

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of response hearing with Grant Thornton held on 19 April 2013

Introduction

1. Grant Thornton (GT) said that it fully supported the provisional findings and stressed that the needs of the shareholders, as the ultimate customers of the audit, should be the priority when reforming the market. It did not see the provisional findings as a criticism of auditors or as an observation on corporate governance but more of an observation of how the audit role had evolved over the years and the difficulties that shareholders had in understanding how the auditor and the Audit Committee had been discharging their responsibilities to them.
2. GT considered that the proposed remedies formed a thoughtful, measured and balanced package which had a good chance of driving increased competition, for which the benefits outweighed the costs. GT believed that a number of the measures would provide a meaningful stimulus to increase the number of players in the FTSE 350 audit market.
3. GT felt that the Competition Commission (CC) needed to consider non-audit services (NAS) further and examine introducing additional restrictions on the ability of the auditor to provide advisory services to FTSE 350 audit clients as part of a package of measures to increase competition in the audit market. GT said that the most accepted route to the audit market for new entrants was through NAS. GT considered that the costs of restricting provision of NAS by auditors were very low or even negative as there was no shortage of firms that could undertake advisory assignments.
4. GT encouraged the CC to consider consortia audits as a means of increasing visibility of non-Big-4 auditors. It also suggested that the CC should consider requiring companies to offer shareholders a vote, after a tender, on two audit firms, as a means of breaking down institutional prejudice. In light of GT's support of the provisional findings, GT also strongly recommended that the CC should retain the proposed balanced package of measures and remedies in order to achieve its policy objectives successfully, and should resist calls for individual remedies to be removed or diluted as this could adversely affect the impact of the CC's package of measures.

Mandatory tendering

5. GT fully supported the Financial Reporting Council's (FRC's) initiative of introducing tendering of the audit contract every ten years on a 'comply or explain' basis. It considered that there was a body of evidence to suggest that 'comply or explain' could be a reasonably effective way of creating change in behaviours. It also supported the CC going further because it considered that there would almost inevitably be a 'rump' of companies that would resist the change. Introducing a statutory underpinning to the requirement to tender could enable quicker and more effective change.
6. GT had tracked FTSE 350 corporate governance behaviours over a period of time and it had found that a portion of companies resisted change under 'comply or explain'. It considered, from observing existing 'comply and explain' provisions in the code, that the level of increased compliance typically increased in the first year and flattened out thereafter.

7. GT noted that, based on its experience, those companies that had a strong corporate governance culture or 'tone from the top' tended to fall into the 'comply' camp than those that had less regard to these issues. The 'comply or explain' principle had worked well in gently herding companies in a certain direction but there were certain companies that did not want to comply. 'Comply or explain' tended to leave the decision on whether to comply or not in the hands of management, even if *post factum* shareholders had the opportunity to express dissatisfaction through AGMs.
8. Whilst GT could not correlate, directly from its research, the level of compliance by companies with particular characteristics that would lead them to 'explain' rather than 'comply', it considered that with respect to audit, there existed widespread resistance and ingrained thinking in relation to tendering and rotation in the FTSE 350. GT's expectation was that consequently, companies were more likely to seek to explain, rather than comply.
9. GT considered that Audit Committees were more influential and involved during tender discussions than during reappointment decisions.
10. GT had never lost or moderated its independence as an auditor as a result of long tenure with a client. It considered that a length of time for any individual on one client could degrade independence but not to the point at which an auditor would not be independent. Independence was baked into the DNA of an auditor. The issue of overfamiliarity with an older client might result in the loss of challenge because an auditor was familiar with the risks, though not in a loss of independence. One of the things audit partner rotation did was to refresh the level of challenge. Whilst GT would never go into a situation trying to get around the independence rules, it did consider that it needed to be careful that it did not become too locked into its thinking. Familiarity with a client might produce this. GT accepted that long audit tenures could lead to a perception of a loss of independence rather than an actual loss of independence, although there may be a real loss of challenge.
11. GT referred to a recent example where a listed organization, as part of its tender process, requested comments on specific aspects of its accounts and its policies. GT saw this as a healthy process. It raised some challenges to the company and was ultimately successful in the tender. However, GT would be concerned about providing pre-clearance on accounting policies as part of a tender process as it would often not have enough information to reach such a conclusion.
12. It would not be a desirable situation if companies were seeking to weed out firms that disagreed with their accounting policies on the basis of the extent of challenge firms provided in a tender.
13. In deciding whether or not to submit a tender, GT considered: relevance of the tender to GT; GT's skill set; relationship; seriousness of the tender; time allocation given; extent and access given to information and decision-makers; nature of the sector; and whether it was a sector where GT was seen as a credible audit supplier.

