COMMENTS OF BDO LLP ("BDO") ON THE COMPETITION COMMISSION'S WORKING PAPER ON RESTRICTIONS ON ENTRY OR EXPANSION (the "Entry Restrictions WP")

1 EXECUTIVE SUMMARY

1.1 BDO regards the Entry Restrictions WP as a welcome recognition by the CC of many of the genuine restrictions on entry or expansion into the reference market.

1.2 BDO encourages the CC to proceed with its proposed framework for considering restrictions on entry and expansion and its proposed approach to analysing the various individual strands within that framework. Modelling the profitability of entry and expansion will be an important aspect of the CC's work.

1.3 BDO does, however, have a number of specific comments and concerns in relation to the Entry Restrictions WP, as set out below.

2 FRAMEWORK

Footnote 1 to the Entry Restrictions WP notes that "*around ten FTSE 350 companies are audited by firms other than the Big 4.*" It goes on to suggest that those companies may be "*unrepresentative of other FTSE 350 companies in one respect or another; e.g. they may be less complex, less international; or rejected by the Big 4 on risk grounds.*" BDO believes that this suggestion is misconceived, because:

(a) whilst BDO acknowledges that the very largest FTSE 350 companies are complex and international, the reality is that only 35 or so of the very largest FTSE 100 companies are too complex or large for BDO to be able to audit them at present. BDO can currently audit the great majority of FTSE 350 companies. It would therefore be more accurate to state that the largest and most complex FTSE 350 companies are unrepresentative of the FTSE 350 as a whole in relation to their audit requirements; and

(b) BDO considers that the implication that those FTSE 350 companies which are audited by firms other than the Big Four have been rejected by the Big Four on risk grounds is not only inaccurate, but offensive to those companies and their auditors. [✂].

3 INTRINSIC FACTORS

3.1 Economies of scale

BDO does not consider that it would be credible to suggest that scale economies are such that there is room for only four firms to provide statutory audit services to the FTSE 350, but nonetheless welcomes the CC's empirical investigation into this topic.

3.2 Switching costs

3.2.1 Paragraph 25 suggests that an incoming auditor may face a higher risk of error of omission while it becomes fully acquainted with a company. However:

(a) a "fresh pair of eyes" may be more willing and able to detect errors which might otherwise go unnoticed. An incoming auditor will be looking afresh at the company's records and systems; it may therefore have greater

scepticism and less readiness to accept established procedures without question;

(b) it is not clear whether the alleged "*higher risk*" of error or omission is based on empirical evidence or is simply instinctive. Many of the recent allegations of audit failure have involved alleged failures by long-standing auditors; and

(c) in BDO's view, BDO (like other mid-tier and Big Four audit firms) would expect to devote sufficient resources to becoming fully acquainted with new audit clients to try to minimise (and hopefully eliminate) the alleged higher risk of error or omission.

3.2.2 BDO considers that:

(a) the true costs of switching are often exaggerated;

(b) there may well be a misalignment of objectives between those who are best placed to assess the costs of switching (particularly the CFO/FD) and those who receive the potential gains from switching (particularly investors), given that if the CFO/FD has a good relationship with the existing auditors, he or she may have least to gain and most to lose from a change of auditors; and

(c) it is difficult to measure or quantify gains from switching (such as improvements in auditor service, vigilance and/or quality), which makes comparisons between costs of and gains from switching very difficult.

Incentive misalignment may provide a better explanation for the infrequency of tender opportunities in the FTSE 350 audit market, rather than the costs of switching being high and/or the expected benefits being low, as suggested at paragraph 26 of the Entry Restrictions WP.

4 STRATEGIC BARRIERS TO ENTRY

4.1 Bundling and tying

BDO encourages the CC to continue its assessment of evidence in relation to bundling, particularly: mixed bundling; the potential for bundling; and bundling of group audits.

4.2 Targeting clients of mid-tier firms who have FTSE 350 potential

4.2.1 At paragraph 34 of the Entry Restrictions WP, the CC invites specific examples of Big Four firms targeting clients of mid-tier firms who have potential to move into FTSE 350 with aggressively priced tenders.

