

COMMENTS OF BDO LLP (“BDO”) ON THIRD PARTY RESPONSES TO COMPETITION COMMISSION’S WORKING PAPERS

1 GENERAL APPROACH

BDO does not intend to comment on every point made by every third party (particularly each of the Big Four firms) on each of the CC’s Working Papers. In particular, BDO does not intend to repeat arguments or submissions it has already made, for example in relation to the CC’s issues statement or in hearings with the CC. BDO confines its comments in this document to specific points made by third parties, in particular where BDO disagrees with those comments. However, the absence of a comment from BDO in relation to a particular point made by a third party should not be taken as an indication that BDO agrees with the relevant point.

2 SUMMARY OF BDO’S COMMENTS

2.1 Audit purchasers are not all sophisticated expert buyers

Purchasers of audits are not all sophisticated expert buyers, aware of all the options in the market. Their views of mid-tier firms are often based on assumptions and outdated knowledge. Some purchasers have always purchased the audit from the same supplier, without conducting a tender or benchmarking the service at least once in the last five years.

2.2 Reputation is a barrier to entry and expansion and lags behind reality

There is a widespread belief that no-one ever lost their job for appointing a Big Four firm as auditors (the “IBM effect”), but mid-tier firms do not have that reputational advantage. The reputations of the Big Four firms have not suffered noticeably from several alleged audit failures, accounting scandals and regulatory criticisms; those reputations (and the difference in reputation between the Big Four and mid-tier firms) can be based on out of date knowledge, assumptions and myths. It takes time for the market to recognise an increase in capabilities, such as sector or international expansion. This time lag results in the unjustified exclusion of mid-tier firms from invitations to tender.

2.3 Big Four alumni favour the Big Four firms

Most of the CFOs and ACCs of FTSE 350 companies are alumni of the Big Four firms. Alumni networks seek to strengthen the relationships between firms and their former employees. Each of the Big Four firms has a large alumni network. The combined aggregate effect in terms of business relationships between Big Four firms and former colleagues is considerable. In addition, Big Four alumni collectively reinforce the “IBM effect” and reputational advantage of the Big Four firms, as those who have trained or worked at a Big Four firm are more likely to believe that only a Big Four firm can provide a quality audit for a FTSE 350 company.

2.4 Audit quality is not confined to the Big Four firms

Reputation is not necessarily a function and reflection of audit quality. AIU and PCAOB reports do not indicate that the Big Four firms have superior audit quality to all other firms.

2.5 **Client retention and non-audit services are not a plausible strategy**

Retention of growing clients is not in itself a plausible strategy for entry and expansion in the FTSE 350 market by mid-tier firms. Those clients may believe (or be advised by intermediaries) that they have “outgrown” their mid-tier auditor as they approach the FTSE 350; those clients are also actively targeted by Big Four firms, often with aggressive discounts. Reputation, targeting and intermediary pressure makes retaining such clients very difficult for mid-tier firms.

The supply of non-audit services offers at most a limited opening into the supply of external audit services, as the buyers of those services are different, as are the considerations which apply to the statutory audit compared with specific non-audit services.

The existence of barriers to entry or expansion, such as the limited number of tenders, restrict the chances of mid-tier firms winning audit work from FTSE 350 companies and hinder additional investment by mid-tier firms.

2.6 **Intermediaries are a barrier to entry or expansion**

Intermediaries act as a barrier to entry or expansion by mid-tier firms. There are pressures from intermediaries on their clients to switch to a Big Four firm as they expand. The issue of intermediary influence becomes even more important for companies who aspire to become FTSE 350 companies.

2.7 **The market is not competitive**

There are very few tender opportunities for FTSE 350 company audit work; for most of them, only Big Four firms are invited to participate. Annual bilateral negotiations, whether or not they include benchmarking, are not an adequate substitute for a competitive tender process. The relative rarity of tenders (and the fact that most tenders involve only the Big Four firms) means that most companies have not been through a truly competitive process to determine prices and service levels, which hinders benchmarking, because prevailing prices cannot be said to be set at a competitive level. When the statutory audit market is taken as a whole, it is therefore not functioning as a properly competitive market.

A lack of tenders and switching does not mean that the ultimate customers – investors – are satisfied with current auditors. BDO refers to the investor survey conducted by Oxera, which demonstrates that the market is not working well for its true customers (investors) and that there are genuine issues around (in particular) lack of choice, lack of innovation, conflicts of interest and systemic dependency on a small number of suppliers.

2.8 **Companies should be required to tender at appropriate intervals**

Given the principal-agent issues rightly identified by the CC, formal tendering at appropriate intervals is the best way of ensuring a truly robust outcome for FTSE 350 companies. Those tenders should involve at least one mid-tier firm, to increase the chances of a competitive outcome and help to overcome barriers to entry and expansion.

3 FRAMEWORK FOR ASSESSMENT AND REVISED THEORIES OF HARM

3.1 Deloitte¹

Deloitte:

- 3.1.1 refers at paragraph 2.25 to "*BDO's suggestion that it would generally expect an auditor to have no contact with an ACC or audit committee apart from two meetings per year*". This does not accurately reflect BDO's suggestion. What BDO actually said in its letter to the CC of 19 April 2012 in relation to Deloitte's Summary of its response to the CC's Market and Financial Questionnaire was: "*Depending on the size and complexity of the company it is likely that audit committees will meet with auditors only twice a year.*" That referred only to meetings, not to other forms of contact; moreover, larger and more complex companies may have more frequent meetings between the audit committee and the auditors, as well as other forms of contact;
- 3.1.2 refers at paragraph 2.25 to "*suggestions from BDO and GT that ACCs and management are not well-informed about the audit process and the delivery of audit quality.*" Again, this subtly misrepresents BDO's and GT's positions.² Paragraph 26 of the summary of BDO's hearing with the CC, to which Deloitte refer at footnote 82, actually states that "*BDO ... said that the audit committee ... 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*";
- 3.1.3 refers at paragraph 2.31 to the various reviews of **corporate governance** which have taken place over the last 20 years or so. The UK regime has developed over time and those reviews have each contributed to its development. But that is not to say that the present position is now static or optimal; the CC's investigation can and should contribute to and be consistent with the development of the UK's corporate governance regime, not be restricted by it. While directors, including ACCs and CFOs, may be fully mindful that their role is to pursue and protect shareholders' interests, it is clear from the CC's case studies³ that their knowledge of alternatives to the Big Four firms is often limited and outdated. This does not enhance their ability to make informed purchasing decisions on behalf of shareholders. BDO considers that there are measures which can be taken to improve the competitive dynamics of this market, which would be a logical development of the UK's corporate governance regime and entirely consistent with the direction of travel of recent reviews;
- 3.1.4 states at footnote 127 that "*it appears to us that many or most of investors' concerns relate to reporting rather than the substantive audit process*". As investors have more visibility of reporting than of the substantive audit process, it

¹ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/framework_and_revised_theories_of_harm_wp_deloitte_response.pdf

² Deloitte refers at footnote 82 to paragraphs 3.4 and 9.2 of GT's response to the Issues Statement. However, paragraph 3.4 of GT's response referred to: "*the apparent lack of transparency about audit quality and the inability of audit committees and shareholders to judge whether the level of service is what is required*"; and paragraph 9.2 of GT's response refers to: "*... informational asymmetries with companies and shareholders desiring different outcomes from the audit process and, with difficulty in the assessment of audit quality, most opt for the 'safe' option of making a choice on the basis of reputation.*" Neither paragraph suggested that management or ACCs are not well-informed about the audit process.

³ See footnote 9 below.

is not surprising if a number of their concerns relate to reporting. Increased transparency and disclosure requirements would also be an important part of any remedies package. However, BDO does not consider that **investor concerns** are mostly reporting related, as suggested by Deloitte (at, for example, paragraph 7.4) or that they should be downplayed by the Big Four firms. Investor concerns in relation to a lack of choice, for example, are not confined to reporting. Oxera's investor survey states specifically: "*Almost all interviewees identified areas of concern with the current operation of the large-company audit market, which include limited choice, the impact of non-audit services, conflicts of interest, and lack of disclosure.*"⁴ Oxera also finds that: "*The investors surveyed, especially the larger ones, would typically prefer more engagement and dialogue with the auditors of companies in which they invest*";

3.1.5 refers at paragraphs 3.9(b) and 4.15(b) to the "**expert buyers**" in FTSE 350 companies. This description, however, merits careful scrutiny. Without doubt, CFOs and ACCs in FTSE 350 companies have a great deal of financial and accounting expertise; it is a pre-requisite for the roles which they hold. They are also purchasers of auditing and other professional services. However, this does not mean that they can all therefore be described as "**expert buyers**" of audit services. If someone has, for example, always purchased a service from the same supplier, without:

- (a) going through a tender process;
- (b) benchmarking those services at least once in the last five years (as is the case for 15% of FTSE 350 companies);⁵ or
- (c) requesting a formal proposal or presentation from the auditor before reappointment (as is the case for around one-quarter of FTSE 350 companies);⁶

then the practical steps taken to procure that service are not sufficient to be consistent with the classification "**expert buyer**", as they are not likely to produce adequate information. If that person is also purchasing from the organisation in which he or she trained, the procurement process is even more questionable. BDO therefore considers that references to the "**expert buyers**" (or similar terminology) of audit services in the FTSE 350 by the Big Four firms should not be accepted without question or challenge. This can be contrasted with the use by 3i Group of an external procurement consultancy, referred to by Deloitte at paragraph 3.9: "*that would not be swayed by any relationship issues and which had experience across the largest four auditors to identify best practice, time estimates and differing rates*".

Deloitte's conclusion, at paragraph 7.2(b), refers to "**informed buyers**". That is a more measured and accurate description; whilst they are informed, in that they possess a good deal of relevant information and experience, they are not necessarily sufficiently well-informed or proficient at purchasing to merit the term "**expert**";

3.1.6 sets out a list of customers' needs and demands at paragraph 3.18, which notably omits **reputation**, despite the "IBM effect" referred to in many case studies as a

⁴ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/oxera_investor_survey_report.pdf, page i

⁵ See the Working Paper on CC Survey Results, paragraph 39(a)

⁶ See the Working Paper on CC Survey Results, paragraph 39(b)

reason why FTSE 350 companies use a Big Four firm as their auditor. The tender debrief in relation to [X] (which has been provided to the CC in response to its request for additional information following the hearing with BDO on 4 October 2012) shows that [X].⁷ Deloitte and other Big Four firms claim that there are no barriers to entry; they claim that if only mid-tier firms would invest, they too could win FTSE 350 audit clients. In its conclusions, Deloitte claims at paragraph 7.2(e) that "*barriers to entry and expansion are not such as to inhibit the investments necessary for non-top tier firms to compete more effectively in this market.*" Yet the reality is that:

- (a) There are very few tender opportunities for FTSE 350 company audit work;
- (b) for most of those tenders, only Big Four firms are invited to participate;
- (c) the chances of a mid-tier firm winning such a tender are low, not least because reputation is a major barrier to entry or expansion; and
- (d) in order to win such a tender, a mid-tier firm would have to price its services well below the level offered by a Big Four firm. However, this may place a mid-tier firm in a "no-win" situation, as if an ACC believes that low price equals low quality, he or she will be put off by a low price, while a CFO may be unwilling to purchase from a mid-tier firm without a very large discount.

This means that the likely return on investment will be low. On this basis, the claims that there are no true barriers to entry or expansion, or that they do not inhibit investment, are demonstrably false;

3.1.7 claims at paragraph 4.8 that "*an attractive strategy for mid-tier firms would be to retain their clients as they grow and enter the FTSE 350*". However, in seeking to pursue that strategy, mid-tier firms face four challenges:

- (a) **Targeting** of those clients by the Big Four firms (PwC admits on page 9 of its response to the CC's Revised Issues Statement, at paragraph (a) (ii), that: "*To retain and improve our market position, we continuously need to replenish our FTSE 350 market share by targeting the audits of likely new entrants to the FTSE 350...*"); in BDO's experience, this targeting includes deep discounts;
- (b) pressure from **intermediaries** (including bankers, brokers and lawyers) on their clients to switch to a Big Four firm as they grow and enter the FTSE 350;
- (c) **reputation**, because the down side of the perception of mid-tier firms being leaders for mid-market companies is that expanding companies may believe (erroneously) that they have "outgrown" a mid-tier firm as they approach the FTSE 350 and that they need to "grow" into a Big Four firm to match their new (or imminent) increase in status. This kind of thought process is demonstrated in several of the CC's case studies:
 - (i) Company B, paragraph 21: "*The FD thought it would look odd to have a Mid-Tier firm as auditor as the majority of FTSE listed*

⁷ [X] is also an example of a company where the CFO appears to have been the key decision-maker, rather than the ACC. The CFO is not, however, the agent of the shareholders.

companies used a Big 4 audit firm...there was a perception issue regarding Mid-Tier firms”;

- (ii) Company C, paragraph 67: *“The ACC...thought shareholders and bondholders took comfort in the fact that the company used a Big 4 audit firm.”;*
 - (iii) Company D, paragraph 29: *“The FD...thought that they [shareholders] might be uncomfortable with a Mid Tier firm...this was just a gut feel...using the Big 4 was the safe option. There was less to worry about or justify, and using a Big 4 firm was in line with all the company’s peers and the companies that it came into contact with. Choosing a Mid Tier firm could make it the odd one out.”;* and paragraph 66: *“The ACC thought that shareholders and banks also preferred a Big 4 firm to sign the accounts... it is a commonly held perception in the market that the Big 4 were more credible and therefore it was safer to use a Big firm.”;*
 - (iv) Company E, paragraph 54: *“the ACC thought there was pressure for a PLC to use a Big 4 firm and that the larger the company the greater the pressure was... and that ‘no one lost their job for appointing a top four”;*
 - (v) Company F, paragraph 54: *“The ACC... thought that as companies got bigger shareholders, lenders and investors expected to see a big 4 auditor”;* and
- (d) **Scarcity**, because the CC’s Working Paper on the life cycle of FTSE 350 companies states at paragraph 13 that: *“there has not been substantial movement of companies between index designations during the last ten years”* – in other words, not many companies grow into and remain in the FTSE 350, so a strategy of retaining clients as they grow into the FTSE 350 would, even if it were implemented successfully, take a long time to translate into significant penetration of the FTSE 350.

Together, these effectively create a vicious circle, in which the mid-tier firms cannot retain enough expanding companies to constitute (together with existing FTSE 350 audit clients) sufficient FTSE 350 audit clients to convince other current or prospective FTSE 350 companies (and their other advisers and intermediaries) that the mid-tier firms have the experience of and credibility in the FTSE 350 audit market to be an appropriate alternative to the Big Four firms. See, for example, paragraph 66 of the CC’s case study of Company D, where the *“ACC noted that in another role ... as the company had grown they had switched to a Big 4 audit firm not because of any explicit requirement by shareholders or banks but because it was the predominant view held by people in the market that large companies should have a Big 4 auditor (ie it was the norm)”*;

- 3.1.8 claims at paragraph 4.9 that *“companies which are already audited by mid-tier firms will be very aware of their capabilities.”* Whilst companies may have some awareness of those capabilities, this may well be outweighed by other factors, in particular by what a company (sometimes mistakenly) believes about how external stakeholders will perceive its choice of auditor. A company may also assume that, as a potential FTSE 350 company, it could benefit from consultancy or other services from a Big Four firm, even though in reality those services may not be provided, e.g. due to restrictions on the ability of the auditor to provide non-audit services. BDO has experience of clients being seduced by the lure of the availability

of non-audit services from Big Four firms which subsequently are not provided to them;

- 3.1.9 claims at paragraph 4.14 that it does not believe that **reputation** is a material **barrier to entry**. Yet (contrary to Deloitte's claim at paragraph 4.14(b)), there is clear evidence from the CC's case studies that it is – see 3.1.73.1.7(c) above. Further empirical evidence for this can be found from tender debriefs which BDO has supplied to the CC – e.g. [§]. However, by definition, those debriefs relate to situations in which BDO was actually invited to tender: a barrier also obviously applies where companies do not tender at all (e.g. because they believe there is insufficient choice to justify conducting a tender) or where mid-tier firms are not invited to tender, because they are at a reputational disadvantage. The CC's survey results⁸ show that 82% of ACCs and 84% of CFOs considered reputation of the audit firm with investors, corporate brokers, analysts or external advisers as either "very important" or "important" factor in auditor appointment decisions. Deloitte's response refers to this in Table 2 as "*Reputation of the audit firm*" whilst omitting the important second half of that phrase "*with investors, corporate brokers, analysts or external advisers*". BDO has consistently referred to the influence of intermediaries in this market: this is precisely what is at issue here, yet Deloitte seeks to present this issue as if reputation is assessed only by the ACC or CFO. As is clear from the comments in case studies, this is not the case; in BDO's experience, the issue of intermediary influence becomes even more important for growing companies which aspire to become FTSE 350 companies, who may not have as much confidence to take a robust stance on these issues opposite intermediaries;
- 3.1.10 claims that reputation is not a material barrier to entry, but BDO notes that reputation is a lagging indicator of firms' capabilities and performance. There is a time lag between a change in firms' capabilities (e.g. due to international expansion) and the market's recognition of that change. This is also illustrated by the CC's case studies. Company A's ACC, for example, said at paragraph 65 that "*his view of the Mid Tier firms was based on the original FRC reports, which, in the first year, found that the Mid Tier firms were not as strong as the Big 4 firms. He did not know if they had improved since then.*" Given that the CC's survey found that 34% of FTSE 350 companies cited "*Regional strength/geographic coverage*" as a reason for limiting the scope of firms invited to participate in the tender process, and that the knowledge of many CFOs/ACCs of mid-tier firms' international networks appears to be out of date, this reputational time lag appears to result in the unjustified exclusion of mid-tier firms from invitations to tender;
- 3.1.11 claims at paragraph 4.14(c) that "*To the extent that companies switch away from the mid tier firms as they grow, these decisions cannot be based on reputational bias against the mid tier firms' capabilities.*" This is incorrect. The influence of intermediaries in relation to such companies is strong. Those intermediaries tend to steer such companies towards the Big Four firms. See 3.1.7, 3.1.8 and 3.1.9 above;
- 3.1.12 claims at paragraph 4.27(d) that "*the evidence from the case studies ... indicates that: ... ACCs and CFOs ... have good visibility of the marketplace*". Whilst ACCs and CFOs may have good visibility of the Big Four firms, it is clear from comments made in a number of the case studies⁹ that they do not have accurate up to date

⁸ See Table 11 at page 15 of the Working Paper on CC Survey Results.

⁹ See, for example, Company A's CFO (paragraph 38), whose "*views on the mid-tier were based on his seven years' experience as an auditor*" at a Big Four firm; Company A's ACC, who said (at paragraph 65) that "*his view of the Mid Tier firms was based on the original FRC reports, which, in the first year, found that the Mid Tier firms were not as strong as the Big 4 firms.*"; Company B (paragraph 21): "*needed an auditor with an office in every country in which it operated or might operate. The FD had not looked but did not know if any*

knowledge and awareness of the capabilities and international networks of the mid-tier firms. This (together with a complacency about the extent of their knowledge and awareness) perpetuates and increases their reluctance to use mid-tier firms, which therefore perpetuates the Big Four firm's almost complete domination of the reference market. Unsurprisingly, Deloitte seek to present this as "*good visibility*". This reality is not consistent with Deloitte's claim (at paragraph 5.5) that "*company stakeholders* [by which they presumably mean company management and the audit committee] *are deeply conscious of their role as guardians of shareholder interests*". BDO submits that custodianship requires more than relying on outdated knowledge and assumptions about the capabilities of potential suppliers of an essential service;

- 3.1.13 quotes a phrase from BDO's response of 14 August 2012 to PwC's response of 6 July 2012 to certain third party submissions at paragraph 6.12(a). However, the interpretation placed on that phrase is not completely accurate. To reiterate, BDO's position is that an improved market structure would give more choice, and reduce the systemic dependence on the four largest firms. BDO sees no reason why audit quality would be lowered if the structure of the market was different;
- 3.1.14 claims at paragraph 7.2(c) that "*reputation cannot be divorced from actual quality provided ... reputation becomes a function of, not a proxy for, actual quality.*" BDO does not agree. The reputations of the Big Four firms have been remarkably unscathed despite a number of accounting scandals, regulatory criticisms and alleged audit failures. In contrast, the reputations of the mid-tier firms with many key purchasers and intermediaries are often based on outdated knowledge, assumptions and myths; and
- 3.1.15 claims at paragraph 7.3 that "*There is ... no basis in the evidence that has been put to the CC for the CC to reach any conclusion other than that no adverse effect on competition arises in the market for FTSE 350 audit services.*" BDO disagrees. In particular, BDO refers to the investor survey conducted by Oxera, which demonstrates that the market is not working well for its true customers (shareholders) and that there are genuine issues around (in particular) lack of choice, lack of innovation, conflicts of interest and systemic dependency on a small number of suppliers.

