COMMENTS OF BDO LLP ON THE COMPETITION COMMISSION'S WORKING PAPER ON BUNDLING OF AUDIT AND NON-AUDIT SERVICES

1 CONSULTING EXPERTISE

BDO is aware that the Big Four deploy their consulting expertise on audit bids to demonstrate broader sector credentials and experience as a way of differentiating themselves. However, the services that such consultants offer will often be incompatible with the audit role, e.g. for ethical reasons. The implications which prospective audit clients may form is of the offer or availability of a bundle of services and knowledge, although that may not in fact be available to them. One recent example of which BDO is aware involved [✂].

This issue does not appear to be addressed in the Working Paper, but should be taken into account by the CC.

2 ANALYSIS OF THE CC'S DATASET

2.1 Paragraph 4(c) refers to quantitative analysis of engagement profitability to examine whether there is any evidence of price differentiation. If the dataset can support such analysis, it should also support some form of price concentration analysis and profitability analysis. It is difficult to judge the quality of the dataset, but we note that Annex 2 paragraph 3(c) describes 16% of the data (716 data points of 4,616) being dropped due to an observed profit margin in excess of 100%. BDO has concerns about whether, in the context of a market investigation, it is advisable to drop a significant number of observations on the basis that profits appear 'too high'. We also note that Annex 2 paragraph 3 point (d) seems to include a typo: it refers to the exclusion of observations with a "*profit margin of less than 100 per cent—12 data points*". Presumably this should read "*profit margin of less than 0 per cent*"?

2.2 Paragraph 7 states that firms are "*not allowed to differentiate their pricing on the basis of NAS*", yet paragraph 18 says the CC has found "*some instances where NAS were offered at a discount if that firm was selected as auditor*", which, in the absence of economies of scope, would be instances of mixed bundling. Paragraph 48 also refers to similar examples. It is unclear whether the CC has fully investigated this issue, since the CC says at paragraph 48: "*we are not able to comment on whether such discounting excludes firms which are not the auditor from providing these services to develop a client relationship*".

2.3 Paragraph 25 notes that NAS fees were lower than the audit fee for 74.4% of FTSE 350 companies. BDO notes that this leaves around 25% of public interest entities who have been paying more for NAS than for audit. In these circumstances there are two potential concerns:

(a) where the auditor of a FTSE 350 company derives more income from non-audit services than from audit, this creates a potential independence problem, insofar as the non-audit services may involve activities (such as consulting) which create potential conflicts of interest; and

(b) since Big Four audit firms can evidently derive much more income from NAS than from audit for certain FTSE 350 companies, the question arises as to whether it is in their rational financial interest to bid competitively to win an audit with a client for whom they already provide substantial NAS

(in circumstances where the independence rules entail that certain NAS will be reduced if the audit tender is won).[1]

2.4 These concerns are potentially significant, and seem to apply more broadly than 25% of the FTSE 350, according to the CC's findings in other working papers:

> *"(g) Whilst the majority of FTSE 350 companies surveyed did not consider their choice to be limited between the Big 4 firms, there was a substantial minority (**around 40 per cent**) for which this was the case. The main reasons given were related to conflict of interest and independence issues. We consider that the number of potential bidders could adversely affect perceptions on the potential benefits to be had from going through a tender process*."[2] [emphasis added]

2.5 To get an indication of the potential scale of the issue, BDO asked Oxera to examine the CC's public dataset. Figures 1 and 2 below illustrate that in a given year (2010), the ratio of non-audit to audit fees for a FTSE 350 audit client can reach as high as 10:1, and that over time (2002-10), for certain FTSE 350 companies the ratio of non-audit to audit fees can be 2:1, 3:1, or even approaching 4:1. The proportion of FTSE 350 companies falling into the group where non-audit fees exceed audit fees is around 25% in Oxera's analysis, the same proportion as in the CC's analysis.

