



Inquiry Manager  
Audit Market Investigation  
Competition Commission  
Victoria House  
Southampton Row  
LONDON  
WC1B 4AD

12 January 2012

Dear Sir/Madam

**Competition Commission Inquiry into the supply of statutory audit services to large companies in the UK**

We are delighted to submit evidence in response to the Commission's Issues Statement and look forward to further dialogue in accordance with the Administrative timetable published last month.

By way of background, and to put our comments in context, Governance for Owners (GO) is an independent partnership between its executives and long term investors such as Railpen, CalPERS and IPGL. GO offers a number of investment management and shareowner services products, including:-

- The GO European Focus Fund that invests in a small number of European public companies where value can be added through exercising owners' rights to address key structural or strategic governance issues that have historically impaired company performance
- GO Stewardship Services that offer independent voting, corporate engagement and other advisory services on environmental, social, and corporate governance (ESG) matters.

GO has also made a number of submissions to the UK Financial Reporting Council (FRC) on audit matters, including our submission on the subject of Audit Choice, which was the genesis of a number of the FRC's conclusions leading to the formation of the Market Participants' Group, whose work features prominently in the FRC's submission to the Commission.

At the heart of our Audit Choice submission is that measures to widen choice must be cost effective and not inadvertently lead to a reduction in audit quality. As investors, we rely upon and require audits of the highest quality. For example, whilst a sensible cap on the market share of FTSE listed audits for any one audit firm could help, too low a cap might increase choice at the price of a reduction in overall quality.

We note the three possible adverse effects you have identified for examination, viz., (a) sub-optimal audit quality and levels of innovation; (b) higher prices and costs; (c) less competition in non-auditing markets. We have the following suggestions in that respect of those lines of enquiry:

- (a) sub-optimal audit quality and levels of innovation. We suggest that the level of investment in quality and innovation (with care as to what is included therein) of the Big Four and the next level of firms over the last five and ten years will be instructive, as will an exposition by the firms of the innovations they claim to have introduced. There is a lot of noise around the level of investment in quality but little clarity around the benefits therefrom. The reports of the AIU should also be of value on this matter.
- (b) higher prices and costs. The transparency of audit costs as reported in company accounts is helpful but the Commission will require further information from the companies as to how much of any year on year change relates to change in scope (e.g., acquisitions, disposals, new regulations, quality changes) and how much related to changes in the rate of charge.
- (c) less competition in non-auditing markets. An interesting consequence of the pressure on companies to reduce their use of their auditors for the supply of non-audit services is the automatic reduction in choice (by one) available for the supply of such “forbidden” services. What is not clear from published accounts is whether that is a serious restriction for companies or whether for such services there is sufficient choice of non-Big Four Accountancy firms and non-accountancy firms to meet the need. This is a question worthy of the Commission’s attention.

We also note the Commission’s six theories of harm: (a) high concentration and barriers to entry; (b) bundling of services by the four largest firms; (c) customer conduct; (d) regulatory distortions; (e) tacit coordination by the four largest firms; (f) information asymmetries. We comment as follows:

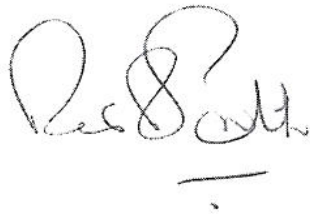
- (a) high concentration and barriers to entry. We note the change in the level of concentration over the past 15 years during which the gap in size of the Big Four and the other firms has grown dramatically. The research we suggest above into levels of investment in Quality and perhaps also into levels of investment in marketing might prove instructive here. There have been a significant number of audit tenders over this period and the companies’ reasons for not choosing a non-Big Four firm and what they consider such firms would need to do to become viable choices would seem worthy of further investigation. As we have noted in submissions to other bodies, the Partner rotation rules may have contributed to providing the Big Four with an apparent advantage (certainly one they have asserted).
- (b) Bundling of services by the four largest firms. There has been a significant pressure on companies to restrict the level of non-audit services from their auditors. There has also been some useful work by the APB on better definition of what should be considered audit related services where there is clear benefit to the companies and their shareholders in using the auditors. The Commission notes the potentially harmful competitive effect of the bundling of statutory audits of parent companies and subsidiaries, which we consider a very ripe area for examination. We note that whereas the shareholders of the parent company appoint the parent company auditors (and in listed companies the audit committee plays a leading role in the recommendation to the Board and in turn the shareholders); the subsidiary company appointments are entirely the gift of parent company management. We suspect that the laws and rules

relating to client confidentiality and liability might need reviewing (on a global basis) to effect real change here without simply leading to duplication of cost. Such changes, whilst significant, should not be seen as an insurmountable hurdle, in our view.

- (c) customer conduct. As the Commission acknowledges, companies' infrequent tendering may not reflect the extent that the threat of tendering acts a competitive check on prices and spur to maintaining quality. Audit firms have often used the assertion that audit failures are more frequent in the first years of a new audit supplier as an argument against switching. We recommend that the Commission examines the evidence to establish how real this assertion is.
- (d) regulatory distortions. Regulation per se tends to favour the established larger players in any market. Indeed, established players frequently encourage regulation as a way of making it harder for new entrants. The issue of how to address the exit from the audit market by one of the Big Four is important. We have previously suggested to the FRC that BIS should have a well developed "phoenix plan" whereby a new firm or firms, partially funded by Pension Schemes (as major investors) and making good use of prominent independent persons to act as chairman and non-executives in the new firm(s) could be established quickly offering roles to those members and staff of the exited (or exiting) firm not tainted by whatever has led to the exit and then offering to do the audits previously done by the exited firm. We offer the Commission the same suggestion.
- e) tacit coordination by the four largest firms. We consider it worthwhile for the Commission to investigate the situation where there are only three firms of auditors being used in an industry and examine whether there is any evidence of tacit cooperation. If there is not such evidence in those situations, we consider other areas identified by the Commission as likely to be more fruitful.
- (f) information asymmetries. These are self-evident, as the Commission highlights. The alignment of auditors' behaviour with their duties to the shareholders is at the heart of this issue. A lot has been done over the last twenty years in the UK to increase the role and influence of audit committees in relation to the appointment, remuneration and evaluation of auditors of listed companies as well as how the auditors' report to the audit committee. Whilst this has probably had a positive impact on audit quality and been a useful restraining influence on fees, it may well have inadvertently also reinforced "play safe" behaviours by audit committees which favours the Big Four. Shareholders can exercise influence over auditors in their voting at AGM's via both the reappointment of the auditors and of the chairman and members of the audit committee. There is little evidence of shareholders often using either vote in this way. Recent suggestions elsewhere requiring greater transparency around tendering. The choice of tenderers and tender processes along with periodic compulsory tenders together with a presumption of change of audit firm every second or third tender, seem likely to prove helpful counterweights to the information asymmetries' effects on competition.

We hope you find these comments helpful. Please contact us if you would like to discuss any of the points made above. Further information or eventual clarifications can be directed in the first instance to Eric Tracey, Partner (tel: + 44 (0)20 7614 4750, email: e.tracey@g4owners.com).

Yours sincerely

A handwritten signature in black ink, appearing to read "Peter Butler". The signature is written in a cursive style with a horizontal line underneath.

Peter Butler  
Founder Partner and CEO

A handwritten signature in black ink, appearing to read "Eric Tracey". The signature is written in a cursive style with a horizontal line underneath.

Eric Tracey  
Partner