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Dear Sirs

BDO LLP Response to the Statutory Audit Market Invitation to Comment

We welcome this market study into the statutory audit market and the request for comment. In our response below we comment in particular on the potential outcomes outlined in your paper that we feel could be most successful.

Restrictions on audit firms providing non-audit services

A) Issues

Q1 - How well is the audit sector as a whole serving its stakeholders?

This is a very broad question. There are several workstreams currently in progress that are directly relevant to aspects of this question. These include the Kingman Review and Project Flora. They will provide comprehensive evidence on this matter based on a wide group of responses and therefore we believe that these should be the primary source of information for the CMA on this matter.

Theme 1: The Audit Framework

Q2 - How well does the audit framework support the interests of both direct shareholders and also wider stakeholders in the economy?

Please revert to our response to question 1.

Theme 2: Incentives and governance

Q3 - To what extent doe the decisions made by audit committees support high-quality audits, whether through competition for audit engagements or otherwise?

In general we believe that audit committees are appropriately diligent and seek to fulfil their duties conscientiously. However an audit is 'credence good' where quality is difficult to measure and as such false proxies are used such as the size of the audit firm or a firm's current roster of clients in the sector. The correlation of these factors to audit quality is weak.

We believe these false proxies explain why Challenger Firms with better records on audit quality are consistently being unsuccessful in tenders and becoming frustrated that they are there simply to make up the numbers rather than be a real contender.

We believe that investors want lower materiality and more areas scoped in even if this results in higher fees. These are clear indicators that investors want audit quality to be the dominant determinant for audit committees when making appointment decisions.

Q4 - How has this changed following the Competition Commission's intervention?

Since the last Competition Commission review the number of tenders has markedly increased. Some audit committees have run tenders for the first time and found it to be a steep learning curve. This has highlighted the inexperience of many audit committees in particular in trying to decide what it is they are seeking from an audit appointment.

Whilst the FRC have provided guidance - and it is no more than guidance, that is it is specifically non-mandatory - as the key regulator it has been passive in providing leadership and in fostering competition to where audit quality is the dominant determinant.

Theme 2: Choice and Switching

Q5 - Is competition in the audit market working well? If not, what are the key aspect hindering it?

There are a number of signs that the level of audit quality is not improving, including the FRC's AQR findings. This should logically lead to an increase in costs for the audit firms as they expend greater resources on improving quality.

In a normally functioning market an increase in costs should lead to increases in prices (notwithstanding the possibility of excess profits). However despite increased liquidity in the market and a resultant increase in the number of observable price points there are no noticeable increases in price. This clearly implies that audit quality is currently not the dominant determinant in audit tenders.

We believe the key causal factor is that the consequences of poor audits are not easily observable - for example, a small sample of AQRs, restrictions on auditor liability making negligence issues be difficult to penalise) and therefore undervalued by participants, that is that the usual way in which a credence goods market operates is not happening in the audit market.

Q6 - In particular, how effective is competition between the Big Four and between other firms and the Big Four?

Challenger Firms have not been successful in penetrating the higher end of the PIE audit market, despite an abundance of tenders across sectors, size and geography the level of successful tenders is very small.

It is impossible therefore to conclude that there is effective competition that, for example, acts as an incentive to prevent Big Four firms becoming complacent. This has occurred in a period in which BDO's AQR grades have increased to the best in the market and unlike a number of our rivals we have not been subject to any damaging enforcement rulings. In our view this demonstrates that size and established brand (particularly as a result of the so called 'alumni bias' effect) act as a barrier to entry and as a result the positive impacts of greater competition are being withheld.

We cannot comment on competition levels intra Big Four firms.

Q7 - How has this changed following the Competition Commission's intervention?

We believe there has been a material change in that Challenger Firms have seen their market share decline.

Q8 - What is the role for competition in the provision of audit services in delivering better outcomes (ie consistently higher quality audits)?

