

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of response hearing with BDO LLP held on 10 April 2013

Introduction

1. BDO LLP (BDO) circulated a slide presentation: [Presentation to the CC](#).
2. BDO welcomed the Competition Commission's (CC's) provisional findings and supported the fact that the CC had proposed a potential package of remedies. It agreed that shareholders were the true customers of audit. However, it considered that a regulatory nudge was required to help overcome barriers to selection and expansion. It considered that there were no substitutes for a formal tender process in terms of having real opportunities to be considered. BDO also highlighted that auditors needed to be seen as independent as well as actually being independent. It suggested that the following areas could merit further work by the CC: the price effects of switching; and whether four firms were sufficient—BDO considered that this latter issue was fundamental to the market, and was surprised the CC did not comment on this explicitly. It was concerned that if one of the current Big 4 firms failed, leaving three firms, this would create a serious issue around auditor independence if one of the remaining three firms were to become too big to fail. BDO was also disappointed that the CC had not given more consideration to further limits on the provision of non-audit services by auditors. Overall, however, it supported a number of the measures proposed by the CC.
3. BDO considered that its views on remedies did not appear to be very different from those of the Big 4 firms, based on its review at this stage of the responses that had been published on the CC's website.
4. However, BDO keenly supported mandatory tendering and considered it crucial to ensure that the benefits of pricing, innovation, quality and efficiency were achieved. It considered that the requirement to tender should be set at every seven years and audit engagement partner rotation requirements should be of the same duration, in line with current international partner rotation requirements. Tendering should be on an open book and transparent basis, to deal with the information asymmetry that currently existed in favour of incumbent auditors. BDO did not think the seven-year period was disproportionate or overly burdensome. It did not think the time period should be considered fixed, and companies would be able to tender more often if they wanted to. The cost concerns for tendering had been overstated and were based on the past and present model, where tendering was infrequent.
5. The recent changes to the Corporate Governance Code were unlikely to be enough, although it was too early to determine the impact of the Code. BDO had not seen the rapid increase of tendering that some had anticipated. Moreover, these changes did not deal with the principal-agent issues or transparency issues. They were unlikely to reduce barriers to entry or increase choice as they would lead to Big-4-only tenders. BDO opposed mandatory rotation because it restricted choice. However, it considered that mandatory rotation might be appropriate as a backstop, if a company had not changed its auditor after a long period, such as 20 years.
6. BDO supported AQR reviews as the best independent assessment of audit quality currently available in the market, but considered that they were not perfect. The AQR reviews only considered one aspect of an audit: its quality in terms of recorded

compliance with International Standards on Auditing, and they took a bottom-up approach.

7. Consistent with other market participants, BDO supported the prohibition of Big-4-only clauses and considered they should be prohibited in all forms in all markets, as the real battle for FTSE 350 clients occurred before they entered the FTSE 350. BDO considered they could be prohibited by Order.
8. BDO supported strengthened accountability of auditors to the audit committee. In its view, the requirement for auditors to be seen to be independent from executive management was key. Any extra resources required by audit committees to meet these requirements would, in BDO's view, be a small price to pay to ensure independence.
9. BDO suggested the following measures to enhance shareholder/auditor engagement: for shareholders to vote on the audit committee report; a special resolution for the reappointment of incumbent auditors following a tender; audit engagement partners to present directly to AGMs on the conduct and outcome of audits; and for the audit committee chairs (ACCs) to answer shareholder questions at AGMs. BDO noted that the Financial Reporting Council (FRC) and international auditing standards bodies had done a lot of work recently on external reporting requirements, which it supported.
10. BDO would have liked to have seen measures to encourage the use of joint audits explored further. The cost and quality issues relating to joint audits had been overstated. It also supported liberalizing rules on ownership and control of auditors to allow new and smaller audit firms to grow faster.

