COMMENTS OF BDO LLP ON COMPETITION COMMISSION WORKING PAPER ON VIEWS OF INVESTORS AND OTHER STAKEHOLDERS

1 "LIMITED DIRECT EVIDENCE"

1.1 BDO is concerned that the CC appears to have conducted only limited investigation into the views of investors, although investors are the true customers for the audit product. It is important to the balance of the CC's investigation that it pays sufficient attention to customer views. While the customer, for whom audit is produced, is not the direct purchaser in this market, that is not a valid reason for the CC to marginalise the customer. Rather, it is a reason to investigate further the principal-agent issue and the problems it causes for competition for the audit of public interest entities. See, for example: "*Audit is for shareholders, not auditors and not company executives*",[1] a paper by USS and other investors. BDO trusts that investor views will be taken into consideration by the CC, and that the principal-agent problem will receive due attention.

1.2 At paragraph 16, the CC says it has "*limited direct evidence from investors on the price and quality of audits*". BDO refers the CC to investor papers by USS et al,[2] who say "*we believe the current system is not delivering*", and more specifically to part 2.2 of Oxera's Investor Survey Report, which summarises investor views on quality and the price-quality trade-off. For example: *"Five investors also highlight concerns about what they currently perceive as a degree of cost-cutting by audit firms and how this might affect the quality of audit*."[3]

2 LACK OF CHOICE

2.1 The CC's Working Paper does not refer to the extent of investor concern at the lack of choice in the audit market. This is a material omission. Oxera's Investor Survey Report, paragraph 2.3.3, stated that: "*All the associations and all bar one of the investors surveyed consider there to be a problem with choice in the audit market. For two investors, the problem is not the lack of alternative audit firms, but audit committees and companies not using the choice available".* This issue cannot continue to be ignored if the CC are to do justice to the views of investors and other stakeholders.

2.2 The International Corporate Governance Network (ICGN) has highlighted this issue: "*The ICGN is a global membership organisation of institutional and private investors, corporations and advisors from 38 countries with capital under management in excess of US$10 trillion. [...] The lack of choice may adversely impact audit quality and hence the reliance that investors can place on audited financial statements. We agree with the view that the 'risk could be mitigated through increased choice of auditors.' While in some industries, a choice of four suppliers may be perfectly acceptable, we do not believe that such a choice is sufficient with respect to audit. We believe that such a small choice may not only adversely impact audit quality (see above) and increase cost, but it can also be an impediment to innovation*".[4]

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1 http://www.uss.co.uk/Documents/Letter%20to%20FT,%20Audit%20is%20for%20investors%2013%20Sept%202012.pdf

2 http://www.uss.co.uk/Documents/Audit%20-%20a%20long-term%20investor%20position%20paper%20on%20proposed%20EU%20reforms%2022%20Nov%202012.pdf

3 Oxera Investor Survey Report, p. 7.

4 https://www.icgn.org/component/k2/item/1045-letter-to-the-financial-reporting-council-re-the-interim-report-of-the-market-participants-group-on-choice-in-the-uk-audit-market

2.3 The Universities Superannuation Scheme (USS) has also highlighted this issue: "*The signatories to this paper are large institutional investors and investor associations. The institutions manage approximately EUR 1.66 trillion on behalf of their members / investors. [...] We believe the current system is not delivering, as evidenced by: [...] Too few large auditors providing audit services to the largest listed companies*".[5]

3 QUALITY OF AUDIT REPORT

3.1 At paragraph 68, BDO notes with some concern the investors' point that: "*there were cases of significant variation in the numbers reported by financial institutions that held the same type of instruments, for the same purpose, even where those institutions had the same auditor*". BDO queries whether this can be said to represent good quality audit.

