

COMMENTS OF BDO LLP ON COMPETITION COMMISSION WORKING PAPER ON ENGAGEMENT LEVEL PROFITABILITY ANALYSIS

- 1 Table 1 shows average engagement profitability (standard hours, combined, period average) as 51.3%. Table 2, according to the CC's description, differs only from Table 1 in that partner time is included as a cost in Table 2. Observed profitability in Table 2 should logically therefore be *lower* than in Table 1. BDO notes, with some concern, the result in Table 2 that average engagement profitability (standard hours, combined, period average), with partner time included as a cost, shows a *higher* rate of profitability, at 65.3%. BDO assumes this is an error, but would appreciate an explanation by the CC, given that the CC uses its calculations to reach various conclusions.
- 2 Paragraph 11(a) notes that auditors with tenures of over five years achieve greater profitability. BDO infers from this finding that "*the threat of tender*" does not in fact achieve the same result for companies as actually tendering and switching auditor, and notes that this is consistent with the data on audit fees seen in the CC's public dataset (which indicates higher fees for longer tenure).
- 3 Paragraph 18 indicates that "*a large firm would be in a better position*" to absorb the familiarisation costs associated with each new client. Given the CC's findings elsewhere that economies of scale as between BDO and the Big Four are not significant, BDO suggests that "*a large firm*" in paragraph 18 should not be read as a reference only to the Big Four.
- 4 Paragraph 23(b) states that the assessment of aggregate profitability "*should not be used to reflect the overall profitability of a firm's audit business*". Whilst it may well not be a perfect proxy for profitability, it appears to be the best available to the CC at present and an interesting indication of relative profitability of different audit firms (in particular, how profitability of each of the Big Four compares with that of other firms), whilst acknowledging in particular that the calculation of partner costs is imperfect. This is consistent with the CC's own observation at paragraph 4 of Appendix 2 that "*the measurements of profitability should be treated as relative rather than absolute measures of profitability*".
- 5 Paragraph 25 remarks that the "*steady level*" of audit profitability is "*noteworthy*". BDO agrees, and notes that this is consistent with the audit activity having a low cost of capital (using a CAPM framework to estimate cost of capital). If, as it would appear, audit profits are similar to, but more stable than, profits from other activities of audit firms, this would indicate that audit is more likely to be associated with profits in excess of the cost of capital.
- 6 Paragraph 40 states that "*In all industries, aggregate margins were greater than average margins*". This indicates that larger audits (such as those of companies in the FTSE 100) are more profitable. Since the Big Four conduct nearly all of these larger audits, this is consistent with the existence of a Big Four premium for FTSE 350 audit work.
- 7 BDO does not understand why the first half of each of Table 13 and Table 14 (and the whole of Table 18 and Figure 6) have been redacted, as these relate to all firms rather than being firm specific. The redactions effectively prevent informed analysis of and comment on those Tables.
- 8 Appendix 2, paragraph 4 indicates that the CC regards its estimate of the cost of partner time as "*conservative*" and that it "*will overstate the level of profitability of engagements*", based upon a comparison with the information "*some parties have*

been able to provide". BDO understands this as a reference to the estimates of partner salary provided by PwC.¹ It is not evident to BDO why the CC has not undertaken its own estimate of partner salary, using a benchmark approach, given the centrality of these estimates to profitability assessment in the relevant market. Unless the CC has its own benchmarked estimate, or checks and endorses the estimates of PwC, BDO considers that the CC cannot reach the conclusion that its simplified approach (doubling the cost of directors) is conservative or otherwise.

- 9 BDO notes that because the CC has found that the proportion of partner time is higher for the larger engagements relative to smaller engagements, engagement profitability for larger assignments is especially sensitive to the robustness of estimates of the cost of partner time.
- 10 In Appendix 2, paragraph 9(d), the figure "100" in the phrase "*profit margin of less than 100 per cent – 12 data points*" cannot be correct; presumably it should read "0" per cent (i.e. those which had negative profitability).

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