12 October 2012

Grant Thornton Response to the Competition Commission ("CC") working paper entitled "Overview"

1 Introduction

1.1 This memorandum sets out the response by Grant Thornton to the Competition Commission's ("CC") working paper entitled "Overview" ("the working paper") which was issued on 28 September 2012.

1.2 We comment below on certain specific points raised by the CC, including on areas which we believe merit further investigation. In particular, whilst we concur with the CC's initial view (e.g. "*that there are barriers to entry and expansion that limit the ability of Mid Tier firms to constrain the competitive offerings of the Big 4 firms*"), we are surprised that the CC has been unable to put greater weight on the adverse outcomes which have arisen as a result of competition not working effectively. As set out further below, we think there is a sufficient body of evidence for the CC to be able to clearly conclude that there are features of the market giving rise to adverse effects.

2 Adverse outcomes

2.1 In paragraph 37, the CC observes that "*We have not so far seen evidence of a strong link between market concentration and outcomes such as price and quality*". In this regard, we disagree with the CC and consider that there is evidence before the CC that the dominance of the largest four audit firms in the supply of audit services to the FTSE 350 is leading to adverse customer outcomes including in relation to price and quality. We also note that in some areas where further evidence would be welcome, such as price concentration analysis, the CC has chosen not to investigate further, and is therefore removing the possibility of finding a strong link between concentration and market outcomes.

2.2 The CC have to date been unable to conclude (and measure the extent of) any adverse outcomes regarding price, profit, quality, choice or systemic risk. However, whilst we acknowledge that many of the matters referred to remain open for further investigation, in our view there is sufficient evidence in the working papers which have been published by the CC to conclude that adverse effects on competition arise.

Price concentration analysis

2.3 We note from the working paper entitled "Price Concentration Analysis" that the CC has chosen not to undertake a thorough price concentration analysis. In our view the difficulties which might be encountered in performing such an analysis are not sufficient to prevent a review being performed and we encourage the CC to reconsider its conclusion. As the CC will be aware, any econometric assessment of this nature will inherently have its imperfections. This has not stopped the CC conducting such analysis in a number of recent cases (e.g. in the local buses market investigation), and placing significant weight on the results of that analysis. In this regard, the relevant question to consider in conducting such analysis is not whether it gives a "perfect" answer (which it hardly ever will), but whether the results of the analysis (combined with the other quantitative and qualitative evidence available) are sufficiently robust to provide an indication of what is happening in the market.

We will be providing a separate submission on the "Price Concentration Analysis" working paper which deals with our views in more detail, including suggestions on how the analysis could be performed appropriately.

Switching auditor leads to better outcomes

2.4 We consider that there is sufficient evidence before the CC which shows that switching auditor leads to improved audit quality and reduced prices. The implication of this is that increased tendering and switching (and reduced concentration) should be expected to lead to lower prices and higher quality. In particular, we note the following evidence:

a) In aggregate, real audit fees decrease following a change in auditor (see paragraphs 20 – 23 and figure 6 of the CC's Working Paper entitled "Descriptive statistics"). In particular, figure 6 shows that for FTSE 350 companies the total real audit fee fell by just under 20 per cent in the first year after switching took place;
b) Audit fees per hour decrease following a change in auditor (see paragraphs 36 – 39 and figure 10 of the CC's Working Paper entitled "Descriptive statistics"). Figure 10 shows that in the first year after switching, the audit fee per hour for FTSE 350 companies fell from just under £80 per hour to just over £50 per hour (i.e. a fall of around 37%);
c) 82 per cent of companies found that switching auditor resulted in a lower price, increased quality or had both of these of these effects (see paragraph 185 of the CC's Working Paper entitled "Nature and strength of competition in the supply of FTSE 350 audits");
d) The CC has found that "*audit fees always reduce when switching auditor regardless of whether this change is in favour of a Big 4 or non Big-4 firm*" (see paragraph 197 of the CC's Working Paper entitled "Evidence relating to the selection process: tendering, annual renegotiations and switching");
e) the CC's survey shows that when asked "*what impact did switching auditors have on the audit price?*", 52% of FTSE 350 companies that switched in the last 5 years said that the audit fee was lower (63% if the "don't know" responses are excluded), and 64% of FTSE 350 companies that switched said that audit quality was higher following switching (75% if the don't know responses are excluded) (see slides 64 and 65 of the presentation by IFF Research entitled "Competition Commission Statutory Audit Services Survey, July 2012);
f) the CC's analysis based on the public data set shows that in the first year following switching, real audit fees per £1m of turnover fell by 18% for FTSE 350 companies, 19% for FTSE 250 companies and 29% for FTSE 100 companies (and fees remain lower until the fifth year after switching (see table 195 of the CC's Working Paper entitled "Evidence relating to the selection process: tendering, annual renegotiations and switching"); and
g) The CC's dataset identifies that switching auditor to a mid-tier firm from the largest four firms reduces the audit fee significantly (by over 80% in the first 2 years after switching) but that moving the other way around (to one of the largest four firms from a mid-tier firm) increases the audit fee. The table set out below provides an analysis of this benefit.

Change in audit fee in the years following a change in auditor (compared to previous fee) amongst FTSE 350 companies						
	Years after switching					
	1	2	3	4	5	6
Percentage change in total audit fee						
Big-4 to mid-tier firm	-83%	-89%	-23%	-25%	-28%	
Mid-tier firm to Big-4	8%	9%	12%	11%	23%	44%

2.5 In our view the above points provide clear evidence that more frequent switching of audit firms would provide significant benefits to the customers of audit services in terms of lower prices and better quality. We encourage the CC to consider the above evidence in reaching its provisional findings.

Role of the ACC

2.6 The CC notes that the institution of the ACC is a regulatory response to the principle-agent problem – and that the ACC is itself another agent (paragraph 31). The CC should not ignore the role of FDs in influencing auditor selection, despite the existence of the ACC. Table 10 of the CC's survey shows that 29% of the FTSE 350 FDs/CFOs surveyed believed that the FD/CFO is most influential in auditor selection, while only 14% said that the ACC is most influential.