29 August 2012

Grant Thornton Response to the Competition Commission ("CC") working paper entitled "The framework for the CC's assessment and revised theories of harm"

1 Introduction

1.1 We welcome the opportunity to comment on the Competition Commission's working paper entitled "the framework for the CC's assessment and revised theories of harm" ("the working paper") which was issued on 10 August 2012.

1.2 We comment below on certain specific points raised by the CC, including on areas which we believe merit further investigation.

2 Revised theories of harm

2.1 We note that the CC proposes most actively to pursue two theories of harm which broadly cover only three of the six theories of harm which were suggested in the CC's Issues Statement (theories of harm 1, 3 and 6). The CC has, however, provided no explanation as to why it has chosen not to pursue theories of harm 2, 4 and 5 of the original Issues Statement.

2.2 We are concerned that the CC should not adopt an overly narrow approach to defining its theories of harm at this stage as this may cause it to fail to have regard to relevant considerations. Grant Thornton considers that each of the six theories of harm suggested in the Issues Statement continues to be worthy of pursuit by the CC. Accordingly, before deciding that it will not actively pursue any of the six theories of harm set out in the Issues Statement, the CC should explain why it is minded not to continue to explore a relevant theory of harm and provide interested parties an opportunity to comment on that decision..

3 Tacit coordination

3.1 The working paper does not indicate the extent to which the CC has considered the issue of tacit coordination. As set out in our response to the CC's Issues Statement, whilst Grant Thornton is not in a position to determine whether tacit coordination has actually taken place amongst the four largest firms, we consider that all the conditions set out in the legal precedent, necessary to facilitate tacit coordination, are present in the market for the supply of audit services to FTSE 350 companies.

3.2 There continue to be new examples of the largest four firms working collaboratively on influencing market outcomes. The most obvious and current one is the establishment of a body which we understand is known as the "European Centre for Audit Quality", the most advertised output of which is the commissioning and publication of a report by Copenhagen Economics ("CE"). The CE report leans heavily on selective information taken out of context based upon a single year's AIU reports with the clear intention of painting a picture, that we believe to be entirely false, that audit quality is higher at the largest four firms than at other firms. The FRC has not supported the conclusions drawn by the CE report. We understand the FRC's conclusions are that where comparable audit work is performed by the ten largest firms it is of comparable quality. The CE report seeks to persuade buyers of audit services to continue to do so from only the four largest firms and has been widely circulated by a number of partners of the four largest firms to authorities around the World, including BIS and UK Government.

3.3 We have also seen further examples of the largest four firms coordinating to market themselves as a group. The following is an extract from a publication by one of the largest four firms designed to guide companies on how to have a successful IPO *"While it is not necessarily a requirement, many IPO candidates choose to retain one of the Big Four audit firms as their reputation and independence is generally acknowledged around the world"*. This provides further evidence that the largest four firms are willing to perpetuate a perception that they deliver higher quality than other audit firms in order to preserve the market status quo. One might expect that in a competitive market the four largest firms would seek to differentiate themselves from each other rather than to present themselves as an exclusive group.

3.4 We therefore urge the CC to continue to explore the area of tacit coordination to investigate the degree to which the largest four firms operate as a "cosy club" that might lead to less aggressive competition than might otherwise be expected and which might benefit from the introduction of greater competition from smaller rivals.

4 Principal agent issues

4.1 The CC intends to pursue a theory of harm that various principal agent issues distort competition in the audit market. One such issue is the disparity between shareholder and management demands for audit (paragraph 81 of the working paper). We endorse this view and consider that there is a significant disparity in this area. We have previously provided the CC with evidence that investors/shareholders are calling for change to the structure of the audit market for large companies[1].

