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25 March 2013

Dear Sirs

**Investigation into the market for the supply of statutory audit services to large companies in the UK**

Grant Thornton UK LLP (Grant Thornton) welcomes the opportunity to comment on the Competition Commission's (CC's) provisional findings with respect to the supply of statutory audit services to large companies in the UK (Provisional Findings).

As one of the leading UK audit firms, Grant Thornton has a particular viewpoint and interest in the debate regarding the overall structure of competition in the audit market and we are also well placed to understand and articulate the competition issues that face audit firms from outside of the largest four firms in the supply of audit services to large companies. Enhanced competition, both between the four largest audit firms and between these firms and other firms (like Grant Thornton), would inevitably be of benefit to both companies and their shareholders.

The findings of the CC set out in the Provisional Findings reflect concerns raised by many stakeholders about the structure of the UK large company audit market, and are broadly in line with our own direct experience and our observations on the operation of the wider market. Considered in the round, the evidence, and analysis set out in the Provisional Findings and the conclusions of the CC all point towards there being a serious structural/behavioural problem in the large company audit market.

The CC has presented compelling evidence for the need for intervention in this market. In particular the CC was right in identifying relevant features of the FTSE 350 market that give rise to an adverse effect on competition ("AEC") as a consequence of companies' limited willingness to switch auditor; barriers to expansion and selection for firms outside of the largest four; auditors having misaligned objectives, as between shareholders and company management; and auditors competing on the wrong parameters. We agree that this unwillingness to switch operates between the largest four firms, as well as between these four and other audit suppliers with the requisite capabilities. We agree with the CC that the market for FTSE 350 audits would be significantly improved by enhanced competition between the largest four through the application of the proposed remedies. However, (as you might expect) we would see significant *additional* benefits arising from entry and expansion by firms outside of the four largest accounting firms, so that the market in FTSE 350 audits becomes markedly less concentrated over time.

The relevant features of the markets identified by the CC, and the resulting AEC, has led to adverse outcomes in the form of higher prices, less innovation and less differentiation than would otherwise be the case. Were the features of the market identified by the CC, and the AEC, to be satisfactorily remedied, this would lead to an increase in competition, in particular through facilitating the increased entry into the supply of audit services to FTSE 350 companies by auditors other than the largest four.

We do not regard the CC's Provisional Findings as a criticism of auditors or an understatement of a strong corporate governance regime in the UK, more an observation of how the audit role has evolved and the difficulties shareholders have in understanding how the auditor and audit committee have been discharging their responsibilities to them.

Subject to the detailed comments set out in the Appendix to this letter, we therefore believe that the Provisional Findings should substantially become final.

We set out in the appendix to this letter our views and evidence on the Provisional Findings. We have commented separately on the remedies which the CC intends to explore further.

If you have any questions on this response, please contact either Steve Maslin (Direct T: +44 (0)20 7728 2736; E: [steve.maslin@uk.gt.com](mailto:steve.maslin@uk.gt.com)) or Martin Drew (Direct T: +44 (0)1865 799914; E: [martin.s.drew@uk.gt.com](mailto:martin.s.drew@uk.gt.com)).

Yours faithfully



Grant Thornton UK LLP

# Appendix – Grant Thornton views on the Provisional Findings

## 1 Market outcomes are consistent with a lack of effective competition

- 1.1 In considering the Provisional Findings of the CC it is necessary to have regard to the evidence as a whole and to take a holistic view in considering whether there is effective competition in the supply of statutory audit services to large companies and, if there is not, why that is the case. In this regard, all of the evidence and conclusions in the Provisional Findings point in the same direction and demonstrate unequivocally that there is a serious structural/behavioural problem in the large company audit market which prevents effective competition from emerging.
- 1.2 These problems are leading to poor outcomes for customers, with investors and shareholders voicing the need for increased choice and more competition in the FTSE 350 audit market.<sup>1</sup> In particular, the evidence before the CC is that when an audit firm is switched, it leads to lower prices for customers, and is likely to lead to better quality audit service. Given the low rate of tendering and switching, current levels of competition between the largest four firms cannot be relied on to result in optimal consumer outcomes. It follows that increased switching and tendering would be expected to lead to better outcomes for customers, particularly in terms of price and quality.
- 1.3 Against this background, the CC was correct in investigating observable market outcomes to determine whether competition was working effectively, and was also correct in identifying the relevant market outcomes to inform that assessment.<sup>2</sup> For the reasons summarised below, we strongly agree that those observed market outcomes are not indicative of a well-functioning market.
- The structure, tenure, and rates of switching in the relevant market (and resulting impact on prices)*
- 1.4 As set out in Grant Thornton's further submission of 1 November subsequent to the publication of the CC's working papers ("Status Paper"), the structure of the large company audit market is not consistent with the characteristics of a market which enjoys healthy competition.<sup>3</sup> We note that the market has suffered a sustained period of high levels of auditor concentration and that switching levels are low and auditor tenures excessively long. In particular we highlight certain points in the paragraphs that follow.
- 1.5 There are high levels of concentration with the largest four audit firms accounting for the overwhelming majority of audits in the FTSE 350. The CC has found that the four largest audit firms accounted for over 99% of audit fees paid by FTSE 350

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<sup>1</sup> See Grant Thornton response to the CC's Issues Statement.