4.2.2 [✂], which has been listed on the London Stock Exchange since [✂], has been heavily targeted by [✂] for several years. BDO understands that [✂] has given unsolicited audit fee quotes at a discount to the existing fee and has made comments aimed at undermining BDO's depth (tracking partner rotation).

4.2.3 [✂] received an unsolicited audit proposal from [✂] in [✂] at a fee of [✂], when BDO's audit fee was then [✂]: see the copy email in the **Attachment** to this document**.** BDO audited [✂] until [✂] were [✂] auditors.

5 FIRST MOVER/INCUMBENCY ADVANTAGE AND REPUTATION

5.1 Reputation

5.1.1 Paragraph 36 of the Entry Restrictions WP suggests that mid-tier firms' chances of winning FTSE 350 tenders may be lower than necessary to achieve profitability because they are unable to match the reputation of the incumbent firms. However, that paragraph appears to assume that:

(a) There are a reasonable number of tenders by FTSE 350 companies, when in fact such tenders are few and far between;

(b) Mid-tier firms are considered by FTSE 350 companies in relation to such tenders, when this is often not the case, even when mid-tier firms would be willing and able to audit those companies; and

(c) Mid-tier firms are unable to match the reputation of incumbent firms, or unable to do so with the FTSE 350 company, although the reputational advantage of incumbent Big Four firms may not be fully justified, or may be with key intermediaries rather than the company itself.

5.1.2 There is no doubt that the Big Four enjoy a very considerable reputational advantage, both individually and collectively, over other audit firms and that this adversely affects the chances of mid-tier firms winning audit work from FTSE 350 companies. However, this is subtly different from the way in which Paragraph 36 is phrased.

5.1.3 In theory, reputation can act as a useful signalling device for quality in markets with asymmetric information. However, the evidence emerging from the CC's investigation indicates that reputation does not have a benign function in the relevant market, since incentives are misaligned. In particular, BDO refers to *"the disconnect between the demand (from shareholders and other stakeholders) and supply (in terms of the product delivery by auditors*)"[1] and the impact that this has on the role of reputation in the audit market.

5.1.4 Paragraph 37 of the Entry Restrictions WP suggests that investors are more reliant on auditor reputation than the individuals making the purchasing decision (the CFO and ACC). However, the results of the investor survey recently conducted by Oxera indicate that investors are very concerned about AIU reports and scandals (which relate directly to auditor quality), whereas CFOs/ACCs do not place a high weight on adverse comment by regulators when selecting the auditor. In other words, personal experience and relationships may be more important for CFOs and ACCs than for investors, while at least some investors may place a higher importance on external quality benchmarks (such as AIU or US PCAOB reports) than do CFOs or ACCs.

5.1.5 Paragraph 40 of the Entry Restrictions WP states that "*large firms have reduced incentives to lower audit quality opportunistically in order to retain any single client."* BDO does not have any incentive to lower audit quality in order to retain (or win) any single client; nor (in BDO's view) do other mid-tier firms. Whilst size may (not necessarily correctly) often be perceived as a signal of quality, BDO does not consider a lack of incentives to lower audit quality to be a relevant factor in relation to the Big Four in comparison with mid-tier firms. Neither BDO nor (so far

---

[1] http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/framework_for_the_ccs_assessment.pdf, para 81.

is BDO is aware) other mid-tier firms are financially dependent on any one client to an extent which could give rise to such an incentive. Indeed, BDO notes that paragraph 53(g) of the Entry Restrictions WP states that the restrictions governing the proportion of fees an audit firm may receive from one audit client "*would be unlikely to affect the ability of non-Big 4 firms to tender for FTSE 350 audits other than the very largest clients".*

5.2 International network effect

5.2.1 BDO has a substantial international network. However, there appears to be a gap between the reality of BDO's network and the awareness of that network on the part of CFOs, ACCs and some investors, as indicated by the CC's case studies. This is therefore an important aspect of reputation. The barrier to entry or expansion is not therefore the lack of an international network, but the perception of that international network in comparison with the perceptions of the Big Four's networks.

5.2.2 A lack of an international network does not prevent large audit firms outside the Big Four from providing audit services to the FTSE 350, as:

(a) BDO and GT already have such networks; and

(b) most companies in the FTSE 350 do not need a complete global audit network, or anything like it.