3.2 BDO notes that there is ample support for its view that there has been a **lack of innovation** in the audit product, which operates to the detriment of investors and other stakeholders: for example, in paragraph 69 the institutional investors are identified as stating that the audit had become "*too much of a utility product… [that] was no longer differentiated on the basis of quality as very little judgment was required when undertaking an audit*", and in paragraph 75 the CC notes that the PwC survey highlights that "*audit reports themselves do not give meaningful information*" and "*information on the 'behind closed doors' aspect of the audit would be valuable*…" A number of key stakeholders identify several additional "*outputs*" and measures to promote more disclosure in respect of the audit report with the clear objective of enhancing quality.

3.3 At paragraph 16 the CC indicates that some investors have little information about audit quality. BDO notes that it is the function of audit regulatory bodies to monitor and provide information with respect to audit quality, and that in the Oxera survey: "*several of those surveyed keep an eye on audit quality and independence by considering proxy measures, such as the ratio of non-audit fee to audit fee, or by reading the reports of the UK Audit Inspection Unit or the US Public Company Accounting Oversight Board"*.[6]

4 PERCEPTIONS OF QUALITY OF MID-TIER FIRMS

4.1 At paragraph 30 the CC gives the views of four investors, three of which express some preference for the Big Four. BDO points out that the views of these three investors are likely to be in the minority, outweighed by the large number of investors who are comfortable with the idea of FTSE 350 companies looking outside the Big Four, and indeed who have raised serious concerns about the current limited choice of auditor.

4.2 BDO refers the CC to Oxera: "*All except one [investor] consider that there is a problem with choice in the large-company audit market [...] Only one investor surveyed considers that having four firms is enough […] none of the investors surveyed thinks that there is a genuine gap in capability between the Big Four and mid-tier firms for the purpose of many FTSE 350 audits*".[7] BDO also refers the CC

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[5] http://www.uss.co.uk/Documents/Audit%20-%20a%20long-term%20investor%20position%20paper%20on%20proposed%20EU%20reforms%2022%20Nov%202012.pdf

[6] http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/oxera_investor_survey_report.pdf, page i

[7] http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/oxera_investor_survey_report.pdf, page ii

to the concerns of investors as expressed to the European Commission. A wide group of investors (managing €1.66 trillion on behalf of their members/investors) have stated openly their concerns about: "*Too few large auditors providing audit services to the largest listed companies*".[8] The broader issue, therefore, is whether audit is providing sufficient assurance to capital markets.

4.3 BDO notes that in paragraph 35 the institutional investors say that they "*did not consider that there was a difference between the Big Four firms and the others*"; the institutional investors also seem to be aware that the relevant reports from the AIU and the PCAOB make it clear that BDO's audit quality is comparable to the Big Four firms. Similarly, BlackRock is mentioned at paragraph 36 as stating that "*identity of the auditor was unlikely to affect its decision to invest … there would be no issues with one of the top four to six firms auditing any of the companies in the FTSE 350"*. This is reflected in the majority of investors' lack of concern over any change in auditor, provided that such investors are given an adequate explanation.

4.4 USS has commented as follows on this issue: "*Surveys of CFOs, Financial Directors and other financial controllers (e.g. 2009 Accountancy Age and Financial Director study of audit firms) suggested that mid-tier firms provided a better service than the Big 4. Academic studies also suggest no evidence of difference in quality*".[9]

4.5 All of the investors surveyed by Oxera that are cited by the CC in paragraph 39 support the view that the audit services supplied by the Big Four firms are not necessarily synonymous with superior quality. For example, the investor surveyed in paragraph 39(e) notes that there were "*about 14 or 15 firms that investors would trust (and there could be more)*", while the investor surveyed in paragraph 39(f) considers that firms "*such as PKF (UK) LLP, Mazars LLP and Moore Stephens LLP outside the big six should [also] be considered*".

4.6 To the extent that any investors consider the Big Four a better option, this seems to be the result of the "IBM effect" rather than any discernible difference in quality: for example, Threadneedle is quoted as saying (at paragraph 29) that there was "*a default view that the bigger firms were safer, even though this was not borne out by the evidence*". This would also seem to be the key driver for any concerns expressed in respect of change from a Big Four firm to another auditor: given the lack of switching in practice, any such concerns appear to be based upon the potential reputational effect rather than real experience.

