COMPETITION COMMISSION

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of a hearing with Grant Thornton held on 30 January 2012

1. Grant Thornton (GT) gave a presentation at the start of this hearing and a non-confidential copy of this presentation can be found here: Presentations to the CC. This summary sets out additional points made by Grant Thornton.

Overview of Grant Thornton

2. Grant Thornton International's (GTI's) organizational structure was very similar to at least two of the large four auditors. GTI had made a significant investment in the last ten years in its international organization and now spent approximately $60 million a year on its international infrastructure. It had made significant investment into creating a more cohesive organization, for example it had established international practice heads, a global board of governors and the major firm CEOs met on a quarterly basis to discuss international strategy.

3. GT referred to its UK credentials and provided an overview of its UK organization as set out in the presentation, which it stated demonstrated that it was a substantial and well-recognized brand. It believed strongly in hiring quality people and had over 8,500 applications last year for 250 places in the firm. GT had continued to invest in its staff and the quality of those staff throughout the difficult economic environment, and had won a number of awards in recognition of the investment it made in its staff.

Strategy

4. In 2008, GT formulated a strategy referred to as 'Vision 2012', which focused on integrating the recent merger that had occurred, driving forward profitability and targeting four segments of the marketplace: the public sector (where there was a significant presence in audit); large privately-held businesses; SMEs/individuals: and most critically, the listed market. It had achieved most of the objectives set out in this strategy and had recently rolled out a new strategy 'Ambition 2015'. As part of this strategy it wanted to increase its market share of the FTSE 350 significantly, through a mixture of advisory services, where it already had a strong presence, and audit. In the public sector, GT was already one of the top-three suppliers. Overall GT had an ambition to expand into the FTSE 350 audit market, principally through expansion from the provision of advisory services but also directly through audits.

Quality

5. GT emphasized that there should be a clear distinction between the scale of an audit company and the quality of the audit/capabilities of the auditor. There had been a tendency for these terms to be used interchangeably, for example the European Commission's Green paper on audit[1] referred to firms over a certain size auditing the majority of listed entities and then referred to 'other' firms. GT thought that this suggested that large firms with many billions of fees had the capability to perform the audits of large companies, and then that there were other firms, which created a doubt based on size.

[1] http://ec.europa.eu/internal_market/auditing/reform/index_en.htm#new.

6. Similarly there was a separate Audit Inspection Unit (AIU) quality report (on an annual basis) for the large four auditors but a report every two years for GT and BDO and another report for other auditors. This suggested that there were three layers of audit quality. GT thought that this had helped to create the general, false, impression that there was a difference between these firms with regard to quality. In fact GT said that there was evidence that the quality of reporting between the four largest auditors and GT was very similar, and this was supported by feedback from its advisory clients and the entities that it audited.

7. GT also explained that it already audited some very complex organizations (eg in the public sector) which were larger than some of the FTSE 350 companies. The feedback from these clients had been that the audit was of a very high quality and to a very high standard.

8. GT had been given feedback on newly-appointed audits that often those companies felt they had been given a robust audit and that GT had 'kicked the tyres', by undertaking robust and rigorous detailed test checking and sense checking of the numbers in comparison with the previous auditors

Capability to audit large companies

9. There were recent examples of GT participating in the audit of very large companies within the FTSE 350, as well as auditing large companies that were not listed but had the characteristics of firms in the FTSE 350. For example, GT had been employed to audit a number of subsidiaries across 27 countries for a very large global organization in the FTSE 100 [✂] whilst the group auditor had been retained. Some of these entities earned revenues in excess of $1 billion. GT stated that it had delivered greater efficiency in that audit, met deadlines, and reduced the companies' audit fees substantially, which indicated that it was very capable of auditing large, complex international organizations.

10. GT also explained that it had invested significantly in non-audit skills, in order to be able to undertake complex and large audits properly. For example, it carried out regulatory work in the area of insurance, pension work on covenants, and worked as trustees on the disposal of British Airport Authorities' assets. Despite having the necessary skill sets and quality, GT said that it had been unsuccessful so far in expanding into auditing large-scale FTSE 350 entities because of the domination of the four largest auditors. GT accepted that the very largest global organizations, with operations in 150 to 200 countries, were of a scale which was beyond that which GT could service, but considered there to be very few, if any, organizations in that position. GTI had member firms which covered just over 100 countries, and therefore an audit beyond that scale might prove challenging.

11. GT noted, however, that the vast majority of companies in the FTSE 350 had audit fees of less than £1.5 million, with market capitalizations of no more than a few billion. These were the types of organizations that GT worked with on a regular basis. GT would also be comfortable undertaking audits with fees up to £3 million as long as it was within the areas of its expertise. It would want to understand the kind of risk being undertaken. GT said that 290 out of the FTSE 350 companies were comfortably within its scope and competency and there were approximately 60 companies with fees greater than £3 million for whose audits it was currently unlikely to bid.