<sup>2</sup> Which are those set out at paragraph 7.3 of the Provisional Findings.

<sup>3</sup> See, in particular, Status Paper at paragraphs 2.1 to 2.4.

companies and over 96% of audit engagements of FTSE 350 companies in 2010.<sup>4</sup> The very limited presence of firms other than the four largest in auditing FTSE 350 companies demonstrates that those firms currently offer very limited, if any, competitive constraint to the largest four audit firms.

- 1.6 There is a very stable market in which the market shares of the largest four audit firms have varied relatively little over time, as confirmed in paragraph 7.8 of the Provisional Findings. The Provisional Findings also evidence that the market shares of the four largest audit firms "*remained broadly stable over time both in terms of number of FTSE 350 engagements and the value of FTSE 350 engagements*".<sup>5</sup> This illustrates that there has been no material market share shifting either from the largest four firms to the mid-tier auditors or between the largest four firms themselves and points to competition being muted. In addition, the FRC Fifth Progress Report on the implementation of the Market Participants Group recommendations stated that there was "*little indication that concentration in the audit market is reducing or is likely to reduce in the near future*".<sup>6</sup> This is unsurprising given the barriers to entry and expansion that exist in the market, and the fact that Grant Thornton and the other suppliers of audit services have been unable to break the stranglehold that the four largest suppliers of audit services have on the market.
- 1.7 The level of tendering in the large corporate audit market is very low. For example, the Provisional Findings states that there were only 83 instances in which a FTSE 350 company switched auditor (excluding those where companies switched from Arthur Andersen following its collapse and instances where a company changed to/from a joint audit) over the ten-year period from 2001 to 2010.<sup>7</sup>
- 1.8 In part as a consequence of low levels of tendering, there are very low levels of switching between auditors in the FTSE 350, with the result that the average tenure for an audit is of very significant length. Grant Thornton's own research into corporate reporting within the FTSE 350 "A Changing Climate, Fresh Challenges Ahead" indicated that in the period from May 2010 to April 2011, only five FTSE 350 companies changed auditor (indicating a change rate of 1.4% of FTSE 350 companies per year). A report by the Economics Affairs Committee entitled "Auditors: Market concentration and their role" also showed that a FTSE 100 auditor remains in place for 48 years on average, with a FTSE 250 auditor having an average tenure of 36 years. The CC's own analysis indicates that annual switching rates among FTSE 350 companies ranged between only 1.5% and 3.5% between 2001 and 2010 (excluding switching by Arthur Andersen clients) and that the average annual switching rate among FTSE 350 companies was only 2.4%. The average annual switching rate for FTSE 350 companies was lower than for listed non-FTSE-350 companies, which varied between 2.8% and 8.2%<sup>8</sup>, and averages at around 5% per annum.

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<sup>4</sup> Provisional Findings, Tables 7.1 and 7.2.

<sup>5</sup> Provisional Findings, paragraph 7.8.

<sup>6</sup> Financial Reporting Council Fifth Progress Report on the implementation of the MPG recommendations, June 2010, page 6.

<sup>7</sup> Provisional Findings, paragraph 7.16.

<sup>8</sup> Provisional Findings, paragraph 7.17 and Appendix 5, Table 4 (paragraph 41).