Where price is the dominant determinant for buyers increased competition will, under conventional economic theory, reduce price. If audit quality is the dominant determinant for buyers then increased competition should rationally drive up quality. However there is no indicator that this happening. We firmly believe this is partly because common with other credence goods audit quality is difficult to measure and sometimes is not the dominant determinant of buyer's behaviour.

Q9 - In practice, how much choice do large companies and public interest entities have in the appointment of an external auditor?

It is an undisputable fact that four major players dominate the upper end of the PIE audit market and challenger firms have struggled to build market share. Given the combination of incumbent firms being time barred and conflicts of interests inherent in the provision of significant levels of non-audit services, it is not uncommon for three of the Big Four to be ruled out of a tender process.

Companies are increasingly looking outside of the Big Four for participants in tenders. However, given the low success rates of Challenger Firms we believe this provides a façade of competition only. It is real choice not fake choice that will bring the benefits of greater competition.

Q10 - What are the key factors limiting choice between auditors?

Any potential audit firm must have competence, resources and depth to service the engagement. We recognise there are approximately twenty companies at the top of the FTSE 100 where we would fail this criteria at present.

In addition to being credible audit firms must be independent. This can be a particular issue where the audited entity has bought non-audit services from a number of potential audit firms. In addition to this assessment of independence, companies will often avoid firms who audit close rivals or insist upon separate offices / teams.

International reach is sometimes held out as a restricting factor however all the Challenger Firms have extensive international networks and more often it is outdated views of buyers that lead to this being an issue. This is an example of the alumni bias where Big Four Alumni who have critical roles on audit committees and often assume conditions that existed decades ago still prevail today.

Q11 - What are the main barriers to entry and expansion for non-Big Four audit firms?

The primary barrier to entry or expansion of Challenger Firms is demand side bias. A number of the Challenger Firms have the supply side capacity and capability to complete in the upper end of the PIE audit market to a far greater extent than they do today.

The causal factors of this bias include the false assumption that size or brand (rather than reputation) is a proxy for quality, alumni bias and a general lack of awareness of buyers. This is reinforced by the actions of regulators, who have not supported a competition agenda. Indeed one regulator has established a pricing structure that deliberately discourages Challenger Firms from increasing their market share by making the marginal cost of an additional PIE audit client prohibitively expensive. (The relevant documents are in pour responses to the CMA.)

We also believe that the failure of the regulator to properly and effectively regulate the demand side behaviours in the interests of good corporate governance and corporate reporting have contributed to this.

Theme 4: Resilience

Q12 - Is there a significant risk that the audit market is not resilient? If so, why?

Any market that is dominated by a small number of suppliers will face resilience issues if one of those firms either exited the market. This exit could be voluntary due to a lack of economic return or brand related due to a major corporate failure or enforced by a regulator such as a ban on taking on new clients. Indeed the market dominance of the Big Four has effectively removed the ban on tendering from the regulators toolkit because of the perceived lack of choice such a move would trigger. The phrases 'too big to fail' and 'too big to regulate' are highly relevant and create a moral hazard in terms of disincentives for firms responsible for poor quality audits.

A further area where the market can be shown to lack resilience is when a sector suffers from a series of restatements, for example, facilities management in 2015/16. Investors rejected auditor reappointments (or voted against them in large numbers) but management teams struggled to identify audit firms from within the Big Four who had not been impacted. This undermines confidence of investors.

Theme 5: Regulation

Q13 - What is the appropriate balance between regulation and competition in this market?

Generally in a regulated market the regulator is primarily concerned with ensuring market position is not abused to create excess profits. In the audit market the key issue is not excess profits but the excess low audit quality.

From a users' standpoint audit quality this should be the dominant determinant. However as audits are a credence good, competition dynamics are driven by other determinants such as price, personal chemistry, past brand experience and size. Regulation therefore needs to ensure quality is the dominant determinant and incentivise participants accordingly whilst providing greater transparency over audit quality.

