COMMENTS OF BDO LLP ("BDO") ON THE NATURE AND STRENGTH OF COMPETITION WITHIN THE MARKET WORKING PAPER[1]

1 NATURE AND STRENGTH OF COMPETITION WITHIN THE MARKET

1.1 Innovation

1.1.1 In paragraph 30, the CC states that the audit firms identify "*areas of previous and possible innovation*" as essentially about improving efficiency rather than varying the service output. The CC further states that they are "*primarily determinants of cost efficiency*".

1.1.2 BDO considers that this shows how little real innovation has occurred in the audit market. In BDO's view, the key issue is whether the audit product has evolved sufficiently in order to meet the evolving needs of customers, i.e. shareholders. As noted in paragraph 4.1.2 of BDO's response to the CC's Issues Statement "*statutory audit has remained largely unchanged for a long period, while companies' communications have changed considerably*".

1.2 Visibility of elements of an audit

In Figure 1 *"Visibility of measures and indicators of various aspects of audit quality"*, the CC makes no mention of the reports prepared by the UK Audit Inspection Unit or equivalent bodies in other jurisdictions.

1.3 Roles of ACCs and FD/CFOs

1.3.1 In paragraph 51, the CC concludes that the AC and FD, plus management, are the "*individuals that are relevant to an assessment of the nature of competition for FTSE 350 audits*." Audit is a product supplied for the benefit of investors, but BDO is concerned that the CC appears to regard investors' assessment of competition as irrelevant, while including management (from whom auditors should obviously be independent). The CC has the evidence of the Oxera investor survey, which should have been included in this Working Paper. Further, the CC has apparently omitted intermediaries (such as brokers) from its assessment of the nature of competition. As explained at BDO's hearing on 4 October 2012, the role of intermediaries is an important element of the functioning (or lack thereof) of competition in the reference market.

1.3.2 So far as the "*preferences and perceptions*" of the ACC and FD/CFO are concerned (as referred to in paragraph 51), BDO considers that Big Four alumni (such as the great majority of FTSE 350 CFOs and ACCs) are more aware of the capabilities of, have more contacts with and therefore tend to favour, the Big Four. Paragraph 74 states that "*the majority of FDs/CFOs and ACCs for FTSE 350 clients have worked for one of the Big Four firms*" – indeed, according to the CC's survey, 66% of FDs/CFOs surveyed had previously worked for one of the Big Four firms, while 60% of ACCs surveyed had previously worked for one of the Big Four firms (paragraph 24 of the CC's survey results). BDO agrees with the CC that such Big Four backgrounds "*could make them (CFOs/ACCs) less aware of the quality and experience of non-Big Four firm*" (paragraph 120).

1.3.3 Accordingly, although the CC considers that "*FDs and ACCs are sophisticated purchasers of audit services*" (paragraph 76), those people do not appear to be

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[1] Reference to paragraph numbers are to paragraphs of the relevant working paper ("WP") unless stated otherwise.

sufficiently aware of the capabilities of the mid-tier firms. The fact that "*about three quarters*" of FTSE 350 companies "*would consider only Big Four firms*" (paragraph 118) certainly supports such a view. Such innate conservatism is perhaps not surprising: ACCs (individuals that are largely towards the end of their successful careers) will not only have long-standing relationships with Big Four firms, but they are unlikely to wish to risk adversely affecting their or the companies' reputations by being seen to be party to any appointment that the ACC considers may be seen as higher in risk. (See paragraphs 5.3.7 and 5.3.8 of BDO's response to the CC's Issues Statement.). This pattern of behaviour is unhelpful to the functioning of competition, since choices are potentially being made on the basis of false assumptions. For example, an ACC may assume that shareholders prefer him or her to choose a Big Four firm, but the ACC does not check this assumption, and therefore may take a decision based on a false premise.