Provisional findings

11. BDO had submitted in its response to the provisional findings that the key question was whether shareholders could be confident that the current auditors acted in the best interests of shareholders, not necessarily whether such auditors had actually acted or would act in the pursuit of other interests. In terms of providing an audit, it was important for the CC to be concerned with both the perception and reality of independence. Auditors and ACCs needed to position themselves so that they (like Caesar's wife) would be above suspicion, particularly because of the difficult principal-agent problem. There was currently a gap between perception and reality. In BDO's view, it would be rare to find an auditor not wishing to act in the best interests of its ultimate customers. Auditors, in reality, were attempting to serve three groups of customers: executive management, the audit committee and shareholders. In most cases these interests were likely to overlap, but where they did not, BDO considered it would be unlikely that an auditor would favour management over shareholders.

Mandatory tendering

12. BDO suggested that companies should be mandated to tender for their audit services contract every seven years. It had chosen this period to align it with the term that audit partners could serve, which was seven years around the world. Only in the UK was it five years. While the term was not based on any exact science, BDO had tried to find a balance between not unduly burdening corporates and determining an appropriate time to change. BDO had considered the typical career span of an audit partner, which it said was in the region of 20 to 30 years. A seven-year engagement was not going to be so material in terms of such a career that it might tempt an individual to behave inappropriately. However, if there were no tenders within ten

years, then an individual might potentially act for a client for half of his/her career, which might be sufficiently long for that individual to become more at risk of compromising his/her independence. Where there were performance issues with the audit provider, it saw no reason why companies could not tender earlier, particularly if tendering was in future more frequent anyway and was not considered as significant an exercise as it was now (particularly given that non-executive directors would then have more experience of tenders). Similarly, a merger or a significant change in management might act as a trigger to an earlier audit tender. Engagements would not necessarily be agreed as seven-year terms, but could be for much shorter periods of (say) two or three years, which would be reviewed and discussed at such intervals depending on fee negotiations etc, and still subject to annual approval by shareholders at the AGM.

13. BDO suggested that a regulatory body such as the FRC should opine on what constituted an exception from the obligation to tender. Given the principal-agent issue, the decision not to tender should not be in the hands of management. In contrast with 'comply or explain', the onus would be on management to seek a waiver of the obligation to tender if they felt they had a good reason. Any such waiver should only last for one year.
14. BDO did not think the full machinery of the public procurement process was required but important principles from this process—in terms of transparency, equal treatment, openness etc—should be applied to audit tenders. The current revisions to the Governance Code did not address this issue of creating a sufficiently level playing field that allowed any firm that considered itself capable of conducting an audit of the relevant company to be considered.
15. BDO proposed that all tenders should be publicized on a dedicated, independent website. Companies would be required to indicate the objective criteria they required their auditors to meet, and audit firms should be allowed to submit expressions of interest for the tender if they considered they met those criteria. This would create a transparent and level playing field. The website could be hosted by the FRC, which would have a small level of additional responsibility to ensure that the criteria companies proposed were appropriate and objective.
16. BDO envisaged a layered approach where there would be more firms that met the initial criteria, but the number of firms would be narrowed down (or firms might decide to opt out) at appropriate stages. Those firms that progressed through each stage would get greater access to the company management team to gain a greater understanding to enable them to bid more accurately, and the audit committee would have a better understanding of what they were buying.
17. The audit committee—as the buyer—needed to take a greater role in the decision to award the audit contract. BDO suggested that currently management provided the audit committee with a shortlist of which audit firms to award the contract to, which the audit committee then endorsed.
18. All tenders should be on an open-book basis, giving sufficient information to overcome incumbency advantages. BDO did not think the current changes to the Code did this, and so, in its view, under the current Code changes, audits were simply likely to be passed around the Big 4 firms. However, BDO emphasized that it did not have to be completely open book, provided certain key information was made available to all bidders who met the relevant criteria.
19. BDO considered that having more transparency—in terms of informing the market of prospective tenders, and requiring the tender process to be more detailed and

structured—would help current barriers to entry and expansion related to reputation and experience to be overcome. It would allow other firms to know that a tender was taking place and put themselves forward against objective, justifiable criteria. This was not the case at the moment. The requirement to tender on this basis needed to be mandatory to avoid the risk of companies explaining away the requirement to tender.