We believe regulators should have explicit mandate to enhance competition and remove barriers to entry that are not consistent with promoting audit quality. These include proportionality of enforcement fines and fee structures that distort economic decisions. We also believe that the regulator should seek to regulate the behaviour of the buy-side, that is the audited entities in particular audit committees.

B) Potential Measures

Q14 - Please comment on the costs and benefits of each of the measures in Section 4 and how each measure could be implemented

We believe we have covered this in other areas of our submission.

Q15 - Are there any measures that we could consider that address the issues highlighted in section 3? If so, please describe the following: a) aim of the measure, b) how it could be designed and implemented, and c) the costs and benefits of each such measure.

1) Audit Only Firms

We do not believe that audit only firms will be economically viable without a significant increase in audit fees, not just for PIEs but all companies throughout the economy. Negative cost synergies due to complete separation will be greater than current profit levels and create significant losses in stand- alone audit firms. This will lead to an increased burden companies of all sizes the vast majority of which are not impacted by the current audit market issues.

2) Break- up of the Big Four

As the Invitation to comment identifies the separation of an audit firm from its international network leaves that firm effectively stranded in terms of its ability to service international clients. We would expect those firms to continue to lose market share until they become economically unviable. Conversely the firms that remain connected to the Big Four international networks would be expected to grow market share.

3) Restrict Provision of Non Audit Services by the Big Four

Whilst this would allow Challenger Firms to grow their non-audit practices faster it would restrict choice in a part of the market that is not directly affected by a current lack of choice. In practice as a consequence of more frequent audit tendering companies are already becoming smarter about predicting future conflicts and keeping certain audit firms 'clean' in order to have more choice in their audit appointment.

4) Market Share Caps

We believe this is the most impactful intervention and could be implemented to have a short term impact as well as create a platform for Challenger Firms to build capability in the longer term. Whilst there would be short term restrictions on choice this intervention will create greater choice in the longer term and eventually after the market is 'corrected' the caps could be removed.

This intervention could be as simple as by 2023 no audit firm can act for more than 60 FTSE 350 audit clients. Failure to comply will result in censure and / or fines based upon the additional fees secured. The companies yielded by the Big Four should not be overly weighted with smaller entities for example investment trusts companies. These would not create a platform for competition nor high risk / low economic return companies that discourage new entrants. Similarly the companies yielded by the Big Four should not be their most unprofitable or troublesome clients.

As we have previously said to the CMA the use of a monitoring trustee arrangement to manage an orderly divestment of clients (and staff) could ensure that the larger firms do not game the changes.

So far as entities audited by the Big Four are concerned, such an intervention would create an opportunity cost for Big Four firms that do pitch that would create a disincentive to aggressive pricing and greater focus on quality. Similarly, companies that have weak control environments or poor governance would have greater difficulty in finding a reputable auditor creating a clear incentive to those companies to improve their risk profile. We believe this measure would of itself create a different relationship between entities and their auditors based around the need for quality corporate governance and corporate reporting (on the demand-side) and quality auditing (on the supply-side).

So far as non-Big Four auditors are concerned, such an intervention would allow Challenger Firms to grow their capability and demonstrate a clear track record on audit quality. As companies became more familiar with those audit firms and the false barrier to entry of size equates to quality was dispelled those caps could be reduced or even removed.

We would expect similar caps to apply within financial services and other non-listed PIEs.

We believe that this measure more than any other will have a marked impact on audit quality.

5) Joint Audits

Whilst this may have a place amongst a package of measure we do not believe this intervention will have sufficient impact. We retain concerns that joint audits will not be truly joint but include major and minor elements where the Changer Firms will be allocated minor roles.

We are aware - and the papers we have submitted in the document request support this - that the development of joint audits into what has been termed "top slicing" where a smaller firm signs off the audit work of a Big Four firm will result in no increase whatsoever in audit quality and will operate to undermine the audit rotation rules.

Furthermore we believe this intervention could create a significant cost and time burden on companies that is potentially disproportionate to any benefit.