12. GT said that GTI had a number of mechanisms in place to enforce common standards across its international network, including its global audit tool. In response to challenges faced by the large international audit networks following the collapse of Enron and similar companies, GT had remodelled its review process for member

firms and established a formal programme called the 'GT Audit Review'. Under this, partners and managers from outside the region of the network firm would review a sample of the largest audits, assess the quality of the documentation and the judgements made, and review the national processes in place with the firm for dealing with local regulation and the application of international tools and standards. GT had also revamped its international ethical and independence procedures with tools to ensure compliance with procedures and avoid any conflicts of interest. GT had categorized its member firms depending on the size and sophistication of the audit leadership at those firms, and depending on the size and complexity of the nature of activity this would trigger the need to obtain agreement from an independent international panel to either take on a client or to reaccept an appointment.

13. GTI had sanctions in place should there be any issues with the quality of its member firm audits. If firms were not in compliance then they were asked to take remedial steps, but if these did not happen then firms would be (and had been) expelled. Each member firm was inspected every three years and the level and nature of such inspection depended on the sophistication and experience of the firm.

14. GTI's Brazilian firm had been bought by Ernst & Young and its Danish firm had been bought by PwC. Firms had to give notice in order to leave GTI's network and had to pay a penalty. GT had replaced both those national firms relatively quickly. GT stated that in the case of the Brazilian firm, the commercial damage caused by the sale was relatively limited as it had been able to replace the firm with a smaller, but still substantial firm of good quality and had been able to attract staff from its previous firm. This was also the case in Denmark.

Barriers to expansion

15. GT said that it had made some very serious investments in the audit market but that there were barriers in entering at the FTSE 350 level. It was generally accepted that there were low levels of switching within the FTSE 350. GT's FTSE 350 governance report indicated that there were only five changes in audit appointments for the FTSE 350 in 2011. GT also noted PwC's evidence in its submission to the Competition Commission (CC) that there were probably only 13 to 14 tenders a year, which meant that on average firms tendered only once every 25 years, and that this might not result in switching. The four largest firms had stated that part of the reason for this was that there were high investment costs both to audit firms and to companies in tendering. GT said that although this might be a factor in the very largest 50 to 60 multinational organizations, the rest of the businesses in the FTSE 350 were not dissimilar to audit tenders outside the FTSE 350 where there was more frequent tendering, which typically lasted four to six weeks. GT did not consider that a four-to six-week tender process was an insuperable barrier for companies to continue to run their businesses successfully, nor was it an unwieldy amount of time for an audit firm to put into the tender process.

16. GT outlined the investments it was intending to make in the audit business which it said demonstrated the level of investment it was willing to make in this market. It had a business strategy to grow the overall business by £125 million by 2015. It was hoping to take on additional work in the region of £10 million relating to public sector audit work and was looking at acquisitions. It had a past record of making serious investments to increase the scale of its business, for example the RSM Robson Rhodes transaction. It had also helped to increase the capabilities of the Indian member firm of GTI. GT explained that for obvious reasons it was only willing to make investments where these would give returns and where there were not barriers in the market. GTI also wished to double the aggregate revenues of its member firms by 2015, from $3.5 billion to $8 billion and it noted that there had been some signifi-

cant mergers and acquisition activity in the emerging markets of China, Russia and India.

17. GT said that the reputation of the four largest auditors was also a barrier. The largest four auditors had been successful in creating a 'big four' global brand which was of mutual benefit to them. This reputation made it easier for them to win work, which in turn helped to reinforce their reputation. The recent report by Oxera had demonstrated the inherent conservative nature of Audit Committee Chairs who were generally reluctant to be seen moving away from the big four auditors. Many finance directors were also alumni of the largest four auditors and therefore had established connections with those auditors. GT said that it audited a large organization which it had won from one of the four largest auditors, and that in the first year of its appointment GT had identified a substantial error in the organization's balance sheet which led to a restatement of that balance sheet. This organization had expressed positive feedback for the service provided by GT and the technical work it had undertaken, at a lower fee than charged by the previous auditor. This demonstrated that some of the audits of the largest firms had been lacking in certain areas and that GT had the ability to audit large companies successfully and competently. GT said there were situations where companies required advice on accounting treatments from a firm other than its auditor, but companies had been dissuaded from giving this work to GT as its auditor had said this should be done by one of the other big four auditors.

18. GT also stated that it had either been prevented from being appointed as an auditor or this had been made more difficult, because of clauses in the lending agreements of companies. Some of these contractual difficulties arose because it was easier for companies to appoint one of the big four auditors if these were already pre-approved by the banks. But there were also situations where a lending covenant required the use of a big four auditor. In one case the company was allowed to change its auditor to GT but reserved the right to make higher interest charges as a result. GT said that these restrictions not only applied to companies in the FTSE 350 but also to fast-growing companies awaiting listing. GT gave the example of [✂], a company that had a lending agreement with HBOS which GT understood prevented GT from acting as auditor, although GT could provide other advisory services.