- 1.9 Such low levels of tendering and switching mean that the competitive constraints on incumbent auditors are more muted than would otherwise be the case and also makes it extremely difficult for Grant Thornton and other suppliers of audit services to destabilise the competitive advantage of the four largest audit firms and grow market share. More importantly, increased tendering and switching may be expected to lead to better outcomes for customers of the audit service.
- 1.10 In our experience the higher switching rate observed outside the FTSE 350 has not led to excessive costs for either firms or companies. As the statutory audit fee as a proportion of turnover is generally higher for these companies this would suggest that any negative cost or other negative consequences of more frequent switching would also be proportionately higher. Since these markets have a higher switching rate, and a greater number of suppliers competing for audit assignments, this points to a conclusion that where increased effective competition is evident there are benefits to companies from more frequent switching. If this was not the case, it would be expected that companies would choose not to switch, and given the additional proportionate costs, switching rates might be expected to be lower, not higher, in this part of the market.
- 1.11 The CC has demonstrated that real audit fees decrease following a change in auditor.<sup>9</sup> In particular, for the median FTSE 350 company the total real audit fee fell by 17% in the first year after switching took place (18% for real audit fees per £1m of turnover), and fees remained lower until the fifth year after switching.
- 1.12 In addition, we cannot at present understand PwC's conclusion in its econometric analysis of switching data. Our provisional analysis is that the price reduction on switching is more enduring than PwC has concluded. Grant Thornton is investigating this issue further and may make a further submission on this point once that analysis is complete.
- 1.13 Further, the CC has found that audit fees per hour decrease following a change in auditor (see paragraphs 91 to 96 and Figure 17 of Provisional Findings Appendix 5). Figure 17 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%). The CC has also identified that "*[f]or both FTSE 350 and non-FTSE-350 engagements the fee per hour decreases in real terms in the years after switching auditor*".<sup>10</sup>
- 1.14 The CC's survey of companies that had switched in the last five years identified that 52% of FTSE 350 companies that responded noted that switching auditor resulted in a lower fees, and 48% noted increased quality, with 20% reporting both reduced fees and improved quality. In general, around 75% of FTSE 350 companies surveyed said that switching resulted in some benefits in the first and/or following years<sup>11</sup>. We have also observed that the public sector audit market has seen a reduction in prices, and benefits from high quality, as a result of the change in the way major public sector audits have been procured by the Audit Commission. In this market, the barriers to entry which are prevalent in the FTSE 350 are not

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<sup>9</sup> Provisional Findings, paragraphs 7.37 to 7.41 and Appendix 5, Table 5 and paragraphs 52 to 58.

<sup>10</sup> Provisional Findings, Appendix 5, paragraph 94.

<sup>11</sup> Provisional Findings, Appendix 3, paragraph 67.

present, as they are overcome by having regular and transparent tendering and switching, a process which has seen a significant increase in the number of firms competing in the market. Although it is still early days the dynamic by which the Audit Commission engages in the auditor procurement and appointment process, acting as a proxy for the shareholder interest, has meant that the output of these audits is also less distorted by the interests of management and more aligned with the needs of the client - in this case the Audit Commission.

- 1.15 The market outcomes described above, in conjunction with other outcomes addressed below, provide clear evidence that the structure and dynamics of the market are poor, with long auditor tenures exacerbated by low levels of tendering and/or switching by companies resulting in low levels of effective competition between the four largest audit firms. Greater competition and more frequent switching (and, indeed, tendering) of audit firms would result in more effective competition and provide significant benefits to the customers of audit services in terms of lower prices.
- 1.16 As an example, in previous submissions we have drawn the CC's attention to the public sector audit market, where tendering and switching of audit firms is more frequent and which market is commonly regarded as having the features of high quality,<sup>12</sup> good value for money and innovation. It might be helpful for the CC to elicit the views of the NAO, Audit Commission and Audit Scotland about the impact of a change in auditor on audit quality, since they will have monitored the audit quality, service and audit price of many entities where such a change has occurred over such short periods as every 5 years. Our understanding is that increased frequency of audit firm rotation in the public sector has led to good value for money and improved quality and service for the institutions involved.

*The choice of auditors open to FTSE 350 companies*

- 1.17 As found by the CC, the FTSE 350 is highly concentrated with the largest four firm accounting for the overwhelming majority of audits. Moreover, the very limited presence of firms other than the four largest in auditing FTSE 350 companies demonstrates that those firms are rarely considered by FTSE 350 companies when they switch. In consequence, FTSE 350 companies have a more restricted choice of auditor than would otherwise be the case and incumbent auditors face less competition for their ongoing engagements than they would were the company more willing to switch.
- 1.18 We note that the situation is exacerbated in certain industries within the market where there are sometimes only two or three of the largest four firms providing audit services. Independence rules, conflicts, and regulations further limit choice, which means that the choice of auditor (from the largest four firms) for many companies will be even more limited. 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

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<sup>12</sup> See the Audit Commission's 2012 Quality Review Programme report at <http://archive.audit-commission.gov.uk/auditcommission/SiteCollectionDocuments/AnnualReports/2012/20120621-quality-review-programme.pdf>.

competitors in the market. Conflicts of interest (both legal and commercial) can therefore result in choice of auditor (from the largest four firms) being extremely limited, which is not adequately captured by a comparison of the market shares of the largest four audit firms.

