

**Confidential**

The Competition Commission  
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19 April 2012

Our ref: 011695/JAR/sed

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For the attention of Dipen Gadhia Esq, Inquiry Manager

Dear Sirs

We are responding to the recent publication of the non-confidential version of the "Summary of Deloitte's response to the Competition Commission's Marketing [sic] and Financial Questionnaire", dated 6 March 2012 (the "Deloitte Summary").

We consider that the Deloitte Summary has misinterpreted information in our previous submissions to the CC and incorrectly represents the competitive dynamics in the audit market, in particular as regards the opportunities for expansion of mid-tier firms in providing large company audits, and the relationship between audit fees and concentration. We believe it to be important that these matters are brought to the CC's attention. We will not comment on all aspects of the Deloitte Summary, as it would be unhelpful for all parties (including the CC) to engage in a "tit-for-tat" written exchange of views on every matter which arises during this inquiry. We are happy for the CC to publish this response on its website.

**Misinterpretations of BDO's views**

The Deloitte Summary claims (at para 2.22) that the success of firms such as ourselves to develop non-audit services with FTSE 350 companies "*should provide a compelling opportunity for those firms to win audit engagements*". It then claims (at para 2.23) that BDO and Grant Thornton have not leveraged those relationships to gain a larger share of the reference audit market and that "*This is perhaps unsurprising given that BDO and Grant Thornton themselves concede that they are incapable of providing high quality Audit Services across the FTSE 350*". They then reference this (in footnote 25) to our "*surprising*" statement that we "*would be reluctant to invest in acquiring [these capabilities] because of the uncertainty of success*".

We regard these comments as a highly selective and misleading interpretation of our submissions. In particular:

- (1) We have made it abundantly clear that BDO is entirely capable of providing a high quality audit service across the FTSE 350, except to a small number of the largest companies which for particular reasons are currently beyond BDO's capabilities. This lack of capability will relate to specific sector skills and experience, typically with the largest financial institutions. What the audit market needs – and the CC investigation can help with this – is a reduction in the perception bias and prejudice against mid-tier firms, and a greater number of tender opportunities for large company audits. These changes would encourage additional investment.





- (2) The typical buyer of a non-audit service will not be the Audit Committee, but is more likely to be a senior member of the finance team, such as the CFO, the Financial Controller, or the Head of Tax. A finance team purchase will be more technical and value driven. The buying criteria of finance professionals and Audit Committees will be different. This is influenced both by the public nature of the audit appointment and by the composition of Audit Committees more generally. In this context, we refer the CC to the comments made in the House of Lords on 14 March 2012 by Lord Hodgson of Astley Abbots, a non-executive director of Marstons, a FTSE 250 company (see: <http://www.publications.parliament.uk/pa/ld201212/ldhansrd/text/120314-gc0001.htm>):

*"I am the senior independent director - the SID, as it is known in the trade - of one of the FTSE 250 companies. I am a member of its audit committee and chair of its remuneration committee ... The committee hit the nail on the head when it mentioned in paragraphs 18.vi and 18.vii, "the perception that big is best", and, "the reputational assurance of using Big Four auditors". These things are at the heart of the difficulty that we face. I do not wish to press the noble Lord, Lord Currie of Marylebone, but I think it unlikely that my co-directors would be prepared to take on a firm outside the big four, even if it were demonstrably cheaper and probably even if the service was the same. We are reaching the tipping point, but we are not there yet ... The company of which I am the senior independent director is a simple company. We are entirely in the UK; we have no overseas operations. Our final salary pension scheme is closed. The only complication in our business is that we have some hedging and some derivatives for our longer-term borrowings."*

This illustrates the challenges and barriers faced by audit firms outside the Big Four, even if they face a cheaper and equivalent audit service. It also illustrates why there are different challenges in relation to the supply of audit services (where the supplier is chosen by the audit committee) than for the supply of non-audit services (where the supplier is chosen by a senior member of the finance team).