6) Direct Support by the Big Four

We do not believe this intervention has any merit other than to reinforce the current brand superiority bias. To date there has been no clear articulation of what form any support would take.

7) Reduced Barriers for Switching Staff

We believe this would be a solution to the secondary issue that arises from a move to a less concentrated market and as such would only be effective as part of a package of measures. At present protections such as restrictive covenants help all firms including Challenger Firms from losing key partners and staff often to Big Four firms. We would therefore be concerned that measure could reduce the capability levels in Challenger Firms if protections are not included.

8) Ownership Structures of Firms

We do not believe this is a relevant causal factor and as such any intervention would be effective. We have invested highly significant amounts every year in our audit platforms and tools. Access to further capital would not have impacted on the majority of investments that we are currently making. Clearly building spare resource capability and specialist teams which do not generate revenue potentially for years for would be an additional potential investment but not one that would appear attractive to potential investors.

Q16 - One way to create audit-only firms would be through separate ownership of the audit and non-audit services practices of the UK audit firms. Could this be effective, and what would be the relative scale of benefits and costs?

We have considered the viability of our audit business as a standalone entity and concluded that without a significant increase in audit fees it would not be economically viable. We believe other firms - including the Big Four - have reached the same conclusion. This increase in fees would not be restricted to PIES but all entities throughout the economy.

Multi-disciplinary firms enjoy significant cost synergies that would lost in an audit only firm and the audit firm would need to hire deep specialists in areas such as valuations or pensions where they currently have access on an as needed basis. It would be challenging for those specialists to retain their level of expertise if they were no longer involved in highly specialist advisory projects.

Q17 - How do the international affiliations of member firms affect the creation of audit only firms? What is the extent of common ownership of audit firms at the international level?

Our current international structure requires us to have a single member firm responsible for the UK. It is only permissible for there to be more than one entity in the territory if required by law. Furthermore, all member firms are required to use the name BDO. In order to comply both the audit and non-audit firm would be required to be called BDO which could undermine public confidence in the separation. Therefore whilst we believe it to be possible under our international framework, to create the genuine perception of independence would be more challenging. We believe other firms would face similar challenges.

Many PIE audits involve substantial component audits performed in foreign jurisdictions. Whilst we could legally achieve the required legal separation in the UK this would not be mirrored in the audits of foreign components which will often make up the majority of trading activity and where the auditor would remain part of a multidisciplinary firm.

Q18 - What should be the scope of any measures restricting the provision of non-audit services? For example, applying to the Big Four only, the Big Four and the mid-tier audit firms, or any firm that tenders for the audits of large companies and PIEs?

We believe that the restriction on the provision of non-audit services to PIE entities is critical to restoring public confidence in the independence of auditors. We believe that when a firm becomes the auditor it must excuse itself from all non-audit work other than work that is an extension of the audit appointment. Given how critical we believe this is to the credibility of the profession this cannot be restricted to any group of firms.

For non PIE entities there are often net benefits to deregulation of the rules restricting non audit services. This will often for example result in a higher quality level of financial reporting.

Market Share Cap

Q19 - How should the market shares be measures? - number of companies audited, or audit fees or some other measure?

We believe that the number of companies audited provides the best measure of market share. Any measures based upon audit fees will be impacted by short-term movements including individual company specific transactions, exchange rate fluctuations, which could create unnecessary volatility with no underlying benefit. The costs of monitoring based upon fees would be greater and the ability of companies to make predict choice restrictions would be lower.

Q20 - Could the potential benefits (greater choice, and resilience) of a market share cap be realised?

Properly designed market share caps will ensure that there are more active audit firms participating in the market. In the short-term, this will restrict choice, as some audit firms will have maximised their market share and not be willing to participate in a tender, whilst there will be greater incentive for challenger firms to participate. However, in the longer term it will create a wider pool of potential firms. The market will then be more resilient to the failure of any individual firm or a short-term withdrawal for example resulting from an enforcement sanction.

