5 October 2012

Grant Thornton Response to the Competition Commission ("CC") working paper entitled "Evidence of tacit coordination"

1 Introduction

1.1 This memorandum sets out the response by Grant Thornton to the Competition Commission's ("CC") working paper entitled "Evidence of tacit coordination" ("the working paper") which was issued on 24 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, the CC has confirmed the existence of many of the conditions that are conducive to tacit coordination taking place, but we believe has erroneously reached the conclusion that tacit coordination is unlikely on the basis that (i) there is a lack of price transparency in the market to facilitate coordination, and (ii) the market shares of each of the largest four firms have changed over time. This is considered in further detail below.

2 Tacit coordination

2.1 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.

2.2 We note that the CC similarly identifies in the working paper that many of the features required for tacit coordination to take place are met. In particular, the CC sets out an initial view that:

a) the audit market is highly concentrated (i.e. the largest four firms have consistently carried out the audit for more than 90 per cent of FTSE 350 companies and 95 per cent by value) (paragraph 22),
b) there are "*high and persistent*" barriers to entry and expansion (paragraph 32),
c) there is limited competitive constraint by mid-tier firms (i.e. the CC states that "*the Big 4 firms face limited competitive pressure from other audit firms*") (paragraph 33),
d) there is the existence of switching costs (paragraph 34) and
e) there is stable demand due to the statutory requirement for an audit (paragraphs 24 -27).

2.3 However the CC also provides an initial view that the features of price transparency and market share stability are not sufficiently present in the FTSE 350 audit market for tacit coordination to take place. In these two areas, we disagree with the CC's initial view.

Price transparency

2.4 The CC states in paragraph 28 that "*our initial view is that this is not a market in which prices are particular transparent*", which is largely on the basis that: (i) auditing is not an homogenous product which means that it is not straightforward to compare audit fees; and (ii) the level of publicly available information may be insufficient to allow accurate comparisons of audit fees to take place (paragraphs 29 and 30). Grant Thornton considers this analysis to be inaccurate for the reasons below.

2.5 Firstly, as noted by the CC in paragraph 28 of the working paper, the name of a company's auditor and the audit fees paid by FTSE 350 companies are publicly disclosed in a company's annual report and accounts. This means that it is very easy to determine at any point in time which firm is the auditor for every FTSE 350 company and what fees are being charged. In addition, as this information is published annually it is also easy for rival firms to monitor the extent to which fees have changed over time (e.g. following a tender, or a change of auditor) as well as to benchmark these fees against other companies in the FTSE 350.

2.6 In this regard, the prices charged by audit firms are significantly more transparent than for almost all other professional service providers. This transparency allows the largest four audit firms to understand the prices that their rivals charged for an individual assignment (both in the previous year as well as over time), and thus arm them with critical information when tendering or analysing pricing of an individual company or within a sector of the FTSE 350. To the extent that any switching of auditor by FTSE 350 companies has taken place, this level of pricing information also allows the largest four audit firms to understand the competitiveness of their bids and to identify whether any particular rival is pricing aggressively.

2.7 We note that it is also clear from the CC's working paper titled "the nature and strength of competition in the market for FTSE 350 audits" that companies are able to, and do, compare audit fees with those paid by other companies in the same sector and/or of similar size and complexity[1]. The CC also notes in the same working paper that "our assessment suggests that when an auditor is reappointed, the scope of the audit and fees in the previous year is the starting point for the vast majority of discussions."[2]. In our view this provides evidence that audit firms are able to carry out an appropriate level of comparison on FTSE 350 audit fees (which are all in the public domain) and use this information as an appropriate parameter for price comparisons now and in the future.

2.8 Second, given that audits are subject to specific minimum standards, there is a high degree of transparency with regard to the level of service provided to audit FTSE 350 companies. Innovation, confidential and unique know-how, and intellectual property are not significant features of this market, which means that there is a high degree of transparency in relation to the factors affecting the audit fees being charged. In addition, to the extent that any switching has taken place between the largest four audit firms, they will already have insight as to the level of resources required to audit the FTSE 350 company in question.

