



## **Grant Thornton Response to the Competition Commission ("CC") working paper entitled "Nature and strength of competition in the supply of FTSE 350 audits"**

### ***1 Introduction***

1.1 This memorandum sets out the response by Grant Thornton to the Competition Commission's ("CC") working paper entitled "Nature and strength of competition in the supply of FTSE 350 audits" ("the working paper") which was issued on 2 October 2012. We comment below on specific points where we believe further investigation is merited. A separate submission from Grant Thornton is being prepared which will pick up on the more general themes expressed in this working paper and other working papers.

### ***2 Visibility of elements of an audit***

2.1 In Figure 1 'Visibility of measures and indicators of various aspects of audit quality' we note that the CC makes no mention of the reports prepared by the UK Audit Inspection Unit or equivalent bodies in other jurisdictions. These reports, perhaps the most objective available indicators of audit quality, are noted by investors (see the Oxera Investor Survey, page 7) and we would expect others such as Audit Committee Chairs (ACCs) to also give them weight.

### ***3 Relevant customers***

3.1 In paragraph 51 the CC concludes that the AC and FD, plus management, are the 'individuals that are relevant to an assessment of the nature of competition for FTSE 350 audits.' Since audit is a product supplied for the benefit of investors, to provide assurance as to statements made by management, we see the complete omission of investors as relevant individuals either as an error, or as evidence that the choice process for selecting auditors must be reformed. In this regard, we refer also to the CC's paragraph 132, which indicates that the FD is 'directly accountable' for most of the variables over which audit firms compete, such as fees and quality of service.

### ***4 Market testing by the company***

4.1 In paragraphs 93 and 94 the CC refers to periodic re-negotiations of the audit fee and benchmarking of audit fees by some companies. This practice may occur, but we suggest its effectiveness is considered in light of the CC's quantitative evidence. This indicates that audit fees in fact rise considerably in the years after switching auditor (between the largest four audit firms), and by year 5 are 50% higher than in the year before a switch was made.<sup>1</sup> Since in the first year after a switch was made fees are 19% lower than previously, the ability of the largest four audit firms to renegotiate fees upward from this level does not seem to be significantly constrained. This evidence suggests that the 'degree of bargaining power' referred to by the CC at paragraph 192 is in fact very limited, and that a 'benchmarking exercise' is certainly no substitute for actual switching.

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<sup>1</sup> We do not understand how the CC's dataset is consistent with the statement at paragraph 196 that fees 'decline after the first years of engagement', and we suggest that paragraph 196 be amended.

## **5**      *Switching*

5.1      In paragraph 101 the CC refers to its calculation of switching rates and auditor tenure. These calculations are necessarily incorrect assuming that the CC has access to data that only, or mainly, pertains to the period 2000 to 2011. The CC can observe neither the start date of audit engagements which commenced prior to 2000, nor the end date of audit engagements which are still active in 2011. We suggest that the CC reconsiders or caveats its calculations, in particular those on auditor tenure.

5.2      In paragraph 169 the CC states that average auditor tenure for FTSE 350 companies was about 11 years. This is incorrect, for the same reasons as noted above since if auditor tenure were 11 years, the annual switching rate would be approximately 9%, which it is not.

5.3      In paragraph 111 the CC notes that 40% of FTSE 350 companies surveyed have not tendered because of associated costs. Since the CC finds elsewhere at paragraph 169 that 40% of FTSE 350 companies have never tendered their audit, or have done so more than 10 years ago, we would question whether some of the companies surveyed have recent experience by which to judge whether tendering and switching is in fact disruptive or costly. We also suggest paragraph 111 is read in light of paragraph 185, which reveals that 90% of companies who switched and experienced a change in quality said that the switch had improved audit quality.

## **6**      *Choice*

6.1      In paragraph 126 the CC recognises that a large minority of FTSE 350 companies may face further limits on their choice, i.e., they are able to choose from fewer than four firms. We refer the CC to the evidence of AFME, who noted that in some circumstances ‘The choice was narrowed to one’.<sup>2</sup>

6.2      In paragraph 165(b) the CC states that tender lists typically include ‘at least three firms’. This is incompatible with paragraph 98 of the Selection Process working paper, which states that ‘In our data set, the average number of participants to tenders is two’.<sup>3</sup> We further note that the CC’s data is recognised to be incomplete (para 95), and that this limitation should be recognised wherever tender data is being used, rather than only in the Selection Process working paper.

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<sup>2</sup> [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/afme\\_hearing\\_summary.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/afme_hearing_summary.pdf), para 19.

<sup>3</sup> [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence\\_relating\\_to\\_the\\_selection\\_process\\_tendering\\_annual\\_renegotiations\\_and\\_switching.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/evidence_relating_to_the_selection_process_tendering_annual_renegotiations_and_switching.pdf), para 98.