Mid-Tier firms could provide this. The FD told us 'maybe it's a mindset but it's got to be the Big 4 as they will have an office, and I can't be 100 per cent sure that the Mid Tier will'; Company B (paragraph 45): "The ACC did not know, but guessed that Mid-Tier firms were represented by affiliates in other areas of the world."; Company C (paragraph 21): "The CFO ... explained that they (the Mid-Tier firms) would not have the international scope or specialism the company required and so the company probably did not invite them to tender."; Company C (paragraph 34): "The CFO...was concerned that currently it would mean using Mid-Tier 'partner' firms in different territories and said this was too hard and he did not need this added difficulty."; Company C (paragraph 66): "The ACC thought that no Mid-Tier firm would have wanted to tender when the current auditors were appointed and did not think this had changed. ... The ACC did not believe that Mid-Tier firms had the geographical spread or the expertise in ... insurance to be able to perform the company's audit."; Company D (paragraph 65): "The ACC...considered that given the company's international reach the Mid Tier would not be able to conduct the whole audit and it was an advantage to use only one firm."; Company G (paragraph 28): "The GFC had limited interaction with mid-tier firms. ...he did not think they had suitable presence and expertise...to audit the company..."; Company G (paragraph 70): "The ACC said that considering a mid-tier auditor for the company would be irresponsible. Whilst in the UK he thought that there were high-quality mid-tier firms, this was not always the case in other countries."; Company H (paragraph 31): "any potential auditor had to have broad international strength. For this reason, the FD thought that it was possible that only the Big 4 firms would be invited to tender..."; Company H (paragraphs 71 to 73): "The ACC thought it was 'almost inconceivable' that the external audit would go to a non-Big-4 firm...This was because of the company's international presence and the fact that the locations of the company were unknown and changing. He noted that the mid-tier firms audited mineral extraction companies listed on AIM and therefore had sector expertise. It was international coverage and consistency that was the issue. The ACC thought that mid-tier firms did not have a consistent presence in enough countries ... The ACC did not see it as his ongoing role to have knowledge of the capabilities of the other audit firms".

3.2 EY¹⁰

EY claims:

- 3.2.1 at paragraph 8 that "*there is not necessarily any commonality of interest within any single category of stakeholders*". This may or may not be the case, but it does not weaken or go against the CC's revised second theory of harm; it could even be said to demonstrate the importance of identifying and addressing principal-agent issues; and
- 3.2.2 the CC should "*consider carefully to what extent these issues are already addressed through other regulatory mechanisms*". BDO does not disagree, but the CC is in a position to take a more holistic view than other regulators. BDO notes that the FRC has told the CC that it has "*exhausted its audit regulator's toolbox*".¹¹

3.3 KPMG¹²

KPMG claims:

- 3.3.1 at paragraph 3.2.3 that "*As independent non-executives, AC members have no incentive to act in any other way than in shareholders' interests, and there are strong incentives to fulfil this role well.*" However, in order to retain their position on the board, and to be nominated for and appointed to other non-executive roles, AC members arguably have an incentive to maintain a good working relationship with management and/or the Chairman of the board. An AC member who gains a reputation as being awkward or challenging may find himself or herself isolated and ruled out of contention for other positions; in this context, an AC member's reputation has several dimensions. An AC member therefore arguably needs to strike a balance between acting in shareholders' interests and maintaining a good relationship with other directors, including management. It is therefore not correct to state that an AC member has no other incentive besides acting in shareholders' interests, particularly if shareholders may include management as well as other investors, so that different shareholders may have different interests;
- 3.3.2 at paragraph 3.3.7 that "*Reputation is extremely easy to lose*", yet several highly publicised alleged audit failures do not appear to have tarnished the reputations of the audit firms involved, including Big Four firms;
- 3.3.3 at paragraph 3.3.9 that "*the assertion that quality is difficult to judge is inaccurate*". BDO disagrees, particularly insofar as investors are concerned;
- 3.3.4 at paragraph 3.4.4 that "*a lack of switching of audit firm is fully consistent with companies achieving a competitive outcome through renegotiations and benchmarking*"; BDO disagrees, because:
 - (a) BDO considers (as does the CC at paragraph 141(c) of the Working Paper on the Nature and Strength of Competition in the supply of FTSE 350 audits) that only by going out to tender are companies in a proper position to assess the competitiveness of all aspects of the audit product provided by the incumbent; and

¹⁰ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/framework_and_revised_theories_of_harm_wp_ey_response.pdf

¹¹ See page 10 of the FRC's presentation to the CC, published by the CC on 10 January 2012.

¹² http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/framework_and_revised_theories_of_harm_wp_kpmg_response.pdf

- (b) the CC's survey found that about one 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-appointment¹³;
- 3.3.5 at paragraph 3.4.5 that "*competitive pressures and outcomes are ensured by the existence of credible alternatives to any company's incumbent audit firm*". This is at odds with investor concerns about lack of choice, as illustrated by AFME's statement at its hearing with the CC that: "*the choice was narrowed to one*"¹⁴;
- 3.3.6 at footnote 42 that "*the case studies provide further evidence that the mid-tier audit firms are not as active in approaching companies*", yet the case studies show a marked reluctance on the part of ACCs/CFOs to consider mid-tier firms, coupled with a lack of awareness of the current capabilities and international networks of mid-tier firms;
- 3.3.7 at paragraph 4.3.8 that there are "*no aspects inherent to the process of switching, independent of the quality of audit firms, which would prevent any company from switching if it thought it could get a better service (or a more cost effective one) elsewhere*". BDO regards this as supporting the case for mandatory retendering by FTSE 350 companies for their audit work, so that companies can regularly assess whether they could get a better service or a more cost effective one elsewhere and (if so) to switch their audit;
- 3.3.8 at paragraph 4.3.8 that "*we strongly disagree with the suggestion that the background of the FDs and ACCs at any of the largest four audit firms has any negative impact on competition. Rather, the background of FDs and ACCs at the largest four audit firms means they are better able to judge the technical qualities of audits...this means that they are better able to select an audit firm that delivers a high quality technical audit.*" In relation to the **background of FDs/CFOs and ACCs**, BDO has two main areas of concern:
- (a) **Primary alumni effect:** Most of the FDs/CFOs and ACCs of FTSE 350 companies are alumni of the Big Four firms.¹⁵ Each of the Big Four firms has an extensive, well-established and on-going alumni network, whose primary purpose is to strengthen the relationships between the relevant firm and its former employees. It is not unusual:

¹³ See paragraph 95 of the CC's Working Paper on the Nature and Strength of Competition.

¹⁴ See paragraph 19 of the Summary of Hearing with the Association of Financial Markets in Europe held on Friday 29 June 2012.

¹⁵ PwC's Response to the Nature and Strength of Competition Working Paper says at footnote 192 that PwC's research shows "*59 current FTSE 100 FDs with a background of having worked at one of the four largest audit firms.*"; the CC's Working Paper on the CC's Survey Results states at paragraph 24 that "*Two-thirds (66 per cent) of the FDs/CFOs surveyed had previously worked for one of the Big 4 audit firms...This proportion is similar for FDs/CFOs of FTSE 350 companies ... Around 60 per cent of the ACCs surveyed had previously worked for one of the Big 4 audit firms...Again the proportion is similar for ACCs of FTSE 350 and other companies.*"

- (i) for Big Four auditors to move into an accounting role with one of the firm's larger clients and then to continue to work with their former firm in that new role¹⁶ (indeed, BDO believes that the Big Four firm's business models assume that many of their young accountants will leave to take up positions in companies, many of which will be clients or prospective clients of the Big Four firms); nor
- (ii) for former employees of Big Four firms to engage (or continue to engage) their former employers to provide services.¹⁷

Given the number of Big Four firm alumni, the aggregate **network effects** in terms of business relationships between each of the Big Four firms and their former colleagues are considerable. This is not improper: it is perfectly understandable that customers should choose to work with advisers that they know, respect and trust. However, BDO considers that the overall effect of these links and relationships is to strengthen the relationships between each of the Big Four firms and their respective clients, which enhances auditor tenure and militates against switching. Given the existing market shares of the Big Four firms and the number of their alumni, the effect is to reinforce the Big Four's position and increase the barriers to entry or expansion by mid-tier firms; and

- (b) **Secondary alumni effect:** Big Four alumni collectively reinforce the "IBM effect" and reputational advantages of the Big Four firms, as those who have trained or worked at a Big Four firm are more likely to believe (or to share in a form of "group think") that only a Big Four firm can provide a quality audit for a FTSE 350 company. BDO considers that this secondary alumni effect means that Big Four alumni will be more likely than other people to:
 - (i) have greater knowledge and experience of Big Four firms than of the mid-tier firms;¹⁸

¹⁶ See the second item ("How the audit game really works") in Damian Reece's column in the Daily Telegraph on 4 December 2012 at: <http://www.telegraph.co.uk/finance/comment/damianreece/9719993/The-Sky-is-the-limit-for-Rupert-Murdochs-clean-up-operation-at-News-Corp.html> (accessed at 18.00 on 4 December 2012); and an article dated November 30, 2012 by Thomas M. Brehmer in Accounting Today: <http://www.accountingtoday.com/news/Sarbanes-Oxley-Failed-Address-Problem-Audit-Firm-Independence-64852-1.html> which states that: " the Big Four firms regularly court audit committee members, offering webinars and conferences. They have a direct line with audit committee chairs, many of whom are former partners from the audit firm."

¹⁷ See: "Herda and Lavelle (2012) reports results of surveys from 204 practicing auditors at two public accounting firms in the U.S. (a large national firm and a large regional firm) to test their predictions. The sample consisted of 70 staff auditors, 62 seniors, 40 managers, 23 senior managers, and 9 partners. Herda and Lavelle (2011) reported results of surveys from 303 former auditors of a Big 4 firm to test their predictions. Of these respondents, 81 per cent left the firm voluntarily and the average tenure with the firm was 4.5 years. Among the alumni surveyed, 50 per cent had referred the firm to those seeking professional services and 30 per cent actually had purchased professional services from their former firm." <http://aaajournals.org/doi/full/10.2308/ciia-50277>

¹⁸ As shown by the CC's case studies: see footnote 9 above. This is also consistent with PwC's comments at paragraph 41 of its response to the Nature and Strength of Competition Working Paper: "The NSCP ignores the fact that this is a reference market with a very limited number of players on both the supply and demand sides. The relatively small world of FTSE 350 ACCs and FDs facilitates access to up-to-date information and experiences from those involved in audit appointment decisions, who themselves have extensive experience working with a range of companies and audit firms, as well as concurrent appointments in many cases. Such informal assessment takes place both: (i) as between audit firms and purchasers, as the audit firms seek to build relationships with potential audit clients by demonstrating their quality and efficiency; and (ii) as between purchasers in exchanging information about good and bad experiences of audit firms".

- (ii) invite only Big Four firms to tender if and when they decide to conduct an audit process for a FTSE 350 company; and
- (iii) challenge a mid-tier incumbent more than a Big Four firm incumbent if they take up a new position as a CFO or ACC at a FTSE 350 company, as they are generally predisposed towards Big Four firms.

This is illustrated by the second sentence in the quotation from paragraph 4.3.8 of KPMG's response, which shows why the Big Four firm background of most FDs and ACCs *does* impact on competition. It is clear that KPMG believes that those who have worked at a Big Four firm will have much greater ability than those who have trained anywhere else to know what a good audit looks like; the implication is that only Big Four firms deliver good audits, despite independent evidence to the contrary from the AIU and PCAOB.¹⁹ If an accountant is trained by those who share and reinforce this attitude, he or she is likely to accept and absorb a similar attitude or "group think", and in turn prefer to use a Big Four firm when he or she is in a position to make such a choice. Indeed, KPMG goes on to say at paragraph 4.5.3 that "*To the extent that FDs or ACCs are more likely to appoint one of the largest four audit firms, this is a reflection of genuine differences in the ability of the largest four audit firms to deliver technical quality.*" In other words, KPMG believes that the Big Four firms have superior technical quality to all other firms, although this view is not supported by the AIU or PCAOB reports.

BDO is not suggesting that former employees of any of the Big Four firms have any intention to act in a way which is not in the best interests of their current employer, or seeking to impugn their integrity; merely that the reality is that their relationships, knowledge and attitudes play a part in their decision making.

These points (i.e. the existence and extent of the primary and secondary alumni effects) could be investigated further by the CC: e.g. the number of FTSE 350 ACCs and/or CFOs who used to work for the current auditors of their companies;

- 3.3.9 at paragraph 4.5.5 that "*the mid-tier audit firms...do not make the same effort and investments in approaching these companies and demonstrating their capabilities.*" BDO disagrees. While BDO has not to date prioritised making unsolicited approaches to FTSE 350 companies for audit work, not least because of the considerable barriers to entry and expansion in this market, one of the challenges facing mid-tier firms is that CFOs and ACCs are generally unresponsive to approaches by mid-tier firms. See, for instance, BDO's correspondence with the CC about its attempts to engage with the then new CFO of Company F;
- 3.3.10 at paragraph 4.6.4 that the CC has recognised "*the important role of reputation as a reflection of quality*". BDO regards reputation as a barrier to entry or expansion – as does the CC, as shown in its Working Paper on Barriers to entry: reputation and experience. BDO believes that size has often been taken as a proxy for quality; and
- 3.3.11 at paragraph 5.5.4 that "*There is nothing to stop mid-tier audit firms making these investments to become more credible alternatives for FTSE 350 companies...mid-*

¹⁹ See: <http://www.complianceweek.com/pwc-takes-hit-in-latest-inspection-asks-pcaob-to-act/article/268033/>

tier firms do not make the same investment in approaching FTSE 350 companies to encourage them to switch.". BDO notes that the existence of barriers to entry or expansion, in particular those identified by the CC, are important factors which do reduce the likelihood of mid-tier firms winning audit work from FTSE 350 companies as they reduce the likelihood of profitable entry or expansion in that market. These are genuine impediments to additional investment by mid-tier firms.

3.4 PwC²⁰

PwC claims:

- 3.4.1 at paragraph 7(b) that the CC is assuming that principal-agent problems exist in this market and that PwC is "*not aware of any ... evidence*". The implication is that there are no such problems in the market. Yet there are plenty of examples of audit failure and of criticisms of auditors for failing to identify problems earlier, e.g. in relation to the banking crisis;
- 3.4.2 at footnote 11 that "*Occasional poor performance ... does not equate to acting deliberately against the interests of one's ultimate employers (i.e. the company's shareholders)*". This is not the correct test. The existence of principal-agent problems does not depend on there being deliberate wrongdoing by auditors. Misalignment of objectives may result in inadvertent errors or a difference in decisions, without there being any intentional wrong on the part of the relevant auditor. For example, an auditor could become too close to management and become inclined to give management the "benefit of the doubt" or insufficiently sceptical of management's approach as an unconscious process, rather than as a result of a deliberate conscious choice to act improperly;
- 3.4.3 on page 6, at paragraph (a)(iii), that ACCs: "*are experienced purchasers and have a good understanding of audit markets.*" As stated at 3.1.3 and 3.1.5 above, BDO considers that the CC's case studies demonstrate that many ACCs' knowledge of the capabilities and networks of mid-tier firms is out of date and that they display little appetite for refreshing that knowledge. This is not consistent with a "*good understanding*" of audit markets;
- 3.4.4 on page 7, at paragraph (b)(iii), that low switching rates show that "*companies are not concerned*" about low quality or highly priced audits. That is illogical and incorrect. This demonstrates a failure of PwC to recognise the principal-agent issues which the CC correctly identifies as a theory of harm. The true customers here are the investors, who may well be concerned about quality and pricing, but do not have enough visibility of audits, or empowerment in relation to relevant decision making. However, in practice, it is company management, including the audit committee, which makes the choice as to whether to switch. Moreover, low switching rates may also result from a lack of choice: if companies believe that they have limited choice of auditor, they are less likely to switch. AFME's evidence to the CC indicates that lack of choice is an issue for many companies;
- 3.4.5 on page 8, at paragraph (e), that many ACCs and FDs do not have a Big Four firm background or left one of the Big Four firms "*only a relatively short period after qualification*". This distorts the position. While there are some ACCs and FDs who do not have a Big Four firm background, the majority of FTSE 350 ACCs and FDs do have a Big Four firm background. The CC's own case studies and survey

²⁰ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/framework_and_revised_theories_of_harm_wp_pwc_response.pdf

demonstrate this clearly.²¹ How quickly the individuals left after qualification is irrelevant; they still have a Big Four firm training and background. See 3.3.8 above;

3.4.6 on page 9, at paragraph (e)(iii), that *"ACCs and FDs have often experienced the mid-tier firms directly and actively consider whether the mid-tier firms should be invited to any tender of the audit."* BDO disputes this. Most FTSE 350 ACCs have a Big Four firm background; many have little direct experience of the mid-tier firms. Tenders in this market are very rare (PwC itself refers to the *"relative rarity of large company audit tenders"* at paragraph (a) (iv) of the Annex (page 10). On the rare occasions when tenders do take place for a FTSE 350 company's audit, the majority of them do not involve a mid-tier firm;

3.4.7 on page 9, at paragraph (a)(ii), that: *"To retain and improve our market position, we continuously need to replenish our FTSE 350 market share by targeting the audits of likely new entrants to the FTSE 350..."*. This confirms BDO's position²² that the Big Four firms actively target growing companies which have the potential to join the FTSE 350;

3.4.8 at footnotes 36 and 54 that *"30% of FTSE 350 companies invited at least one mid-tier firm to tender."* This is manifestly incorrect. While 30% of FTSE 350 companies which **invited tenders** for their audit work may have invited one or more mid-tier firm to tender, hardly any FTSE 350 companies actually went out to tender for their audit work in the last five years (or indeed in any previous period – see 1.4.6 above for PwC's reference to the *"relative rarity of large company audit tenders"*). Thus the true number or percentage of all FTSE 350 companies which invited a mid-tier firm to tender is much lower, and way below the 30% claimed;

3.4.9 on page 10 (at paragraph (b)(i)) that: *"the existence or otherwise of barriers to entry and expansion is of limited relevance."* BDO disputes this. The existence of considerable barriers to entry and expansion into this market:

- (a) limits customer choice (in particular when coupled with rules on conflicts of interest and independence);
- (b) reinforces the oligopolistic nature of this market;
- (c) reduces incentives to innovate;
- (d) leads to higher prices by facilitating a "Big Four Premium"; and
- (e) reduces pressure to deliver audit quality.

They are therefore of direct and considerable relevance; and

3.4.10 on page 12, to recognise that *"the role of the AC could evolve – particularly in terms of the detail reported to shareholders."* BDO agrees that there is considerable scope for more transparency and details in relation to AC reporting to shareholders. BDO considers that additional requirements in this area should be part of a package of remedies in relation to the adverse effects on competition in this market.

²¹ The CC's Working Paper on the CC's Survey Results states at paragraph 24 that: *"Two-thirds (66 per cent) of the FDs/CFOs surveyed had previously worked for one of the Big 4 audit firms... This proportion is similar for FDs/CFOs of FTSE 350 companies ... Around 60 per cent of the ACCs surveyed had previously worked for one of the Big 4 audit firms... Again the proportion is similar for ACCs of FTSE 350 and other companies."*

²² See BDO's response to the CC's Issues Statement, paragraphs 1.5 and 5.1.1, and BDO's comments on the CC's Working Paper on Market Definition, paragraphs 6.1 and 6.2.

3.5 **Grant Thornton**²³

BDO agrees with the comments made by Grant Thornton in its response.

3.6 **Mazars**²⁴

BDO agrees with a number of Mazars' comments. However, unlike Mazars, BDO does not regard mandatory firm rotation as the appropriate solution to potential principal-agent problems.

