STATUTORY AUDIT SERVICES MARKET INQUIRY

Summary of a hearing with BDO LLP held on 13 February 2012

1. BDO LLP (BDO) gave a presentation at the start of this hearing and a non-confidential copy can be found here: Presentation to the CC. This summary sets out additional points made by BDO.

BDO's position

2. In BDO's view, the reference market does not work effectively, leading to adverse effects on competition that cause harm to clients of the audit profession generally and to some competitors. There are barriers to entry and expansion which affect companies much smaller than those in the reference market, in both the listed company market and the private company market. There is exclusionary behaviour by key intermediaries besides terms in bank loan agreements. Lack of choice of auditors is a real problem for many companies, but more importantly also for investors and shareholders.

3. BDO submitted that the Big Four[1] had reinforced their dominance by acquiring firms from it and others, particularly in emerging and important international markets; using deep discounting to win or obtain clients; and claiming that they provided a higher level of audit quality.

4. BDO considered that these problems would be exacerbated if one of the Big Four were to leave the market. It believed that the problems could be remedied through the imposition of a combination of remedies.

5. BDO welcomed the attention the profession was receiving, initially by the House of Lords inquiry and now with the CC inquiry, which it believed had been one of the consequences of the credit crunch. This had allowed it and others to express views about some features of the profession and what could be done to improve the functioning of the market.

BDO International

6. BDO had international revenues exceeding $5 billion. It offered a broad range of services including: tax; corporate finance; forensic risk; restructuring; and operational advice. It said that with respect to the markets it served and aspired to serve, its size or service offerings had not held it back. BDO noted that it had made significant investments: financially, in experience, in building its brand, risk and policy, and talent recruitment. Among its UK partner base, it had a number of Big Four lateral hires.

7. BDO considered that there were only about 35 or so of the largest UK listed businesses that it would currently not be able to audit, such as the very largest financial services, oil, pharmaceutical and telecom companies. It was confident that it could audit the rest of the FTSE 350.

[1] This term was used by BDO to refer to the current four largest auditing firms: Deloitte; Ernst & Young; KPMG; and PwC.

8. BDO's network structure was similar to that of its largest competitors; with commitments to work together; operational integration and substantial exit penalties if a member firm wished to leave the network. It had experience of member firms leaving its network, some years ago in France, where the firm left to join Deloitte, and more recently in Brazil, where the member firm joined KPMG. BDO was contesting the latter before the national competition authorities.

Strategy

9. Referring to slide 7 of its presentation, BDO noted that after the Big Four, BDO was the next largest firm both in terms of the number of countries in which it operated, and revenue in US dollars. It believed that the market in western economies in audit advisory services was not growing significantly and it did not see it growing over the next few years. The competition was for market share as opposed to organic growth. BDO's view was that there was more scope for significant growth opportunities in emerging markets. Its strategy was to continue to invest in developed western economies and also to invest in emerging markets. Based on 2009/10 figures, BDO had broadly a 3 per cent market share in the UK but had achieved much more significant growth in China, where the market was much less concentrated. BDO considered that the UK was representative of most of Western Europe and North America.

10. BDO considered that the Chinese position would be important in future. It might be able to benefit from that and achieve more growth in Western economies as more Chinese businesses invested in Western economies.

BDO in the UK

11. In the UK, BDO operated from 15 offices and had 2,500 partners and staff. BDO said that its core UK market included businesses that were turning over many hundreds of millions of pounds and included businesses that might be owner managed or private equity backed. These businesses included some in the FTSE 250 but fewer in the FTSE 100. BDO's top 500 clients represented over 40 per cent of its fee income and included clients that were large both domestically and internationally.

12. BDO said that client feedback (independently obtained and benchmarked) showed that it received higher levels of recommendations than other firms. It stood out in a number of areas in relation to: value for money; transparency regarding fees; the way it engaged with clients; the relationships it had; and the way it listened. It considered that this was important because in considering audit quality, such relationships were as important as bench strength or technical standards. It noted that it faced challenges related to perceptions around: its size, with some companies not considering that BDO was big enough; its geography; its ability to deal with complex situations; and whether it had the deepest industry expertise. In its view, there was some reality to these issues, but most of the time it proved not to be the case.