19. GT said that one of the ways it had sought to penetrate the FTSE 350 was by having a shared or consortia arrangement by which it was not the group auditor but audited substantial components of the groups. There was anecdotal evidence that some companies were being led to believe that the international auditing standards on group audit (ISA 600) precluded this by requiring that only firms from a single network could be used in a group audit, which was not the case.

20. GT said it was difficult for the market to assess the relative qualities of the audits undertaken by the different firms. GT was the first firm to push for reports on quality into each individual firm, and the Financial Reporting Council (FRC) had started to move towards this. However, GT considered that much of the value of an audit took place behind the scenes and therefore it was very difficult even for companies themselves to get a fair assessment of audit quality, and even more so for investors who were the ultimate customer.

Auditor choice

21. GT said that there were a range of factors which led to growing companies switching to one of the four largest auditors. For example, if there was either a new lender, another bank coming into a bank syndicate, a private equity institution or the sponsors of an Initial Public Offering, this might lead to greater pressure to change to one of the largest four auditors. If a company had an ambition to enter the FTSE 350

then this might lead to a change in its board and its non-executive team, which could in turn trigger a review of its auditor. There were a number of ways in which GT monitored such risks, for example it had an annual client quality review to assess the service GT was offering, whether there were any gaps in service provision and if there were any threats of which it should be aware, such as a change in business strategy or a change in the composition of the board. If there was an incoming new audit committee team then GT might, for example, make a presentation to that team or, depending on feedback received from the company, GT could look to strengthening its own audit team. These methods had mixed results in preventing the company from tendering or from changing its auditor.

22. In addition to this, GT also had a client service review programme with a large proportion of its clients, where its largest clients were surveyed face to face by its leadership team to ascertain what they were looking to do over the next 12 months and to focus on client satisfaction and ensuring GT was delivering to high levels of service. GT also had a team in place both within the FTSE 350 and with the companies on the tier below, to build reputations and relationships with the companies and their various advisers. GT had also sought ways of building links with other institutions, for example it instituted a FTSE 350 governance review which had been well accepted and it chaired one of the professional bodies groups looking into the interaction between the regulators and governments on behalf of the audit profession, which had reviewed FTSE 350 risk practices and behaviours. Senior leadership within GT had spoken to banks about the 'big four' covenants in lending agreements on numerous occasions and it had set up a private equity group to win work and build institutional acceptance. GT said that although this had helped to some extent, changing perceptions about choosing auditors outside the largest four was a long process.

23. GT looked to attract new FTSE 350 clients by identifying those where it already had some knowledge of or contact within the firm, for example if it had carried out non-audit work. The building of FTSE 350 contacts was then based on building relationships with the selected companies, understanding their issues and finding opportunities to help them. As a first point of contact, GT would often seek to win non-audit work with companies in order demonstrate the strength of GT's work and brand, with the hope of being considered if a company ever sought to change its auditor. It would also discuss with the company the possibility of a consortium audit. There was a mixed level of interest at the level of the Finance Director or the audit committee in this kind of contact. In some cases GT was 'pushing at an open door' but with others it was more difficult. GT devoted significant resources to seeking to win work and build relationships with companies. It had a number of partners spending a significant amount of time doing this. This was supported by other mechanisms, for example holding events, seminars, briefings and other intelligence-led programmes.

Other

24. GT considered five-year audit rotation among partners to be a very sensible measure, striking the balance between allowing the partner to develop a good understanding of the organization but not build up too close a relationship. However, GT said that many commentators would question whether companies should be changing their auditors more frequently than 48 years or more, particularly given that the audit function was for the benefit of investors rather than the company. There was no consistent position taken by companies and audit committees regarding audit partner rotation. Some companies saw this as a means of achieving a change without a full tender process while for others (typically outside the FTSE 350) it might be the trigger for a tender. GT did not think that audit partner rotation brought the

same benefits as a full formal tender exercise although it did not believe that a full tender every five years was required.

25. GT thought there was no clear answer on whether audit quality suffered during the first years of an audit. There could potentially be some difficulties in the robustness of the audit, as the audit team would still be getting to grips with the complexity of the organization. However, equally a new audit team often had a fresh approach and would try even harder to get under the skin of the organization in order to illustrate the quality of its audit. GT had discovered errors in previous audits in the first year of a new engagement on several occasions. The largest four auditors had referred to the Bocconi Report, which was some Italian research suggesting that audit quality in the first two years of an appointment was reduced. However, a number of UK academics had questioned the relevance and quality of this research. GT suggested that the CC could look at independent information held by the National Audit Office, Audit Scotland and the Audit Commission on service and audit quality when there was a change of appointment.

26. GT said that typically there needed to be more resource (ie staff hours) during the first few years of an audit, in order to get to know the company. These costs would not be recoverable but were necessary in order to get a foothold. GT might also offer to include some other services in the first years of an audit which would not ordinarily be part of an audit, such as a health or compliance check. An audit committee would seek some assurance that the bid for an audit was fair, and that GT was not bidding low initially but expecting to ratchet up the price in subsequent years, unless the scope of the audit was seriously wrong or there were serious problems within the organization.