4 **RESTRICTIONS ON ENTRY OR EXPANSION**

4.1 **Deloitte**²⁵

Deloitte claims:

4.1.1 at paragraph 3.2(c) that the CC's focus on tendering omits the opportunity for entry by retaining "*growing clients who may be expected to enter FTSE350 in the foreseeable future*". See 3.1.7 above in relation to this point;

4.1.2 at footnote 24 (having quoted from paragraph 3.19 of BDO's response to the CC's Issues Statement) that it "*assume[s] that BDO cannot expect competitor firms to eschew competition for its clients: competition from top tier firms for those clients is to the benefit of those clients*". BDO considers Deloitte's statement as misrepresenting the BDO position: at no point in its response to the CC's Issues Statement does BDO suggest that it should be protected from the normal competitive process. BDO's contention is that the Reference Market is not functioning as a competitive market: accordingly, the Big Four firms' conduct cannot be characterised as normal competitive conduct;

4.1.3 at paragraph 3.1.8(c) and footnote 40 that "*BDO and GT have told the CC that they already have extensive and useful points of interaction with the FTSE 350 through the supply of non-audit services*", citing paragraph 3.2.2 of BDO's response to the CC's Issues Statement. However, it is clear from the actual wording of paragraph 3.2.2 of BDO's response to the CC's Issues Statement that BDO has made no such claim to the CC: moreover, the relevant paragraph clearly highlights the differences between audit services and non-audit services, in terms of the latter being primarily a decision for the CFO (rather than the audit committee) and the fact that it is relatively easy to change supplier for non-audit services;

4.1.4 at paragraph 3.19 that the "*openings for mid-tier firms to grow their FTSE 350 audit client base should not be understated*" and cites in particular the mid-tier firms' non-audit service provision as illustrating such openings. BDO considers that the supply of non-audit services offers a limited, if any, opening into the supply of external audit services, given that the purchasers of, and the considerations surrounding, the statutory audit are distinct from those in respect of specific non-audit services;

²³ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/framework_and_revised_theories_of_harm_wp_grant_thornton_response.pdf

²⁴ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/framework_and_revised_theories_of_harm_wp_mazars_response.pdf

²⁵ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/restrictions_on_entry_or_expansion_wp_deloitte_response.pdf

- 4.1.5 at paragraph 4.16 that "*companies' satisfaction with their current auditor is an important explanation of current levels of switching*" and in paragraph 4.23 that "*[t]his is exactly the outcome that would be expected in a market that was functioning well for consumers*". BDO considers that this is not necessarily the case, and that low levels of switching are generally more indicative of a market which is not functioning competitively;
- 4.1.6 at paragraph 5.23 that BDO has (according to BDO's own submissions) made "*significant investments*"; Deloitte also acknowledges in paragraph 6.16 that "*the biggest mid-tier firms have made substantial investment in their networks*." BDO considers such statements surprising, given Deloitte's claims at paragraphs 3.18(a) and 5.28 (set out in detail in its response to the CC's Framework for Assessment and Revised Theories of Harm Working Paper) that there are essentially no barriers to entry, and that if only mid-tier firms would invest, they too could win FTSE 350 audit clients;
- 4.1.7 at footnote 24 that "*allegations of low pricing targeted at mid-tier firms' clients (... are false)*..." and emphasises at paragraph 5.26 that "*it does not specifically target clients of mid-tier firms with "deep discounts"*". BDO refers the CC to the examples of [X] and [X] set out at paragraph 5.1.14 of BDO's response to the CC's Issues Statement, which illustrate this practice of deep discounting by [X] and other Big Four firms, and has encouraged the CC to investigate these examples further;
- 4.1.8 at paragraph 6.3 that "*reputation is not a proxy for quality; it is a function of quality*." BDO does not agree; see 3.1.14 above. Moreover, BDO considers that reputation may well act as a proxy for quality to the extent that the Big Four firms benefit from a 'halo' effect, where their respective brand equity is sufficiently strong to negate any negative impact, even in respect of well-publicised audit failures (see 3.3.2 above).
- 4.1.9 at paragraph 6.14 that, given BDO's stated capabilities (reproduced at paragraph 6.13), "*[e]xperience per se does not appear to be a material barrier to entry*". However, this statement conflates actual capability with the perceived lack of capability by the relevant decision-makers in respect of the statutory audit: the issue is not so much BDO's lack of experience, but the assumptions of ACCs and FDs that mid-tier firms such as BDO do not possess the relevant experience and/or capabilities (e.g. in respect of their respective international networks), and therefore do not consider such firms as serious contenders for the role of statutory auditor in the first place;
- 4.1.10 at paragraph 6.18 "*that there remains a difference in capability... between Deloitte's network and that of the largest mid-tier firms*." BDO believes that any such differences are primarily a matter of scale rather than capability, given that its international coverage (as confirmed by the CC) is broadly similar to the Big Four firms;
- 4.1.11 at paragraph 6.25 that there is a "gap" between the technical capabilities of the mid-tier firms and the Big Four firms, citing evidence from certain of the CC's case studies. See 3.1.10 above in relation to this point;
- 4.1.12 at paragraph 6.21 that in respect of the Swiss market, it has been able to "*grow a competitive practice from a position of relative weakness*", citing several major Swiss companies as new clients since 2005; however, BDO understands that a

significant proportion of those clients were referred to Deloitte in Switzerland by other members of Deloitte's international network;²⁶ and

4.1.13 at paragraph 8.3 that: "*there is little evidence to back up such allegations [of other forms of pressure from advisors], and ample evidence to the contrary.*" BDO disagrees with Deloitte's claim and refers the CC to the evidence that it has already provided to the CC on this issue (which will necessarily be limited to those instances of which it is aware). See also the extracts from the CC's case studies set out in 3.1.7(c) above.

4.2 **EY²⁷**

EY claims:

4.2.1 at paragraph 3(iii) that "*there is a fundamental distinction between costs of entry and barriers to entry*" and "*[i]t is for audit firms to explain why they have not chosen to make these investments over time and/or not sought to grow over time*". BDO considers the two factors – costs of entry and barriers to entry - to be inextricably linked (see 3.3.9 and 3.3.11 above). BDO has committed significant resources to investment activity in those areas – particularly in those areas identified by EY at paragraph 3(iii) - but the barriers to entry/expansion identified by the CC represent genuine impediments to further investment by the mid-tier firms;

4.2.2 at paragraph 3(iv), that "*it is possible to ... grow an audit business one client at a time*" in the FTSE 350. BDO does not disagree with this proposition in principle; however, the clear lack of tendering opportunities for mid-tier firms in respect of FTSE 350 clients means that it would be very difficult indeed to make this happen in practice;

4.2.3 at paragraph 3(v), that any material deviation from "*gold standard*" quality would result in a "*positive and non-trivial probability of irreparable harm to its reputation*": but see 3.1.14 and 3.3.2 above;

4.2.4 at paragraph 3(vi), that the current position of the Big Four firms is "*a consequence of continuous investment over 10-15 years*" and "*that there is no reason that a determined entrant could not break in*" over such a time period in the period, with the requisite investments, mergers etc. BDO considers this to be misconceived. In particular, BDO disagrees with the proposition that the current position of the Big Four firms is solely the result of relatively recent investment by the Big Four firms – the issues relating to Big Four incumbency date back decades in respect of certain FTSE 350 clients; EY also omits to mention the impact on the Reference Market of the collapse of Andersen;

4.2.5 on page 3, that the significance placed by the CC on lobbying and alumni networks is "*overstated*". As set out at 3.3.8 above, BDO considers the Big Four firm background of the ACCs and FDs as a key factor underlying the lack of competition

²⁶ BDO understands from BDO Ltd (BDO's operations in Switzerland) that while Deloitte AG now audits a number of firms with offices in Switzerland, a significant proportion of these clients were not clients originating in Switzerland. For example, BDO Ltd understands that Kempinski Hotels was referred by Deloitte Germany and Orascom was originally a client of Deloitte Egypt. In addition, BDO Ltd believes that a significant number of Deloitte's existing clients in Switzerland, including Accor, Chanel and Iveco (FIAT), were also referrals from Deloitte's international network. Finally, Deloitte AG is a member of Deloitte UK and is not run as an independent Swiss firm.

²⁷ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/restrictions_on_entry_or_expansion_wp_ey_response.pdf

in the reference market; its importance, therefore, should not be underestimated; and

4.2.6 on page 4, that audit firms are subject to "*constant scrutiny*" in respect of quality, and referring to the AIU reports as an example. However, as noted at 3.3.8 above, the same AIU reports do not demonstrate a material difference between the technical quality of the Big Four firms and that of the larger mid-tier firms.

4.3 **KPMG**²⁸

KPMG claims:

4.3.1 at paragraph 3.3.2 that the "*CC itself recognises that it has no evidence that [targeting mid-tier firms' clients] is a strategic barrier to entry, as it has heard 'allegations' but no 'specific examples' of this 'sort of behaviour' occurring.*" BDO notes that in its letter to the CC dated 23 January 2012, it provided the CC with details of companies, in particular FTSE SmallCap/AIM companies, likely to enter or just outside the FTSE 350 (judging by size and growth rate) and who had recently switched their audit to a Big Four firm or (BDO believes) were being actively targeted by one or more of the Big Four firms. See also 3.4.7 above regarding PwC's targeting of likely new entrants to the FTSE 350;

4.3.2 at paragraph 6.2.3 that "*reputation is earned through investments in delivering high technical quality*" and that it "*must be maintained through continued investments in quality*"; it further claims at paragraph 6.2.4 that the ease with which reputation can be lost means that "*audit firms are incentivised to provide an audit of high technical quality*". KPMG disagrees with the CC's view that an audit firm's reputation may distort companies' decision to purchase audit services: at paragraph 6.2.6, it states that any "*significant mismatch between perceived reputation and actual quality would be put right in the short term*". BDO agrees with the CC that purchasing decisions may be distorted if the Big Four firms benefit from a 'halo' effect, where their respective brand equity is sufficiently strong to negate any negative impact, even in respect of well-publicised audit failures (see 3.3.2 above);

4.3.3 at paragraph 6.2.7 that the CC should take account of "*independent regulators' reports on audit quality amongst the various factors that contribute to an audit firm' reputation*". However, as noted at 3.3.8 above, neither the AIU or PCAOB reports demonstrate a material difference between the technical quality of the Big Four firms and that of the larger mid-tier firms;

4.3.4 at paragraph 6.3.2 that there is no "*structural barrier to such firms obtaining specialist resources for firms prepared to invest*". In the few cases where BDO does not currently have sufficient capability, this may technically be possible; however, it does not resolve the "Catch-22" situation, whereby a firm cannot gain certain knowledge and expertise (and would be reluctant to invest in acquiring them) without the experience of acting for a large client in that sector, and it cannot gain the large client as it does not have the relevant knowledge and expertise which is perceived to be necessary; and

4.3.5 at paragraph 6.6.2, that its "*participation in the regulatory process does not translate into 'influence*". BDO disagrees with KPMG's interpretation of the lobbying process; it agrees with the CC that lobbying, in whatever format, is

²⁸ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/restrictions_on_entry_or_expansion_wp_kpmg_response.pdf

designed to influence relevant decision-makers to the advantage of the firm involved.

4.4 PwC²⁹

PwC claims:

- 4.4.1 on page 2 and at footnote 7 that the mid-tier firms do not possess the necessary "*attributes*" in order to conduct audits of the FTSE 350 companies, and that such attributes are valued by all companies in the FTSE 350, not limited to the largest and most complex companies. As noted in BDO's response to the CC's Working Paper on Market Definition, BDO considers the largest and most complex FTSE 350 companies to be unrepresentative of the FTSE 350 as a whole in respect of their audit requirements, and that there are no distinctive Big Four "*attributes*" required to provide audit services to the rest of the FTSE 350;
- 4.4.2 on page 2, that both GT and BDO's respective claims that they already have the capability to audit all except the largest and most complex FTSE 350 companies may not reflect reality: PwC expressly states that "[w]e do not know if this true...". BDO considers PwC's scepticism in this respect to be unjustified;
- 4.4.3 on page 3, that "*perception bias and prejudice*" is not relevant to ACCs/FDs decisions to (re)appoint Big Four firms, that the evidence confirms that a difference in "*attributes*" is the "*real reason for the choices made by the customer*" and that "*more tenders would not help [the mid-tier firms] enter the market*". BDO refers the CC to 3.3.8 above: the best way for BDO to attempt to counterbalance such prejudice is by obtaining access to such decision-makers through increased tendering opportunities. BDO reiterates that the real customers for audit services are the companies' shareholders, and not the ACCs/FDs, contrary to PwC's claim;
- 4.4.4 on page 3, that the mid-tier firms do not see the FTSE 350 audit market as a "*good commercial opportunity*". BDO considers this claim as misrepresenting the real situation, which is that the mid-tier firms have been effectively shut out of the reference market;
- 4.4.5 on pages 4 and 5, that mid-tier firms are not currently incentivised to expand "*due to the highly competitive nature of the market, which means that there are no supernormal profits or dissatisfied customers to target*". PwC appears to be conflating competition with entry profitability and lack of switching: the fact that entry may not currently be profitable and/or switching rates are currently low does not necessarily mean that customers in that market are receiving maximum value for money or are satisfied with their current auditor;
- 4.4.6 on page 10, that "*lack of switching is not an indicator of complacency (as might be suggested for such customer behaviour in consumer markets)*". BDO disagrees: complacency is relevant to ACCs/FDs decisions not to switch, or even tender their audit requirements – as indicated in the CC's analysis, often the decision to retender is based upon a substantial breakdown of quality, which implies that lesser factors would not prompt ACCs/FDs to look elsewhere; and
- 4.4.7 on page 12, that any suggestions by lender's professional advisers to appoint Big Four firms reflects their "*knowledge of the independence and quality that will be delivered by the largest firms*". BDO considers such suggestions rather to reflect

²⁹ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/restrictions_on_entry_or_expansion_pwc_response.pdf

the general prejudice in favour of the Big Four firms, rather than detailed knowledge of the audit market – particularly where such professional advisers are likely to have limited experience of the mid-tier firms.

5 MARKET DEFINITION

5.1 KPMG³⁰

KPMG claims:

5.1.1 at paragraph 1.13 that *"there is no clear dividing line between the characteristics of different audit clients"*. This contrasts with the PwC position, which emphasises the specific *"traits"* which distinguish FTSE 350 audits from other audits – see 5.2.1 below. KPMG further states at paragraph 2.14 that: *"any particular market definition is unlikely to be fully accurate, and precisely capture the set of relevant competitive constraints on audit firms. For example, the CC's definition of the FTSE350 applies only to past and current constituents of the FTSE350 index, rather than also including potential entrants to the FTSE350 and it may be that some of these companies should be included in the relevant product market"*. BDO agrees that a sharp distinction should not be drawn between companies within the FTSE 350 and companies just outside the FTSE 350, particularly since the Big Four firms target clients of mid-tier firms that have FTSE 350 potential; and

5.1.2 at paragraph 2.16 that *"if the audit firms currently providing services to [FTSE 350] companies were to worsen their offer by some relatively small amount, they would lose business to other audit firms not providing statutory audit services to this group of companies ... these other audit firms provide a very real competitive constraint, which ... is important for the CC to acknowledge and take into account in its analysis, whether or not these firms' services form part of the relevant product market."* (emphasis added). BDO disagrees with this proposition. As indicated at 4.4.6 above, the CC's analysis demonstrates that often a decision to retender (as opposed to annual renegotiations) is based upon a substantial breakdown of quality, which implies that a slight breakdown of quality by the incumbent auditor would not result in a loss of business. Moreover, based upon the CC's survey results, even when FTSE 350 companies do go out to tender, they often only invite Big Four firms to tender, so such companies would be far more likely to switch to another Big Four firm than to one of the mid-tier firms. It is difficult to see how, in such circumstances, the mid-tier firms currently provide a *"very real competitive constraint"* on the Big Four firms.

5.2 PwC³¹

PwC claims:

5.2.1 at paragraph 3 that the *"general premise that FTSE 350 audits are the largest and most complex UK company audits – and can be distinguished on that basis – is both supported by the CC's analysis and consistent with our experience"*; PwC further states in paragraph 4 that the *"CC recognises the traits which distinguish FTSE 350 audits and the characteristics of the large audit firms which are required to provide such audit services"*. BDO considers that PwC's comments do not reflect the heterogeneous composition of the FTSE 350 and, in particular, the fact

³⁰ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/market_definition_kpmg.pdf

³¹ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/market_definition_pwc.pdf

that the audit requirements of the largest FTSE 350 companies are not necessarily representative of those of smaller FTSE 350 companies. Accordingly, BDO disagrees with PwC's proposition at paragraph 4 (reiterated at paragraph 6(iv)) that only the Big Four firms possess the "specific skills and attributes"/"characteristics" necessary to provide audit services to the FTSE 350;

- 5.2.2 at paragraph 6(v) that the fact that FTSE 350 companies generally switch from mid-tier firms to the Big Four firms reflects "the reality that when the largest companies consider the services of the mid-tier firms at tender, the mid-tier firms are not successful" and that this is due to the Big Four firms offering a "more attractive package of experience and expertise, quality service and price". BDO considers the reasons for switching from a mid-tier firm to a Big Four firm to be more complex in practice and, as illustrated at 3.1.6 and 3.1.7 above, switching is often driven by reputational considerations that are not necessarily linked to mid-tier firms' actual offerings;
- 5.2.3 at paragraph 6(c)(i) that the fact of "one competitor having a stronger offering than a second competitor [in a specific sector] does not mean that the second competitor ceases to exercise a competitive constraint or be an option for companies". BDO considers that, given the clear importance of the "IBM effect" in the Reference Market, any perceived weakness in a particular sector (e.g. banking and financial services) would directly and substantially affect the extent to which that competitor can exercise any competitive constraint. See 3.3.5 above; and
- 5.2.4 at paragraph 6(d)(i) that "there is clear evidence from companies and the mid-tier themselves that the smaller firms are not capable of auditing the larger and more complex companies without making investments to improve their capabilities". BDO considers this statement conflates two distinct issues: the fact that BDO has submitted evidence that it believes it is currently unable to audit 35 or so of the largest FTSE 350 companies with the perception - unfortunately prevalent amongst a wider group of FTSE 350 ACCs/FDs (i.e. not limited to the largest FTSE 100 companies) - that BDO's current offering cannot meet their requirements. Presenting the two issues as one again results in the over-attribution of the characteristics and audit requirements of the largest FTSE 100 companies to all FTSE 350 companies.

6 **RESPONSE OF ERNST & YOUNG ("EY") TO VARIOUS CC WORKING PAPERS, INCLUDING NATURE AND STRENGTH OF COMPETITION³²**

6.1 **Barriers to entry and expansion**

- 6.1.1 EY claims at paragraph 3.5 that "the possibility of other audit firms developing novel competitive strategies ... could, and should, have been market tested by the smaller firms if they are committed to gaining a larger presence in the FTSE 350 audit sector. Market disruptive strategies by non-incumbents which have been successful in securing market share have been seen in other industries."
- 6.1.2 BDO considers that the various barriers to entry and expansion which the CC has identified present genuine and significant obstacles to the success of such strategies (see 3.4.9 above). Given the existence, size and combined effect of those barriers, profitable entry or expansion into the market for statutory audits by firms outside the Big Four is extremely difficult and unlikely. This is consistent with

³² http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/nature_and_strength_ey.pdf

the high levels of concentration which have been present in that market for many years.

6.1.3 More specifically, whilst BDO has increased its experience of working with FTSE 350 companies, this does not necessarily translate into increased audit work from them, in particular because:

- (a) Those making the purchasing decisions at the relevant companies are different, in that (in particular) audit committees have no say regarding decisions as to who (other than the company's auditor) should provide non-audit services;
- (b) the "IBM effect" applies to a much greater extent for audit services, as the appointment of an auditor is public and subject to shareholder confirmation, while the appointment of an adviser for (say) tax advice is not;
- (c) the influence of intermediaries is much greater in relation to audit work; they tend to favour the Big Four firms; and
- (d) the reputational advantage of the Big Four firms is particularly strong in relation to audit work.

6.1.4 Analogies with "*other industries*" (which have not been specified by EY) are not appropriate given the high level of concentration in the audit market compared with markets for (for example) other professional services and the existence and extent of barriers to entry and expansion in the relevant market. Audit can also be distinguished from most other professional services on the basis that it is a mandatory requirement.

6.2 **Competitive pressures**

6.2.1 As to the purchasing expertise of FDs/CFOs and ACCs in relation to audit services, (see EY's comments at, for example, paragraphs 4.8(b), 4.24, 4.30, 4.38 and 4.40 (b)) see 3.1.3 and 3.1.5 above.

6.2.2 BDO notes that EY states that: "*A majority of companies do not consider choice to be limited.*", which implicitly concedes that a proportion of companies do consider choice to be limited, and that "*Even if there are only a limited number of potential alternative firms*", which also appears to concede that choice of audit firms is restricted. BDO notes that PwC's Chairman and Senior Partner, Ian Powell, was recently quoted in Accountancy Age³³ as saying that: "*It would be better if there was more choice ...*".