- 1.19 In this regard, Oxera stated in its 2006 report that "*According to the audit committee chairs survey, around one in eight FTSE 350 companies have two audit firms conflicted out as alternatives to their current auditor, leaving them only one [alternative among the four largest audit firms] in the event of an audit tender. Oxera also found that around one in eight companies in the survey use all of the largest four firms across audit and non-audit services, potentially restricting their effective short-term choice of auditor to zero*".<sup>13</sup>
- 1.20 The OFT also noted that concentration in the auditing of some specific industry sectors such as banking, mining, and utilities may be substantially higher, as not all of the largest four audit firms are present throughout such sectors;<sup>14</sup> For example, in the financial services sector, there are only three firms providing auditing services to the large banks in the UK. The need for independence means that an audit firm could not audit a bank which acted as a supplier of financial services to that firm. Such rules potentially result in choice of auditor being even more limited. Oxera stated in its 2006 report that "*on the question of choice, Oxera has found that a limited number of UK-listed companies, primarily in the financial services sector of the FTSE 100, have no effective choice of auditor in the short run*".<sup>15</sup>
- 1.21 The House of Lords select committee also found that "*most witnesses believe that the dominance of the largest four firms limits competition and choice in the audit market. Ethically, audit firms are unable to accept work which would place them in conflict with other work for the same or other clients*".<sup>16</sup>
- 1.22 Additional restrictions on the choice of auditors available to companies may also arise from specific regulatory requirements. For example, multi-national companies choice may be restricted by regulation, such as the Sarbanes-Oxley Act of 2002 in the US, which limits the ability of public reporting companies to appoint as their auditors firms who supply them with certain types of non-audit services.<sup>17</sup> Further, audit firms may have internal policies that prohibit them from taking an audit appointment where a substantial proportion of the company's subsidiaries are audited by other firms.
- 1.23 Finally, the CC has noted in its Provisional Findings that restrictions over the appointment of auditors (and therefore restrictions over a company's choice of auditor) currently exist in written form in template leveraged loan documentation (e.g. that provided by the Loan Management Association). We are aware that these clauses also exist, equally importantly, in unwritten form and in agreements outside of the template leveraged loan documentation referred to by the CC (for example in transaction related contracts and in lending contracts which stipulate that a firm

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<sup>13</sup> Paragraph 5.3.1 of the Oxera report "Competition and Choice in the UK Audit Market", 2006.

<sup>14</sup> OFT Reference, paragraphs 1.5, 4.27 and 5.51.

<sup>15</sup> Page i, fourth bullet, of the Oxera report "Competition and Choice in the UK Audit Market", 2006.

<sup>16</sup> Paragraph 26, "Auditors, market concentration and their role", volume 1, Select Committee on Economic Affairs, 2nd report of Session 2010-2011

<sup>17</sup> OFT reference decision, paragraph 5.66.

outside of the largest four cannot be used for advisory work such as for restructuring or due diligence assignments). The impact of informal and oral restrictions imposed by institutions are a particularly effective means by which a company's choice of auditor is limited (and thus effective competition is muted). We encourage the CC to seek a deeper understanding of this, to ensure that the detailed implementation of the proposed remedy addresses both the formal and informal restrictions that are currently widespread in the market. Grant Thornton has also provided evidence of the types of documentation in which we have identified such clauses in our response to the working paper entitled "Restrictions on entry or expansion". We would suggest further that the CC consider evaluating the extent to which restrictions of this type are present in documentation issued by legal advisers and investment houses.

- 1.24 In our view the perceived lack of choice by companies in the market is another indicator of a market with ineffective competition and is an issue which should be addressed. The remedies proposed will go some way to addressing this issue, but there are additional measures that would both help to address the AECs found and further address this issue of lack of effective choice. These include the encouragement of consortia audits and further restrictions on the provision of non-audit services to audit clients. In an audit environment in which restrictions over non-audit services are necessary, additional restrictions will have little impact on further limiting a company's choice of auditor, but will act as a powerful measure to break down barriers to entry to the market for firms outside of the largest four audit firms. We have set out in more detail in the Grant Thornton submission on remedies as to why we believe these additional remedies are necessary. In the context of the Provisional Findings we believe that the findings provide adequate justification for both addressing this lack of effective choice issues and justifying these additional remedies with respect to the AECs found.

*The profitability of the largest four audit firms*

- 1.25 We note that the CC has been unable to reach a conclusion on whether audit firms generate profits above competitive levels or otherwise in this market, on account of difficulties in valuing capital employed; the intangible nature of the asset base in this market; difficulties in cost allocation (as firms offered both audit and non-audit services); and difficulties in identifying costs due to the partnership ownership structure.
- 1.26 Nevertheless, the CC has identified a range of evidence which indicates that the supply of audit services to the FTSE 350 companies is a very attractive business line for the largest four firms.<sup>18</sup> Grant Thornton considers that, when assessed in the round, this evidence is very strongly suggestive of the largest four firms making returns above the competitive level in the supply of those services to FTSE 350 companies.
- 1.27 Indeed, Grant Thornton considers that the evidence identified by the CC is likely to understate the profitability of the largest four firms in providing audit services to the FTSE 350, such that the CC has been unnecessarily cautious in its conclusions

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<sup>18</sup> Provisional Findings, paragraph 7.92.

on the overall profitability of the largest four firms. By way of example, the profit margins (evidenced by average profit per partner) of the largest four audit firms are significantly higher than that of the next largest audit firms (Grant Thornton average profit per partner in 2011 was £342,000 while the largest four firms presented average profits per partner of between £663,000 and £763,000 in their latest publicly available accounts).