2.9 Third, not all of the largest four audit firms are present across all sectors, which means that in certain sectors/industries there are even fewer rivals to monitor. This also means that the largest firms who are present in those sectors are more likely to come into contact with each other (e.g. in bidding for any tenders which do take place) and to have greater insight as to the level of resources required to audit the firms in those sectors.

2.10 Fourth, when considering an audit tender, the largest four firms will typically have experience (present or past) of providing non-audit services to the company in question. This aids them to understand all of the company-specific factors which the CC notes in paragraph 29 (such as 'the complexity and risk profile of the organisation').

2.11 Fifth, as noted by the CC, there is stability in the demand for audit services (due to the statutory requirement for medium and large companies to have their financial statements audited). This means that it is easy for the largest four firms to decipher the actions of their

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[1] See paragraph 96 of the CC working paper entitled "Nature and strength of competition in the supply of FTSE 350 audits".

[2] See paragraph 65 of the CC working paper entitled "Nature and strength of competition in the supply of FTSE 350 audits".

rivals from any random market-wide factors affecting demand and prices. Accordingly, the stability of the demand for audits is a feature of the market which makes it easier for the largest four firms to monitor the actions and fees charged of their rivals.

Stable market shares

2.12 The CC states in paragraph 23 that "*there are differences between the Big 4 firms in the shares they have had of FTSE 350 audits (measured by number of clients and audit fees)*" and that "*the shares each of these firms has had of FTSE 350 audits (measured by number of clients and audit fees) have changed over time*", which the CC points to in support of its conclusion that the market is not conducive to tacit coordination.

2.13 However, the market shares of auditors to the FTSE 350 have remained highly stable over a prolonged period, as noted in paragraph 22 of the working paper. In addition, the CC states in its Descriptive Statistics working paper that "*Figures 1 and 2 both show that the Big 4 firms consistently earned over 90 per cent of total real audit fees among both all companies and FTSE 350 companies*" (paragraph 12), with the charts clearly showing that the market shares of each of the largest four firms have remained highly stable over time. Accordingly, there is no evidence of any material market share shifting either from the largest four firms to the mid-tier auditors or between the largest four firms themselves.

2.14 We note also that the CC have concluded that they are unable to perform any appropriate price-concentration analysis[3] due to the lack of variation in the concentration variable. This would indicate to us that market shares of the largest four firms are indeed highly stable and which do serve as a feature conducive for tacit coordination to take place.

2.15 Therefore, in our view, all of the criteria necessary to facilitate tacit coordination are met and we consider that the CC should continue its investigation as to whether tacit coordination exists in practice.

Other points

2.16 We note from paragraph 55 that the CC have considered whether the largest four firms have coordinated over participation in tenders, but we are unclear whether the CC have also tested whether the largest four firms have submitted prices to tenders in a manner that appears coordinated. Similarly we are unclear as to whether the CC have performed analysis to determine if the largest four firms' pricing pattern is disrupted when there is a maverick (mid-tier) competitor involved in the tender (such as is suggested at Annex 1, paragraph 1(a)).

3 Other evidence of coordination between the largest four firms

3.1 As previously described to the CC, we have noted a number of 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 (at least internally within the largest four firms) as the "European Centre for Audit Quality", the most advertised output of which is the publication of a report by Copenhagen Economics ("CE")[4] commissioned jointly by the largest four firms. 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.

[3] See paragraphs 72 and 76 of the CC working paper entitled "Price concentration analysis"

[4] Copenhagen Economics report entitled "Regulation of the Market for Statutory Audits: Review of the EC impact assessment", dated February 2012

We believe that the largest four firms use the CE report to seek to persuade buyers of audit services to continue to do so from only the four largest firms. The CE report has been widely circulated by a number of partners of the four largest firms to authorities around the World, including BIS and UK Government.

3.2 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.

3.3 We therefore urge the CC to continue to explore this area 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.