6.2.3 If, as EY claim at paragraph 4.19, "*The threat of a tender process ... prompts a competitive reaction from the incumbent auditor*", then mandatory retendering should enhance competition between audit firms, which could benefit both companies and shareholders.

6.2.4 The citation at footnote 20 to EY's response is incorrect; the reference should be to the Working Paper on the Nature and strength of competition, not to evidence relating to the selection process.

³³ <http://www.accountancyage.com/aa/interview/2229149/interview-pwc-chairman-and-senior-partner-ian-powell>

- 6.2.5 EY claims at paragraph 4.33 that *"it ... should be assumed that the offerings of incumbent audit firms continue to be competitive."* BDO submits that the CC should not make any such assumption, which BDO regards as unjustified and complacent, in particular given the relative rarity of competitive tenders for FTSE 350 audits. EY appears to try to apply the outcome of competitive tenders to all companies, whether or not they have conducted tenders, and however long it may have been since any tender was conducted.
- 6.2.6 The extract quoted by EY at paragraph 4.40 from paragraph 194 of the CC's Working Paper on the Nature and strength of competition should finish with the words *"their existing audit"* not *"their existing client"*.

7 FIRMS' STATED COMPETITIVE STRATEGIES

7.1 Deloitte³⁴

- 7.1.1 At paragraph 3.1(b), Deloitte quotes part of the comments attributed to BDO in paragraph 26 of the Appendix to the CC's Working Paper on Firms' stated competitive strategies. However, those comments are taken out of context with the other comments attributed to BDO in that paragraph, in particular that *"BDO considered that it was able to compete with its own strong technical accounting team. BDO considered that GT was the only other non Big 4 firm which did not suffer from a lack of consistency in audit quality both in the UK and internationally."* In other words, BDO does not consider that it or GT suffer from a lack of consistent quality in the UK or internationally, as implied by the phrase quoted by Deloitte.
- 7.1.2 In relation to Deloitte's suggestion at paragraph 4.4 that the way for mid-tier firms to expand is to retain their current audit relationships with companies which are likely to grow into the FTSE 350, see 3.1.7 above.
- 7.1.3 As regards "low balling", in BDO's experience, heavily discounted bids by Big Four firms in competitive tenders against it are not based on seasonality. Indeed, if audit fees were so strongly linked to seasonality, one might expect more companies to consider changing their year ends to reduce their audit costs. BDO has previously invited³⁵ the CC to compare audit pricing following tenders which involved only Big Four firms with audit pricing following tenders which also involved other firms.

7.2 KPMG³⁶

BDO notes that KPMG does not attribute discounts entirely to seasonality and that (in its comments in relation to paragraph 12 of the Working Paper) it identifies complexity and geography as well as seasonality as the *"main factors affecting price"*.

³⁴ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/firms_stated_competitive_strategies_deloitte.pdf

³⁵ See paragraphs 4.3.2, 5.5.2 and 7.1.1 of BDO's response to the CC's issues statement

³⁶ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/firms_stated_competitive_strategies_kpmg.pdf

7.3 **GT**³⁷

BDO agrees with GT that *"the level of audit fees in relation to individual FTSE 350 firms is more transparent than acknowledged by the CC."*

7.4 **Mazars**³⁸

BDO agrees with Mazars that competition for a small number of infrequent tenders between only some of the firms with the necessary capabilities and capacity does not constitute active competition.

7.5 **PwC**³⁹

PwC claims:

7.5.1 at paragraph 8 that *"Large companies can use the threat of tender – whether implicitly or explicitly – to achieve highly effective outcomes from their existing audit firm"*. PwC refers at paragraph 12(i)(A) and footnote 12 to the evidence given on behalf of The Hundred Group of Finance Directors that *"audit firms know we have a choice and that very often is all you need to keep their pricing and the quality of their service honest"*. It is, however, ironic that this statement was made by the CFO of BG Group, Mr Ashley Almanza, given that (as reported in The Times on 6 October 2012⁴⁰) BG Group recently conducted a tender for its audit and switched its auditor from PwC to EY. BG must therefore have concluded that the threat of tender was not *"all you need"*;

7.5.2 at paragraph 8(c)(ii) that *"There is no evidence of high prices or profitability"*. BDO disagrees; in relation to profitability, see Oxera's comments on PwC's Profitability Analysis paper⁴¹; in relation to prices, see the paper by LSE Enterprise⁴², as well as slide 11 of BDO's presentation to the CC hearing on 4 October 2012, which quoted the CC's public dataset statistics as demonstrating that a switch to a mid-tier firm from a Big Four firm cuts audit costs by 83% in year 1 and 28% by year 5 on average, while a switch from a mid-tier firm to a Big Four firm increases average audit costs by 8% in year 1 and 23% by year 5 on average⁴³;

7.5.3 at paragraph 10(b) that *"We disagree with any suggestion that switching is infrequent"* but the reality is that FTSE 350 companies change their auditors rarely

³⁷ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/firms_stated_competitive_strategies_grant_thornton.pdf

³⁸ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/firms_stated_competitive_strategies_mazars.pdf

³⁹ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence_on_switching_costs_pwc.pdf http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/firms_stated_competitive_strategies_pwc.pdf

⁴⁰ <http://www.thetimes.co.uk/tto/business/industries/supportservices/article3560229.ece> ;

⁴¹ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/profitability_analysis_oxera_comments_on_pwc_paper.pdf

⁴² http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/bdo_further_submission_lse%20report.pdf

⁴³ See also paragraph 2.4 of GT's response to the CC's Overview Working Paper for a table setting out this information: http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/overview_grant_thornton.pdf

(less than once every 25 years on average⁴⁴); BDO considers that such companies change other professional advisers more frequently. FTSE 100 companies change auditors less frequently than FTSE 250 companies;⁴⁵ the CC's Working Paper on Evidence Relating to the Selection Process suggests that FTSE 350 companies tender for their audit around once every 25 years;⁴⁶

- 7.5.4 at footnote 30 that "*the sum total of the positive unprompted responses for not having tendered the audit ... comes to 133%*" but as stated in 10.3.10 below, companies were able to make multiple responses to this part of the CC's survey;
- 7.5.5 at paragraph 11(b), footnote 35 and paragraph 1.1 of the Annex that the "*profitability of our FTSE 350 audit engagements do not depend on the tenure of these engagements*", yet this is not what the CC found at paragraph 11(a) of its Working Paper on Engagement Level Profitability, which stated that "*auditors with tenures of over five years achieve greater profitability*" (see 9.3.5 and 10.3.6 below);
- 7.5.6 at paragraph 15 that "*the mid-tier firms are significantly less active than the four largest firms in building these relationships in the FTSE 350*" and at paragraph 2.1 of the Annex that "*the mid-tier have distinct and less ambitious strategies than the four largest firms ... this is indicative of their real view on their capability to compete successfully in the FTSE 350 audit market*". However, as stated at 8.1.2 below, if mid-tier firms approach the FDs/ACCs of FTSE 350 companies less frequently than those of non-FTSE 350 companies, this is because of the lack of access and opportunity, not the implementation of any strategic objective. As highlighted at the CC hearing on 4 October, this is clearly a strategic focus for BDO (see 3.3.9 above);
- 7.5.7 at paragraph 1.4 of the Annex that "*we have seen no evidence to support the suggestion that the four largest firms 'low-ball' in order to win audits in competition with smaller firms*", but, tellingly, PwC goes on to say that where "*... mid-tier firms have been invited to tender ... we would seek to ... offer a price that reflects a range of factors. These would include ... our views on what the likely competitive levels of bid will be ... It is this competition which drives price down – and if the result is close to cost pricing, this is an outcome which is entirely consistent with a competitive market.*". The clear implication of these comments is that:
- (a) PwC will offer a lower price if a mid-tier firm is involved in a tender;
 - (b) as a result, only if mid-tier firms are involved in the tender process is the outcome entirely consistent with a competitive market; and
 - (c) not only should the CC require FTSE 350 companies to put their audit out to tender after a given number of years, but that at least one mid-tier firm should be invited to tender, to ensure more meaningful price competition.

⁴⁴ See the CC's Issues Statement, paragraph 9(f) and BDO's response to the CC's Descriptive Statistics Working Paper, paragraph 1.2: http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/descriptive_statistics_bdo.pdf

⁴⁵ See the CC's Issues Statement, paragraph 9(f) and Oxera's 2006 Report published by the FRC which indicated that an FTSE 100 auditor "*can expect to remain in place, on average, for a period of 48 years*".

⁴⁶ See: <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).

PwC notes in footnote 56 that 46% of non-FTSE 350 firms said that they invited only the four largest firms to tender. Assuming that Big Four firms take a similar approach to pricing depending on whether or not mid-tier firms have been invited to tender (whether the client is inside or outside the FTSE 350), prices for audits of non-FTSE 350 firms are also likely to feature a "Big Four premium" when only Big Four firms have been invited to tender. BDO has invited the CC to compare audit prices after tenders involving mid-tier firms and those after Big Four only tenders; and

- 7.5.8 at paragraph 2.3 of the Annex that non-audit work is an opportunity for mid-tier firms to build relationships with FTSE 100 companies, but BDO considers that the supply of non-audit services offers a limited, if any, opening into the supply of external audit services, given that the purchasers of, and the considerations surrounding, the statutory audit are distinct from those in respect of specific non-audit services - see 2.3, 4.1.3, 4.1.4, 6.1.3 above and 11.2.9 below.

8 COMPETITION COMMISSION'S SURVEY RESULTS

8.1 Deloitte⁴⁷

Deloitte claims:

- 8.1.1 at paragraph 6.1 that the "*observed tendering rates reflect rational behaviour of companies*". It further claims that the CC's survey results show that "*[c]lients do not unreasonably exclude auditors from the tender process. When clients restrict the number of companies they invite to a tender, they do so for reasons related to quality and efficiency.*" (paragraph 6.1(b)). BDO notes that these propositions assume that the relevant company has at least a reasonably good knowledge of the market for the supply of audit services, including a proper awareness of the capabilities of the mid-tier firms. See 3.1.12 above; and

- 8.1.2 at paragraph 9.2 that the fact that mid-tier firms appear (from the CC's survey results) to approach non-FTSE 350 clients more frequently "*suggests that they may be strategically focussing on winning non-FTSE clients*". BDO refutes Deloitte's claim: if mid-tier firms approach the FDs/ACCs of FTSE 350 companies less frequently than those of non-FTSE 350 companies, this is because of the lack of access and opportunity, not the implementation of any strategic objective. As highlighted at the CC hearing on 4 October, this is clearly a strategic focus for BDO.

8.2 KPMG⁴⁸

KPMG claims:

- 8.2.1 at paragraph 2.4.1 that the CC's survey results show that "*FDs and ACCs are not biased towards any particular audit firm, but rather judge audit firms on the basis of their quality*". See 3.3.8 above;
- 8.2.2 at paragraph 2.6.3 that the CC's survey results show that "*mid-tier firms are less likely to approach companies outside of tenders, which might be one further reason why they are less likely to be invited to tender.*" As noted at 8.1.2 above, this is again the result of the lack of access to the relevant decision-makers; and

⁴⁷ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/cc_survey_results_deloitte.pdf

⁴⁸ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/cc_survey_results_kpmg.pdf

8.2.3 at paragraph 2.9.2 that *"there is some evidence in the survey that non-audit services are likely to be, if anything, more important for mid-tier than four largest audit firms"* and cross-refers to a slide from the CC's presentation. BDO does not consider that the relevant slide supports such a statement in respect of the Reference Market: the slide in question notes that *"expertise in non audit services was more likely to be considered important by non FTSE 350 FDs (although relatively low proportion felt this was important overall)"* (emphasis added), i.e. the slide refers to solely to FDs' perceptions, without linking this to any evidence provided by BDO. BDO further notes that its penetration of the FTSE 350 in respect of both audit and non-audit services is limited.

8.3 Mazars⁴⁹

BDO agrees with Mazars that:

8.3.1 investors' views would be helpful in terms of *"providing an insight into the extent of the principal-agent gap"*; and

8.3.2 voluntary switching rates are very low indeed.

9 EVIDENCE ON SWITCHING COSTS (AND IMPLICATIONS FOR BARRIERS TO ENTRY)

9.1 Deloitte⁵⁰

9.1.1 Deloitte notes at paragraph 4.3(a) that the CC survey shows that *"only 16% of respondents reported that costs of getting new auditors up to speed was a relevant factor ... and only 13% that the costs of tendering was a relevant factor"*: Deloitte further claims that this is because such costs *"are vastly outweighed by the other reasons why companies may choose not to tender – primarily that they are happy with the quality and value that they are currently receiving"*. BDO notes that there is clearly a distinction to be made between the minority of FTSE 350 companies that have actually conducted a tender process, and found that the costs involved to be outweighed by the benefits (as reported elsewhere in the CC's survey), and the majority of FTSE 350 companies that have not gone out to tender, and therefore are not in a position to conduct such an analysis. BDO suggests that the latter group may be looking to justify their failure to conduct tenders.

9.1.2 Deloitte cites at paragraph 4.3(e) the Hermes statement that the *"costs of switching were incurred in management time spent to explain to a new auditor how the company functioned and to justify existing accounting decisions. However, from a shareholder perspective, this was money well spent, since it entailed more rigorous scrutiny"* (emphasis added by Deloitte). BDO notes that this statement supports its position that switching costs should not be exaggerated, particularly by those companies who have not actually experienced tenders or switching; it also supports BDO's view that the clear benefits of switching are understood by the investor community.

9.1.3 At paragraph 4.3(f), Deloitte has misinterpreted the results of Oxera (2006) Table A1.7, regarding switching costs. Looking at the Oxera table reproduced by Deloitte

⁴⁹ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/cc_survey_results_mazars.pdf

⁵⁰ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence_on_switching_costs_deloitte.pdf

it is readily apparent that the ranking of different factors influencing barriers to switching is not the same as that described in Deloitte's paragraph 4.3(f).

9.2 **KPMG**⁵¹

KPMG:

- 9.2.1 claims at paragraph 2 that “[d]isincentives to switch ... arise because clients receive higher quality”. BDO notes that the KPMG argument not only conflates both actual and perceived quality, but also disregards the “IBM effect”. See 3.1.6 above;
- 9.2.2 notes at paragraph 3.3.6 that the CC has presented “only a very few examples of where companies stated that [that they may be discouraged from switching due to reputation concerns]”. BDO notes that this again disregards the “IBM effect”, which is evident from the CC's case studies;
- 9.2.3 cites at paragraph 3.4.3 the results of the CC's survey “which showed that 27 per cent of FTSE 350 companies that switched in the last five years did so because ‘reviewing keeps things fresh/avoids complacency/policy to switch regularly’”. BDO notes that these results support its position that there are clear benefits to be derived from switching, and therefore more FTSE 350 companies should seek to avail themselves of such benefits by tendering more frequently and inviting a wider pool of suppliers;
- 9.2.4 states at paragraph 3.6.4 that it “expect[s] its competitors, including mid-tier audit firms, to offer... similar levels of diligent planning and project management to ease any transition to their services”. BDO agrees that the management of transition is a core activity of any audit practice; and
- 9.2.5 claims at paragraph 3.9 that “[e]ven if some customers were irrational or incorrect in perceiving the size of switching costs, this cannot be characterised as a switching cost”. BDO notes however that, to the extent that such beliefs - even if they do not reflect the reality of switching - colour the perception of the relevant decision-makers (ACCs or FDs) they can still act as a deterrent to tendering and, therefore, switching.

9.3 **PwC**⁵²

PwC claims:

- 9.3.1 at paragraph 4 that there is no gap “between what large companies perceive to be the costs involved in tendering and switching and the reality.” However, if the company concerned has not previously run a tender for its audit, let alone switched auditors, and the relevant executives have no direct experience of tendering for the audit or switching audit firms, it is hard to see why they should be assumed to make accurate assessments of the costs of tendering and switching, as PwC claims. Since the Big Four firms have every incentive to “play up” those costs (and EY has admitted⁵³ that it instructs its staff to refer to the costs and disruption of tendering and switching if a client suggests that it may wish to go to tender), it is very

⁵¹ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence_on_switching_costs_kpmg.pdf

⁵² http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence_on_switching_costs_pwc.pdf

⁵³ In paragraph 16 of the CC's Working Paper on the evidence on switching costs (and implications for barriers to entry);

possible that their long term clients' assessments of these costs will not be as accurate as PwC claims. Comments made by the FD of Company E in the CC's case studies,⁵⁴ together with the results of the CC's Survey (see, for instance, slide 67 on the impact of switching on internal costs) are reflected in the CC's statement at paragraph 72(e) of its Evidence on Switching Costs Working Paper that "*Those that have switched have not found the process particularly burdensome or the costs particularly high*";

- 9.3.2 at paragraph 5(a)(iii) and at footnotes 19 and 40 that the CC's survey shows positive reasons for not switching which amount to 133%; however, companies were able to make multiple responses to this part of the CC's survey, so counting the number of responses to a particular element and then dividing it by total number of responses is not the natural way to interpret the data (see 10.3.10 below);
- 9.3.3 at paragraph 12 that "*the quality of advice received from an auditor increases as the audit firm becomes more familiar with the company's business*". However, BDO considers that the rate of increase will reduce over time; moreover, the risk of overfamiliarity or lack of independence on the part of the auditor also increases over time, as is recognised by the requirement for audit partner rotation. If auditor longevity was wholly advantageous, mandatory audit partner rotation would not have been required;
- 9.3.4 at paragraph 12(c) that "*a company's existing audit firm has a real incentive to avoid a tender wherever possible*". BDO agrees and encourages the CC to bear this in mind when considering the Big Four's submissions on switching, switching costs and tendering;
- 9.3.5 at paragraph 14 that "*there is no relationship between the profitability of our FTSE 350 audit engagements and the length or tenure of these engagements*", yet this is not what the CC found at paragraph 11 (a) of its Working Paper on Engagement Level Profitability, which stated that "*auditors with tenures of over five years achieve greater profitability*" (see 10.3.6 below); and
- 9.3.6 at paragraph 16 that if levels of tendering and/or switching materially increase in the future, "*certain observations made by the CC on the way the market operates at the present time may not apply – in particular as regards the willingness of audit firms to incur tendering costs and bear a share of the costs of transition for companies were these costs to arise more frequently and be amortised over shorter appointment periods.*". However, BDO confirms that it would be willing to incur tendering costs and bear its share of the costs of transition for companies were such costs to arise more frequently and appointment periods to be shorter than at present.

10 NATURE AND STRENGTH OF COMPETITION IN THE SUPPLY OF FTSE 350 AUDITS

10.1 Deloitte⁵⁵

- 10.1.1 Deloitte states at footnote 57 that "*Whilst we dismiss the 'loyalty to a previous employer' argument completely, we also find it incomprehensible that a period of previous employment at one of the top tier firms could result in loyalty to the 'Big*

⁵⁴ Company E, paragraphs 22 and 52

⁵⁵ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/nature_and_strength_deloitte.pdf

4' as a whole". It is not unusual for an employee of a Big Four firm to move to a client in an accounting role during that firm's relationship with the client (see 3.3.8 above.) This can develop and/or contribute to the relationship between the ex-employee and the firm concerned. The Big Four firm's extensive alumni networks are intended to continue and strengthen the relationship between former employees and the firm concerned. This builds on employees' existing knowledge of and likely confidence and trust in their former colleagues, which can often be a factor when they are deciding to whom to turn for advice and assistance. This is not solely or necessarily a matter of "loyalty" to a previous employer and BDO would not characterise it in those terms. Similarly, BDO would not refer to such relationships as *"loyalty to the Big Four as a whole"*. Such a description effectively mischaracterises the point.