1.3.4 Moreover, BDO notes that, according to the CC's analysis, a third of FTSE 350 companies did not carry out benchmarking or other formal comparisons or request a formal proposal or presentation from the auditor before re-appointment (paragraph 95). Such "*limited information on the outside options*" (paragraph 111) would only reinforce the erroneous, but widely-held, view that there are no significant gains to be had from switching auditors. This is to be contrasted with the fact that 90% of those companies who switched and found a difference in quality said that quality had gone up (paragraph 185). Such an overwhelming response in favour of the benefits of switching only highlights the discrepancy between the perceptions and the reality of switching auditors.

1.3.5 In paragraphs 130 and 131 the CC describes ACCs, but gives no consideration to what BDO has previously termed the *"IBM effect"*. As discussed in BDO's hearing on 4 October 2012, this is a significant driver of the exclusion of mid-tier firms. This is also clear from the CC's case studies, including Case Studies D (paragraphs 29 and 66) and E (paragraph 54). See paragraph 2.9 of BDO's comments on the CC's Working Paper on Evidence on Switching Costs (and Implications for Barriers to Entry).

1.4 Tender processes

1.4.1 Although paragraphs 78 to 84 indicate that structured and thorough processes for tenders do exist, BDO considers that FTSE 350 companies should not only tender more often, but should also research the wider market more widely. This would help them decide whether and when to tender, and which companies should be invited to tender.

1.4.2 BDO notes the result of the CC's survey that, on average, frequency of tendering is lower among FTSE 350 companies: 40% of FTSE companies and 21% of others had not tendered ever or within the last 10 years (paragraphs 43 and 44 of the CC's survey results). The CC elsewhere measures the average tendering rate at about 4%, implying that FTSE 350 companies hold tenders on average once every 25 years.[2] Moreover, even when firms do tender, they usually only invite Big Four firms: only 23% of FTSE 350 companies invited BDO to tender, only 14% invited Grant Thornton and less than 3% invited other firms (at paragraph 45 of the CC's survey results). Indeed, out of 44 FTSE 350 tenders within the last five years, 27 were "*Big Four firms only*", i.e. 61%.

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[2] http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence_relating_to_the_selection_process_tendering_annual_renegotiations_and_switching.pdf, para 2(b).

1.4.3 BDO agrees with the CC's view at paragraph 194 that the passage of time since the last tender will increasingly affect companies' ability to assess effectively the competitiveness of the audit product and service provided by their existing auditors, and that "*only by going out to tender are companies in a much better position to assess the competitiveness of all aspects of the audit product provided by the incumbent*" (Paragraph 141(c)). BDO also agrees with the CC that "*without a tender an assessment of the potential gains from tendering and/or switching will be based on incomplete information*" (paragraph 180).

1.4.4 BDO considers that the above propositions support BDO's view that FTSE 350 companies should be required to engage in mandatory retendering, not only as good corporate practice, but also as a matter of corporate governance, consistent with those companies' duties to their respective shareholders. However, mandatory tendering should, in BDO's view, be coupled with a requirement to invite non Big Four firms, in order to combat the bias described above in favour of the Big Four. Moreover, given that "*some FTSE 350 companies in certain sectors might be limited in their choice of Big Four firm on the basis of relevant experience*" (paragraph 147), mandating the participation of non-Big Four firms could also address a perceived lack of choice: the CC's own survey indicates that a "*substantial minority (around 40 per cent)*" considered choice to be limited between the Big Four firms (paragraph 141(g)).

1.5 Switching costs

1.5.1 BDO maintains that switching costs for the client company should not be exaggerated: it therefore disagrees with the first part of the CC's statement in paragraph 105 that "*in aggregate there are substantial search and switching costs*" but agrees "*that any costs should not seen as an insurmountable barrier to switching*", particularly by those companies who have not actually experienced tenders or switching.

1.5.2 Moreover, BDO agrees with the CC's statement in paragraph 72(e) of the Working Paper on Evidence on Switching Costs (and Implications for Barriers to Entry) that "*[t]hose that have switched have not found the process particularly burdensome or the costs particularly high. Firms go to considerable efforts to ease the process and to manage the risks involved*".