13. BDO noted that it had made significant investment over the years into its UK business, funded by a combination of partner capital and bank debt. Access to capital had not been a barrier to growth. It would have an open mind about making significant investments to access the top end of the market if it considered that there would be opportunities for BDO. In its view, the rewards for its partners were at the top end of its peer group, which allowed it to be competitive. However, to recruit the most highly-paid auditors from the Big Four would require it to pay at a level inconsistent with its current scales.

Audit quality

14. BDO considered that if the overall objective of an audit was to achieve reliable and effective reporting, then this had three pillars: a financial reporting framework, reporting on the right financial information; corporate governance; and audit quality, including independence of the auditor.

15. BDO's view was that the best definition and description of audit quality was contained in the Financial Reporting Council's (FRC's) audit quality framework: audit was a process with inputs, processing and outputs. BDO noted the FRC's five drivers of audit quality: culture within the audit firm; skills and qualities of audit partners and staff; the effectiveness of the audit process; the reliability and usefulness of the audit report; and factors outside the auditor's control, eg corporate governance at the entity.

16. BDO explained how it as a firm implemented these (set out on slide 12 of its presentation). BDO noted that it considered that all its processes were scalable and could be adapted to much larger audits. It considered that its processes were broadly consistent with its largest competitors. It noted that as part of its quality control framework it conducted: cold reviews; engagement quality control reviews; technical reviews; internal consultation; partner appraisal on the basis of quality, which had an impact on profit share; knowledge sharing; implementation of a global standard audit methodology and standard IT support tool; global risk and quality policies and guidance; accreditation processes for member firms that wished to join; reviews of member firms; and participation in regulators such as the FRC and global policy groups.

17. BDO referred to a number of client case studies to illustrate how it delivered effective quality. It noted that some of its clients were involved in quite complex sectors, had large turnovers and locations in a number of countries.

Submissions of the Big Four

18. BDO referred to responses made by the Big Four to the CC's issues statement, which were largely and clearly summarized in PwC's 'Four Pillars'. BDO considered that each of those 'Four Pillars' could be subjected to scrutiny and challenge. BDO believed that firms outside the Big Four could audit large companies. It considered that the submissions seemed to make an assumption that the reference market was homogenous, and that only the Big Four had the capabilities to audit companies within it. BDO contended that this was not the case and that the market included a wide variety of companies, such as [✂], which employed fewer than 200 people and had many characteristics of small owner-managed businesses and retail companies which were relatively straightforward to audit. Many smaller companies were more complex, particularly in the technology sector. BDO said that it audited companies across the marketplace which were equivalent to companies in the FTSE 350.

19. BDO said that the Big Four suggested that only they had the relevant specialist expertise to conduct these audits. BDO pointed out that this was not the case. BDO had pensions, technical, valuation and tax specialists. It noted that the Big Four's growth was not through investments, but rather through mergers in the 1980s and 90s, helped by the collapse of Andersen. It said that it now faced challenges that the Big Four had not faced when they were growing. It noted that KPMG acknowledged that much of the investment required was about spending time and effort rather than money.

20. BDO claimed that it made similar investments to the Big Four in terms of improving its processes, but that it could not invest in expanding its audit partner team substan-

tially, for example on buying a large bank audit team from a Big Four firm, because of the uncertainty around obtaining the work for a larger team. It also noted that its growth was hindered when significant parts of its network were bought at what appeared to be uneconomic prices by its largest competitors.

21. BDO referred to PwC's submission that there was fierce competition in this market among four players. BDO noted that there were not always four credible players in all areas of the market. The example most frequently cited was that Ernst & Young did not compete in retail banking. BDO considered it would not be possible to introduce a banking team from elsewhere in the world were Ernst & Young to win a bank audit, because of the differences in national regulations and accounting standards. BDO considered that choice was further limited because of conflict rules.

22. BDO did not think that either competition or economies of scale determined a need for only four firms. It said that the Big Four claimed to be differentiated between themselves, but while it accepted that individual teams and partners might be recognized for particular skills, the firms were always collectively referred to as the 'Big Four'.

23. BDO accepted that there were costs involved in tendering, both for the company and the audit firms. However, this was not more than a couple of days' time for audit committee members, and a couple of days' time for the Finance Director and some senior finance staff. For the audit firm, it would involve an investment in the time of people that it already had. BDO considered that this was a cost of doing business. It noted that whatever the costs were, it would expect to see payback earlier than the current frequency of switching of 30 to 40 years.

