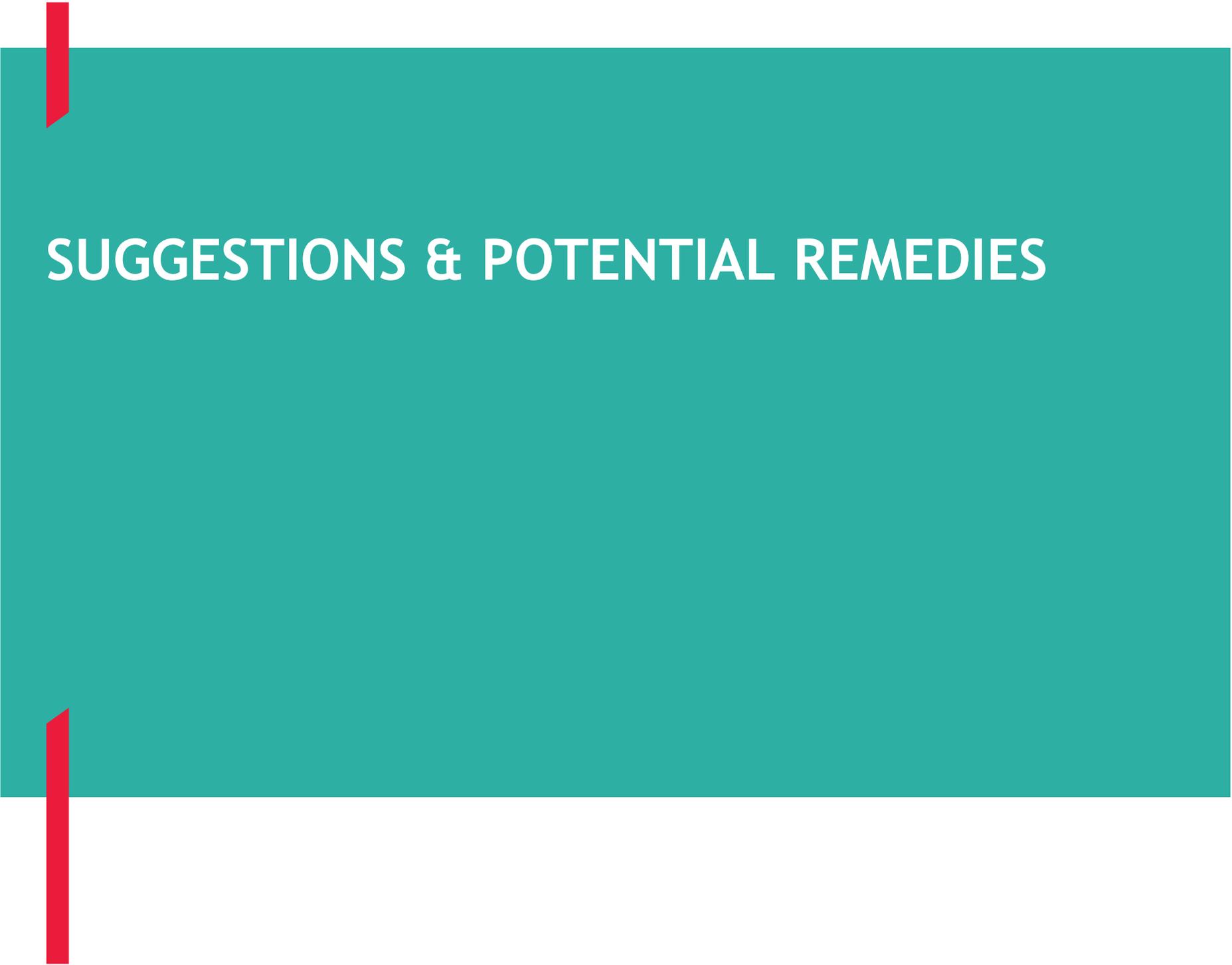
(3) The Pricing of Initial Audit Engagements by Big 4 and Leading Mid-Tier Auditors, Michael J Peel, Professor of Financial Management (2012)



OTHER ARGUMENTS BY THE BIG FOUR

Our observations

- Is audit differentiated or a commodity? Inconsistent arguments by Big Four (coordination issue: ‘differentiated’ - innovation issue: ‘heavily prescribed’)
- Independence of regulators - but most trained and worked at Big Four
- Big Four acknowledge that regulation is required as quality is difficult to observe - but is at odds with buyer power argument (and greater competition would help too)
- Access to capital ‘not a problem’ - but could be for smaller firms if expansion were attractive (eg because more tendering occurred)



SUGGESTIONS & POTENTIAL REMEDIES



SOME SUGGESTIONS FOR THE CC

Conduct further survey work

- Survey shareholders and other stakeholders, not just CFOs and ACCs

Analyse profitability, economies of scale, price-concentration

Consider how Big Four influence regulators

Issue additional information requests

Ask audit firms:

- For information about their investments to sustain market position
- How many of the CFOs and/or ACCs of clients are their alumni?
- For more evidence of innovation
- For more information on audit pricing: compare Big Four only tenders with others



POTENTIAL REMEDIES

No 'silver bullet' - a combination is required

- Transparency and investor involvement
- Innovation
- Mandatory retendering
- Non audit services
- Consortia, joint and shared audits
- Intermediaries
- Ownership and capital structure
- Liability limitation
- Rules against deep-discounting and other exclusionary behaviour
- Address risk of 'Four to Three' (eg in case of failure, ensure that remaining 'Big Three' do not pick up the pieces)

Inappropriate remedies

- Market share capping
- Mandatory rotation
- Break-up of Big Four

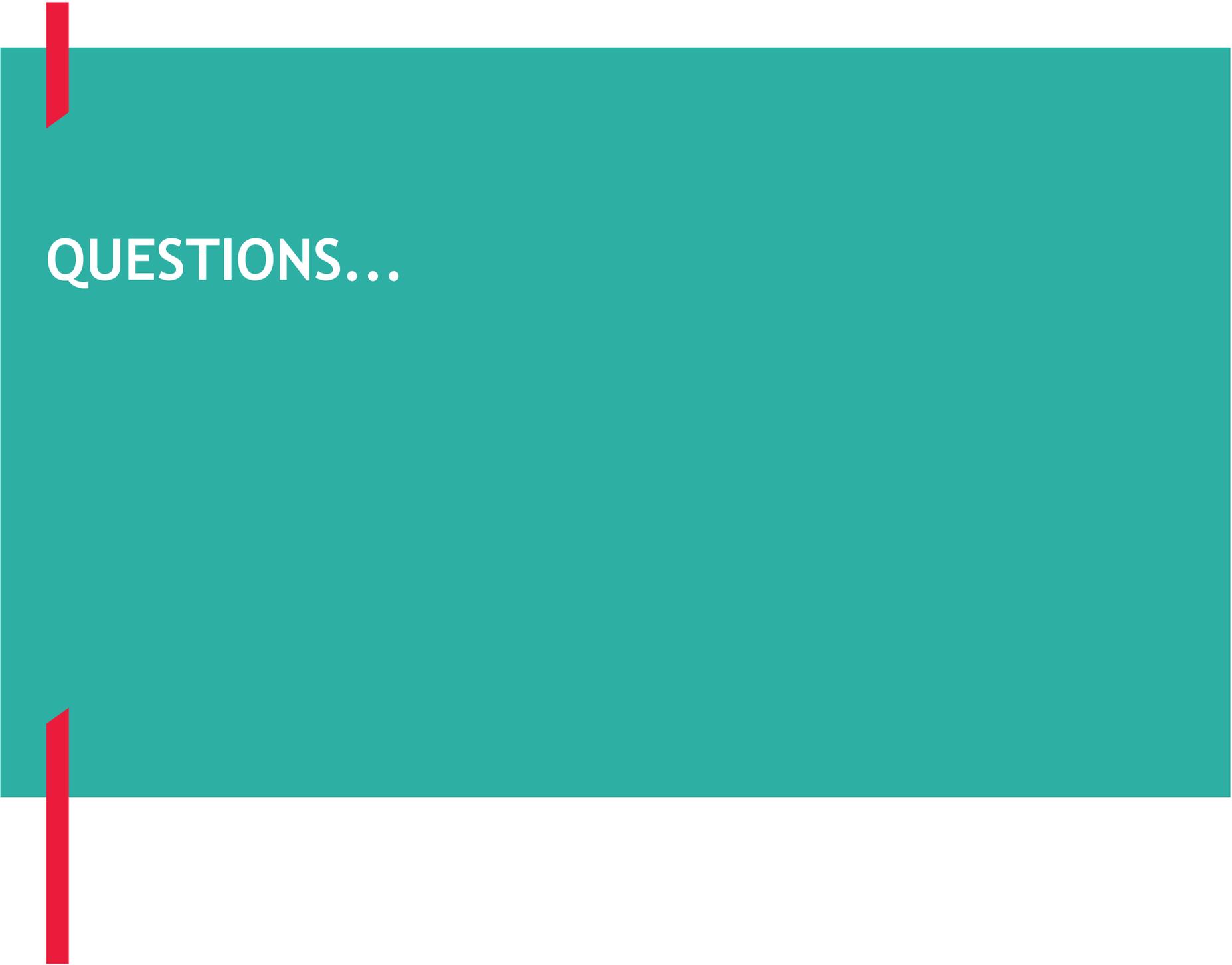


A MORE COMPETITIVE AUDIT MARKET...

...would provide greater stability to the capital markets and allow investors and other stakeholders to make informed decisions about risk

It would feature:

- More innovation
- More choice
- More frequent tendering
- More switching
- Greater independence
- Better service for shareholders
- Competition on price, quality and service
- Less risk of systemic damage from one firm's failure or exit



QUESTIONS...