- 10.1.2 The Big Four firms appear to believe that they have a monopoly on audit quality. That belief appears to be inculcated into their staff at all levels. If and when staff leave the Big Four firms, the purchasing decisions they make are likely to be influenced by the attitudes they have absorbed during their training or other employment with the Big Four firms, with the result that they are likely to purchase from Big Four firms, whether or not their previous employer. This operates to the benefit of the Big Four firms and the detriment of other firms.
- 10.1.3 Deloitte comments on the tender process and its robustness at section 4. BDO notes that tenders for FTSE 350 audits are relatively rare and infrequent and that in many cases only Big Four firms are invited to participate.
- 10.1.4 Deloitte claims at paragraph 7.9 that: *"There is simply no evidence that companies limit their choice of auditor by virtue of any bias against non-top tier firms."* BDO strongly disagrees. Whilst BDO would not generally use the term "bias" in this context, a combination of reputational advantage, familiarity, intermediary influence, lack of up-to-date knowledge of the capabilities of mid-tier firms, restrictive clauses in loan agreements and the "IBM effect" combine to produce a strong predisposition in favour of the Big Four and against other firms. This is, in effect, bias, which acts as a powerful barrier to entry and expansion. BDO has provided the CC with relevant evidence on these points;⁵⁶ the CC's case studies also include clear evidence on this, as BDO has previously noted.⁵⁷
- 10.1.5 Deloitte claims at paragraph 7.11 that *"no evidence has been given by firms"* to support the proposition that companies might feel that they could not switch from a Big Four firm to a non-Big Four firm because of the signal that it would send to the market and at paragraph 7.13 that *"there is no evidence that pressure from third parties plays any material role in constraining the choice of companies with respect to their auditor."* BDO strongly disagrees. BDO has provided the CC with examples of feedback from tender debriefs when companies have indicated that they have been influenced by the views of third party intermediaries.⁵⁸ The CC's survey results also demonstrate:
- (a) the importance to FTSE 350 companies of the reputation of the audit firm with investors, corporate brokers, analysts or external advisers;⁵⁹ and

⁵⁶ See, for example, paragraphs 1.6, 3.4 and 3.5 of BDO's Comments on CC Working Papers on which comments were due by 12 October 2012.

⁵⁷ See 3.1.7(c) and footnote 9 above; see also paragraph 2.9 of BDO's Comments on CC Working Papers on which comments were due by 5 October 2012 (specifically, the CC's Working Paper on Evidence on Switching Costs)

⁵⁸ See paragraphs 3.1.7 and 5.1.2 of BDO's response to the CC's Issues Statement

⁵⁹ See Table 11 and paragraph 35 of the CC's Working Paper on CC Survey Results

- (b) the importance of pressure from shareholders, bankers, lawyers or analysts as a trigger to seriously consider switching, cited by 54 per cent of FDs/CFOs and 62 per cent of ACCs as "very likely" or "likely" to prompt a company seriously to consider switching.⁶⁰ This conflicts with Deloitte's claim at paragraph 7.12(a) that: "*for the overwhelming majority of FTSE 350 companies, alleged concern about external pressure is not a factor impeding choice.*"
- 10.1.6 Deloitte claims at paragraph 7.19 that "*In practice, conflict concerns do not limit auditor choice.*" BDO disagrees. Whilst conflicts may be capable of being managed in the long term, at any given moment conflicts of interest are a factor limiting auditor choice: not least because that is how they are viewed by companies.
- 10.2 **KPMG⁶¹**
- KPMG:
- 10.2.1 challenges the "*CC suggestion that the alumni status of ACs and FDs in any way restricts competition*". See 3.3.8 above; however, BDO considers that it is not the status of those alumni which restricts competition, but the behaviour of those alumni;
- 10.2.2 claims at paragraph 1.11 that "*low tendering and switching rates do not signal a lack of competition and are fully consistent with a competitive market.*" BDO disagrees. Low levels of switching were regarded as contributing to a lack of competition in the market in the CC's market investigation into Personal Current Account Banking Services in Northern Ireland (May 2007);
- 10.2.3 claims in Annex 1, re paragraphs 17 to 20, that its "*investments represent continual innovation*". BDO considers that investment cannot necessarily be equated with innovation. Although all the auditing firms have invested substantially, much of this investment has improved cost efficiency and/or service quality in relation to audit, rather than changing the ultimate output of the audit. In other words, innovation has tended to relate to the manner in which the product is delivered, rather than producing a different product from the perspective of the ultimate customer, the investors. KPMG appears to acknowledge this later in the Annex, in relation to paragraphs 39, 84, 112 and 167, when it says that "*innovation in the nature of the statutory audit product itself is limited to some extent by the legal definition of the audit product, and by clients' willingness to commission assurance over a broader information set than required for statutory purposes.*" ;
- 10.2.4 claims in Annex 1 that "*one should expect long tenures as a product of an effective competitive process*". BDO disagrees. One cannot seek to infer from long audit tenures that the market is competitive and that this is an indication of effective competition. Most competitive markets do not feature tenures averaging over 30 years. Even if one accepts that there are inefficiencies associated with frequent switching, BDO considers that switching could happen much more frequently for FTSE 350 companies than it does at present without significant inefficiencies. KPMG has itself pointed to the CC's own evidence that "*companies which have switched have not found the process costly.*" BDO also considers that long tenures are more likely to give rise to or exacerbate principal-agent issues, including concerns relating to the independence of the auditor;

⁶⁰ See Table 16 and paragraphs 55 and 56 of the CC's Working Paper on CC Survey Results

⁶¹ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/nature_and_strength_kpmg.pdf

- 10.2.5 claims in Annex 1 (in relation to paragraph 126 of the Working Paper) that "*there is no evidence that this limitation in choice has any adverse effect.*" However, BDO notes that:
- (a) there is often considered to be less competition in relation to audits in the financial services sector;
 - (b) the CC's Working Paper on Engagement level profitability analysis states at paragraph 10 that "*'Financials' industry audits achieved the highest average engagement profitability*", which suggests that limiting choice can lead to higher prices; and
 - (c) investors have raised concerns about limitation in choice;⁶²
- 10.2.6 claims in Annex 1 (in relation to paragraph 143 of the Working Paper) that "*The CC states that tender events are frequently limited to the largest four audit firms. There is no evidence that this has any adverse effect on competition.*" BDO strongly disagrees. The exclusion of mid-tier firms from tenders operates as a genuine and substantial barrier to entry and expansion. It perpetuates the Big Four's stranglehold on the reference market. Increasing mid-tier audit firms' awareness of forthcoming tenders, as suggested by KPMG in relation to paragraph 158 of the Working Paper, would be of little benefit if mid-tier firms continue to be excluded from most of those tenders; and
- 10.2.7 claims in Annex 1 (in relation to paragraph 196 of the Working Paper) that "*firms do not take advantage of audit clients when it comes to maintaining fees after any 'learning by doing' efficiencies have been realised.*" However, BDO notes in this context the CC's Working Paper on Engagement Level Profitability analysis states at paragraph 11(a) that: "*Profitability broadly increases over the first five years of an engagement and auditors with tenures of over five years achieve greater profitability.*"
- 10.3 **PwC**⁶³
- PwC claims:
- 10.3.1 at paragraph 8(c) that "*there are potentially high switching costs involved in changing auditor*", but this view is not shared by other Big 4 firms, or by BDO; PwC later says at paragraph 3.20 of Annex 2 that "*the CC should not overstate the impact of switching costs*" and at paragraph 3.21 that "*The CC's Survey shows that switching costs are not prohibitively high*". BDO considers that those later comments are more accurate;
- 10.3.2 that tenders are not necessary to achieve competitive outcomes. Yet the evidence is that switching leads to higher quality and lower prices. Moreover, conducting a tender for the audit enables companies to demonstrate to shareholders that they have "market tested" the audit service in a manner which properly reflects their duties of stewardship and principles of good corporate governance. This is harder to demonstrate in the absence of a tender. This is illustrated by EU public

⁶² See, for example, paragraph 19 of the CC's Summary of hearing with the Association of Financial Markets in Europe; see Oxera's Investor Survey Report, paragraph 2.3.3, which 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.*"

⁶³ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/nature_and_strength_pwc.pdf

procurement law, which is founded on the principle that competitive tenders are the appropriate way to achieve competitive outcomes. Under public procurement law, even sophisticated public bodies, with a good knowledge of their markets, who are happy with existing suppliers, have to follow a competitive public tender process, not simply threaten or imply that a competitive tender may be held. BDO notes that EY appears to recognise this, as it states at paragraph 4.2 of its response to various working papers that: "... *competitive interaction is more visible and intense during a tender process ...*";

- 10.3.3 at paragraph 15(e) that "*there is no evidence of correlation between pricing, profits and concentration, and the evidence of audit profitability is consistent with what would be expected in a competitive market*". BDO submits that this is incorrect. Several empirical studies have established a link between price, profit and concentration; see, for instance: LSE Enterprise, (2008), 'Concentration, Auditor Switching and Fees in the UK Audit Market' (see 7.5.2 above);
- 10.3.4 at paragraph 22 that companies have "*an intimate understanding of the comparative merits of different firms*", yet it is clear from the case studies that CFOs and ACCs often do not have an up to date understanding of the merits of mid-tier firms (see 2.1, 3.1.5, 3.1.8, 3.1.10, 3.1.12, 3.4.6 and 4.1.9 above);
- 10.3.5 at paragraph 23(e)(i) that "*As the CC's evidence shows, prices fall immediately after tenders. However, it is important to recognise that those who tender are companies which were often dissatisfied with the price they were able to obtain prior to the tender ... Similarly, to the extent that there may be an observed improvement in quality after a switch, as the CC recognises, this largely reflects the fact that a tender process is more likely to be initiated where there are concerns about quality.*" BDO submits that there is an obvious inference that the CC should draw from the observations that quality improves and price falls after a tender - tenders help purchasers achieve optimal outcomes;
- 10.3.6 at footnote 67 that "*there is no relationship between audit tenure and profitability*" and at paragraph 28, at footnote 136 and paragraph 2 of Annex 3 that "*there is no relationship between the profitability of our FTSE 350 audit engagements and the length or tenure of these engagements*", yet the CC's Working Paper on Engagement Level Profitability found at paragraph 11(a) that "*auditors with tenures of over five years achieve greater profitability*". However, without sight of the redacted Figure 1 it is difficult to make more informed comment on PwC's claim; BDO has therefore asked the CC to reconsider the redaction of Figure 1;
- 10.3.7 at Section 3 that companies can effectively assess and judge quality and price without a formal tender, but Figure 2 shows that 41% of companies which did not switch auditors had audit fee changes above 10% (including 11% of such companies which had price increases of over 50%) and 58% of such companies had a price increase. BDO submits that Figure 2 does not necessarily demonstrate robust annual pricing negotiations; PwC itself notes at paragraph 3.26 of Annex 2 that "*an increasing number of companies are now deciding to tender for corporate governance reasons*";
- 10.3.8 at footnote 86 that there "*is a striking correspondence in the characteristics cited in the CC's survey between (i) what is most important in determining audit quality and in appointing auditors (experience, expertise, independence, challenge, ability to detect misstatements, efficiency (see slides 33 and 38 of the CC's Survey) and (ii) the reasons given for not selecting mid-tier firms (lack of size, coverage, expertise and experience) (see slide 85 of the CC's Survey).*" BDO disagrees. The most important factor cited in deciding whether to appoint or reappoint was the experience and knowledge of the engagement partner (as PwC itself notes at

paragraph 36(e)(i), third bullet); the second was good working relationships with the audit team. In contrast, the largest reason given for not formally considering any firm outside the Big 4 was the size of the audit firm and geographic coverage. PwC may wish to regard size as a proxy for expertise, but this is not necessarily the case, if what matters most is the experience and knowledge of the engagement partner. Moreover, ACCs and CFOs views of mid-tier firms geographic coverage can often be out of date (see 3.1.10 and 3.1.12 above) and BDO's international coverage is greater than most FTSE 350 companies require;

- 10.3.9 at paragraph 47 that "*While recognising that companies are aware of the potentially considerable costs of switching, the NSCP suggests that they are less able to judge the benefits ... Again, this is an example of concepts that may have validity in consumer markets being incorrectly applied to experienced large business purchasers.*" BDO agrees with PwC's characterisation of FTSE 350 companies as experienced purchasers, but the principal-agent problem in the audit market means that PwC's overall logic is flawed. Audit is not a typical business-to-business market, precisely because of the principal-agent problem;
- 10.3.10 at paragraph 52 that "*the CC misreads the statistics ... one of several arithmetical errors which have been used to support the CC's position*" and says "*the total number of responses counted cumulatively ... amounting to 172%*". PwC's criticism is not valid. Companies were able to make multiple responses to this part of the CC's survey, so counting the number of responses to a particular element and then dividing it by total number of responses is not the natural way to interpret the data. The CC (and its market research company IFF) had interpreted the data correctly. This point also applies to footnotes 56 and 114;
- 10.3.11 at paragraph 56(a) that "*the average FTSE 350 tender has 3.7 bidders*". BDO submits that this is incorrect. The CC's evidence states: "*98. In our data set, the average number of participants to tenders is two.*"⁶⁴ however, PwC seems to agree with the CC's evidence at paragraph 4.7(a), page 55: "*In fact, the number of firms which participate in what the NSCP recognises as the current effective tender process is often only three or even two.*";
- 10.3.12 at paragraph 58 that "*large companies do not suffer from any material lack of choice in practice when selecting their audit firm*", and at paragraph 4.2 of Annex 2 that "*we consider that conflict and independence issues have a minimal effect on choice*", but see 10.2.5 and footnote 62 above in relation to this point;
- 10.3.13 at paragraph 4(e) of Annex 1 that "*there is no evidence that companies that switch achieve better long-time outcomes than those that do not.*" BDO disagrees. It is ironic that PwC frequently describes ACCs and FDs/CFOs as "*experienced, sophisticated, knowledgeable purchasers*", but does not credit them with being able to achieve better long-term outcomes by switching. As stated in slide 11 of BDO's presentation to the CC at the hearing on 4 October, the CC's own statistical analysis of the public dataset showed that switching auditor from a Big Four firm to a mid-tier firm produced major price reductions (28% by year 5). This contrasted strongly with switching from one Big Four firm to another or from a mid-tier firm to a Big Four firm; moreover, the CC's survey showed that a clear majority of those companies which have switched reported reduced prices and/or increased audit quality;⁶⁵

⁶⁴ See the CC's Working Paper Evidence on Switching Costs (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)

⁶⁵ See slides 64 and 65 of the CC Audit Survey

- 10.3.14 at paragraph 6(d) of Annex 1 that *"there is no evidence that tendering is less frequent than is optimal for this market"*. BDO disagrees. It is difficult to see why the present low frequency of tendering should be "optimal" for this market, however well it might suit the market leader;
- 10.3.15 at paragraph 2.3 of Annex 2 that: *"This experience of auditing large FTSE 350 companies is exactly what mid-tier firms are unable to offer, and we believe a critical reason why they are not selected when they participate in tenders ... even when companies engage in very detailed scrutiny of mid-tier firms' capabilities, they prefer to use the greater experience and attributes offered by the four largest audit firms"*. BDO considers that this demonstrates the existence of barriers to entry and expansion in relation to audits for FTSE 350 companies;
- 10.3.16 in paragraph 2.3 of Annex 2 that mid-tier firms *"almost invariably lose"* when they are involved in tenders against the Big Four firms. However:
- (a) PwC acknowledges that **incumbents tend to lose tenders** (*"less than 20% of existing audit firms are successful if the company goes to tender"*): see paragraphs 4 and 23(c)(i) of its Response; if this is true for the Big Four, it is at least as true for mid-tier firms. The CC's survey found that non-FTSE 350 companies are more likely to switch auditors than FTSE 350 companies. They are also more likely to have mid-tier firms as incumbent auditors. Once they have decided to go to tender, the existing mid-tier firm therefore faces an uphill battle to retain the client, particularly given the factors mentioned below;
 - (b) there are **very few tender opportunities** each year in relation to FTSE 350 company audits;
 - (c) the Big Four firms have **significant reputational advantages** in tendering against mid-tier firms. The "IBM effect" applies in tender situations to the detriment of mid-tier firms; where a mid-tier firm is not the incumbent and the ACC and/or CFO have more familiarity with the Big Four firms, perhaps as alumni (see 3.3.8 above), the "IBM effect" will tend to apply particularly strongly;
 - (d) BDO's experience is that Big Four firms will **price aggressively** in tenders against mid-tier firms; companies will expect the mid-tier firms to beat the Big Four firm's prices by a considerable margin if they are to move to a mid-tier firm from a Big Four firm (see 3.1.6 above);
 - (e) expanding non-FTSE 350 companies which are clients of mid-tier firms are **targeted by the Big Four firm**, both because they are likely to join the FTSE 350 and, by winning them from the mid-tier, the Big Four firms strengthen their claim that the mid-tier firms lack experience of auditing large FTSE 350 companies;
 - (f) BDO's experience is that **intermediary influence** plays a part in tender decisions, both in terms of who to invite to tender and in terms of the outcome of the tender process; this works to the benefit of the Big Four firms and the detriment of the mid-tier firms; and
 - (g) if PwC are so confident of winning tenders against mid-tier firms, PwC should not oppose any requirement that companies put their audit out to tender after a given interval, or that those invited to tender should include mid-tier firms;

See also 3.1.6, 3.1.7 and 5.2.2 above;

- 10.3.17 at paragraph 3.7 of Annex 2 that "*the issue of potentially limited choice has been overstated.*"; but this is not the view of investors, who are the real customers in this market and for whom lack of choice is a real and widely shared concern (see 10.2.5 and footnote 62 above);
- 10.3.18 at paragraph 3.7 of Annex 2 that "*We therefore disagree with the statement that audit firms are likely to participate in tenders except where they wish to retain non-audit engagements - the choice is the company's.*" BDO submits that this conclusion is implausible. An audit firm would rationally make a decision as to whether to bid for an audit given its own profit incentive (including existing revenues from non-audit services). Tender participation cannot be exclusively determined on the demand side;
- 10.3.19 at paragraph 3.10(c) of Annex 2 that "*61% undertake formal proposals before reappointment.*" BDO submits that this is a mischaracterisation of the CC's results. Only 28% of FTSE 350 companies undertake formal proposals on an annual basis, and since audit is an annual appointment, this is the relevant statistic. See Table 12, page 16 of the CC's survey results Working Paper;
- 10.3.20 at footnote 180 that "*As the CC has found, the conditions for tacit co-ordination are absent regardless of the question of fee transparency - see the Tacit Co-ordination WP.*" BDO submits that this is inaccurate. The CC's finding was: "*many of the market conditions conducive to tacit collusion in relation to market share appear to be satisfied*". See paragraph 57 of the CC's Tacit Coordination Working Paper;
- 10.3.21 at paragraph 3.28(c) of Annex 2 that "*Even if an individual did have a preference for a particular firm because of past employment, it is not clear why such an individual would also prefer one of the four largest firms of which they have no personal experience over a smaller firm.*" BDO considers that the answer is often reputation, including the attitudes and "group think" absorbed during training at a Big Four firm (see 3.3.8, 10.1.1 and 10.1.2 above);
- 10.3.22 at paragraph 3.29(b) of Annex 2 that "*there is no compelling evidence of lenders or other of having an undue influence over auditor appointments.*" BDO disagrees; auditor clauses in loan agreements give lenders the power to restrict choice of auditors; BDO has provided examples to the CC of intermediary influence over auditor appointments;
- 10.3.23 at paragraph 4.7 of Annex 2 and at Annex 4 that "*academic opinion suggests that markets with the characteristics of audit are at their most efficient with four or fewer competitors*", yet this would mean that the audit market was less efficient before the demise of Andersen and that it was even less efficient when there were eight large audit firms. It is hard to see why this should be the case;
- 10.3.24 in Annex 3 that non-switchers frequently negotiate substantial changes in audit fee. However, Figure 2 also shows that 58% of FTSE 350 non-switchers had increases in their audit fee and that 41% of FTSE non-switchers had increases in their audit fee of 10% or more in a period (2000-2011) when annual CPI inflation averaged 2.5%; while Figure 3 also shows that from 2007 to 2011, 52% of FTSE non-switchers had increases in their audit fee and that 33% of FTSE non-switchers had increases in their audit fee of 10% or more; and
- 10.3.25 in Annex 4 (in an Opinion of Professor Steffen Huck) that:

- (a) *"Large firms stand to lose more from providing low quality services than do smaller firms"* , but all firms risk insolvency if their reputation is damaged irreparably. Ironically, the Big Four firms have managed to preserve their reputations despite allegations of audit failure in relation to various companies;
- (b) *"increasing returns to scale have been empirically documented in audit markets"*, although the CC's Working Paper on Economies of Scale in Operating Costs found no readily identifiable evidence of economies of scale in non-staff costs; and
- (c) *"n=4 delivers outcomes which are close to full market efficiency"* and that *"n=4 is quite likely to be ... the optimal practical number of suppliers in the market for statutory audits for the largest companies"*, but does not make clear why n=5 or n=6 would deliver worse or less efficient outcomes.

Annex 4 does not, however, refer to the concerns of investors, or their role as the ultimate customer of the audit.