20. Audit firms should tell companies early on in any tender process if they did not agree with any of the company's current accounting treatments. BDO did not see any particular difficulties with the issue and gave an example where it had done this. The company in question had understood BDO's reasons for disagreeing and had appreciated the fresh approach that BDO had brought to the issue. In BDO's experience most audit partners were extremely unlikely to accept timidly an accounting treatment they did not agree with, for fear of not being appointed.
21. BDO did not think that an independent body would be required to do very much in terms of oversight, overview and regulation of the tender process, and this could be taken on by the FRC. The organization would be responsible for ensuring that any criteria set were objective and not foolish. This activity, BDO envisaged, would be funded in the same way as other FRC activity was funded, with market participants paying for it. Appeals were likely to be around the setting of criteria. BDO did not believe that there would be any appeals of decisions not to appoint as this would result in a difficult relationship with the relevant audit committee which would impact upon the effectiveness of the audit.
22. BDO suggested that a similar position as existed in the Grocery Supply Code of Practice could be created, with the appointment of an independent ombudsman to resolve disputes, with the power to award costs.
23. BDO hoped that creating a greater level of transparency around auditor selection criteria would ensure that companies set criteria according to their actual requirements. For example, a company based only in the UK should not state that it required auditors that operated in more than 100 countries. BDO's proposal required the principles of equal treatment, transparency and non-discrimination to be respected. Audit committees would be required to report publicly, and this could be at the AGM, on a change of auditor against the criteria that it had set out. This should reduce the risk of bias influencing the decision. The requirement to report on how a tender had been conducted was being brought in by the FRC, and the detail required could be expanded.
24. BDO supported open-book access for tendering firms so that all bidders could have an accurate understanding of the company's control environment, but it did not consider that the entire audit file should be made available. The most important part of the audit file that needed to be made available was the audit plan, the management letter and the outcomes. This would include the issues discussed within those documents and the challenges the incumbent auditors had encountered in obtaining appropriate evidence, together with some of the critical papers prepared by management for the auditors on areas such as going concern and recommendations that auditors had made to the company around improving the control environment. In BDO's view, this meant disclosing about half a dozen key documents which were provided to the audit committee in any case, and would help deal with the current information asymmetry (in favour of the incumbent auditor). These documents would contain sensitive information and so the company would need to be protected by confidentiality agreements.

25. BDO did not consider that ownership of the audit file needed to change—this should still sit with the auditor. The current requirements for former auditors to provide information to new auditors worked well in practice, but this was required only after a new appointment was made, not before. Making this information available to bidders would be excessive, since that level of detail was not required at tender stage. Providing information to that level of granularity might even stifle innovation. Once potential bidders understood the risks and issues, as set out, for example, in the management letter, this would allow them to present their view on the best way of tackling them, and would encourage innovation. BDO did not think the information contained in such documents would be overly commercially sensitive. Firms were used to respecting confidential information.
26. If tendering became more frequent, audit firms would spend much less time trying to develop relationships as a way of supporting their bid. The process would become much more straightforward for companies: they would create data rooms with the necessary information on their systems, processes, corporate and management structure and year-end papers. This would become much more routine for them to organize. Audit committees were likely to become much clearer in the criteria that they were looking for, because they would become more experienced buyers and would be less likely to set criteria that were of interest but which they were not really interested in (but felt it was good practice). Audit firm submissions were also likely to become much more streamlined.
27. BDO agreed that if it were able to present its proposition as a provider of audit services against clear, open and transparent criteria on more occasions, then it was confident that it would be able to win more audits.

Mandatory rotation

28. Audit firms had found ways of minimizing the disruption that mandatory audit engagement partner rotation was designed to cause as a means of maintaining audit firm independence. In that sense it did not seem any longer to serve its original purpose.
29. Mandatory firm rotation was an uncompetitive way of dealing with a competitive problem—the issue of the perception that long tenures undermined independence. This remedy limited choice and incentivized audit firms that knew that they were going to be rotated off an engagement to remove their best people from such work. However, particularly in light of the fact that investors were likely to demand some form of audit rotation, BDO did consider that a mandatory rotation requirement set at 20-year tenures could be appropriate as a backstop to deal with the moral hazard issue—to prevent companies continually using the tender process to reappoint the same firm on each occasion. BDO considered that there was no particular magic in choosing a 20-year period, but at a European level the debate seemed to be around periods of between 14 and 20 years. It was important, however, that it was combined as part of a package that included mandatory tendering, else the mandatory rotation date would become the fallback date for tendering, rather than part of a more regular process.