Q21 - What do you consider to be the relative scale of the costs of a market share cap, such as increased prices and potentially reduced competition, and potential benefits/

In the transition phase of implementing market caps several firms will need to reduce their market share. We predict that in the absence of external monitoring the relative profitability (and risk) will be key determinants in the decision-making criteria of those audit firms. This would result in the least profitable and/or highest risk clients being yielded to the challenger firms and see Big Four firms benefit from the scarcity impact of selling one of their quota units in the form of higher prices.

We therefore believe external monitoring is a critical component of any package of measures. Short-term restrictions in choice are likely to lead to increase in price particularly if the current price level does not correctly price the level of audit risk. However, the level of competition amongst remaining firms will ensure excess profits are eradicated.

Post the transition phase it would be expected that increased supply side capacity in the form of a greater number of active firms would reduce fees to a level commensurate to the level of risk and any inefficient firms would be unable to pass on inefficiencies in the form of excess pricing.

Q22 - What should be the appropriate level of such a cap, collectively for the Big Four for the measure to achieve its objective? For example, 90%, 80%, 70%.

This clearly depends how many active participants are need to create effective competition but for two or three challenger firms to have a credible market position the collective cap cannot be greater than 80% of the FTSE 350. Ideally it should be between 60% and 70%, but designed at the level of the maximum number of audits anyone firm can undertake - say 60. In order to minimise the dislocation in the market we would recommend that these caps are either phased in or a transition period gives an opportunity for orderly market behaviour. This additionally provides an opportunity for some smaller challenger firms to invest in greater scale.

Q23 - Could a joint audit be an effective means of implementing a market share cap?

Whilst we are sceptical regarding the impact of joint audits as a cornerstone intervention, we could envisage it as part of a package of measures including market share caps. Audit firms that had reached their caps may want to divide individual units into two by undertaking joint audits in conjunction with a challenger firm. If these audits were truly shared evenly, we believe this would have a positive impact.

Incentives and Governance

Q24 - Should the auditors and those that manage them (eg audit committees, or an independent body as described in section 4) be accountable to a wider range of stakeholders including shareholders, pension fund trustees, employees, and creditors, rather than the current focus on shareholders?

Currently international accounting standards including the Conceptual Framework are written from the perspective of investors. Extending the auditors focus to include other stakeholders would require changes to accounting standards applicable not just to the UK but internationally.

We are of the view that amendments to the Corporate Governance regime, which could apply solely to the UK, are a better and more practical means of achieving this objective.

Q25 - If yes, should audit committees (in their current form) be replaced by an independent body that would have a 'public interest' duty, including for large privately-owned companies? Should this body be responsible for selecting the audit firm, managing the scope of the audit, setting the audit fees and managing the performance of the audit firms?

Audit Committees play a key role in the audit process. They have a broad and deep understanding of the business and the industry or environment that it operates in. It would, in our opinion, be unlikely that this could be replicated by an independent body. If an independent body selected the audit firm, managed the scope of the audit, set the fees and managed the performance there would be no role for an audit committee to contribute its experience and knowledge to the audit process.

Further taking away this critical role would be taking place at a time when we believe that the responsibilities of audit committees regarding corporate reporting should be increasing.

As such, we do not believe such an intervention would be beneficial.

Q26 - Please describe the benefits, risks and costs of such an independent body replacing audit committees

The replacement of Audit Committees with an independent body whilst dealing with the issue of Big Four bias would, in our view, create an overlapping ineffective governance framework, which could both reduce the responsibility of directors and lose the effectiveness of their knowledge and insight.

Q27 - Should companies be required to tender their audits and rotate their auditors with greater frequency than they currently are required to do? What should be the costs and benefits of this?

We believe that the current system is working well in terms of creating appropriately liquidity in the audit market albeit not opening up the market in terms of choice. There are significant switching costs for both the auditor and the company which require an extended period of appointment (subject to performance) to be economically viable.

Yours faithfully

BDO LLP

BDO LLP