4.2 In considering further this asymmetry of information (between FDs, ACCs and shareholders), it is most important to understand the views and attitudes of investors. In this context the CC should have regard to the results of the Oxera survey of shareholder attitudes[2]. This report concluded that, amongst other things, audit quality is not sufficiently visible to investors, investors do not believe that there is a genuine gap in capability between the four largest firms and the mid-tier firms for the purpose of most large company audits (although there is a capability "perception gap" which leads virtually all large companies to appoint as auditor one of the largest four firms) and that greater auditor choice would benefit confidence and resilience in the capital markets, audit quality, innovation and pricing.

4.3 We note further that the CC's own case studies presentation[3] includes a finding that there are significant differences in the factors considered to be important to assess audit quality between FDs, CFOs and ACCs (slide 30). This gives further evidence that there is misalignment of interests between stakeholders. The presentation notes that ACCs assign much greater importance to the auditor's rigour and independence (e.g. 45% of ACCs said that reliability and usefulness of audit report was very important, 35% said a high degree of challenge was very important and 28% said independence of audit firm was very important. This compares to 22%, 14% and 8% of FDs/CFOs, respectively).

4.4 In order to further facilitate the CC understanding the requirements of shareholders, we recommend that the CC considers seeking further views directly from investors.

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[1] See Grant Thornton response to the CC Issues Statement and Grant Thornton's response to the PwC Memorandum dated 6 July 2012.

[2] Oxera investor survey entitled "Investor views on market outcomes and potential remedies in the audit market"

[3] Competition Commission Statutory Audit Services Survey performed by IFF Research

5 Auditor choice

5.1 We noted in our response to the CC's Issues Statement that the characteristics of the FTSE 350 audit market result in companies being restricted in their choice of auditor, especially in certain 'specialist' sectors. Companies may be forced into choosing one or two audit firms owing to independence rules over the provision of non-audit services and due to the lack of experience inherent in other audit firms. Firms may also be reluctant to appoint an auditor that is auditing the accounts of key competitors in the market. Conflicts of interest (both legal and commercial) can therefore result in choice of auditor being extremely limited, which is not adequately captured by a comparison of the market shares of the largest four firms. Lack of choice is likely to lead to higher costs for the company and, ultimately, investors.

5.2 A lack of choice does not receive sufficient attention in the CC's revised theories of harm. An increased level of competition and choice would likely lead to an increase in innovation and differentiated services. Whilst, as the CC acknowledges, it is the case that significant aspects of the audit service are regulated, this does not remove the capability for innovation and variety in the way in which services are provided. Accordingly, we consider that a lack of innovation and variety as a consequence of lack of effective competition should be afforded greater consideration by the CC.

5.3 We note also that the CC is not apparently considering the scenario where one of the four largest firms fails ("a 4-to-3 scenario"). As set out in our response to the CC's Issues Statement, a 4-to-3 scenario would further limit choice and create a significant loss of market confidence and further distort the market and increase barriers to entry. Since this issue is also the focus of the European Commission and the Treasury Select Committee, we suggest that it continues to be considered by the CC as part of their investigation.

5.4 In our view the CC could usefully explore the limitation of auditor choice in the market further. A lack of choice could become a permanent feature of the market without effective regulatory intervention. In particular firms outside of the largest four are likely to cease investment in the FTSE 350 market if it becomes apparent that entry into or expansion in this market is impossible. Therefore adding firms to the choice set would provide a material benefit to market stability.

6 Other points

6.1 The CC notes in paragraph 90 of the working paper that high audit fees will incentivise "excess investment", in areas such as marketing and other activities which are not relevant to audit quality, in order to establish reputation and build relationships to win FTSE 350 audit clients. Such activity could weaken competition by raising barriers to entry. We consider that this point should be investigated further also in the context of the CC's profitability analysis.

6.2 The CC assumes in its working paper that the reference market is homogeneous. However the market is not homogeneous, with many specific sectors and size tiers found throughout the FTSE 350, in which additional detriments could arise (such as financial institutions). We suggest that the segmentation of the reference market should be considered further by the CC.