- (3) The reference to our approach to investment was in the context of these highly specialist sectors, made up of the very largest companies, and to BDO making large commitments without there being more regular tender opportunities to expand into large company audits. As we said at our hearing with the CC on 13 February, the reference market is not homogeneous. We gave the CC the practical example of our potentially hiring a 'large bank team', and having it sit idle, at very high cost, until we waited for the rarity of a tender opportunity arising in that sector. We reiterate that we are willing and able to continue to invest in our practice and are prepared to take normal commercial risks in so doing. However, our reluctance to invest recklessly should not be taken as indicating that we have no potential investment plans across the reference market as a whole, nor that we have not made significant investment in our practice in recent years. In addition, Deloitte seems to imply, at various points, a parallel between its own position in 2002 adopting a 'Strategy and Growth Plan' (para 2.4) and what it sees as the opportunities of BDO and others to invest in the present day. It is obvious that when Deloitte adopted its growth plan in 2002 –immediately after its absorption of the Andersen UK practice (and already having 67 FTSE 350 clients of which 18 were FTSE 100 companies) – Deloitte was hardly in the position of a firm 'entering' the FTSE 350 market. Paragraphs 3.7 to 3.16 of the Deloitte Summary discuss the discernability of audit quality. As the references to which they are responding have been redacted (though we find it hard to understand how those references can be said to be sufficiently confidential to justify being redacted), it is difficult for us to tell if this is a response to comments from us or from a third party. However, there is reference to a similar point in paragraph 26 of the summary of our hearing with the CC on 13 February. The Deloitte Summary

is based on the contention that they have extensive and challenging engagement with “*most company stakeholders*”. It seems, however, that ‘stakeholders’ for Deloitte are either the company’s officers or its employees, as the only external engagement they refer to is the AGM, but most observers agree that AGMs are no occasion for ‘engagement’ of any type. Depending on the size and complexity of the company it is likely that audit committees will meet with auditors only twice a year. It is therefore difficult to see how this endorsement of quality by stakeholders (in particular investors) actually takes place.

Paragraph 4.7 of the Deloitte Summary notes their awareness that some parties have made submissions to the CC that consider ‘choice’ as an additional heading of detriment. This was certainly true of us. Paragraph 4.8 states that “*there is no evidence that the current level of choice is insufficient*”. This is incorrect, in light of the evidence that companies in certain sectors, in particular banking, have a choice among only one or two audit firms, and that 28% of audit committee chairs surveyed by Oxera in 2006 disagreed with the statement that there is enough choice of alternative auditors. Financial regulators have been concerned ever since the collapse of Andersen that four audit firms is not enough, as a 4-to-3 scenario would create systemic risks. We further refer to the summary of the CC’s hearing with Hermes Equity Ownership Management and in particular to the appended letter from Hermes and other major investors dated 3 July 2006 which stated that “*having only four service providers is not conducive to a properly competitive market for audit services*”. The CC might also look at the evidence given to the House of Lords Select Committee, such as the comments from Mr Guy Jubb of Standard Life Investments: “it is the lack of choice that is the area of particular concern to us”.<sup>1</sup>

### Price and concentration

Section 6 of the Deloitte Summary claims that there is no relationship between audit fees and concentration, and criticises the work of Oxera and the OFT on this subject. Unfortunately Deloitte has not made public its work on price-concentration, so we are unable to comment properly on the merits of that work. In any event, the CC plans to carry out its own econometric study of price-concentration with a more up-to-date and comprehensive set of data.

However, for the sake of clarification we note the following omissions from and errors in the Deloitte Summary:

- (1) Deloitte omits to mention that various independent studies, other than those by Oxera and the OFT, have found there to be a significant link between price and concentration. We are aware that the CC has commissioned a literature survey. Deloitte (para 6.6) makes the rather self-serving comment that: ‘Despite a critique of the robustness of Oxera’s analysis by PwC in 2008, this analysis formed a significant part of the OFT’s evidence base in making its reference to the CC.’ So Deloitte places weight on PwC’s critique, but fails to note that a 2008 study by the LSE in essence came to the same findings as the Oxera study (the LSE study was commissioned by BDO and has been made available to the CC).
- (2) Deloitte criticises Oxera’s finding on the relationship between price and concentration. We cannot see any mention of a critique of Oxera’s finding that there is a ‘Big Four premium’, which was also found in the LSE and Cardiff Business School studies, nor of Oxera’s econometric analysis of switching (section 3.3).