24. BDO stated that the Big Four targeted BDO clients far smaller than those in the reference market, starting at firms with a turnover of around £60 million and including private companies. It did not accept suggestions that switching was greater than suggested because of the churn of companies entering and leaving the FTSE 250 and 100. Switching for audit was much more infrequent than for other professional services.

25. BDO referred to PwC's submission that large companies were effective purchasers. BDO said that this ignored the reality that the real customers of audit were investors and shareholders, not company management. They lacked any real power. In BDO's view, the audit committee was a surrogate, in a trustee position for the shareholders. It considered that the AGM was not an effective forum in which to consider the appointment of the auditor. It said that there was no discussion of the appointment of the auditor with shareholders/investors outside the AGM. BDO said that this created considerable asymmetry: auditors were paid for by the company, appointed, effectively by the non-executives, while working for people who had no sight of what they did or what they reported. On this basis, BDO questioned whether auditors were appointed on the right basis. BDO considered that, perhaps because of a lack of regulation or other incentives to require them to be more rigorous, audit committees could fairly be said to be failing to ensure adequate audit quality.

26. BDO considered that the Big Four's submissions contained confusing messages about audit quality. It said that the audit committee, supplemented to some extent by internal management, found it difficult to obtain an objective picture of audit quality. BDO considered that the audit committee was likely to have a good understanding of price and service to management but not regarding whether the auditor had the necessary professional scepticism to challenge the management team on difficult issues.

27. BDO rejected PwC's point that there was no need for tenders in the market because companies constantly threaten to tender. BDO said that the only way a company could know the market rate was by tendering. The threat of tender was not a sufficient substitute to determine the market rate.

28. BDO thought that there was a familiarity and conservative bias that affected audit committees and other market participants, for example CFOs. It submitted that 61 out 66 chartered accountants who were CFOs were alumni of the Big Four. Audit Committee Chairs would have had working relationships with the Big Four throughout their professional lives. BDO accepted that this was not unnatural. BDO said that it was only formed in 1963 and so had not been around long enough to have these relationships. In BDO's view, these relationships resulted in exclusionary behaviour against BDO.

29. BDO referred to Big-Four-only clauses in bank lending agreements, and informal exclusionary behaviour by other intermediaries, such as investment and clearing bankers, brokers and lawyers, which worked against BDO.

30. BDO noted, in reference to the last pillar in PwC's submission, that the current make-up of the market had resulted in a lack of innovation. It noted that audit had been largely unchanged over the last 100 years, even though companies had changed considerably. It said that annual reports of accounts did not affect share prices any more or make the news. What companies said at an analysts' briefing or a webinar was now more important. The annual report was now becoming largely a document of record, only considered if something went wrong.

31. In BDO's view, the concept of the expectation gap existed 35 years ago and still existed. It said that this demonstrated a long time over which nothing had happened about changing/evolving the product so that it would be more useful to shareholders. BDO considered that the lack of innovation was further illustrated in relation to the issue of 'going concern' and the collapse of some of the major banks, which were issued clean audit reports just before they collapsed. In BDO's view, there had been little consideration of what auditors could have done differently in this situation.

32. BDO also said that if, as BDO hoped, the CC talked to investors, the CC would see that investors considered that there was a lack of auditor independence and that they did not have any real choice.

33. With respect to points made by the Big Four on whether audit was a differentiated or commodity product, BDO considered that if it was differentiated then there should have been more innovation.

34. In relation to whether regulators were sufficiently independent, BDO noted that most staff at the FRC trained and worked for the Big Four.

35. BDO said that the Big Four submitted that regulation was required because quality was difficult to measure but at the same time they said that the largest companies were effective purchasers. In BDO's view, these two arguments were not consistent.

Reputation and pricing

36. With respect to the Big Four providing a higher level of quality in terms of its audits, BDO referred to issues at Olympus, Lehman, RBS, Refco, AIG, Satyam, JP Morgan, Enron and Waste Management and suggested that the point that the Big Four made that their audit quality must be high otherwise they would lose their reputations could not be right given the failures listed.