11 BARRIERS TO ENTRY: REPUTATION AND EXPERIENCE

11.1 Deloitte⁶⁶

- 11.1.1 Deloitte considers (at paragraphs 2.3 and 2.4) that BDO and Grant Thornton's respective *"substantial relationships with FTSE 350 companies"*, when combined with their *"substantial audit relationships with large multinational companies"*, should in practice translate into *"good opportunities to demonstrate expertise even where they do not have pre-existing experience with a specific FTSE 350 company"*. BDO considers that this goes to the heart of this investigation. The reality is that despite possessing broadly equivalent capabilities to the Big Four firms, which would be sufficient for the audit purposes of all but the very largest FTSE 100 companies, mid-tier firms such as BDO and Grant Thornton are rarely given the opportunity to demonstrate their expertise and experience to the relevant decision-makers (ACCs/FDs). This lack of access is due to the cumulative effect of various barriers to entry and expansion, which have been identified by the CC in various Working Papers: however, BDO believes that reputation is a key element of this.
- 11.1.2 In respect of the perceived influence of Big Four firm alumni, Deloitte states at paragraph 3.3 that *"[t]here is no basis for these allegations of bias, and such bias certainly cannot be inferred from the mere fact of previous employment"*. Deloitte further states that it *"completely disagrees with these allegations which seem to us to be a direct criticism of the integrity of some of the UK's leading business people. FTSE 350 CFOs and ACCs will not and do not take important commercial decisions on the basis of loyalty to a previous employer"*. BDO considers the actual position to be much more nuanced than represented in Deloitte's statements: see 3.3.8 above.
- 11.1.3 Deloitte claims at paragraph 4.1 that mid-tier firms *"make less significant efforts to make sure that FTSE 350 companies are aware of [their] capabilities"*: although in paragraph 4.3 it adds that *"Grant Thornton and BDO are markedly more active than other non-top tier firms (especially as regards non-FTSE 350 clients) but still fall some way short of the top tier firms"*. As noted at 8.1.2 above, to the extent that mid-tier firms approach the FDs/ACCs of FTSE 350 companies less frequently than

⁶⁶ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/b2e_reputation_and_experience_deloitte.pdf

those of non-FTSE 350 companies, this is because of lack of access and opportunity.

- 11.1.4 Deloitte claims at paragraph 5.1 that there is no evidence before the CC to support the CC's statement that "*Because reputation is only a proxy for accurate information on quality and capability it may over time depart from reality*" (Paragraph 76 of the CC's Working Paper). It further claims at paragraph 5.2 that if Deloitte ceased to deliver the quality that its clients expect of it, "*its reputation will suffer in short order*". See 3.1.9, 3.1.10 and 3.1.14 above - particularly in respect of the "IBM effect", notwithstanding several alleged audit failures, accounting scandals and regulatory criticisms in respect of the Big Four firms. However, as noted at 3.3.8 above, neither the AIU or PCAOB reports demonstrate a material difference between the technical quality of the Big Four firms and that of the larger mid-tier firms.
- 11.1.5 Deloitte claims at paragraph 7.5 that "*there are no external pressures or restrictions preventing FTSE 350 companies from appointing a mid tier auditor.*" BDO disagrees. Intermediaries are a considerable influence, particularly for growing companies which aspire to join the FTSE 350; clauses in loan agreements also restrict auditor choice. See 2.3, 2.5, 3.1.7, 3.1.8, 3.1.9, 3.1.11 and footnote 58 above.
- 11.2 **PwC**⁶⁷
- 11.2.1 PwC claims at paragraph 5 that the "*question is not whether the reputation of the largest firms is undeserved*" (emphasis added by PwC) but "*whether the mid-tier firms objectively have the same level of capacity, quality, expertise and efficiency as the largest firms with the consequence that their lesser market reputation is an unfair reflection of their actual position*". BDO considers these two questions to be inextricably linked: the question is whether the reputation gap between the Big Four firms and the mid-tier firms is wholly justified. In BDO's view, if the audit services supplied by the mid-tier firms – in particular, BDO and Grant Thornton - are of comparable quality to those supplied by the Big Four firms, then the Big Four firms cannot claim to have a monopoly on quality. As noted at 3.3.8 and 11.1.4 above, neither the AIU or PCAOB reports demonstrate a material difference between the technical quality of the Big Four firms and that of the larger mid-tier firms.
- 11.2.2 Moreover, PwC subsequently claims (consistent with its responses to other Working Papers) that the Big Four firms are in a special category insofar as mid-tier firms may possess certain, but certainly not all, of the so-called "*attributes*" required to audit large companies: at paragraph 7(b), PwC states that "*there can be no doubt the mid-tier firms do not possess the capabilities to audit the largest and most complex companies as this is accepted by the mid-tier companies themselves*": PwC reiterates this point at footnote 9, where it states that the "*mid-tier firms themselves recognise that they have lesser attributes and resources than the largest firms*". PwC further claims that such "*attributes*" "*demonstrate a proper differentiation between the larger and smaller audit firms*".
- 11.2.3 As set out at 4.4.1 and 4.4.3 above, the largest and most complex FTSE 100 companies are not representative of the FTSE 350 as a whole, and there are no distinctive Big Four "*attributes*" required to provide audit services to the rest of the FTSE 350. In addition, BDO considers the stark dichotomy promoted by PwC between larger and smaller audit firms does not reflect the reality of the market: in

⁶⁷ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/b2e_reputation_and_experience_pwc.pdf

practice, there is a sliding scale from the larger audit firms to the smaller audit firms.

- 11.2.4 PwC acknowledges at paragraph 7(c) that the mid-tier firms "*may have the technical competency to conduct an audit of smaller FTSE 350 companies*"; however, PwC suggests that such mid-tier firms would not possess the requisite combination of "*technical and service standards*" that large companies expect. BDO considers such claims to be unfounded: in a market where the mid-tier firms are rarely even invited to tender, let alone actually supply, audit services to the FTSE, PwC cannot point to evidence that the service standards of the mid-tier firms are objectively inferior to the Big Four firms – the real issue is the reputation that the Big Four firms have for possession of "*superior attributes*", which acts a barrier to entry by implying that the offering of the mid-tier firms is somehow inferior.
- 11.2.5 PwC compounds the above claim at paragraph 10 where it states that the mid-tier firms are "*less experienced*" in auditing large companies and suggests that Top Track and AIM company audits performed are "*less complex*" than FTSE 350 audits. BDO disagrees with PwC and refers the CC (in particular) to the evidence that it has submitted at the CC's hearing with BDO dated 4 October 2012: in BDO's view, there is no strong distinction to be made between FTSE 250 companies and a number of AIM companies, and BDO considers the supply of audit services to the FTSE 350 as a natural extension of its business.
- 11.2.6 PwC claims at paragraph 14 that the CC does not explain in the Working Paper how the **background of ACCs/FDs** may influence their respective decision-making, and that such influence could only be characterised as improper bias ("*contrary to their duties to the company*") or lack of ability to make an "*objective judgement*" based on the merits, which (accordingly to PwC) would be surprising, given the CC's characterisation of ACCs/FDs as "*experienced and knowledgeable buyers*". PwC further states at paragraph 1.12 of the Annex to PwC's response that it believes "*the fact that a number of ACCs and FDs may previously have worked for one of the largest audit firms is no basis to conclude that they improperly prefer their previous employer or any other of the largest audit firms.*"
- 11.2.7 BDO reiterates that it is not making any claims as to the impropriety of the conduct of the majority of ACCs/FDs that are alumni of the Big Four firms. Nor does it dispute that such ACCs/FDs are experienced and knowledgeable in their respective fields. It would, however, dispute that such experience and knowledge necessarily translates into a sophisticated procurement practice: see 3.1.5 above.
- 11.2.8 BDO's comments on the primary and secondary alumni effects of a Big Four firm background of the majority of FTSE 350 ACCs/FDs are set out at 3.3.8 above. These effects are not contingent upon the ACCs/FDs having been employed recently by the relevant Big Four firms.⁶⁸ The fact that a minority of FTSE 350 ACCs/FDs may not have a Big Four firm background does not alter those concerns in respect of the majority. Moreover, prior employment at a Big Four firm is not a pre-requisite for the "IBM effect" (although it can reinforce it; see 3.3.8 above). Accordingly, BDO disagrees with PwC's claim at paragraph 14(a) that the fact that one third of FTSE 350 ACCs/FDs had not previously worked with one of the Big Four firms means that they "*would not be influenced by any alleged bias or lack of objectivity*".

⁶⁸ The PwC research noted in footnote 23 - that more than 71% of the current FTSE 100 FDs had left their alumni firms over ten years ago – can be discounted as not being relevant to this issue.

- 11.2.9 PwC claims at paragraph 15(a) that the fact that mid-tier firms have existing relationships with many FTSE 350 companies through the provision of non-audit services means that FTSE 350 companies should be aware of their respective qualities. See (for example) 4.1.4 above as to why the provision of non-audit services offer at most a limited opening into the supply of external audit services, as the buyers of those services are different.
- 11.2.10 PwC claims at paragraph 16 that “it is not surprising that investors are in some cases unhappy about the prospect of a mid-tier firm being appointed”. BDO considers that such a proposition is both inaccurate and unsupported by the evidence before the CC; the CC has not published any evidence that investors have specific concerns about BDO. The CC’s Working Paper on Views of Investors and Other Stakeholders demonstrates that the majority of investors clearly have no concerns over any change in auditor, provided that they are given an adequate explanation. Moreover, as set out in detail in BDO’s comments on that Working Paper, BDO considers the CC’s conclusion 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” to be unsupported by the evidence:⁶⁹ the relevant adverse comments⁷⁰ do not identify or specifically refer to any mid-tier firms, other than as part of a general critique of non-Big 4 firms, of which BDO is not representative (the latter critique would also appear to be motivated primarily by the “IBM effect”). Oxera’s investor survey shows that investors would be comfortable with BDO or GT auditing most FTSE 350 companies.
- 11.2.11 PwC concludes at paragraph 19 that the CC’s views that large firms are unable to judge quality and therefore select audit firms based on proxy measure “*are wrong*”. See 3.1.14 and 4.1.8 above.
- 11.2.12 PwC “*notes with interest*” at paragraph 1.6 of the Annex the CC’s finding that “*mid-tier firms appear in their tender documents to anticipate that they may be regarded as weak in a number of jurisdictions and therefore seek to emphasise their strength in those areas*”. BDO considers such marketing activity in relation to sector coverage and/or global presence as an entirely legitimate means of educating the market, particularly in the light of reputational issues associated with the Big Four firms. Given comments from PwC such as “*the quality and scope of mid-tier firms’ international networks may be a particular issue*” (paragraph 1.5 of the Annex), BDO may consider it necessary to clarify the actual position to prospective clients.
- 11.2.13 PwC claims at paragraph 1.14 of the Annex that “*Mid-tier firms appear to choose to target Top Track or AIM companies more actively and this demonstrates that they rightly recognise that their attributes are better suited to these typically less complex and/or international companies*”. See 11.2.3 and 11.2.5 above.
- 11.2.14 PwC cites at paragraph 2.2(b)(ii) of the Annex the views of the Hundred Group: in particular it quotes the Hundred Group as confirming that the “*Big Four bias exists*”. BDO agrees with the Hundred Group as to the existence of such “*bias*”, although it disagrees strongly as to the underlying reasons for its existence.
- 11.2.15 PwC speculates at paragraph 2.3 of the Annex as to whether the appointment of mid-tier firms as auditors of large companies may give rise to “*questions by investors as to whether such an appointment was appropriate given the mismatch*”

⁶⁹ Paragraph 79(b) of the CC’s Working Paper on Views of Investors and Other Stakeholders.

⁷⁰ These are set out in paragraphs 41 and 42 of the CC’s Working Paper on Views of Investors and Other Stakeholders and taken from Rathbone, Artemis, Schroder, Standard Life Investments and an undisclosed entity.

between the smaller firm's capabilities and the demands necessary to audit a large company". See 11.2.10 above.

11.3 **KPMG**⁷¹

KPMG:

- 11.3.1 claims at paragraph 15 (of its General Comments) that "*clients do not generally rely upon reputation as a proxy for quality*". However, at paragraph 16 KPMG also claims that the supply of audit services is an "*experience good*". BDO agrees with KPMG that audit should be characterised as an experience good; see also 3.1.14 and 4.1.8 above;
- 11.3.2 states at paragraph 1.2 that to the extent that it takes "*'strategic' actions such as advertising and sponsorship, these are simply the promotion of the underlying quality...they cannot preserve reputation, but are designed to raise awareness of it*". BDO disagrees; such measures in BDO's view serve to strengthen the brand, which is inextricably linked with the "IBM effect". Such measures may also strengthen the alumni network effects mentioned at 3.3.8 above;
- 11.3.3 claims at paragraph 2.2.1 that mid-tier firms have "*ample opportunity*" to leverage their existing relationships with large companies in respect of non-audit work into audit work. See 4.1.4 above;
- 11.3.4 further states at paragraph 2.3.2 that it is not clear to it how "*reputation - as opposed to the observable qualities - of a firm's international network has any bearing whatsoever on the choice of auditor or the ability of the mid tier to compete*". See 3.1.10 and 3.1.12 above;
- 11.3.5 claims at paragraph 2.5.1 that "*[t]o the extent that different audit firms are perceived differently, this represents actual differences in quality*". BDO considers such an approach to be fundamentally misconceived: see 3.1.14 above;
- 11.3.6 agrees with the CC at paragraph 2.5.2 that "*experience, pre-existing relationships and a strong international network are important to clients*", but then disagrees that they act as a material barrier to entry, in that experience can be gained and relationships formed. BDO agrees that in principle such barriers to entry could be overcome, and it continues to invest in realising these objectives, particularly in respect of its international network: however, it is also clear to BDO that, despite its investments and efforts, it will be unable to gain sustainable market share within the FTSE 350 given the current structure of the market and (in particular) reputational barriers to entry, without intervention in the market;
- 11.3.7 further cites at paragraph 2.5.2 evidence before the CC which in KPMG's view demonstrates that the mid-tier firms "*are continuing to expand their international networks at a faster rate than the largest four international networks*". However, KPMG fails to mention the strategic acquisitions by it and the other Big Four firms – for example, KPMG's acquisition of BDO's Brazilian network firm – which have not only had a major adverse effect on investments made by the mid-tier firms, but also have the effect of reducing competition both in the country of the acquired firm and internationally;

⁷¹ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/b2e_reputation_and_experience_kpmg.pdf

- 11.3.8 claims at paragraph 3.2.1 that *"there is no sense in which the status of many FDs and ACCs creates any kind of bias"*. See 3.3.8 above;
- 11.3.9 refers at paragraph 3.3.1 to the *"common belief"* identified by the CC that the staff at the Big Four firms are of higher quality than those at the mid-tier firms, and claims that *"there is no sense in which there is any 'gap' between actual and perceived quality"*. However, as noted at 3.3.8 above, neither the AIU or PCAOB reports demonstrate a material difference between the technical quality of the Big Four firms and that of the larger mid-tier firms;
- 11.3.10 acknowledges at paragraph 4.3.1 that CFOs/FDs/ACCs may not have an up to date knowledge of the mid-tier audit firms, and seeks to explain this *"at least in part"* by the lack of effort by the mid-tier firms in building and publicising their capabilities. BDO's comments in respect of the lack of access to such decision-makers are set out at 8.1.2 and 11.1.3 above. Moreover, to the extent that the lack of up to date knowledge is not due to a lack of effort on the part of the mid-tier firms, KPMG appears to be admitting that there is a reputational issue which is beyond the mid-tier firms' control;
- 11.3.11 claims at paragraph 5.1.5 that the fact that *"of the companies which only invited the largest four audit firms to tender in the previous five year, only 11 per cent gave 'wanted to use the Big 4' as a reason"* indicates that any *"prestige value that derives from 'Big 4' status is not determinative in selecting an audit firm"*. BDO considers KPMG's conclusions to be misconceived: the fact that all of the relevant companies invited only the Big Four firms to tender is, in BDO's view, vastly more persuasive of the fact such companies only wanted a Big Four firm than whether or not they ticked the relevant box in the CC's survey. Indeed, the fact that nearly 90 per cent did not tick the relevant box supports BDO's general contention that the factors that favour the Big Four firms derive from a general mindset (which itself is the cumulative result of several influences) rather than any conscious preference;
- 11.3.12 notes at paragraph 6.3.1 that BlackRock *"did not believe resistance to audit firms outside of the largest four stemmed from investor pressure but rather board reluctance"*. In BDO's view, this clearly supports the CC's theory of harm relating to principal-agent issues: it demonstrates that management has little interest in talking to auditors outside the Big Four firms, although the real customers – the investors – are keen for them to expand the limited pool of potential suppliers. It also implies – contrary to KPMG and other Big Four firms' assertions – that it would be an uphill struggle for the mid-tier firms to gain access to the relevant decision-makers in order to inform them of their respective capabilities;
- 11.3.13 claims at paragraph 6.3.1 that *"no evidence of financial institutions insisting on, or enforcing, so-called 'Big 4 only' clauses in loan contracts [has] been received by the CC"*. BDO considers that this misinterprets the CC's Report on auditor clauses in loan agreements, which found such restrictive clauses to be widely used in syndicated agreements and present in the LMA leveraged loan standard agreement. Such clauses were also widely reported as being present in bilateral loan agreements (see paragraph 42 of the CC's report on auditor clauses in loan agreements);
- 11.3.14 refers to the Oxera report at paragraph 6.4.2 as finding that *"investors do not perceive there to be a genuine capability gap between the mid tier and the largest four audit firms, except for the largest FTSE 100 companies, specialist and multinational companies"*: KPMG considers that this *"still leaves a significant portion of the FTSE350 open to the mid tier firms"*. KPMG has, however, misquoted Oxera. Oxera's investor report says that: *"All investors consider that there may be a genuine capability gap between the Big Four and mid-tier firms for certain very*

large (the top 15–30 FTSE 100 companies), specialist, or multinational companies." i.e. Oxera are specific that it is only the top-end of the FTSE 100 where investors perceive a capability gap. BDO agrees with the findings of the Oxera report, in that BDO has the technical capability to audit most of the FTSE 350, but disagrees with KPMG's conclusion that this somehow leaves the market "*open*". The existence of extensive barriers to entry – in particular, the reputational advantages of the Big Four firms – have the precise effect of closing off that part of the FTSE 350 market that ought, in principle, to be open to competition from the mid-tier firms. In addition, the principal-agent issues in relation to investors mean that those who could benefit from change have the least power to initiate it. It is therefore not meaningful to claim - as KPMG does at paragraph 6.6.2 - that "*there are few or no examples of investors actually exerting pressure on companies to switch auditor*";

11.3.15 claims at paragraph 7.2 that reputation: "*is not a factor at all for clients in relation to their existing auditor, because they are able to readily observe the quality of audits*". However, this would seem to be inconsistent with KPMG's other claim (made above and repeated at paragraph 7.2) that it is not difficult for new entrants to demonstrate audit quality to prospective clients – clearly such prospective clients are not in a position to "*readily observe*" the quality of an audit product that has not been supplied, and therefore must make assumptions as to quality. KPMG also does not mention the fact that switching away from an incumbent auditor may, in certain circumstances, have a reputational impact (as noted in the CC's Working Paper on the Views of Investors and Other Stakeholders); and

11.3.16 states at paragraph 7.3 that the fact that many ACCs/FDs are alumni of the Big Four firms is relevant "*because those individuals are likely to know what a high quality audit looks like, thus obviating the need to use proxies*". Such a statement only reiterates the primary and secondary alumni effects identified at 3.3.8 above.