4.7 In the light of the above, BDO considers the CC's conclusions in paragraph 79(b) to be unsupported by the evidence set out in the CC's Working Paper. Paragraph 79(b) states that, in respect of some investors/end-users, "*a change particularly from a Big 4 to a Mid Tier auditor was seen as an issue and would raise concerns*". However, the relevant adverse comments - set out in paragraphs 41 and 42 of the Working Paper and taken from Rathbone, Artemis, Schroder, Standard Life Investments and an undisclosed entity - do not identify or specifically refer to any mid-tier firms, other than as part of a general critique of non-Big 4 firms (the latter critique would also appear to be motivated primarily by the "IBM effect" indicated in paragraph 1.3.3 above): in particular, the CC should not assume that the "*division 2"* firms referred to by Artemis are synonymous with the mid-tier firms. Indeed, the undisclosed investor expressly carves out "*one or two*" of the (presumably larger) mid-tier firms from the general proposition that any move away from Big Four firm could raise issues. Accordingly, BDO believes the wording

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8 http://www.uss.co.uk/Documents/Audit%20-%20a%20long-term%20investor%20position%20paper%20on%20proposed%20EU%20reforms%2022%20Nov%202012.pdf

9 http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/universities_superannuation_scheme_submission.pdf

of paragraph 79(b) – in particular, the reference to "*a Mid Tier auditor*" - to be inappropriate. Likewise BDO believes that the CC should clarify at paragraph 80 that a "*move from a Big 4 to a non-Big-4* " auditor should not be read as a blanket statement covering all non-Big 4 audit firms. According to the balance of evidence before the CC, investors are on the whole not concerned if a company (outside the top-end of the FTSE 350) switches to one of the largest mid-tier firms, and indeed positively wish to see companies reduce their dependence on the Big Four audit firms.

5 LACK OF INFLUENCE OVER AUDITOR CHOICE

BDO notes that there is also ample evidence to support its view that there is currently limited disclosure to shareholders of the reasons for the choice of auditor: in paragraph 52 the CC notes that, in response to the CC's survey, the "*majority of investors said that they had no influence on auditor choice*". Paragraph 47 sets out some of the underlying reasons for the lack of visibility and/or influence over the auditor selection process in respect of institutional investors, including the fact that "*they were not aware of the change until the AGM"* and *"confidentiality arrangements*" making it "*very difficult to obtain any real information from the auditor about the reasons for the auditor's departure*"; moreover, investors "*also had very little visibility regarding prospective tenders for auditors*". Further, in paragraph 39(f), the investor surveyed by Oxera notes that "*[i]nvestors did try to make the point to companies not to just look at the Big 4 firms, but this had not made an impact*".

6 PRINCIPAL-AGENT ISSUES

BDO considers that much of the evidence referred to by the CC supports the CC's principal theory of harm relating to principal-agent issues. For example, the CC specifically states at paragraph 72(b) that in reviewing Oxera's interview summaries, it noted that, according to one investor, *"[a]uditors were much too close to company management, in particular to finance staff and did not act in the best interests of shareholders*." In addition, the CC cites at paragraph 53 and again at paragraph 60 the fact that investors who sought to put issues to the auditor had been "*blocked*" by the ACC (who controlled access to the auditor). Moreover, in paragraph 53, the institutional investors are cited as thinking "*that they had no meaningful influence on the initiation of the audit*". Such evidence supports BDO's view that those who could benefit from changes – the true customers of the audit firms – have the least power to initiate such changes.

7 INVESTOR DIVERSITY

BDO considers that the CC should note investor diversity and the consequences of that diversity in terms of different investors' perspectives on audit. Some investors are active long-term investors (e.g. pension funds), for whom audit is a significant issue given the importance to them of true and fair accounting. In contrast, others are passive investors (e.g. those holding index tracker funds), to whom audit is a much less significant issue. The former category will therefore express the greatest concerns; these concerns should not be discounted or disregarded merely because different types of investors, who may have different priorities as a result of their different investment strategies, do not express similar concerns.