COMMENTS OF BDO LLP ("BDO") ON THE COMPETITION COMMISSION'S WORKING PAPER ON MARKET DEFINITION (the "Market Definition WP")

1 Disproportionate impact of the largest FTSE 350 companies

1.1 BDO welcomes the CC's general approach to market definition, which is pragmatic in recognising that "constraints from outside the market and any segmentation within it"[1] are relevant to the analysis of competition, regardless of the precise delineation of the market. It is obvious, for example, that competition issues that apply with regard to the audit of FTSE company number 351 are unlikely to be very different from those applying to FTSE company number 350. BDO appreciates that the CC will adopt a reasonable approach and consider all relevant factors. However, BDO wishes to highlight concerns that would arise if the CC were to focus too closely on a market defined only as the provision of audit services to all FTSE 350 companies.

1.2 BDO considers that defining the relevant product market solely as the provision of audit services to all FTSE 350 companies does not reflect the heterogeneous composition of the FTSE 350. The nature and scope of the audit of the largest FTSE 100 companies is not necessarily representative of, nor reflected in, the audit requirements of smaller companies, particularly those companies that are at the lower end of the FTSE 350.

1.3 Accordingly, a lack of differentiation between the FTSE 350 companies could result in the over-attribution of characteristics and audit requirements of the largest FTSE 100 companies to all FTSE 350 companies.

2 Segments within FTSE 350

2.1 Similarly, although the CC says the Big Four all acknowledged that banking and certain utilities required particularly complex audits, and that there were some sectors where non-Big Four firms had no presence among FTSE 350 companies (e.g. healthcare, telecoms, utilities and technology companies) the CC does not find particular sectors or sizes of companies within the FTSE 350 to constitute separate markets and it "*cannot define separate markets within the supply of audit services to FTSE 350 companies. In particular, we do not have the evidence to suggest that there are segments of FTSE 350 companies…for which the choice of potential auditor is different from those of other FTSE 350 companies*." (paragraph 43 of the Market Definition WP).

2.2 BDO considers the stated lack of evidence somewhat surprising, given Ernst & Young's perceived weakness in banking/financial services, which paragraph 38 of the Market Definition WP appears to recognise. BDO also refers to the CC's summary of the hearing on 29 June 2012 with AFME, which states that choice in some parts of the market is virtually eliminated, at least in the short run: "*If a company had global operations and the Big 4 were considered the only safe option, typically the other three audit firms were already doing the company's non-audit work and possibly one of the other two might not be expert in the relevant sector anyway and the choice was narrowed to one*"[2]. BDO trusts that the CC will consider further potential segmentation within the FTSE 350, in line with paragraph 46 of the Market Definition WP, which states that: "*our decision on market definition*

---

[1] Para 3, Market Definition WP.

[2] http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/afme_hearing_summary.pdf, para 19.

does not preclude us from assessing competition within sub-segments of the FTSE 350 … In particular, we will consider groups of companies of different size and complexity and we also note that banking and insurance are two sectors that may require separate analysis, depending on the issue."

3 BDO notes that the general figures given by the CC in paragraphs 26 and 29 (eg, switching rates) are based only on a comparison of averages between FTSE 350 companies, as a group, and non-FTSE-350 companies, as a group. Using these figures for market definition has the potential for circularity. For example, the CC cites the median audit fee for FTSE 350 companies as £579k and for other listed companies about a third of that amount, at £193k, and goes on (at paragraph 31) to conclude that such differences provide evidence that the FTSE 350 is a separate market. However, the CC does not mention that the median audit fee for FTSE 100 companies is £2.8m, eight times higher than the median audit fee for FTSE 250 companies (£342k). The example is cited by BDO to demonstrate that, depending on what is the starting point for calculating the averages, it is possible to find various large differences in the characteristics of different candidate markets, which leads to a potential element of circularity in using company characteristics to define the relevant market.

4 In any case, the CC's descriptive statistics from its public data enable more sophisticated comparisons which will assist the CC in assessing the level of competition in different market segments. As an example, BDO notes that the cumulative total of annual FTSE 100 switching since 2001 is 19.4% (1.8% per year), measured by number of clients, but only 7.1% (0.6% per year) measured by fees. By comparison, cumulative FTSE 250 switching since 2001 is 30.3% by clients and 26.2% by fees. It is clear from these statistics that the highest value FTSE 100 work has been subject to much less switching, since the value of fees switched is not proportionate to the number of clients switched. This may indicate that competition is functioning less well towards the top end of the FTSE 350. BDO notes that in other parts of the market, such as private companies, where concentration is lower, the competitive dynamic is clearly more vigorous, as measured by switching rates judged by clients or fees – the cumulative total switching since 2001 is above 60% for private companies and above 50% for other listed companies.

5 Impact of audit concentration on company conduct

5.1 In paragraph 30 of the Market Definition WP, the CC states that the observed differences in company characteristics between FTSE 350 and non-FTSE 350 companies "*are likely to be factors in explaining differences in the levels of audit concentration*". BDO challenges this statement, because it is mixing cause and effect:

5.1.1 The factors identified in paragraphs 26 and 29 of the Market Definition WP should not be regarded as explaining differences in levels of audit concentration, but should be regarded as effects of the high degree of concentration in the large company audit market. In other words, it is because that market is highly concentrated and choice is restricted that audit fees are higher, hourly rates are higher, companies have longer relationships with their auditors, switching rates are lower and FTSE 350 companies tender their audit less frequently. The "*characteristics*" identified by the CC (e.g. longer relationships, higher audit fees, less tendering and switching) are the effect of the lack of choice in a concentrated market, rather than the cause of it.

5.1.2 In BDO's view, concentration in the relevant market is perpetuated and enhanced by the conduct of the companies within the FTSE 350.

5.2 The CC's comment about the "*characteristics*" of FTSE 350 companies is an illustration of the over-attribution of characteristics and/or audit requirements of the largest FTSE 100 companies to all FTSE 350 companies, as mentioned in paragraph 1.3 above. BDO understands that most FTSE 350 companies do not operate in dozens of jurisdictions and do not have highly complex structures and/or business models. BDO reiterates that it acts for a number of private companies that are of a much bigger scale than some FTSE 350 companies (paragraph 24 of the Market Definition WP). There are only 35 or so of the largest FTSE 100 companies which BDO would currently be unable to audit due to their significant global dimensions and/or the degree of sector-specific knowledge required. The difference between the audit requirements and characteristics of these 35 or so companies and the rest of the FTSE 350 are much greater than the differences between the majority of the FTSE 350 and the next 100 or so largest companies.

6 Targeting Clients of mid-tier firms who have FTSE 350 potential

6.1 BDO welcomes the CC's statement in paragraph 47 of the Market Definition WP that "*certain competitive constraints in the provision of audit services may start to take effect when a company becomes fully listed (as opposed to when it becomes a member of the FTSE 350), for example due to external pressure from financial advisers or lenders.*"

6.2 BDO reiterates that the Big Four target expanding clients of mid-tier audit firms who aspire and could reasonably expect to become FTSE 350 companies. Accordingly, BDO hopes that the CC's proposed market definition does not preclude analysis of whether such exclusionary conduct results in an adverse effect on competition. In other words, it is important that the CC does not "ring-fence" the FTSE 350 from other growing companies, as the exclusionary conduct by the Big Four occurs in relation to companies which are then outside the FTSE 350, but the effects of that conduct are then felt within the FTSE 350 if and when those companies join the FTSE 350.