Expanded remit and/or frequency of AQR reviews

30. The Public Company Accounting Oversight Board's (PCAOB's) approach to reviewing audits was much more discursive and challenging compared with the AQR approach. It tended to go into the non-technical areas of an audit as well and challenged, for example, an auditor's understanding of a business. It looked at the judgement issues but principally tested the involvement of the most senior people in

an audit. It was seeking to check that an auditor came to its opinion in a sensible, thorough and reasonable manner. This approach could be put in place in the UK. BDO noted that the AQR had the ability to question the ACC and this was something that the AQR was going to do going forward. BDO saw no reason why company management should also not be interviewed, although it noted that it was the audit committee that should be considered as the buyer of audit services. Questions for the ACC would focus on how the auditor performed its role, not on how the ACC performed his.

31. BDO would like these reports to be more public—assuming that the AQR were able to ‘rebalance’ its approach to be more like the PCAOB—to inform the market better about the quality of the audit that was undertaken. One of its clients that was in the FTSE 350 had recently decided to publish the outcome of the AQR review of its audit in its annual report. If these reports were more public then audit committees might feel under a greater obligation to take action in instances where its auditor had received a poor review. Very often, good audit committees asked partners in a bid situation if they personally and their proposed teams had been reviewed by the AQR and what the outcomes were.
32. BDO would like AQR reports to comment on all aspects of the audit service, both the technical audit quality and the commercial service provided by the firm. This would better inform the market about the quality of the audit provided. The PCAOB did not comment on the commercial aspect of the service at present. Clients were essentially interested in their audit firms delivering the following four aspects, whether in respect of audit services or other services: understanding of their business and what they needed; doing what the firm said it was going to do; being proactive; and providing value for money—which did not necessarily mean being cheap. The AQR could test all of these aspects at a high level and report on them, although it would probably need to take on additional experienced people to do this.
33. The reviews should be reported on a company basis, which would better inform the market and have positive effects in terms of incentivizing the auditor, rather than on a firm basis. The FRC and AQR had created a sort of hierarchy by reporting on the Big 4 annually but every other year for BDO (and Grant Thornton) and every three years for smaller firms. However, BDO accepted that the FRC had to find the most effective way of allocating its limited resources.

Prohibition of ‘Big 4 only’ clauses in loan documentation

34. BDO was not convinced that prohibiting Big 4 only clauses would affect lenders’ willingness to lend. However, prohibiting them outright was likely to send the right message, although behavioural change was likely to take much longer. The prohibition should extend to all documentation where such clauses appeared, such as procurement documentation or other capital or fundraising documentation. BDO gave an example of [X].

Strengthened accountability of the external auditor to the audit committee

35. The current arrangements did not need to be changed a great deal under this remedy. It should be made clear that it was the audit committee that should negotiate scope and price and not the Finance Director (FD), although if necessary with input from the FD. What tended to happen at the moment was that negotiations were conducted by the FD and were then presented for ratification and approval by the audit committee. BDO considered that such a change would not entail more than an extra one or two days a year for the audit committee. It was likely to become

increasingly more difficult to find good ACCs given the more complex accounting/regulatory framework and their increased responsibilities. An audit engagement partner at the moment would go directly to the ACC, bypassing the FD, if he thought an issue warranted it, even if the FD preferred him not to do so.

Enhancing shareholder-auditor engagement

36. Shareholders were taking an increasing interest in matters concerning auditors, which was being translated into an increasing demand for information. BDO supported requiring audit engagement partners to present directly to AGMs on areas such as: the scope of the audit undertaken; the materiality levels used; the major risks from an audit perspective—which would be audit risks rather than broader commercial risks; and how the auditor satisfied itself that there were no mis-statements. BDO suggested that the ACC could engage on such issues as well. One of the reasons investors were silent on this at the moment was because they found it impossible to distinguish between auditors, as they saw the audit report as a commoditized product with a singular opinion. Enhanced reporting would allow differentiation between auditors.
37. BDO suggested that if such dialogue were to take place at an AGM then more institutional investors might be encouraged to attend. It did not think auditors should be appointed for periods longer than one year. It did not think the French system where appointments were fixed for longer periods worked very well.