Mandatory rotation

14. GT said that mandatory rotation would have a very significant impact in terms of encouraging Audit Committees to look at a wider range of firms. It had had some conversations recently with a large insurance company, which it considered was the result of the recent focus on the audit market and was causing even the largest companies to rethink what might have been the norms in terms of auditors. Outside a very small tier of the largest companies, it would become natural for Audit Committee Chairs (ACCs) to want to form relationships with a wider number of firms to increase

the pool of people who had a realistic chance of undertaking their audit. Mandatory rotation would cause a change in mindset or behaviour that was likely to provide not only greater competition between the Big 4 firms, but give companies a wider choice of firms more generally because companies would approach the process knowing there had to be a change in auditor, and not just a need to go through the tender process.

15. GT discussed research in the USA and Australia on mandatory rotation. The Centre for Audit Quality in the USA found that mandatory firm rotation could have an adverse effect on quality and possibly on concentration whereas Australian research seemed to point in the opposite direction. The view of GT in India, which had just introduced mandatory rotation, was that it was more likely to generate opportunities for new entrants to the market or firms outside the Big 4 than the other way around. GT stressed that although there was some academic evidence with regard to mandatory rotation, the evidence may not be robust or consistent.
16. Tendering and rotation, as part of a wider package of measures of greater engagement between ACCs and auditors or auditors and shareholders providing greater information, would lead towards better decision-making and so would lead to changes in the way the market worked. There were some useful parallels that could be drawn from the public sector market, which had the features of regular tendering and rotation. This had created a much more diverse audit market and feedback had suggested that quality was higher and the value for money was good too.
17. With the package of remedies that had currently been proposed, GT would have a much clearer indication of when tenders were likely to happen, which it did not have at the moment. It would be better informed in deciding the most suitable place to invest, to focus on sectors, organizations and connections at the right time to have an ability to compete fairly.
18. GT was content with the current audit partner rotation rules at five years, and proposed mandatory tendering every ten years and mandatory firm rotation every 15 years. In making this proposal, GT had tried to achieve a combination of efficiency and effectiveness by building on features already in the marketplace. It was a sensible approach to link tendering and firm rotation to the period at which partners were rotating. Avoiding unreasonable market disruption was also an important motive behind these figures, which GT believed the market would be able to adapt to and cope with. If a change in auditor occurred every 15 years, it would give better fluidity to the market than every 20 years. Rotation at 15 years was more likely to shift the market dynamic without being disruptive.
19. GT noted that the figures were based on UK practice. GT was unclear where the European debate would end up. If, as GT presumed, the EU headed towards multiples of 7, by selecting multiples of 5, the UK would not be significantly out of line with Europe. GT noted that the timescales were maximum periods and tendering or rotation could happen earlier. Audit partner rotation had some benefits. Requiring a tender event in place of a partner rotation, every five or seven years would create a lot of tender events for the market to cope with and would result in the loss of the benefits of partner rotation.
20. In regard to costs within audit rotation, GT considered that with more frequent tendering, the process of tendering was likely to become more efficient. There would not be a change from the current practice where firms had stated that transition costs were absorbed by the auditor. This was because firms would find it difficult to move away from this concept. However, GT accepted that this would be affected by length of tenure. If companies were tendering every year, this was likely to change behaviours;

if tenders were every five years, firms may try to rationalize costs over a three-year period. If tenures were less frequent (every five to ten years), firms would continue to bear the costs.