5.2.3 On the basis that few companies within the FTSE 350 operate in over 100 jurisdictions (or anything like that number), the number of FTSE 350 companies which actually require a complete global audit network is relatively small, especially outside the FTSE 100. Thus the need for a network providing audit services in a very high number of jurisdictions cannot be a genuine barrier to entry or expansion for the provision of audit services to the vast majority of FTSE 350 companies.

5.3 Attracting talent

Big Four firms offer marginally higher starting salaries for graduates and school leavers, but BDO believes that its training is at least equally good. BDO uses the same people as the Big Four for exam training. BDO considers that it offers a better environment for its employees, empowers people more and offers at least as good career progression, albeit that partner earnings are lower.

5.4 Influential alumni network

5.4.1 Paragraph 51 of the Entry Restrictions WP correctly notes that many FTSE 350 FDs and ACCs are ex-Big Four. This is demonstrated by the CC's Case Studies. At least 16 of the CFOs/ACCs featured in those Case Studies were Big Four alumni. The Case Studies show little if any evidence of those CFOs/ACCs researching the audit market beyond their own existing milieu.

5.4.2 Big Four firms train a high percentage of auditors, many of whom then take up positions with clients or potential clients and go on to use their former firms (or their closest equivalents) as auditors and/or advisers.

6 Regulatory barriers to entry

6.1 Risks of regulatory failures

The various ways in which the regulatory framework may restrict entry or expansion, including those listed in paragraph 53 of the Entry Restrictions WP, all merit careful consideration by the CC, as they may risk regulatory failure, as defined in the CC's original Issues Statement.

6.2 Audit firm ownership

Paragraph 53(f) of the Entry Restrictions WP states that "*Audit firms, including non-Big 4 firms, have not cited access to capital as a barrier to entry".* However, whilst BDO does not have a current need for external capital, and has not to date needed it, large expansion could be funded in different ways, including external capital. Relaxation of rules on access to capital could therefore help facilitate expansion by mid-tier audit firms.

6.3 Requirement for audit committee to approve change of auditor

Paragraph 53(i) of the Entry Restrictions WP says "*Some commentators have suggested that the conservative nature of the audit committee acts as a further barrier to mid-tier firms winning FTSE 350 audits."* BDO considers that this is a considerable understatement of the evidence available in relation to the conservatism of audit committees, including the CC's own case studies and Oxera's 2006 Report.

7 AUDITOR CLAUSES IN LOAN AGREEMENTS AND ADVISOR PRESSURE

Evidence of informal vetos

7.1 At paragraph 56 of the Entry Restrictions WP, the CC invites further specific evidence of informal vetos.

7.2 Examples of informal exclusion are generally difficult to evidence, as by their very nature BDO would not be aware of something from which it had been excluded. However, there are a number of recent examples where BDO's existing relationships have been affected, particularly when financing transactions (not only raising equity capital) were being considered. As previously indicated, these tend to take place well below the reference market, but they have the effect of 'locking in' Big Four relationships longer term. There are two recent examples in particular:

(a) [✂]

(b) [✂]

In each of these situations BDO had demonstrated to management that it had successfully been involved in [✂].

7.3 This position is not restricted to [✂]. In respect of [✂], BDO has had recent experience, related to BDO by its clients, of [✂] asking for BDO to be replaced by [✂]. An example of this was [✂].

7.4 There is evidence that [✂] puts pressure on its investee companies to appoint [✂]. For example, [✂]. In addition, [✂].

7.5 BDO believes that these actions by intermediaries directly affect the reference market, as they have the object and effect of excluding mid-tier firms from the market when their clients are preparing to take the necessary steps to become reference market companies.

8 NEXT STEPS

BDO broadly agrees with the CC's proposed next steps, and emphasises the important of assessing entry profitability in light of the significant barriers to entry, and how this would change if those entry barriers were lowered by regulatory intervention.

9 TACIT COLLUSION

BDO awaits the CC's working paper on tacit collusion between audit firms.

Meanwhile, BDO notes that the barriers to entry and expansion identified by the CC are conducive to tacit co-ordination between the Big Four.

ATTACHMENT

[✂]