Extended reporting requirements

38. Extending reporting requirements would allow firms to differentiate themselves, enabling audit committees and shareholders to have a better insight on how different firms approached audit issues and decide if they wanted a more transparent approach for their company. The current market structure (including the current regulations) stifled such innovation.

Other remedies

39. There should be greater limitations around the types of non-audit services auditors could provide to their audit clients. For example, tax consultancy and management consultancy might be seen to be too close to being allied with management as opposed to being independent from it. It was not so much dependent on the quantity of other services provided, but more the nature of the service being provided, because it might compromise the appearance of independence of the auditor.
40. A by-product of limitations on non-audit services would be that for certain companies, the number of Big 4 firms able to bid for the audit would be limited and this might force the company to look outside this group.
41. BDO did not support the concept of shared (or component) audit because that was unlikely to lead to much exposure for the secondary auditor to the audit committee or improve independence in the way joint audit might do. BDO did consider that joint audit would lead to greater independence and could be managed if planned properly. BDO would be sympathetic to some relaxation of possible tendering and rotation remedies for companies using joint auditors.



BDO LLP

RESPONSE HEARING WITH THE
COMPETITION COMMISSION

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

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10 April 2013



PROVISIONAL FINDINGS

- We welcome the Provisional Findings (“PFs”), especially:
 - Focus on shareholders as true customers
 - There are material barriers to selection and expansion
 - There are no substitutes for formal tenders
 - There is unmet demand from shareholders
 - Auditor independence must be genuine and visible
- Issues meriting further consideration:
 - Price effects of switching
 - Are four firms sufficient?
 - “4 to 3”: each of the Big Four is too big to fail
 - Further restrictions on non-audit services

PROVISIONAL FINDINGS (CONTINUED)

- We agree that a package of remedies is required
- We believe the CC's investigation shows:
 - A concentrated market, with high barriers to expansion and selection
 - Tenders and switching are rare
 - Tenders are the best way for companies to achieve competitive offerings from auditors
 - A lack of innovation by auditors
 - A lack of connection between auditors and shareholders
- Big Four responses:
 - Hostile to PFs, especially perceived criticisms of integrity of NEDs, auditors and corporate governance
 - More positive on remedies

REMEDIES PROPOSED

- Mandatory tendering
- Mandatory rotation
- Expanded AQRT reporting
- Prohibit “Big Four only” clauses
- Strengthened accountability to Audit Committee
- Enhanced shareholder-auditor engagement
- Extended reporting requirements

REMEDIES NOT BEING CONSIDERED FURTHER

- Restricting provision of non-audit services
- Joint/component audit
- Shareholder group responsibility for auditor reappointment
- FRC responsibility for auditor reappointment
- Liberalising ownership and control of audit firms

MANDATORY TENDERING - OUR VIEW

- We support mandatory tendering to:
 - Ensure that companies compare their existing auditor's quality, price and overall service offering in a structured manner and on a more frequent basis
 - Enable companies to achieve the **benefits of switching**
 - Reduce the incentives of auditors to compete to **satisfy management** (rather than shareholder) demand
 - **Increase competition between auditors**, encouraging lower prices, better service, more innovation and greater choice

MANDATORY TENDERING - OUR PROPOSALS

- Align tendering and AEP rotation - every seven years
- **Mandatory** with narrowly defined exceptions
- Publicise tenders via **dedicated independent website**
- All tenders on an “open book” basis
- Principles of equal treatment, transparency and non-discrimination to be respected
- Phased introduction based on audit tenure

MANDATORY TENDERING - OUR RESPONSE TO THE BIG FOUR

- Tendering every seven years is not “disproportionate”
- Tender dates would not be fixed - just the maximum period between them
- Revised Corporate Governance Code is not sufficient
- Cost concerns are exaggerated, due to misapprehensions about the difficulties of running tenders
- Big Four’s other criticisms are overstated
- CC must remedy AECs