21. At present, because tenders were so rare, whenever one came up, all firms tended to compete and those that were unsuccessful in a tender simply had to bear the costs of tendering. In a market where there was more frequent tendering, GT and probably some other firms would become more selective as to which tenders it would enter and it considered that other firms would behave similarly.
22. GT considered that because tenders at the moment were quite rare events, the process could become over-engineered, particularly in large international corporate organizations. People on both the company and auditor side would not be familiar with these tender experiences which added to costs and inefficiencies. GT considered that most of the 'over-engineering' was on the audit firms' side. It gave an example where it had recently pitched to one FTSE 250 company with various subsidiaries around the world. GT's pitch team needed to travel for face-to-face meetings with this business around the world, which added high travel costs. GT felt it needed to do this to allow the company management to obtain agreement from colleagues around the world where GT was to be appointed. GT felt that it would be easier to obtain this if it had met the relevant people around the world. It had been told that it had put in more effort than any of the other bidders, who were three of the Big 4 firms, which it felt it needed to do. However, if such tender events occurred more frequently, then the market would drive a tender process that was more streamlined, with the result that costs to the parties involved may be reduced.
22. GT referred to the public sector environment, which it said had a much more transparent and open set of conditions about how a tender was to be operated and what the key success criteria were going to be and on what basis an appointment was going to be made. GT considered that more frequent tendering in the private sector would lead to a similar position.
23. GT said that with increased frequency and a better understanding of when upcoming tenders were scheduled to take place, greater experience of participating in tenders would drive tender costs down. If the tender process was streamlined or well defined and included tender pitch frameworks and guidance, excessive costs would be avoided and be better managed.
24. If the market was one where rotation was mandated, then the market would define what was required in a tender process and so there would be less need to instruct or define what the process should be. However, GT considered that as a minimum the tender process should allow for: sufficient access to information, including what the big judgement issues to be addressed were; access to key individuals/decision-makers; a clear timetable; details of the key criteria by which tenderers would be measured; and an indication of the purpose of going to tender (ie whether it was just for audit services or was the company looking for other services at the same time).
25. GT would like to see a published definition of what Audit Committees in auditor appointments were seeking from the auditor so that criteria for the appointment decision were widely understood, providing transparency to investors.
26. GT favoured a greater level of restrictions and prohibitions in the provision of NAS by an auditor. It did not consider that requiring companies just to provide explanations to their shareholders on how they managed and selected their suppliers of NAS would be sufficient, although it would be an improvement. It considered that introducing further restrictions would be a cost-effective way of increasing the level of choice in

the market. The provision of NAS was the easiest and first point of entry into the boardroom for new entrants. GT felt that it would have a significant impact on encouraging Audit Committees to look at a far wider range of firms.

27. GT said that a possible concern with just having a requirement to provide explanatory disclosure was that a relatively standard boilerplate set of explanations would evolve to describe why a certain service was appropriate or inappropriate to be provided by the auditor. GT therefore doubted that requiring explanations only would be an effective way of stimulating competition. Its FTSE 350 corporate governance review had highlighted that, even with fewer advisory services now going to the auditor than used to be the case, for every £1 in audit fee earned, the auditor still earned 64p in advisory work.
28. If changes with respect to the requirements to tender or rotate were made, GT indicated that it would accelerate its strategy and investment plans in the FTSE 350. It would look to focus its approach on the FTSE 350 to build on existing strengths and existing relationships. It did not think a big investment was required for it to do this.

Remedy 3—Expanded remit and/or frequency of AQRT reviews

29. GT believed that the process of independent regulation and inspections and public reporting had had a significant benefit for audit quality. However, it would like to see more resource going in to identify some of the root causes of some of the deficiencies that had been identified through inspections over the years.
30. GT considered that the current Audit Quality and Review team (AQRT) reports did not allow the quality of individual firms to be compared against each other, but there was a public perception that this is what they did. GT would welcome a refinement of the content of the reports to enable such comparison. It was ordinarily easier to compile an audit file for a well-resourced FTSE 100 or 250 company because the quality of information provided by a well-resourced finance team in a large company would be of a higher standard, and so it was actually typically more challenging to do the same for smaller companies. So comparing audits of firms that audited well-resourced companies with those that audited not so well-resourced companies might not provide a meaningful comparison.
31. GT said that in the last nine months it had been inspected by the Public Company Accounting Oversight Board (PCAOB), AQRT and ICAEW's Quality Assurance Department. GT found that the PCAOB perhaps focused on larger or more strategic issues and looked at understanding if the auditor got to the right conclusion from a top-down perspective. GT noted that regulators internationally had recently been comparing inspection processes and this had demonstrated significant inconsistencies between them and specifically between the FRC and PCAOB. It was not clear at the moment if one was better than the other. The differences included how findings were captured and reported and how quickly reports were distributed and published.
32. GT did not think it was possible, when subsequently reviewing audit judgements, not to apply hindsight. It described an audit which had received a bottom category marking by the AQRT. It did not dispute this grade based upon elements of the documentation of certain key judgements, since it accepted that there were documentation issues in the audit file. However, GT noted that the audit had actually identified a fundamental flaw in the accounting in the first-year audit which had been missed by the previous audit firm. It suggested that this was an indicator that it had performed a good audit. What had been judged and reported, however, was that it had failed to abide by the professional standards in the way it had documented the evidence. It

considered that the FRC inspection regime needed to develop further so that people could draw meaningful conclusions from its reports. GT considered that the FRC process was some way from being sufficiently robust to allow it to rank firms fairly. GT noted the FRC's intention to undertake thematic reviews, looking at issues across the piece, for example around group audits and looking at group audits for a number of firms. GT was concerned that this would move it even further away from the ability to provide an independent measure of how good an individual firm was.