11.4 **Grant Thornton**⁷²

11.4.1 BDO agrees with Grant Thornton that the 'IBM effect' should be investigated further by the CC.

12 **EVIDENCE RELATING TO THE SELECTION PROCESS: TENDERING, ANNUAL RENEGOTIATIONS AND SWITCHING**

12.1 **Deloitte**⁷³

Deloitte:

12.1.1 claims at paragraph 3.2(a) that the "*detailed tender process*" conducted by FTSE 350 companies "*reduces any incumbency advantage*" and "*levels the playing field*". Deloitte cites the fact that the incumbent firm wins only 20% of tenders as evidence of the "*absence of any significant incumbency advantage*". BDO considers this logic flawed: as set out at 4.4.6 above, BDO considers that the CC's analysis indicates that the main trigger to retender is a substantial breakdown of quality by the incumbent: therefore, it is not surprising that the incumbent does not win most of the tenders triggered by its own sub-standard performance. However, this does not mean that incumbents do not possess an advantage: rather, the incumbency

⁷² http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/b2e_reputation_and_experience_grant_thornton.pdf

⁷³ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence_relating_to_the_selection_process_deloitte.pdf

advantage is demonstrated by the relative lack of competitive tenders for FTSE 350 audits overall;

- 12.1.2 refutes at paragraph 4.1(a) the CC's view that innovation plays little role in the tendering process as "*entirely wrong*". However, the examples quoted by Deloitte at paragraph 4.1(c) – in particular, the fact that the client's selection panel was looking for "*a more commercial approach, value added from the audit and ... detailed understanding of how we would work with them going forward*" – do not, in fact, go to innovation in any meaningful sense, but to what BDO would consider to be essential outputs in the supply of audit services;
- 12.1.3 claims at paragraph 7.7 that there is no basis for the CC's description of the reappointment process as "*standardised*", and that it is "*wrong*" to describe it as consisting of "*mainly discussing the scope of the work and fees for the following year*". At paragraph 8.2, Deloitte claims that "*companies see benchmarking as a meaningful and effective tool*". BDO considers that – irrespective of the level of detail engaged in reappointment and benchmarking processes – such processes are no substitute for a competitive tender process: without such a process, there is no basis to conclude that the visible market price - and, to the extent that it is visible, service offering - is also the competitive offering. Accordingly, in the light of the relative rarity of competitive tenders for FTSE 350 companies, companies should not assume that the market offering represents the best combination of price and services that audit firms would be prepared to offer to win the business;
- 12.1.4 quotes at paragraph 8.2 evidence from 3i Group that it instructed "*an external procurement consultancy that would not be swayed by any relationship issues*". BDO considers that such evidence only underscores the importance of relationships – including alumni relationships - when making the audit appointment in the majority of cases where such procurement consultancies are not involved;
- 12.1.5 considers at paragraph 8.3 that the fact that the CC's Survey shows that 78% of FTSE 350 companies have contacts with other firms demonstrates that CFOs and ACCs are also in a position to undertake informal benchmarking of the audit market through their respective "*regular contact*" with other firms. The evidence before the CC, however, strongly suggests that such contact, and therefore knowledge, is predominantly limited to the Big Four firms;
- 12.1.6 claims at paragraph 9.5(c)(i) that it has found a material error in the CC's calculations, in that the switch by Countrywide plc from KPMG to BDO resulted in a decrease in audit fee of 14%, as opposed to 83%. However, that claim does not alter the general point that audit fees decrease when switching from a Big Four firm to a mid-tier firm; and
- 12.1.7 claims at paragraph 10.1 that "*There is no good basis for ... an assumption ... that only formal tendering generates a truly robust outcome for a company in terms of ensuring optimal value and quality from the audit*". BDO considers that in the light of the principal-agent issues rightly identified by the CC, formal tendering is the best way of ensuring a truly robust outcome for the company and that those tenders should involve at least one mid-tier firm, to increase the chances of a competitive outcome and help to overcome barriers to entry and expansion.

12.2 **KPMG**⁷⁴

KPMG comments in Appendix 1:

- 12.2.1 that it agrees with the CC (referring to paragraph 2(e)) of the CC's Working Paper) that where companies threaten to retender or use other audit firm's proposals to challenge an incumbent, "*this has led to a reduction in the proposed audit fee*"; it considers this "*strong evidence of the bargaining power of our audit clients*". In BDO's view, were KPMG's clients to possess such bargaining power, they would be unlikely to have been paying higher audit fees in the first place: accordingly, BDO considers such a statement to be further evidence of a 'Big Four premium';
- 12.2.2 (referring to paragraphs 34-39 of the CC's Working Paper) that along with the Big Four firms, BDO also has awareness of tenders before they are formally announced. However, it is clear from the relevant paragraphs of the CC's Working Paper that this only holds true where BDO has an existing "*strong*" relationship with the client: given that BDO has far fewer relationships with FTSE 350 companies than any of the Big Four firms, BDO considers that its level of knowledge of tenders should not be considered on a par with that of any of the Big Four firms; and
- 12.2.3 that it notes (referring to paragraph 109 of the CC's Working Paper) the CC statement that in most cases "*non-Big 4 firms spent fewer hours than Big 4 firms in preparing tenders*" and claims that this contributes to the Big Four firms' success rate in tenders. BDO considers that, given the relative rarity of competitive tenders for FTSE 350 companies, and that mid-tier firms are invited to only a limited number of such tenders and win a very small proportion overall, it is not meaningful to draw any conclusions based upon the relative number of hours spent by each audit firm, which may simply reflect a rational allocation of resources based upon realistic chances of winning.

12.3 **PwC**⁷⁵

PwC claims:

- 12.3.1 at paragraph 3(a)(i) that "*we simply do not recognise the CC's description... of the annual reappointments being typically a 'standardised process'.*" and that the CC has understated the use of both reappointments and benchmarking as means to "*exert competitive pressure on the existing auditor*". See 12.1.3 above as regards benchmarking;
- 12.3.2 at paragraph 3.1(a)(i)(B) (and to the same effect in footnote 70) that "*there is no relationship between the profitability of our FTSE 350 audit engagements and the length or tenure of those engagements*" – but see 7.5.5, 9.3.5 and 10.3.6 above;
- 12.3.3 at paragraph 3(a)(ii) that to "*achieve competitive fees and high quality service levels, companies often threaten to tender*". See 12.2.1 above. BDO considers that the fact that companies may resort to such threats in order to achieve a more competitive offering strongly suggests that the offering may not have been competitive in the first place;

⁷⁴ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence_relating_to_the_selection_process_kpmg.pdf

⁷⁵ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence_relating_to_the_selection_process_pwc.pdf

- 12.3.4 at paragraph 3(b)(i) that "*the current rate of tendering and switching is at the appropriate level*" – perhaps it is the appropriate level for PwC, but BDO does not consider that it is at the appropriate level for investors;
- 12.3.5 at paragraph 3(b)(v) that "*greater numbers of tenders and switches would in reality indicate the market delivering a sub-optimal outcome*"; BDO disagrees – more tenders would not do so; more switching could deliver better outcomes in terms of pricing and audit quality, as the CC's survey results show; see 12.3.10 below;
- 12.3.6 at paragraph 3(c) that the "*evidence shows mid-tier firms have the opportunity to present their credentials for appointment*" in terms of being invited to tender, and that the reason that they are unsuccessful is because they lack the necessary "*attributes*". As noted at the hearing with the CC, being invited to tender is not the same as submitting a tender. In respect of PwC's claims regarding "*attributes*", see 10.3.15 and 10.3.16 above;
- 12.3.7 at paragraph 2.3 of the Annex that it is "*striking that mid-tier and smaller audit firms do not maintain contact with companies outside of tenders and have less (or no) advance knowledge of tenders*". However, PwC contradicts itself later in the paragraph by acknowledging that BDO often has advance knowledge (reflecting the relevant paragraphs of the CC's Working Paper), though see 12.2.2 above;
- 12.3.8 at paragraph 2.4 of the Annex that mid-tier firms' stated desire to win an increasing number of FTSE 350 audits is somehow "*contradicted by their failure to take obvious steps to demonstrate this to large companies*". See 8.1.2 and 11.1.3 above as to the lack of access to the relevant decision-makers;
- 12.3.9 at paragraph 3.2(a) of the Annex that the CC's view that tenders are too "*infrequent*" is wholly subjective and unsupported by evidence; it then notes that it would be "*highly inefficient for a company to tender its audit every year*". BDO agrees that it would be not efficient to require companies to tender every year, but the extreme position drawn by PwC should not skew the debate on what would be a reasonable period between tenders. As noted in the hearing before the CC, BDO considers that mandatory tendering at least every seven years would be appropriate;
- 12.3.10 at paragraph 3.2(c) of the Annex that "*Greater numbers of tenders would indicate market failure as this would demonstrate greater dissatisfaction with audit firms. Nonetheless, there is a sufficient level of switching for companies to demonstrate the threat of tendering is real and credible*". BDO considers PwC's characterisation of the market as misconceived: it is the number of FTSE 350 companies that switch as a result of tenders that would demonstrate dissatisfaction with existing firms, not the number of tenders held. See also 2.7 and 12.3.5 above;
- 12.3.11 at paragraph 3.7(a) of the Annex that the CC's view that risk assessments by smaller firms "*tended to be less detailed*" than those of the Big Four firms constitutes a "*significant potential omission*" by those smaller firms when preparing such tenders: it goes on to declare that "*[m]id-tier firms cannot realistically audit large and complex companies if they are unable adequately to assess their audit risks*". BDO considers PwC's statements as misconceived. To the extent that the evidence before the CC shows that non-Big Four firms' tenders may not be as detailed as tenders from the Big Four firms, this may simply reflect the resources allocated to preparing such tenders by those smaller firms, and should not be considered as indicative of their actual capabilities. See 12.2.3 above;

- 12.3.12 at paragraph 3.8 of the Annex that according to PwC, the mid-tier firms' *"lack of expertise ... in assessing risk and achieving a smooth transition may well be significant factors in mid-tier firms failing to win audit tenders"*. BDO strongly disagrees with this proposition, which ignores numerous relevant factors, including the reputational advantage of the Big Four firms: see 2.2 above;
- 12.3.13 at paragraph 3.9 of the Annex that *"the CC's finding that mid-tier firms generally spend fewer hours than the largest four firms in preparing for tenders ... may be indicative of smaller firms not knowing what it takes to win a tender"*. BDO disagrees: see 12.2.3 above; and
- 12.3.14 at paragraph 3.16(a) of the Annex that out of the 20% of tenders won by the current auditor, it would *"expect that many of these wins are in tenders triggered by governance issues"* rather than quality concerns. BDO considers this proposition wholly unsupported by the evidence before the CC – in particular, it is inconsistent with the Big Four firms' own submissions - which clearly indicate that tenders are issued primarily when there is a substantial breakdown in quality (see also 4.4.6 above): indeed, PwC makes this very point just a few paragraphs earlier in the Annex: see paragraph 3.2(c) of the Annex, cited at 12.3.10 above.
- 12.4 **Mazars**⁷⁶
- 12.4.1 BDO agrees with Mazars' claim at paragraph 2 that, based upon the evidence before the CC, a significant number of FTSE 350 engagements appear to have been won without a competitive tender (given the low levels of switching overall in the Reference Market), and that the CC should investigate further whether – to the extent such appointments were made as a precursor to listing – there was any pressure from intermediaries to switch to a Big Four firm at that point;
- 12.4.2 Mazars claims at paragraph 4 that *"A number of the Big 4 emphasise that even where there have not been tenders there have been many threats to put the audit out to tender ... This does not seem to be the sign, at least prima facie, of a market in which the fee is set on an ongoing basis at a level that you would expect if it were actively competitive especially as you [the CC] also report ... that incumbent auditors that participate in tenders usually offered a significant reduction in the fee"*. BDO agrees with Mazars that in a market characterised by few actual tenders, prevailing prices cannot be said to be set at a competitive level; see 12.1.3 above.

13 EVIDENCE OF TACIT COORDINATION

13.1 PwC⁷⁷

PwC states:

- 13.1.1 at paragraph 4 that *"... audit is unusual.. because the annual fee is published, which ensures far more transparency than is the case in relation to non-audit fees, legal fees or the fees of other professional service providers..."*. BDO agrees with PwC that the audit market is a great deal more transparent than other professional services markets; and

⁷⁶ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence_relating_to_the_selection_process_mazars.pdf

⁷⁷ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence_of_tacit_coordination_pwc.pdf

13.1.2 at paragraph 5 that - contrary to the CC's assertion in its Working Paper on the Nature and Strength of Competition – the audit market is sufficiently transparent for *"companies to be able to carry out a worthwhile and effective benchmarking exercise as regards their audit fee against a comparable group of companies"*. However, at the same time PwC considers this level of transparency as insufficient to facilitate tacit coordination in the Reference Market. BDO believes that – contrary to PwC's view – if the market is sufficiently transparent for FTSE 350 companies to be able to conduct a meaningful benchmarking exercise, it is also sufficiently transparent to meet one of the conditions for tacit coordination.

13.2 **Grant Thornton**⁷⁸

BDO agrees with Grant Thornton (at paragraphs 3.1 to 3.3) that the CC should investigate whether the Big Four firms have been involved in areas of collaboration which would not necessarily fall within the established categories of tacit coordination but could nevertheless result in a dampening of competition – for example, when jointly commissioning the Copenhagen Economics report, which strengthens the reputational bias against the mid-tier firms.

13.3 **Mazars**⁷⁹

BDO agrees with Mazars (on page 2) that the CC should investigate further the extent to which the Big Four firms *"have opportunities to shape regulatory, standard-setting and professional requirements"*, as well as *"whether the non-Big 4 have equal access to put their view forward"*.

14 **DESCRIPTIVE STATISTICS**

14.1 **PwC**⁸⁰

14.1.1 BDO has already provided comments to the CC on PwC's response to the Descriptive Statistics working paper. The relevant parts of the relevant email to the CC (Denis Kelly) from BDO's solicitors, Berwin Leighton Paisner (Adrian Magnus) of 21 November 2012 (09:57) are repeated below for the CC's convenience, together with some additional comments.

14.1.2 In BDO's view, companies who changed auditor as a result of the demise of Arthur Andersen should not be included within the switching rates, contrary to the suggestion by PwC. This is because, in most cases, these companies will have been motivated to use Deloitte as auditor, to benefit from the continuity of the same audit partner and audit team who were present during the tenure of Arthur Andersen. BDO does not therefore consider that these situations are typical of a company making an unbiased decision to switch auditor or on which firm to appoint.

14.1.3 BDO notes that the PwC response illustrates that direct switching leads to price reductions even when the alternative categorisation for switching (split between direct switches, consequential switches (e.g. due to Arthur Andersen collapse) and tenders without switches) which PwC propose is used. BDO notes also that if some

⁷⁸ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence_of_tacit_coordination_grant_thornton.pdf

⁷⁹ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence_of_tacit_coordination_mazars.pdf

⁸⁰ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/descriptive_statistics_pwc.pdf

of the obvious outliers are removed, then the average price reduction upon a switch is greater than PwC's illustration would suggest. In particular, some of the examples of direct switches listed in Annex 1 of the PwC response which show a large price increase appear to be incorrectly categorised:

- (a) the 100% increase in price for Pearl Group Holdings No.1 Ltd in 2006 appears to be principally due to the acquisition of Abbey National plc by the company in September 2006, thus increasing audit fees for subsidiary undertakings from £1.2m to £2.6m, and not as a direct result of switching auditor;
- (b) the 196% increase in price for STV Group PLC in 2002 appears to be incorrect as the statutory accounts of the company for the year ended 31 December 2002 show total audit fees at £0.3m compared to £0.2m in 2001 (i.e. an increase of 50%). The auditor change is also shown to be from Arthur Andersen to Deloitte and so would be more appropriately classified as a consequential change (if the PwC suggestion is employed); and
- (c) the 141% increase in price for iSOFT Group PLC in 2005 appears to be largely linked to significant difficulties which that Group were experiencing at the time (for example the 2005 audit report has 5 emphasis of matter sections and a disclaimer on the audit opinion on the view presented in the financial statements). To categorise the 141% price increase as being due to a change in auditor is therefore clearly incorrect;

14.1.4 BDO notes that the PwC response illustrates that tenders without switches generally result in slight price increases (although BDO notes this result is counter-intuitive and should be checked by the CC). If true, this may confirm that it is the process of switching which leads to better outcomes for customers and that the tendering process alone does not achieve the same results. Further PwC's analysis highlights that any consequential switching that occurred resulted in higher prices. BDO views this as unsurprising given that the Arthur Andersen collapse led to an increase in market concentration and a reduction in capacity in the market. This could be an area for the CC to explore in further detail, as it presents a simple natural experiment in price-concentration analysis.

14.1.5 BDO notes the following specific points relating to the PwC response:

- (a) In paragraph 4, PwC note that there are "*prices increases in excess of 1,000%*" in the dataset. In BDO's view, even with the current levels of market concentration, this is not a genuine observation of a price increase and must be driven by other factors or data error. Indeed, BDO believes that the most likely company in question (Thomas Cook - as this is the only example of a change of more than 1,000%) experienced a much smaller change in the audit fee in the time period in question. The statutory accounts for Thomas Cook show audit fees as follows: 2007 £2.6m, 2008 £1.8m, 2009 £2.2m. If the tender was for the audit of the 2008 accounts, it would appear that it actually resulted in a reduction of 30%. Analysis of these numbers should take account of Thomas Cook's MyTravel acquisition in 2007 (<http://www.thomascookgroup.com/mytravel-announcements>);
- (b) in paragraph 8, PwC welcomes the CC's attempt to control for scope (i.e. to present both audit fees absolute and audit fee per £1m turnover) but BDO notes that the PwC analysis itself fails to do this when presenting PwC's own calculations in Table 1, which show audit fees only in absolute terms. The flaws in this approach are pointed out by PwC itself in paragraph 7 "*analysis of audit fees can be misleading if no control is*

included for changes in audit scope". Indeed, the PwC results could be misleading for this reason;

- (c) in paragraph 15, PwC suggests that "switches" driven by M&A activity are all situations in which significant competitive pressures have been brought to bear on the incumbent auditor. BDO considers that this is unlikely to be true in all situations, as a large company which acquires a smaller company does not always have a consequential desire to switch its auditor, and switching at a time of transactional activity may be seen as disruptive;
- (d) in paragraph 16, PwC suggests that price changes following a switch should be assessed based on looking at price changes following a switch plus price changes following a tender. BDO considers that this could be misleading, since a tender is not the same as a switch, and non-incumbent auditors may be minded to price differently to incumbents in a tender situation;
- (e) in table 1, PwC suggests that prices rise on average by 81% (mean) following a tender process. This result is driven by the inclusion of the Thomas Cook Group PLC tender in 2008, which on page 12 is listed as being associated with a 1,940% price increase. These results do not make sense, and appear to be incorrect - see 14.1.5(a) above. This once again points to the need for more careful interpretation of the data, such as examining the change in audit fee per hour following a tendering or switching event; and
- (f) in paragraph 19(c), PwC suggests that the benefits of switching are transitory, with prices reverting back to pre-switch levels. BDO notes that in the CC's own data this is true of Big-4 to Big-4 switches, but it is not true of switches from the Big-4 to the mid-tier, where companies that have switched to a mid-tier auditor continue to experience lower prices (with significantly lower prices persisting at least as long as the CC's dataset continues to show a result, i.e., 5 years post-switching).

14.2 **KPMG**⁸¹

KPMG states in Annex 1 that:

- 14.2.1 *"When a company underwent a merger or acquisition and held a competitive tender to select an audit firm, we believe that when the new company retained the incumbent audit firm of either of the merging entities, then in some instances this should be considered as a switch, depending on the analysis the CC is conducting."* BDO notes that KPMG does not provide any evidence on how often competitive audit tenders occur as a result of mergers or acquisitions. Furthermore, BDO notes that even in such situations, the tender may only involve the merging parties' incumbent auditors rather than being a full competitive tender; and
- 14.2.2 *"rates of tendering and switching (regardless of the method of calculation) are not indicative of the level of competitive pressure on audit firms"*. BDO notes, as stated in 14.1.4 above, PwC's submission that tenders without switches generally result in slight price increases. This may indicate, contrary to the point made by KPMG, that it is the process of switching which leads to better outcomes for customers.

⁸¹ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/descriptive_statistics_kpmg.pdf

15 **BARRIERS TO ENTRY: INTERNATIONAL NETWORKS**

15.1 **KPMG**⁸²

KPMG claims:

- 15.1.1 in its cover letter that the *"mid tier firms have strategies available to them to gain coverage and skills, including expanding their networks, adopting better centralised co-ordination, planning and controls..."* BDO refers to evidence provided to the CC at the hearing on 4 October, where BDO indicated that, as a result of increasingly taking on larger, more complex work, it had made significant investments internationally to create a consistent global brand, modernise its network structure and agree a consistent global strategy. BDO further notes that the proposed merger with PKF has also enabled it to enhance its international network: see BDO's press release at **Attachment 1** announcing the merger of a significant part of PKF China with BDO's Chinese operations. However, as indicated at 3.1.10 above, this does not prevent BDO from being excluded from invitations to tender where it could otherwise demonstrate its increasing international credentials;
- 15.1.2 in Appendix 1 that there are *"very few examples beyond the two cited in the House of Lords Economic Affairs Committee report, of smaller national firms choosing to join larger audit firm networks"*. BDO disagrees and refers the CC, in particular, to [X]. Moreover, as highlighted at the CC hearing on 4 October, BDO's operations in [X] have also been targeted by [X]; and
- 15.1.3 in Appendix 1 that (according to the CC's own survey) *"only 8 per cent of respondents' from UK-only companies considered an international network to be important when choosing an audit"* is relevant to whether FTSE 350 companies would be deterred from choosing audit firms which are perceived to have a *"less developed international network"*. However, BDO highlights that this only relates to companies with no auditable international operations: as noted at paragraph 12 of PwC's response, the proportion increases to nearly two-thirds where between 1 and 40% of the total audit fee is accounted for by non-UK activities. See also 3.1.10 above.

