

## COMMENTS OF BDO LLP ("BDO") ON THE COMPETITION COMMISSION'S BARRIERS TO ENTRY: REPUTATION AND EXPERIENCE WORKING PAPER<sup>1</sup>

### 1 BARRIERS TO ENTRY: REPUTATION AND EXPERIENCE

#### 1.1 Introduction and summary

BDO agrees with the CC's general conclusion in paragraph 80 that the combination of the difficulty of:

- (a) demonstrating experience; and
- (b) overcoming additional reputational hurdles

hinders the larger mid-tier firms from expanding their client base within the FTSE 350. As recognised elsewhere by the CC, while many features of the market, such as intermediary behaviour, continue to block new entry, it is not commercially rational for mid-tier firms to spend considerable resources on targeting FTSE 350 audits:

*"Whilst the four largest firms may be able actively to participate in any tender in the FTSE 350, the smaller firms were less likely to succeed and thus, targeting of specific large clients may not be productive."*<sup>2</sup>

#### 1.2 Incumbency advantage

1.2.1 BDO agrees with the CC that *"Reputation and experience may create an incumbency advantage for current suppliers and hinder entry to the market..."* (paragraph 1). As acknowledged by the CC, this has a direct impact on the decision of a FTSE 350 company to tender at all: in addition, the length of tenure of certain audit firms means that the advantage can be substantial even during tender processes. BDO notes however that - despite such an advantage - the results of the CC's survey indicate that where the company decides to conduct a tender process, the incumbent auditor is usually displaced.

1.2.2 The incumbency advantage is reinforced by the perception among the purchasers of audit services that Big Four staff are of a higher quality than the staff of other audit firms (see 3.3 below).

1.2.3 BDO encourages the CC to investigate econometrically the extent of tenure or learning-by-doing effects (paragraph 106 of the CC's Working Paper on the Nature and Strength of Competition in the Supply of FTSE 350 Audits).

#### 1.3 Quality of staff

1.3.1 BDO agrees with the CC that there is a *"common belief amongst FTSE 350 FDs that the quality of staff in the Big Four firms is higher"* (paragraph 38). BDO considers such a view to be misconceived, but not surprising given that the majority of such FDs are Big Four alumni and have worked with only Big Four audit firms (see paragraph 24 of the CC's Survey Results). In BDO's view, this issue is inextricably

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<sup>1</sup> Reference to paragraph numbers are to paragraphs of the relevant working paper ("WP") unless stated otherwise.

<sup>2</sup> [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/barriers\\_to\\_entry\\_internationalnetworks.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/barriers_to_entry_internationalnetworks.pdf), para 57.

linked with its concern that Big Four alumni are more aware of the capabilities of, and therefore tend to favour, the Big Four. BDO notes that the CC acknowledges that such Big Four backgrounds "*could make them [CFOs/ACCs] less aware of the quality and experience of non-Big Four firms*" (paragraph 120 of the CC's Working Paper on the Nature and Strength of Competition in the Supply of FTSE 350 Audits).

- 1.3.2 BDO's view is compounded by the fact that the purchasers of audit services – FDs, CFOs and ACCs – do not appear to be aware of the current capabilities of the mid-tier audit firms, and appear to make no effort to, refresh their (often outdated) market knowledge: the CC's survey finds that "*CFOs and ACCs in the FTSE 350 companies often did not have up to date knowledge of the capability of Mid-tier firms and about the nature of their international networks*" (paragraph 48) and that "*some views appeared founded on distant experience*" (paragraph 42). This is consistent with the CC's case studies.

#### 1.4 **Use of Big Four firm is the accepted norm**

Paragraph 55(a), (b) and (g) strongly suggest an "*IBM effect*" whereby a Big Four auditor is chosen, not necessarily on the merits, but because if things go wrong the ACC cannot be blamed as they chose the "*safe option*". This point deserves much more attention from the CC. Competition cannot be said to be functioning well if, as indicated by the Company B FD, companies are excluding firms outside the Big Four for the reason that "*it would look odd to have a Mid Tier firm*".

#### 1.5 **Intermediary Influence**

BDO notes that one selection criteria factor which is cited as being very important or important by over 80% of respondents is the "*Reputation of audit firm with investors, corporate brokers, analysts or external advisors*": (see paragraph 34, Table 11 of the CC's Survey Results Working Paper). Reputation with such intermediaries even beats the strength of international networks as a factor, yet the latter (rather than the former) is often given as a reason for not using mid-tier firms. This supports BDO's contention that the influence of intermediaries on choice of auditor is very significant and often operates to the exclusion of non-Big Four firms.