- 1.28 Further, the average profit of Grant Thornton partners who act as the audit engagement partner on a FTSE 350 assignment was £[redacted] for the 2012 financial period (this figure includes a partner who has a wider leadership role in the firm and thus is in excess of a true average were this element eliminated), a sum significantly below that suggested by PwC, of £487,000 - £876,000<sup>19</sup>, in its assessment of the average "salary" that they would expect to have to pay to an employee who was appointed to undertake the audit engagement partner role on FTSE 350 audit work.<sup>20</sup>
- 1.29 Alone, these are strong indicators that the returns being achieved by the four largest auditors from providing audit services to the FTSE 350 significantly exceed those that can be achieved from providing the same services to companies outside the FTSE 350 where there are a greater number of firms competing for mandates.
- 1.30 However, even this observation fails to capture the fact that all the largest four firms provide services to firms outside the FTSE 350 and that their overall profitability in providing audit services will be diluted by providing services in that competitive market. In consequence, it seems highly likely that once the dilutive effect of servicing companies outside the FTSE 350 is taken into account, the profitability of the largest four firms in providing audit services the FTSE 350, assessed by reference to partner profits, is even greater than is suggested by the average partner profitability gap between the largest four firms and the largest mid-tier firms.

#### *Auditor independence*

- 1.31 The CC has provisionally concluded that losses of auditor independence do occur, and that this would not be an outcome that should be observed if auditors were responding only to the demand of shareholders.<sup>21</sup>
- 1.32 The very long tenure of audit firms in the market (as noted further above), is a concern for many investors who believe more frequent changes of auditor would take away perceptions of potential loss of independence which arise when an audit firm is in place for too long. While the current requirement for audit engagement partner rotation is an important safeguard for these concerns at the personal level, it is clear that it does not on its own address the perception that a familiarity threat arises between the company and the audit firm.

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<sup>19</sup> See PwC submission "Observations on the assessment of audit profitability" at table 9. The benchmark salary range is the median for PwC's roles 2 and 1.4.

<sup>20</sup> Although not explicit, table 7 of the PwC submission (op cit) seems to suggest that typically FTSE 250 audits would be carried out at the top end of role 2 through to role 1.4.

<sup>21</sup> Provisional Findings, paragraph 7.149.

- 1.33 In a long term audit engagement, some investors and regulators are concerned that the auditor will tend to identify too closely with the company's management and may mean the auditor's approach becomes 'stale' and susceptible to easy repetition (which a company's management who understand the approach that the long standing auditor will take to their testing, may exploit) and dilutes the auditor's inclination or ability to challenge management assertions.<sup>22</sup>
- 1.34 Linked to these general concerns is the risk that the use by companies of the auditor for the provision of many non-audit services creates further concerns over the independence of the auditor and the familiarity of the auditor with management.
- 1.35 The UK listed audit market currently follows the Ethics Standards issued by the Auditing Practices Board which build on the IFAC code of ethics and which stipulate various requirements regarding the provision of non-audit services by the auditor. These ethical rules prohibit the provision of certain non-audit services in addition to setting parameters over the size and type of fees which are able to be charged. In many cases non-audit services are able to be provided by the auditor if appropriate safeguards are applied and the audit committee gives agreement to the service provision.
- 1.36 Notwithstanding acting in accordance with the above regulations, for many companies the first choice provider of non-audit services is currently the incumbent auditor. Grant Thornton's research into corporate reporting within the FTSE 350 "A Changing Climate, Fresh Challenges Ahead" indicates that companies in the FTSE 350 incurred on average non-audit fees of 80% of their audit fees in the period from May 2010 to April 2011 and, of these, 73 companies paid more to their auditor for non-audit services than for audit services. The report also shows that only 10 companies did not use their auditor to provide any non-audit services during the period of review.
- 1.37 The use of the auditor to provide non-audit services is justified by many companies by the auditor's experience and knowledge of the company and, assuming safeguards are applied, is not in itself an issue. However this scenario results in an environment where the auditor becomes increasingly close to management and, the closer that relationship becomes and the longer it persists, the greater the risk of a loss of independence as perceived by a number of investors. As a further observation, the stronger the relationship between the auditor and management as a consequence of the provision of non-audit services, the more difficult it is for firms outside of the auditor to build relationships and raise their profile with the company – in many cases with non-audit work being allocated to the auditor without consideration of other, equally or better qualified, firms.
- 1.38 If the issues noted above were to be overcome, this would help both to ensure the alignment of the incentives of auditors to compete to satisfy shareholder demand, as well as providing more information to the companies on the potential providers of audit services, and hence improving the competitive dynamic as well.