15.2 **Deloitte**⁸³

Deloitte claims:

- 15.2.1 at paragraph 3.3 that *"mid tier firms are clear that they consider they have been able to make investments that ... give them the ability to deliver high quality audits to the large majority of FTSE 350 companies"*; and at paragraph 4.1 that the mid-tier firms *"all belong to large, established and growing international networks."* BDO agrees: see 15.1.1 above. However, as set out in 15.1.2 above, the Big Four firms have also engaged in strategic acquisitions designed to weaken such networks, thereby significantly undermining BDO's efforts and investment;
- 15.2.2 at paragraph 3.5 that *"there is no evidence that [the mid tier firms] have submitted to the CC supporting a view that the need for an international network constrains their ability to win FTSE 350 audits"*. However, as BDO has consistently maintained before the CC, the real issue – correctly identified by the CC in paragraph 132 of

⁸² http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/b2e_international_networks_kpmg.pdf

⁸³ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/b2e_international_networks_deloitte.pdf

the CC's Working Paper on Restrictions on Entry and Expansion - is not the actual lack of an international network, but the relevant decision-makers' *perception* that there is a lack of international reach: see 3.1.10 above; and

15.2.3 at paragraph 3.6 that its Swiss business is an example of how "*it is possible to grow a competitive practice from a position of relative weakness*"; but see 4.1.12 above.

15.3 **PwC**⁸⁴

PwC claims:

15.3.1 at paragraph 7 that the "*mid-tier firms also have the option to merge or to encourage mergers of other firms within their networks should they wish to speed up the development of their networks*"; PwC repeats these claims at paragraph 17 where it states that the "*larger mid-tier firms are members of... networks which could form the basis of a further phased international expansion if appropriate investment decisions were made*" and at paragraph 18, where it claims that the "*mid-tier also have the option to merger or to encourage mergers of other firms in their networks in order to fast track such development ...*". See 15.1.1 above;

15.3.2 at paragraph 12 that the "*CC also recognises that UK companies with no current overseas activities, but with expectations of expanding overseas in future, are likely to benefit from, and value, the existence of a strong international network*". BDO considers this emphasis on the perceived need for an audit firm with a strong international network and worldwide delivery to be overstated: it is also at odds with the CC's own survey, which finds that "*only 8 per cent of respondents' from UK-only companies considered an international network to be important when choosing an audit*";

15.3.3 at paragraph 20 (and at paragraph 2.4 of the Annex) that in most jurisdictions, "*an acquisition would be subject to obtaining approval, where applicable, from local competition authorities, and such approvals are designed to ensure that the acquisitions do not result in anti-competitive effects*". BDO considers that this statement significantly overstates the likely level of scrutiny: such scrutiny would be subject to the relevant merger control thresholds (which vary significantly according to the jurisdiction) being satisfied and, in voluntary merger control regimes, the merging parties electing to notify the relevant competition authority; moreover, even where such thresholds are satisfied, the relevant authority would focus on the anti-competitive effects in the jurisdiction at issue, and would be unlikely to consider the wider impact of the transaction on the international networks of the firms involved;

15.3.4 at paragraph 27 that the "*recent significant audit problems*" experienced by PwC network firms in both India and Japan has not resulted in any "*long-term detrimental impact on the viability and success of the PwC network or on the UK firm*". BDO considers such a statement only underscores BDO's comments in respect of the "IBM effect" associated with the Big Four firms, first noted at 2.2 above;

15.3.5 at paragraph 5.1 of the Annex that GT and BDO have "*significantly lower*" international coverage than the Big Four firms, but BDO has offices in 138 countries, which is not "*significantly lower*" than the Big Four firms; and

⁸⁴ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/b2e_international_networks_pwc.pdf

15.3.6 at paragraph 5.2 of the Annex that the *"evidence does not support any suggestion that the mid-tier firms are comparable in size or quality with those of the networks in which the four largest firms are members."* BDO considers PwC's statement to be unsupported by the actual evidence before the CC - in particular, the evidence underlying the CC's own assessment that the Big Four and mid-tier have broadly similar international coverage, international methodologies and international platforms. (This is to be contrasted with the results of the CC survey, which demonstrates that the market generally perceives the mid-tier as lacking international reach, even though this is not in fact the case.)

15.4 **Mazars**⁸⁵

BDO agrees with Mazars' comment that the exclusion by individual FTSE 350 companies on the grounds that their international network is not strong enough *"is based on assumptions that would not bear close scrutiny"*. See BDO's comments at 3.1.10 above.

16 **THE LIFE CYCLE OF FTSE 350 COMPANIES**

16.1 **Deloitte**⁸⁶

Deloitte claims:

16.1.1 at paragraph 3.2 that *"there is no evidence to suggest specific targeting of mid tier firm's clients by Deloitte or by top tier firms"*, but see BDO's comments at 7.1.3 and 7.5.7 (the latter in respect of PwC) above; and

16.1.2 *"any auditor switch driven by mandatory tendering requirements is unlikely to have the same qualitative or quantitative impact on quality, price or internal costs as has been observed historically"*. BDO disagrees, because mandatory tendering will not in itself change the reasons why companies will or will not switch auditors. Unless a company can see benefits from a switch, such as higher quality and/or lower prices or internal costs, it is unlikely to change auditor, particularly if the decision to tender was imposed on the company rather than taken voluntarily, e.g. because of a perceived problem with the existing auditor or its service. Mandatory tendering must be distinguished from mandatory rotation.

16.2 **KPMG**⁸⁷

KPMG claims at paragraph 1.2 that *"there is no evidence to support the suggestion that there is institutional bias on firms to switch to the largest four audit firms on entering the FTSE 350."* This is based on Table 6 to the CC's Working Paper on the Life Cycle of FTSE 350 companies. However, Table 7 does not support this claim. When a wider time frame is considered (switches occurring in the two years before, the year after or the year of a change of index designation, rather than those occurring in the year before or the year of a change in index designation), there is a much higher percentage of switches from Mid Tier to Big Four firms, as well as a higher number of such switches when companies are entering the FTSE 350 than

⁸⁵ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/b2e_international_networks_mazars.pdf

⁸⁶ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/life_cycle_of_ftse_350_companies_deloitte.pdf

⁸⁷ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/life_cycle_of_ftse_350_companies_kpmg.pdf

when companies are leaving it. This is more consistent with BDO's experience of its clients being targeted by Big Four firms as they grow and have aspirations to join the FTSE 350. Whether and when a listed company joins the FTSE 350 is not within its control, because this depends on its market capitalisation relative to that of other companies. A wider (two year) time frame is therefore a more appropriate framework within which to review changes in advisers and the CC should not draw conclusions based on a narrow (one year) time frame: in other words, Table 7 is more representative of the position than Table 6 in this context.

17 CHARACTERISTICS OF LONG AUDIT TENURE COMPANIES

17.1 Deloitte⁸⁸

Deloitte claims:

- 17.1.1 at paragraph 1.3 that "*[c]ompanies benefit from the cost efficiencies achieved over time*" and that there is "*no evidence that companies with long tenure are disadvantaged in any way*", but see 7.5.5, 9.3.5 and 10.2.7 above regarding profitability and 2.7 above regarding benchmarking;
- 17.1.2 at paragraph 1.4 that the changes recently introduced by the FRC "*represent a step change in the market*". BDO does not share Deloitte's view as to the extent to which the 'comply or explain' obligation will really change market practice, as BDO believes that most FTSE 350 companies will continue not to put their audit out to tender unless they are subject to a mandatory requirement; and
- 17.1.3 at paragraph 3.3 that the "*relationship between auditor identity and subsequent likelihood of switching is good evidence that top tier auditors deliver the quality of audit services that clients require more often than do non-top tier auditors.*" BDO disagrees. There are several other factors involved, including the "IBM effect", reputational advantages, involvement of Big Four alumni, intermediary pressure, etc. AIU and PCAOB reports do not support the proposition put forward by Deloitte.

17.2 KPMG⁸⁹

KPMG claims:

- 17.2.1 at paragraph 2.1.1 that a low switching rate is "*consistent with the CC's conclusions in previous inquiries, where it has found that even low rates of switching are consistent with competition functioning well*", but see 10.2.2 above;
- 17.2.2 at paragraph 3.3.1 that there is "*no institutional bias or external pressure on companies to switch to the largest four audit firms on entering the FTSE 350*", but see 16.2.1 above; and
- 17.2.3 at paragraph 3.5.5 that "*the absence of switching (ie long term tenure) is more likely to arise as a result of intense competition and the incumbent accommodating its customers' requests.*" BDO considers that the absence of switching should not be assumed to be a result of intense competition. There may be several reasons for an absence of switching, which may include contentment with the service received

⁸⁸ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/characteristics_of_long_audit_tenure_companies_deloitte.pdf

⁸⁹ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/characteristics_of_long_audit_tenure_companies_kpmg.pdf

from the current auditor, but this should not be assumed to indicate or result from intense competition.

18 CLAUSES IN LOAN AGREEMENTS

18.1 KPMG⁹⁰

KPMG:

18.1.1 implies in its response that significant capital (debt or equity) providers might not have sufficient confidence to make capital available if they can not specify their terms, including those relating to appointment of specified auditors. BDO believes that this overstates the position so far as choice of auditor is concerned, having regard in particular to the views of investors surveyed by Oxera; and

18.1.2 claims that "*companies are easily able to relax any restriction so as to include other international firms of auditors should they so wish*". However, the smaller the company and the weaker its negotiating position opposite lenders, the less this will be true. An expanding company which aspires to join the FTSE 350 may feel less able (or be less willing) to try to negotiate a relaxation in contractual restrictions with its lenders in relation to choice of auditors than (for example) a FTSE 100 company; but such clauses may (either in isolation or in combination with other factors, such as intermediary pressure and reputational advantages) cause such a company to move from a mid-tier firm to a Big Four firm before it joins the FTSE 350. Once such a move has occurred, it is unlikely to be reversed. The claim that such clauses have "*negligible practical impact*" should therefore be regarded with scepticism. BDO considers that the impact of such clauses is more likely to be felt on companies before they join the FTSE 350, although that impact may be long lasting.

18.2 PwC⁹¹

PwC claims at paragraph 7 that "*we do not believe that these clauses comprise any material barrier to entry for mid-tier firms to the market for the audit of FTSE 350 companies*". However, BDO considers that these clauses must be seen as one of several barriers to entry which together have a significant exclusionary effect, particularly in relation to growing companies which aspire to join the FTSE 350.

19 ECONOMIES OF SCALE IN OPERATING COSTS

19.1 KPMG⁹²

KPMG refers at paragraph 2.3 to economies of scale arising from "*relationship-specific investments that we make in auditing each individual client's business*". This is consistent with the CC's Working Paper on Engagement Level Profitability, which found at paragraph 11(a) that there was a relationship between longer audit tenure and increased auditor profitability (see 7.5.5, 9.3.5, 10.3.6 and 12.3.2 above).

⁹⁰ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/cbs_clauses_in_auditor_loan_agreements_kpmg.pdf

⁹¹ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/cbs_clauses_in_auditor_loan_agreements_pwc.pdf

⁹² http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/economies_of_scale_in_operating_costs_kpmg.pdf

20 VIEWS OF INVESTORS AND OTHER STAKEHOLDERS

20.1 Deloitte⁹³

Deloitte:

- 20.1.1 notes at paragraph 2.5 that the "*content and format of audit reports is determined by statute and regulators, not individual firms*". Although this is technically correct, BDO considers that this understates the influence that the Big Four firms have on the professional bodies and regulators that shape the relevant legislation. Moreover, the audit report content specified by regulations and statute is only a minimum. No one has expanded it despite urging from the FRC to do so⁹⁴;
- 20.1.2 claims at paragraph 3.4 that "*it is clear that investors recognise that the audit committee is best placed to select the audit firm that is best placed to deliver the highest quality and value*". However, BDO considers that the CC does have evidence to support the CC's principal theory of harm relating to principal-agent issues. For example, 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);
- 20.1.3 suggests at paragraph 4.2 that the "*size of funds under management can be more useful in considering what constitutes a consensus than relying purely on the number of investors*". BDO notes that investors contacted by Oxera in conducting its survey were selected on the basis of the size of funds under management (the aim being to include as many of the largest investors as possible) and included some of the largest funds managed in the UK;
- 20.1.4 dismisses at paragraph 5.8 BDO's suggestion that the current approach to auditing may be evidence of a lack of competition between audit firms as "*absolutely wrong*", with "*no evidence to support it*", and cites the fact that audit reporting in respect of the AIM market is no different from audit reporting in respect of FTSE 350 companies as evidence. BDO is not, however, suggesting that individual firms have control over the scope of the audit. BDO's view is that a high degree of concentration in markets reduces the incentive to innovate. BDO also considers that the professional bodies and regulators have generally not been a major force for innovation in audit reporting (at least until the CC's investigation was under way) and that this may reflect the influence (whether conscious or not) of the Big Four firms on those professional bodies/regulators; and
- 20.1.5 claims at paragraph 5.9 that the issue of audit reporting is not "*connected with market structure, dynamics or competition*", but since audit reporting is at the heart of the service provided by auditors, BDO considers that it should not be regarded as an entirely separate topic: it is closely linked to innovation and service provision.

⁹³ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/views_of_investors_deloitte.pdf

⁹⁴ For example, by Richard Fleck, then Auditing Practices Board Chair, at the Audit Quality Forum : Promoting innovation in audit reporting and communication (24 April 2012) : <http://www.presenta.co.uk/AQF/AQF240412s3.html> .

20.2 **KPMG**⁹⁵

KPMG:

20.2.1 claims on page 2 that the sector's lack of progress on additional information to be provided is because there is a *"lack of demand being presented to individual companies or their auditors"*, which may imply that individual audit firms can influence the audit output (in contrast to Deloitte's comments cited at 20.1.1 above);

20.2.2 equates on page 2 the audit process with other *"matters of importance to shareholders where visibility is greater to the company's Board"*. BDO disagrees: the public nature of the appointment of external auditors and the role of such auditors in relation to a company's financial statements gives the audit process a special significance; and

20.2.3 considers on page 3 that audit committees are *"best placed to identify the audit firm best placed to meet the company's needs"*, but see 20.1.2 above.

20.3 **PWC**⁹⁶

PWC:

20.3.1 states at paragraph 7 that it is *"not aware of any evidence to substantiate"* the CC's theory of harm in respect of principal-agent issues, but as noted in 20.1.2 above, BDO considers that the CC does have evidence to support its theory of harm relating to principal-agent issues;

20.3.2 reiterates at paragraph 1.3 of the Annex its earlier claim that *"widespread disclosure of information relating to the detail of the audit process would not only be wholly impractical, but would also undermine commercial confidentiality and compromise the integrity of the audit process..."*. BDO does not dispute that widespread disclosure, without the necessary checks and balances, would be undesirable: however, the rather extreme position drawn by PwC should not skew the debate on what would be a reasonable level of disclosure; PwC itself has stated (as noted in footnote 16 to its response) that *"the time is right to significantly enhance auditor reporting"*; and

20.3.3 claims at paragraph 1.5 of the Annex that the low incidence of FRRP press releases and accountancy restatements, as well as *"very low level of litigation and regulator complaints"* is evidence of PwC offering a *"safer' audit in respect of large companies"*. However, an audit firm can only be considered a *"safer"* pair of hands if other auditors are demonstrably less safe, but the statistics cited by PwC do not reveal how other audit firms compared. Moreover, there have been occasions when PwC has been associated with regulatory criticisms or alleged audit failures in relation to large companies (e.g. in relation to JPMorgan), whether or not such incidents progressed to formal complaints or litigation.

⁹⁵ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/views_of_investors_kpmg.pdf

⁹⁶ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/views_of_investors_pwc.pdf

21 ECONOMETRIC ANALYSIS OF AUDIT COSTS

21.1 Deloitte⁹⁷

Deloitte claims:

- (a) at paragraph 2.5 that because there are no economies of scale with respect to auditor size: "*the relative positions of the Big Four and mid-tier auditors therefore can have no impact on the costs that mid-tier firms would need to incur to compete effectively for the supply of audit services to FTSE 350 companies.*" BDO notes in response that while the evidence does show that mid-tier firms can potentially offer audit services to large clients as efficiently as Big Four firms (and therefore there are no inefficiencies associated with mid-tier entry), mid-tier firms cannot currently 'compete effectively' for FTSE 350 audits due to substantial barriers to entry. These barriers have been variously described in BDO's submissions and the CC's working papers, and include explicit and implicit Big Four-only clauses, Big Four alumni networks, the 'IBM effect', and low rates of tendering and switching;
- (b) at paragraph 2.7 that: "*The presence of economies of scale with respect to client size therefore makes it less costly for mid-tier firms to audit larger clients than would be the case if those scale economies did not exist. This enhances the feasibility of mid-tier auditors implementing a strategy of incremental expansion*". The first part of this argument is simply a restatement of the CC's findings. The second part, however, is incorrect. The CC's finding of economies of scale with respect to client size applies not only to mid-tier firms but also to Big Four firms – the finding is symmetric. Therefore the existence of these scale economies does not make it any easier for mid-tier firms to win large company audits than if such scale economies did not exist. In fact, the substantial barriers to entry for mid-tier firms mean that mid-tier firms rarely have the opportunity to benefit from the economies of scale that Big Four firms currently enjoy when auditing large FTSE 350 companies; and
- (c) at paragraph 3.1 that the CC's finding that audit costs reduce over time during an engagement results from increased efficiency, and (at paragraph 3.2) that cost reductions are not retained by the auditors, but are shared with clients. BDO points out that this result should be seen in conjunction with the CC's finding in the Descriptive Statistics working paper that fees rise over time after the first year of an engagement (see Figure 6 in the Descriptive Statistics working paper). Fees as a proportion of turnover rise more slowly over time than fees, suggesting that change in audit scope might explain some of the fee increase, but fees do not fall as might be expected if efficiency savings were being fully shared with clients. Pass-on of efficiency savings is therefore incomplete, when looking at the evidence in the round.

⁹⁷ http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/econometric_analysis_of_audit_costs_deloitte.pdf

Attachment 1⁹⁸

BDO announces merger with PKF teams in China

BDO is pleased to announce that a significant part of PKF China will join BDO Li Xin in China before year end 2012. The move strengthens BDO Li Xin's position as the largest Chinese owner-managed audit CPA firm and makes the merged firm the market leader in serving State-owned Enterprises in China.

As a result of the merger, approximately 350 PKF partners and staff have joined BDO, augmenting BDO China's position in Beijing, Shenzhen and Wuhan in particular. The partners and staff of PKF joining BDO are considered to be among the top professional service providers by both the State-owned Assets Supervision & Administrative Committee (SASAC) and the National Audit Office (NAO).

Mr Jiandi Zhu, managing partner of BDO in China and recently appointed to the BDO Global Board, is delighted with this development. *"For BDO China, local market knowledge, industry expertise and technical skills form the basis of the commercially astute and robust opinions we give to our clients. The combined expertise of our partners and staff with State-owned enterprises (SOEs), as well as with listed companies - including H-share businesses – will build upon our approach as well as our position in these market segments."*

"Furthermore, backed by the high standards, global systems and quality service delivery for which the international BDO network is known, we can continue to support the international expansion of our clients, as well as their domestic success."

Martin van Roekel, CEO of BDO, says: *"I am extremely pleased by the positive outcome of our discussions with this addition to BDO China, as such a joining of forces not only strengthens BDO's position but will contribute to our future growth in China. I have just returned from the country, where I visited the impressive new BDO Li Xin office in Beijing. The new partners all expressed their positive agreement with the merger, in particular because they know that the BDO brand stands for exceptional client service, delivered by talented people, and they are very pleased to be part of it."*

"Of course, this news follows on from the announcement earlier this week by the BDO Member Firm in the UK that they are in advanced discussions to merge with PKF (UK) LLP early next year, cementing our position as the largest international accounting organisation focused on the mid market."

⁹⁸ See: <http://www.bdo.my/news-releases/bdo-announces-merger-with-pkf-teams-in-china.html>