THE CODE IS NOT ENOUGH

- “35 tenders per year” - but only five in six months
- “Comply or explain” lets management opt out
- No “open book” process to level playing field
- Barriers to expansion and selection remain, producing “Big Four only” tenders

MANDATORY ROTATION - OUR VIEW

- We oppose mandatory rotation in principle because it:
 - Forces a company to change auditor even if:
 - company has little choice of auditor
 - existing auditor is the best choice
 - Has likely unintended consequences:
 - increased concentration
 - reduced audit quality
 - reinforced barriers to expansion and selection
- Mandatory rotation should therefore only be a last resort

MANDATORY ROTATION - OUR PROPOSALS

- A long stop after 20 years (so no auditor can win more than three tenders in a row)
- Mandatory with narrowly defined exceptions
- Tender process as for mandatory tendering:
 - Publicise tenders via dedicated independent website
 - All tenders on an “open book” basis
 - Principles of equal treatment, transparency and non-discrimination to be respected
 - Phased introduction based on audit tenure

EXPANDED AQRT REPORTING

- AQRT reviews are:
 - Best independent assessment of audit quality
 - Not perfect
- Companies need the right information to make informed choices
- We propose a “rebalancing” of AQRT effort, placing greater emphasis on issues of greater concern to investors
- This would make the quality rating of audits more transparent, to inform the market and drive up audit quality
- Increased costs could be funded by increasing current levies on a proportionate basis

PROHIBIT “BIG FOUR ONLY” CLAUSES

- Contractual restrictions on choice of auditor should be banned
- Prohibition should extend to:
 - All forms of agreement, not just certain templates
 - All companies, not just those in FTSE 350
- Prohibition could be implemented by Order
- Benefits include:
 - Enabling companies to choose their own auditor
 - A clear message that there is choice outside the Big Four
 - Improving the prospects of successful implementation of other remedies, e.g. mandatory tendering
 - Reducing barriers to entry/expansion and selection

STRENGTHENED ACCOUNTABILITY TO AUDIT COMMITTEE

- We support enhanced auditor independence from executive management
- Audit Committee (not FD/CFO) should:
 - Choose auditor
 - Negotiate price and scope of audit
- Implement through enhanced FRC guidance for Audit Committees
- Audit Committee remuneration and resourcing would need to be adjusted

ENHANCED SHAREHOLDER-AUDITOR ENGAGEMENT

- We support enhanced shareholder-auditor engagement
- Auditors should be incentivised to compete to satisfy shareholder demand
- We favour requirements for:
 - A shareholder vote on the Audit Committee report
 - A special resolution to confirm re-appointment of the incumbent auditor after a tender
 - The AEP to present directly to AGMs on the conduct and outcome of audits
 - The ACC to answer shareholders' questions at AGMs

EXTENDED REPORTING REQUIREMENTS

- We support extending auditor reporting requirements.
- Such requirements would:
 - Overcome any reluctance by management to allow further disclosure of information about the audit process
 - Give shareholders more information about audit quality
 - Increase visibility of audit quality, to help companies judge the quality of their auditor
- We support the FRC's proposals on Audit Committee reporting and enhanced audit reporting

OTHER REMEDIES WE SUPPORT

- Further restrictions on the provision of **non-audit services** by auditors
 - 25% of FTSE 350 companies paid their auditor as much or more for non-audit services between 2006 and 2011 as they did for their UK audit
- Remedies to encourage use of **joint audits**
 - Concerns over use of joint audit are exaggerated
- Liberalising rules on **ownership and control of audit firms**
 - To allow new/smaller audit firms to grow faster

CONCLUSION

We broadly welcome the PFs. We continue to support a package of remedies, to include:

- Mandatory tendering
- Expanded AQRT reporting
- Banning restrictions on choice of auditor
- Strengthened accountability to Audit Committee
- Enhanced shareholder-auditor engagement
- Extended reporting requirements
- Measures to address possible failure of a Big Four firm