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<sup>22</sup> See, for example, Provisional Findings at paragraphs 27-28, 11.76 and 11.94.

*Indicators of innovation*

- 1.39 The CC has reached the provisional conclusion that innovation is not at the level that the CC would expect to see in a well functioning market, but acknowledges that this issue is linked to the issue of unmet demand.<sup>23</sup>
- 1.40 In this regard, we note that while there has been much discussion regarding the role of the auditor and the vision for the future, there has been no stepped change in the evolution of the audit to meet what investors are asking for. In our view the audit process and its deliverables have not evolved significantly and audit quality remains an opaque measure for investors with the result that the end user (the investor) is dissatisfied with the process.
- 1.41 Further, there are inevitable difficulties arising from any attempt to evaluate levels of 'innovation' as a consequence of the fact that auditor innovation may be driven by a number of areas such as efficiency of performance or building client relationships, and may not correspond to achieving a better or more expansive opinion with regard to the truth and fairness of the financial statements.
- 1.42 We consider it important to note here the differences between the definition of audit quality as applied by investors, audit regulators and by the company. For example, our experience is that companies may perceive high audit quality to mean, among others, responsiveness, auditor/director relationships, providing access to directors to a more extensive director network, depth of understanding of the business and the ability to give advice on other services at relatively short notice. Conversely, auditor scepticism can be a less important quality looked for by management.
- 1.43 While these are areas on which all audit firms compete, they tend to be areas which are more subjective and cannot be taken as "audit quality measures" independently. However since the delivery of these attributes are perceived by companies as important, audit firms may over deliver on the provision of these areas (for which over-delivery the company pays more), resulting in sub-optimal audit service delivery, in that the service is over-specified and does not match the requirements of the ultimate customer, the investor. Put another way, the apparent lack of transparency about true audit quality and the inability of audit committees and shareholders to judge whether the level of service is what is required, may result in a tendency to "over deliver" on measures which are management serving rather than addressing the audit requirements of shareholders and other investors.
- 1.44 In short, Grant Thornton considers that the CC was right to conclude that an assessment of innovation is inextricably linked with the question of unmet demand. On this issue, and as indicated below, Grant Thornton has consistently acknowledged that despite investors expressing a desire for enhanced auditor reporting, the audit report has to date remained substantially unchanged.

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<sup>23</sup> Provisional Findings, paragraph 7.179.

*Un-met demand regarding the audit product*

- 1.45 The CC has provisionally concluded that there is demand from investors for further and differentiated information regarding the audit of companies and that failure to satisfy this demand suggests that the market is not working effectively.<sup>24</sup> Grant Thornton agrees that the way in which the supply of statutory audit services has developed over time means that full needs and requirements of shareholders is not currently being met by the audit product. Indeed Grant Thornton has been vocal in expressing this view, not just to the CC, but also to industry bodies and in industry fora.
- 1.46 The true customers of audit (the shareholders) are increasingly demonstrating a lack of satisfaction with the current position in the FTSE 350. In particular, comments made by investors to the House of Lords Economic Affairs Select Committee,<sup>25</sup> in the Oxera investor survey and by investors at the ACCA/Grant Thornton roundtable event have all called for change.
- 1.47 There is a strong principal/agent effect resulting from the fact that those who choose/appoint the auditor (i.e. the company) are not the primary customer of audit services (which are the shareholders), and that the needs of shareholders are not being met.
- 1.48 In summary, Grant Thornton strongly agrees with the conclusion that the emerging needs of shareholders are not being met fully by the current audit product.

**2 The CC's theories of harm are well founded**

- 2.1 The CC has reached the provisional view that, cumulatively, the observed market outcomes addressed above, (and dealt with in the Provisional Findings) demonstrate that the market for the supply of audit services to FTSE 350 companies is not working well in terms of delivering optimal outcomes to customers (in particular, to shareholders). Grant Thornton agrees that it is necessary to look at the evidence in the round in assessing whether the market can be said to be working well, and that it is not meaningful to seek to rely particularly on any one observed market outcome (or, indeed, any small subset of those observed market outcomes).
- 2.2 In circumstances in which all of the market outcomes considered by the CC point in the same direction and, specifically, point to a market which is not working well, and has not been working well for many years, Grant Thornton considers that the CC has, in fact, been unduly measured in its conclusion that the market is not working well. Considering the totality of the evidence before the CC, there are strong grounds for reaching that conclusion. Further, given the totality of the evidence before the CC and the fact that it is all pointing in the same direction, the arguments of the largest four firms that the outcomes observed by the CC are the result of an effective competitive process, is simply not plausible. Indeed, the major factors that underpin the current levels of market concentration are either commercial mergers or (in the case of the last increase in concentration) the sudden collapse of a major

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<sup>24</sup> Provisional Findings, paragraph 7.204.