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<sup>1</sup> <http://www.parliament.uk/documents/lords-committees/economic-affairs/auditors/ucEAC110111ev9.pdf>

- (3) Deloitte states in para 6.8 that it verified the FAME database and concluded that the gaps and inaccuracies in the data ‘fatally undermine its robustness as a datasource’. As BDO and its advisers stated at the data meeting at the CC (6 March), the FAME database has its limitations, but that does not mean that the many academic studies on auditing and other topics that use FAME should be completely disregarded. Oxera’s data review reduced the number of observations from 11,260 to 6,600, which is still a significant number of observations (Deloitte claims incorrectly that Oxera did not indicate that any data cleaning was carried out – the Oxera report does indicate this in section 2.4). Furthermore, as also discussed at the CC meeting on 6 March, there is no reason why any remaining errors in the data should be biased one way or another.
- (4) Paragraph 6.12 criticises Oxera’s model for not including variables on audit risk or company size. The Oxera analysis does include a variable for company size, and contains sector dummies to control for sector-specific complexity or risk in the audit process. There is no reason why Deloitte’s particular choice of control variables would be superior to Oxera’s, especially in light of the fact that, in the end, Deloitte’s model seems to have only three variables that have a statistically significant relationship with audit fees (para 6.13). In any case, the CC can test all the various control variables in its own analysis based on the new dataset. BDO has made a number of suggestions for such control variables in an email from Berwin Leighton Paisner LLP dated 27 March 2012 (18:42).

### Profitability

The Deloitte Summary correctly recognises that the IRR and WACC are conceptually the most appropriate method for measuring economic profitability. However, it quickly dismisses the IRR/WACC framework as being too difficult to apply to the audit market and focuses instead on net profit margins and measures of profit per partner.

It is true that it is challenging to apply the IRR-WACC framework to the audit market. However (as Deloitte acknowledges) Oxera in its 2007 report for the European Commission employed a cost of capital calculation, and the CC has previously calculated IRRs or ROCEs in markets where intangible assets are important (and has examined WACC where equity betas for the activity in question are difficult to obtain). It may therefore be premature to drop measures of economic profitability in favour of the less useful metrics, and, while recognising the practical challenges noted by Deloitte, we would welcome the opportunity to explore with the CC how more robust measures of profitability may be developed and used for this market investigation.

We note that Deloitte makes frequent references to substantial ‘investments’ that it has made. While the details of the investments are redacted, the data provided by Deloitte on historic investments will presumably assist the CC if it seeks to calculate the asset base on which profits are earned.

We would also note that even if reliance on ex-post economic profitability measures cannot be absolute, due to such difficulties of data availability, these difficulties are substantively removed when undertaking an analysis of prospective returns - such as may be necessary in considering “entry profitability” - associated with the change in market position of a non-Big Four firm. In this instance, the approach of assessment of prospective return on investment will be more straightforward, and an assessment of cost of capital will be necessary. Oxera carried out analysis of “entry profitability” in its 2006 and 2007 studies and therefore the feasibility of such an exercise should not be in doubt.

Finally, even if Deloitte's Return on Sales results are taken at face value (and we note they are the result of an undisclosed cost allocation exercise), then as far as we can tell they only indicate that Deloitte is very significantly more profitable than the non-Big Four firms. This is not a novel finding, confirming as it does other research on the 'Big Four Premium', but it does appear to demonstrate that Deloitte enjoys some combination of market power and other factors leading to its much higher margins. Deloitte interprets the results as indicating that profits reflect reasonable returns and higher quality, but the obvious alternative explanation is a high degree of market power, either alone or together with the other Big Four Firms. A more refined profitability analysis ought to be able to unpick these factors, by taking account of investment and risk.

We do hope you find the contents of this letter helpful. As you know, we have queried the extent of redactions made from the Deloitte Summary. We are responding at this stage in the interest of timeliness, but we might wish to make further comments if and when further parts of the Deloitte Summary are made available. If there are any matters which you would like us to expand or explain, please do call James Roberts on 01293 591087 or email [james.roberts@bdo.co.uk](mailto:james.roberts@bdo.co.uk).

Yours faithfully



BDO LLP