1.5.3 In paragraph 138, the CC refers to costs that may be incurred by an incumbent auditor when it loses a tender. A potential cost for the CC to consider in this context is that the new auditor may uncover mistakes made by the previous auditor, which may yield a liability for the previous auditor. This is partly why more switching will tend to drive up audit quality.

1.6 Role of intermediaries

1.6.1 BDO agrees with the CC's statement in paragraph 67 that the reputation of the audit firm with investors, corporate brokers, analysts and external advisers is one of the key variables of competition. Indeed, as set out in paragraph 5.1.2 of BDO's response to the CC's Issues Statement, such intermediaries also reinforce the dominance of the Big Four by recommending or insisting that their corporate clients use the Big Four, often on the basis that using any other auditor would be "*going down market*".

1.6.2 This is consistent with the results of the CC's survey: Table 11 of the CC's survey results, which sets out the selection criteria factors which are very important/important, ranks "*Reputation of audit firm with investors, corporate brokers, analysis or external advisors*" above almost all the other factors, even

beating "*strength of international network*" on both grounds, despite the fact that the latter is often given as the reason for not using mid-tier firms (see paragraph 35(c) of the CC's survey results).

1.6.3 Moreover, pressure from intermediaries is considered to be a key trigger for FTSE 350 companies seriously to consider switching (see paragraphs 55 and 56 of the CC's survey results). Clauses in loan agreements requiring or preferring the use of a Big Four firm compound this pressure and create or enhance barriers to entry and expansion.

1.6.4 BDO considers that the role of intermediaries should, therefore, be given more prominence in the CC's analysis. The role of intermediaries should also be clearly separated out from the role of shareholders: according to the Oxera investor survey, none of the respondents reported a difference in quality between the Big Four and the mid-tier firms – the CC survey, however, conflates the two (paragraph 122).

1.7 Competition to win new engagements

1.7.1 In paragraph 165(b) the CC states that tender lists typically include *"at least three firms*". This is incompatible with paragraph 98 of the Selection Process Working Paper, which states that "*In our dataset, the average number of participants to tenders is 2*". The number of participants will presumably affect the nature of competition in tenders (both unilateral and coordinated effects). The CC should investigate, if it has not done so already, the relationship between the number of tender participants and the competitive outcome. Further, the CC's data on tenders is recognised to be incomplete (para 95 of the Selection Process Working Paper), and this limitation should be recognised wherever tender data is being used, not just in the Selection Process Working Paper.

1.7.2 In paragraph 166, the CC states that 40% of FTSE 350 companies surveyed experience a further limitation on their choice (i.e. they cannot even choose among four firms). This is consistent with the evidence from AFME that: "*The choice was narrowed to one*".[3] It is key to this market investigation that the CC conducts further analysis of restricted choice, where competition is constricted by a lack of alternatives.

1.8 Competition to retain engagements

In paragraph 169, the CC states that average auditor tenure for FTSE 350 companies was about 11 years. But the CC can observe neither the start date of audit engagements which commenced prior to 2000, nor the end date of audit engagements which are still active in 2011. The CC must therefore reconsider or caveat its calculations, in particular those on auditor tenure. If auditor tenure were 11 years, as the CC states, the annual switching rate would be approximately 9%, which it is clearly not.

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[3] http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/afme_hearing_summary.pdf, para 19.

1.9 Audit fees

The CC's data shows audit fees rise considerably in the years after switching auditor (Big Four to Big Four), and by year 5 audit fees are 50% higher than in the year before a switch was made. Since in the first year after a switch was made fees are 19% lower than previously, the ability of Big Four audit firms to renegotiate fees upward from the first year level does not seem to be constrained. This evidence suggests that the "*degree of bargaining power"* referred to by the CC at paragraph 192 is in fact very limited, and that a "*benchmarking exercise*" is certainly no substitute for actual switching.