<sup>25</sup> See Grant Thornton UK LLP's submission to the CC's Issues Statement, dated 12 January 2012.

audit provider, neither of which indicate some fundamental competitive dynamic that requires such levels of concentration to deliver effective audit services for large companies.

2.3 Whilst the features of the market that result in an adverse effect on competition leading to the sub-optimal market outcomes observed by the CC could be framed in a number of different ways, Grant Thornton considers that the theories of harm investigated by the CC were well specified and have enabled the CC to identify correctly the principle features of the market giving rise to adverse effects on competition. Specifically, Grant Thornton agrees that:

- companies have a limited willingness to switch provider of audit services as a consequence of informational asymmetries, switching costs and weakened bargaining power;<sup>26</sup>
- there are barriers to expansion and selection which mean that the choice that companies confront when considering switching is more limited than it would otherwise be;<sup>27</sup> and
- there is a principal agent problem that auditors have an economic incentive to respond to management and have less incentive to respond directly to the demands of individual shareholders.<sup>28</sup>

2.4 Each of these adverse effects on competition are consistent with the views and evidence provided to the CC by Grant Thornton during the investigation process.

*The assessment of the willingness of companies to switch and their respective bargaining power*

2.5 The CC has carried out a detailed assessment of the willingness of companies to switch auditor and their respective bargaining power.<sup>29</sup> Grant Thornton supports the approach of the CC to considering this issue and also its broad findings. In particular, Grant Thornton agrees with the provisional view of the CC on the lack of willingness of companies to switch and their limited bargaining power set out in paragraphs 9.257 to 9.263 of the Provisional Findings. At this stage, Grant Thornton does not have any particular further observations or evidence it wishes to provide on this issue.

*Barriers to expansion and selection*

2.6 The CC's conclusions in relation to the barriers to selection and expansion set out at paragraphs 10.1 to 10.34 of the Provisional Findings are entirely consistent with the representations and submissions made to the CC by Grant Thornton.<sup>30</sup>

2.7 Grant Thornton already possesses all of the necessary attributes to service a high proportion of the FTSE 250 and some of the FTSE 100. In this regard, we note and agree with, the CC's conclusion that there is no specific large investment that

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<sup>26</sup> Provisional Findings, paragraphs 9.260 to 9.262.

<sup>27</sup> Provisional Findings, paragraph 10.33.

<sup>28</sup> Provisional Findings, paragraph 13.7.

<sup>29</sup> Provisional Findings, paragraphs 9.1 to 9.264.

<sup>30</sup> See, in particular, paragraphs 3.1 to 3.18 of Grant Thornton's Status Paper.

would need to be made by Grant Thornton in order to expand its activities in supply audit services to the FTSE 350. Indeed, as explained in Grant Thornton's evidence to the CC, a considerable number of our audit clients in other market segments (such as the large private company market and the public sector market) are as complex as many of the FTSE 350 companies.

2.8 Notwithstanding these attributes, Grant Thornton has faced, and continues to face, real barriers in winning FTSE 350 audits. These barriers have been accurately summarised by the CC as follows:

- limited tenders and low-levels of switching (and limited incidence of Grant Thornton being invited to participate in those few tenders that do take place);<sup>31</sup>
- limited awareness by financial directors and audit committee chairs of FTSE 350 companies of the capabilities of audit firms outside the largest four firms.<sup>32</sup> This issue is exacerbated by the fact that a large proportion of financial directors, chief financial officers and audit committee chairs are ex employees or alumni of the largest four firms;<sup>33</sup>
- limited ability to point to experience of auditing FTSE 350 companies;<sup>34</sup>
- a lack of reputation, or perceived ability by those making the appointment for auditors (or on the part of those that influence that appointment).<sup>35</sup> This might also be described as the "IBM effect".<sup>36</sup>

2.9 Grant Thornton therefore agrees with the CC's conclusion that the above factors, and other factors related to "perception", have made it extremely difficult for Grant Thornton to win FTSE 350 mandates, notwithstanding that it has the skills, attributes and capabilities to audit a large proportion of the FTSE 250 and some of the FTSE 100.