33. GT did not think the FRC's current objectives around AQRT reporting were set up to enable it to provide clear independent reference point benchmarking in its reports.
34. Whilst GT accepted that AQRT reporting on a company-by-company basis might better facilitate comparisons among firms and so competition, it thought there were more significant disadvantages to this. The market may make ill-informed decisions to the detriment of the company being reviewed. GT noted that journalists tended to focus on the quantitative information in reports which might lead to undue market consequences, when in reality the audit of the company was very good. GT considered that the current position where the AQRT wrote to the company to clarify any concerns was a sufficient compromise, making sure that those charged with governance knew of the issues and of the quality of the auditor.

Prohibition of Big-4-only clauses in loan documentation

35. GT supported the prohibition of Big-4-only clauses in loan documentation to be mandated more widely, such as in equity documentation or shareholder agreements or wherever else they may appear.

Strengthened accountability of the external auditor to the Audit Committee

36. GT supported re-emphasizing the role of the Audit Committee, to a position similar to that under the Sarbanes-Oxley Act in the USA, which it considered would drive greater independence, accountability and ownership by the Audit Committee for responsibility for engaging with investors. At the moment, there was a tendency for the Audit committee to delegate a lot of that responsibility to the Finance Director (FD). GT did not think this would lead to the Audit Committee becoming less non-executive and more executive. It would be forcing greater communication between those who were tasked with overseeing management, not forcing them to start generating accounting policies or judgements, which would still be for the executive.
37. GT did not think that Audit Committees would have to spend an unmanageable amount of extra time in taking on these responsibilities. It may mean more frequent meetings directly between the auditor and the ACC, maybe three to four times a year. GT did not think an insufficient pool of talented ACCs was a specific issue for ACC resourcing. There was already a challenge to recruit sufficiently high-calibre individuals for all board positions. GT did not think there was a need to mandate ACCs drawing on a separate resource to fulfil their role.
38. GT considered that the current balance in the governance structure was not ideal and did not give enough independence to the Audit Committee to make decisions around the selection of the auditor, particularly where the governance culture was not sufficiently robust. It thought that the structure provided too much scope in some instances for influence by the Chief Financial Officer, who would generally consider it easier to remain with their existing auditor. GT considered that the audit engagement partner primarily related to, at the moment, the FD, not the ACC. The engagement partner would always need a significant level of contact with the FD, but if the

accountability of the Audit Committee and the ACC were made more clear with responsibilities to report to investors, then that may provide a sufficient break in behaviours to ensure that the investors, through the Audit Committee, were seen as the client.

Enhanced shareholder–auditor engagement

39. GT's view was that with increased frequency in tendering and rotation, enhanced audit or Audit Committee reports, greater accountability and interaction with investors, investors would start to become more engaged with audit issues and turn up at AGMs because they would have more information to consider and use. This may make it more likely that investors would exercise their powers on the appointment of auditors.
40. GT proposed, in a world which included more engagement between the Audit Committee and investors, and where there was much greater clarity set out by the Audit Committee as to what it was looking for from its auditors, that Audit Committees should be required to present a choice of two firms that the Audit Committee considered appropriate to audit the company, after a tender process. The Audit Committee would be required to set out how each of the firms met all of the requirements it was looking for and to also denote, with reasons, its preferred candidate. Shareholders would then be required to make the final decision, by vote. This would be an informed way of allowing shareholders to make the decision, empowering them to, for example, introduce other firms into a sector, if that is what they wanted.
41. GT considered that it would be easy to create a mechanism where investors could ask questions in an AGM, in a controlled manner, around issues that concerned them about the audit or the auditor, and that this would be a positive development.

Extended reporting requirements

42. GT supported auditors and Audit Committees providing more information in their reports, such as: areas that had changed significantly from the previous year; and areas that most exercised the management team, the Audit Committee and the auditor. In doing this, it was important that the responsibilities of the company were maintained. GT saw more scope for the Audit Committee to make disclosures around the risks of errors in the financial statements; the key judgement areas; and how they reached those judgements. Auditors could say what they saw as the risks in the financial statements and how they went about challenging management in terms of getting to the judgements. The company should report on how it was going to account for judgements in the financial statements and the auditor on how it got to its audit judgements including its views on materiality levels.

Joint or consortia audit

43. GT thought there was a lot of negativity in the UK on joint audit and a lot of confusion about the differences between joint audit (where two firms signed off the group accounts) and what GT termed 'consortia audit', where a single firm took responsibility for the group statements but two or more firms were responsible for the components of that. GT believed that there was much more of an open mind to consortia audit. The evidence showed that consortia audit was very effective. GT provided the example of [redacted] [one FTSE 100 company], which GT said had seen evidence that consortia audit could drive better audit quality, service quality and price. On the back of this, GT was getting enquiries from boards and investors as to how consortia audit might work.