37. The Big Four nevertheless managed to maintain their reputations. BDO said that there existed a Big Four premium, as was shown by Oxera's price concentration analysis and more recent studies by the London School of Economics and Cardiff Business School. There was a debate to be had about whether this was because of quality, the 'IBM effect' or market power.

38. BDO also said that the issue of deep discounting and pricing over time should be considered by the CC, observing links to profitability analysis, how pricing and profitability linked across the audit assignment and non-audit services, and taking into account whether discounts reflected cost savings.

Potential remedies

39. BDO did not support any remedies that would require market share capping, mandatory rotation or breaking up of the Big Four. It did support a blend of: retendering; liberalization with respect to non-audit services; shared work on single companies or groups; and more transparency.

40. In conclusion, BDO noted that what investors and other stakeholders wanted was stability in capital markets and good-quality information to allow them to make informed decisions about risk. It believed that changes to the audit market would drive some of these wider benefits.

Other

41. In relation to the behaviour of intermediaries, BDO considered that this might be because of ignorance of providers outside the Big Four which could lead to a lack of trust. Size had generally been considered as a proxy for quality. The current level of competition in the market might not be sufficient to lead to innovation, reducing audit to a commodity. If audit was commoditized, then the intermediary might prefer what was in its perception the safest supplier of that product.

42. In relation to competing in the market now compared with before the financial crisis, BDO considered that the Big Four were competing for BDO clients further and further down the market and were more frequently offering deep discounts. It suggested that the CC could examine this by obtaining information on what it cost to run an audit. The costs to deliver an audit should be reasonably well defined. What might be more difficult to understand were the returns from any particular bid. These included: the audit fee, possibly some non-audit work, and an increase in reputation leading to similar instructions from other clients. BDO said that in response to deep discounting, it too had to offer deep discounts.

43. With respect to its network, BDO noted that it had a significant degree of operational integration in terms of its audit methodology, approach to risk and quality, accreditation process, HR framework, client services charter and coordination of strategy. However, each member firm in the BDO network was a country partnership which operated underneath this operational umbrella and was run by the partners in that country.

44. Firms might leave the BDO network, for example if they were bought by a competitor, or if they were expelled because of inadequate quality. With respect to a recent example, where BDO's Brazilian member firm had been acquired by KPMG, BDO considered that KPMG had paid an uneconomic price to acquire the firm. BDO also considered that given the exit fees that were in place within the Big Four networks, it

would generally not be economic for it to acquire one of the Big Four network member firms.

45. BDO said that the current number of four firms at the top end of the market was not an outcome of competition. It believed that there was room for more. Economies of scale did not justify the number of four. It contended that in terms of global reach, it was as capable as any of the Big Four.

46. BDO noted that the profession as a whole was currently debating the possibility for the audit opinion to say more and was considering what additional reporting the auditor could undertake. It believed that this would encourage innovation. BDO said that the regulatory bodies that could drive these changes were largely populated by members of the profession. They faced a huge conflict of interest because introducing such developments would potentially increase the risk of undertaking an audit and it was they in their professional capacity that would have to bear the risks. BDO believed that there was no ability for a firm to differentiate itself at the moment by the content of its audit report.

47. BDO said that an inherent difficulty in relation to audit risk was that audit was a product of confidence. If people lost confidence (based on a firm's reputation) in the audit, then the firm would not survive. BDO said that this was what happened with Andersen. In circumstances where firms had collapsed following the receipt of a clean audit, auditors had generally successfully argued that it was not their role to underwrite whether a business was a going concern.

48. BDO noted that there had been attempts to introduce limitation of liability for auditors. It would be concerned if any changed system led to a negotiated cap figure, as it believed that the Big Four would set that cap at a figure that was not realistic outside the Big Four. BDO would prefer an approach which was proportionate to audit fees charged. BDO said that it could not currently replicate the risk reward model of the Big Four, because they already served the biggest companies which carried the biggest risks which drove their fees. It was very difficult in these circumstances for anyone else to enter this market. BDO did not believe that it would be able to enter this market if it recruited current Big Four partners, as the reputation of the Big Four firm would outweigh the individual reputations of the personnel joining. On the other hand, it did not believe the same applied if a BDO partner went to a Big Four. It considered that there was a greater risk in such circumstances that a client may follow the partner.