*The principle-agent identified by the CC*

2.10 The CC have identified that there is a principle-agent problem whereby audit firms have incentives to respond to management demand rather than shareholder demand; and where there are constraints to prevent auditors from meeting the demands of shareholders.<sup>37</sup> Grant Thornton strongly agrees with this conclusion.

2.11 We concur with the CC's provisional finding that the incentives of audit firms are often misaligned with those of shareholders. This has occurred over time as the audit model has evolved to the current situation where auditors spend most of their time communicating with FDs/CFOs, some time with ACCs and no time with

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<sup>31</sup> Provisional Findings, paragraphs 10.8 to 10.10.

<sup>32</sup> Provisional Findings, paragraphs 10.11 to 10.13.

<sup>33</sup> Grant Thornton's Status Paper, paragraph 3.8.

<sup>34</sup> Provisional Findings, paragraph 10.18 to 10.20.

<sup>35</sup> Provisional Findings, paragraph 10.21 to 10.30.

<sup>36</sup> See, for example, paragraphs 3.10, 3.11 and 3.12 of Grant Thornton's Status Paper.

<sup>37</sup> See, in particular, the Provisional Findings, paragraphs 11.140 to 11.142.

shareholders, the ultimate client. The auditor is inevitably motivated by a desire to meet the demands of FDs/CFOs who are instrumental in auditor appointment decisions.

- 2.12 The fact that little innovation has been noted in the audit market to meet the requirements of shareholders is testament to this situation.
- 2.13 We do not believe that the CC's Provisional Findings are a criticism of auditors or an understatement of a strong corporate governance regime in the UK, more an observation of how the audit role has evolved and the difficulties shareholders have in understanding how the auditor and audit committee have been discharging their responsibilities to them.
- 2.14 However the proximity of auditors to the FD/CFO and the lack of ability for increased auditor-shareholder engagement inevitably places auditors in a situation where the perception that incentives are not aligned is present. In our view, changes are therefore required to ensure that this evolution is realigned with the current needs of shareholders.

### **3 The need for remedies**

- 3.1 Where the CC finds that there is an AEC, as it has correctly done in this case, it has a duty, under S.134(4) of the Enterprise Act 2002, to decide whether it should take action/or whether it should recommend others to take action to remedy, mitigate or prevent the AEC or any resulting detrimental effects on customers. In this regard, Grant Thornton strongly believes that it is necessary for the CC to implement a suitable package of remedies (and has set out in detail in its response to the Remedies Notice, the package of remedies it thinks will be most effective and proportionate in addressing the AEC's identified by the CC).
- 3.2 Intervention is required on the basis that the market cannot be expected to correct itself, either in the short term or in the long term. This is because:
- the market has exhibited sustained periods of high levels of auditor concentration and excessively high auditor tenures over a period of many years. There have been no indications that this will change of its own accord;
  - such limited regulatory intervention as has occurred in the past has not resulted in material change;
  - as demonstrated by their submissions to the CC, the largest four firms have an incentive to maintain the status quo, and have been arguing strongly that no, or limited, change is required. Absent intervention, the largest four firms cannot be expected to facilitate effective change on their own initiative;
  - the principal/agent issue identified by the CC means that the management of companies have limited incentive to bring about change on their own initiative. In this regard, any behavioural changes that might be argued to have taken place since the commencement of serious regulatory scrutiny, and/or as a result, of the OFT/CC's investigation cannot be expected to continue into the future absent effective and permanent intervention. Once

the process of scrutiny is over, behaviour will revert to its previous pattern, unless the rules of the game are changed. In other words, without the process of the scrutiny of the CC we do not think any recent modifications of observed behaviour would have occurred and, even where behaviour has been recently modified, it can be expected to revert to the previous status quo in the event that the CC chooses not to mandate or permanently incentivise changed behaviour; and

- for the reasons set out in the Provisional Findings, audit firms outside the largest four firms will be unable, absent intervention, to bring about effective change in conditions of competition in the supply of audit services to the FTSE 350.
- 3.3 In consequence, Grant Thornton considers that a comprehensive package of regulatory stimulus is necessary to bring about change. Were such changes to take place, and the remedies are successful in creating a level playing field, the CC can expect greater competition amongst the largest four audit firms for FTSE 350 audits but, *in addition*, the creation of conditions facilitating entry by other firms who are well placed to provide audit services to these companies, such as Grant Thornton. This would lead to greater competition and all of the beneficial consumer outcomes that that may be expected to deliver (in terms of lower prices, increased quality, greater innovation, addressing unmet demand and so on).
- 3.4 Whilst there may be no single silver bullet to address the current levels of prevention, restriction or distortion of competition in the large company audit market, Grant Thornton believes that a comprehensive package of regulatory stimulus will be capable of bringing about sustained and meaningful increased competition in the supply of audit services to FTSE 350 companies.