COMMENTS OF BDO LLP ("BDO") ON THE COMPETITION COMMISSION'S EVIDENCE OF TACIT COORDINATION WORKING PAPER[1]

1 TACIT COORDINATION

1.1 The CC's analysis focuses on pricing, market share and tendering, but not other forms of tacit coordination. BDO considers that all the conditions for tacit coordination (including in particular high concentration and stability of market shares, stability of demand, and high and persistent barriers to entry and growth) are met in relation to the reference market: see BDO's comments at 3.5 below regarding price transparency.

1.2 BDO therefore encourages the CC to consider other possible areas of tacit coordination between the Big Four, including in particular:

(a) reinforcing barriers to entry and expansion, in particular in relation to reputation and discouraging switching; and

(b) in relation to the regulatory framework.

These are more subtle but nevertheless potentially very effective areas for tacit coordination between the Big Four, bearing in mind (among other things) the size and reach of their alumni networks.

1.3 BDO encourages the CC to consider in particular whether the Big Four have for many years:

(a) held a particularly strong influence over regulatory bodies, e.g. due to the absolute and (compared with non-Big Four firms) relative numbers of:

(i) secondments of staff of Big Four firms to those bodies;

(ii) representatives of Big Four firms on their committees or other key divisions or organs; and/or

(iii) Big Four alumni in senior positions

and so on;

(b) used their professional and client training, as well as their marketing, employee and other communications, to create and perpetuate their reputational advantage, through (among others) their extensive alumni networks and intermediaries, including the explicit or implicit message that only the Big Four are capable of providing audit quality and/or auditing large companies; and/or

(c) had a common strategy of seeking to deter audit clients from tendering and/or switching which further reinforces barriers to entry - see, for example, EY's advice to partners and staff in this respect, as noted at paragraph 16 of the CC's Working Paper on Evidence on Switching Costs (and Implications for Barriers to Entry).

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[1] Reference to paragraph numbers are to paragraphs of the relevant working paper ("WP") unless stated otherwise.

1.4 BDO notes that the Big Four appear to have jointly instructed Copenhagen Economics in relation to the European Commission's review of the audit market.

1.5 Paragraph 28 says that "*this is not a market in which prices are particularly transparent*". Whilst there is a timelag between audit pricing being agreed and being published, and not all details of services provided are disclosed, the statutory audit market is a great deal more transparent than many markets, particularly other professional services markets (see paragraphs 28-31). Published audit fees are often used as the starting point for pricing proposals from other audit firms, which indicates that they are a useful benchmark; this is not the case in relation to other professional services, such as consultancy or legal advice. Whilst there may not be perfect or full transparency of audit fees, BDO considers that for these purposes the CC should regard audit fees as sufficiently transparent.

1.6 Paragraph 31 states that "*there are substantial costs to a company associated with switching auditor*". BDO considers that this overstates the position.

1.7 The CC refers at paragraph 34 to efforts made by firms "*particularly the Big Four firms*" to make the transition process smooth, but these efforts are not confined to the Big Four firms (see 2.8 above). Tender documents reviewed by the CC should demonstrate that all firms will make considerable efforts to make the transition process smooth, often entailing considerable costs for the incoming firm in the first year in that new role.

1.8 BDO considers that competition between Big Four firms in relation to tenders does not demonstrate a complete absence of tacit coordination between them, though BDO cannot observe what happens in tenders in which it does not participate. This is because:

(a) There are very few tenders for FTSE 350 audits each year;

(b) The Big Four do their best to discourage their audit clients from tendering, so as to minimise the need to retender and the likelihood of switching (see 3.3(c) above);

(c) Most tenders for FTSE 350 audits are contested only by Big Four firms;

(d) It is not clear whether the CC has properly tested whether there is tacit coordination in relation to tenders. For example, paragraph 55 gives no indication whether the CC has tested whether the Big Four are submitting prices to tenders in a manner that appears coordinated, as opposed to whether the Big Four are coordinating over participation in tenders, i.e. do they tacitly agree not to compete in certain market segments; and

(e) There is no indication that the CC has done the analysis proposed by BDO in Annex 1, para 1(a), i.e. to check whether pricing patterns in tenders vary depending on whether there is a maverick (mid-tier) competitor involved in the tender.

1.9 So far as non-audit services are concerned:

(a) Where a Big Four firm already provides non-audit services, it has good insight into the relevant company and if or when that company tenders for audit services, the relevant firm should not have the informational disadvantages referred to in paragraph 29, such as not knowing the complexity and risk profile of the organisation; and

(b) There is a substantial degree of multi-market contact between the Big Four, which would make punishment easier. Specifically, if a Big Four firm wanted to punish a defector from a tacitly collusive arrangement in audit, it would be difficult to punish it in audit because tenders are so infrequent. But it would have another option – to punish it in non-audit services.

1.10 The CC's conclusion at paragraph 56 is:

> "*We consider that certain features in the supply of audit services to FTSE 350 companies appear to be conducive to tacit coordination based on the identity of clients. However, there appear to be other factors, in particular the frequency of switching, uncertainty around the value of engagements and movements in the FTSE 350 companies which, for some of the reasons given by the parties, would not be conducive to tacit coordination*."

However, BDO considers that each of these "*other factors*" can be contested:

(a) Frequency of switching – whilst switching is infrequent, punishment strategies are available in non-audit services;

(b) Uncertainty of value of engagements - to the audit customer it is difficult to benchmark pricing, but to a major audit firm (which provides non-audit services and can observe the history of audit fees) it is probably quite easy; and

(c) Movements in the FTSE 350 - the fact that companies move in and out of this index is irrelevant, as BDO does not agree that the FTSE 350 is a completely distinct market from the remaining large listed company market. While there is some movement in FTSE 350 audit market shares, the movement is so limited that the CC feels unable to attempt a price-concentration analysis, because of the lack of variation in the concentration variable.

1.11 In summary, BDO considers that the CC needs to investigate possible tacit collusion between the Big Four more rigorously and more broadly than it appears to have done to date.