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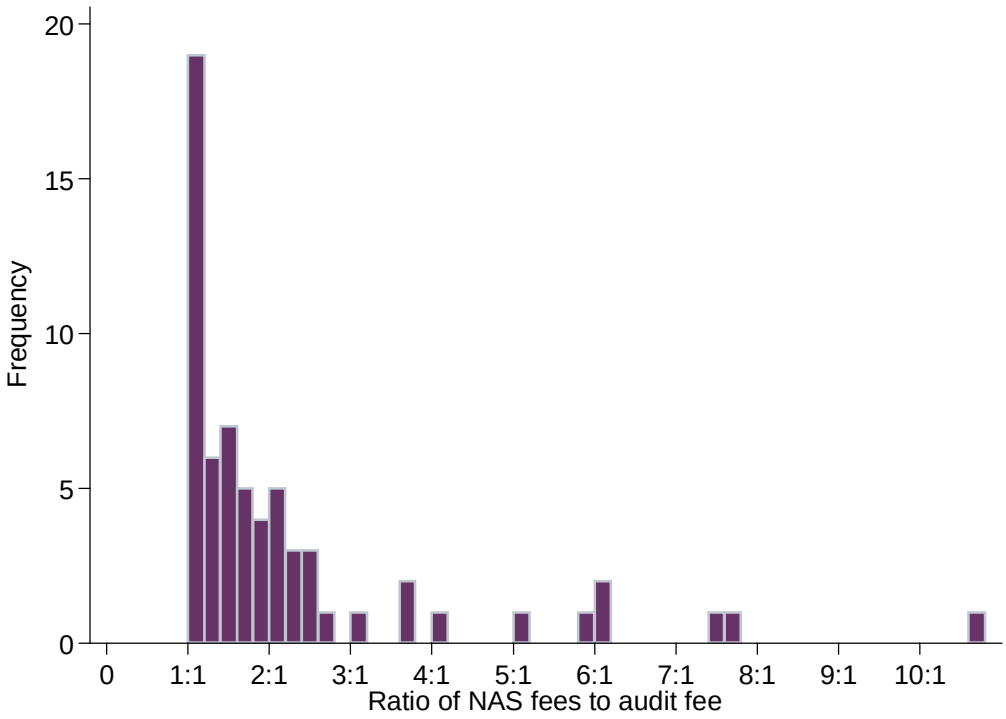
1 The CC confirms at paragraph 33 that NAS can be much more valuable than audit: "*Whilst a large number of companies may use their auditors for some NAS, the value of this may be small in comparison with the total value of NAS/professional services supplied to the company*."

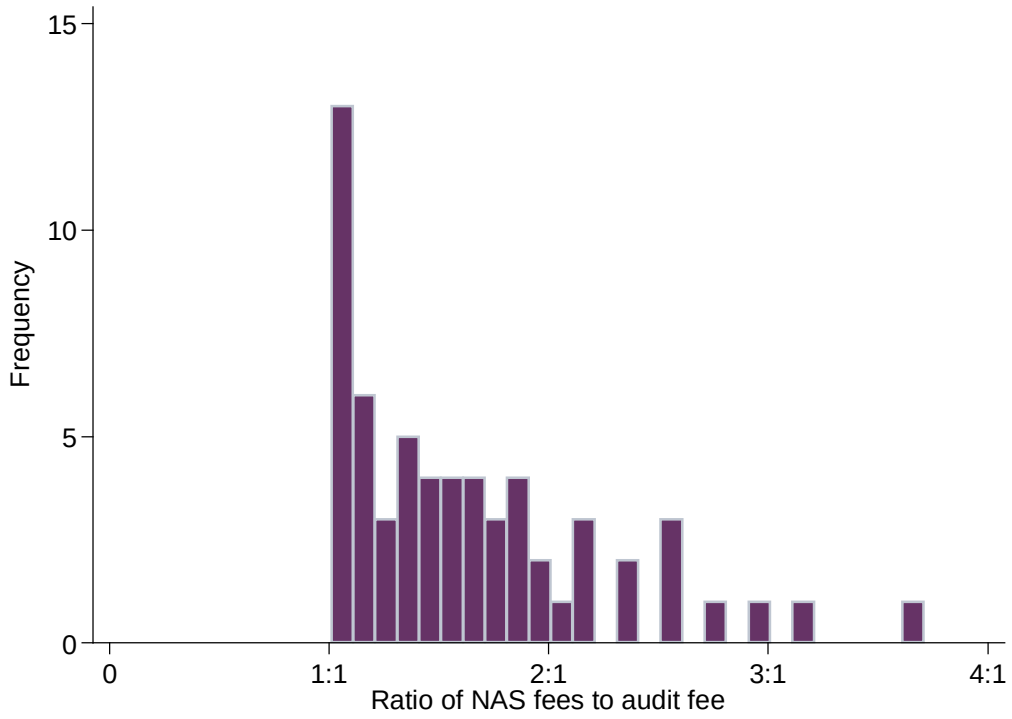
2 http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/nature_and_strength_of_competition.pdf, paragraph 141.

Figure 1 Distribution of ratio of NAS fees to total audit fees for FTSE 350 in 2010, where NAS: audit ratio ≥ 1.1



Note: Ratios of less than 1:1 have been excluded from the picture.
Source: Oxera analysis of CC public dataset.

Figure 2 Distribution of the ratio of total NAS fees to total audit fees for FTSE 350, 2002-2010, where NAS: audit ratio ≥ 1.1



Note: Ratios of less than 1:1 have been excluded from the picture. Only companies that have complete data for the period 2002-2010 have been included.
Source: Oxera analysis of CC public dataset.

3 **TABLE 6**

In table 6, on page 21, the "High" and "Low" headings appear to be the wrong way round, save for the results for basic materials.