Grant Thornton Response to the Competition Commission ("CC") working paper entitled "Restrictions on entry or expansion"

1 Introduction

1.1 We welcome the opportunity to comment on the Competition Commission's working paper entitled "Restrictions on entry or expansion" ("the working paper") which was issued on 17 August 2012.

1.2 We agree with many of the points which are made by the CC in the working paper. However we comment below on certain specific points raised by the CC, including on areas which we believe merit further investigation.

2 Auditor clauses in loan agreements and other forms of pressure from advisors

2.1 Paragraphs 54 – 60 of the working paper provide detail on clauses in loan and investment agreements which restrict a company's choice of auditor to one of the largest four firms. The CC notes a current understanding that "such clauses are common in sub-investment grade or leveraged loan agreements…..[but]… are less common in agreements for investment grade debt". The CC also notes that two out of three ratings agencies said that they would take into account the identity of the auditor when rating a company's debt.

2.2 The CC might wish to amplify its comments on sub-investment grade. Many of the examples we provide in the appendix are companies with institutional (eg PE) investment; though not currently listed, the exit envisaged for such companies often includes listing and therefore the existence of these clauses restricts or eliminates our ability to compete prior to flotation which in turn makes it more difficult or impossible to obtain the audit subsequently. Moreover, the existence of these clauses has a damaging and pervasive impact as many market participants are aware of them and they create an image that banks and other large institutions would prefer to see one of the four largest firms appointed as auditor to all significant entities.

2.3 We commented previously on restrictions over the appointment of auditor in our response to the CC's Issues Statement, and specifically that the restrictions arise importantly in both unwritten form and for companies aspiring to be public interest entities, where auditors outside of the largest four can be precluded from acting for them. In our experience restrictions exist extensively, and not just in relation to sub-investment grade lending agreements. In the case of unwritten or informal clauses, lenders have represented to us that they have no central policy on imposing restrictions, but in practice we have found that they are imposed at a local level, often as standard paragraphs imported from a template document.

2.4 The CC requests further specific evidence of informal veto's in the working paper and we have attached as Appendix A to this paper details of situations encountered by our firm.

2.5 We draw to the CC's attention that The Organisation for Economic Co-operation and Development (OECD) acknowledged that such restrictions are undesirable and that unwarranted restrictions should be removed. The OECD Competition Committee report on competition and regulation in the auditing and related professions (the Report) was published
in May 2010. The Report concluded that "Promoting entry of new international accountancy networks and expansion of existing...networks should be encouraged, by: preventing unnecessary restrictions being imposed on companies by third parties (such as lenders) regarding the choice of statutory audit firm...". The Report stated that "If regulators and competition authorities take the lack of competition in the accountancy services market seriously, therefore, regulatory and market barriers impeding such expansion [should be] addressed." The Report also noted that "Where a company wishes to use a non-Big Four auditor certain market practices may prevent or discourage it from doing so. Market practice has emerged in some jurisdictions including the US, Germany and the UK, whereby third parties such as lenders, impose covenants on the company which restrict the company’s choice of auditor to a Big Four firm or apply more punitive terms and conditions to loan finance where a non-Big Four firm is appointed. Such restrictions are not based on a qualitative assessment of the pool of audit firms available and prevent excluded audit firms from competing with the Big Four firms and thus entering or expanding further into the audit market for large or quoted companies. The positive impact of other initiatives which aim to increase the number of suppliers of large international audits is thus impaired by unnecessary buy-side restrictions."

2.6 The issue is also the subject of debate in other jurisdictions with almost universal acceptance that restrictive clauses in lending and other agreements should be banned. In Europe, the European Commission has recently proposed that "any contractual clause entered into between a public-interest entity and a third party restricting the choice by the general meeting of shareholders ....to certain categories or lists of statutory auditors or audit firms to carry out the statutory audit of that entity shall be null and void".

2.7 All restrictions over the choice of auditor are demonstrably not related to capability or quality of the audit firms involved, as supported by inspection reports issued by regulators, but are sweeping and often impenetrable barriers which reinforce concentration. We propose that the CC should support the OECD position and prohibit or discourage unwarranted restrictions.

3 Signalling

3.1 Paragraph 34 of the working paper notes that a strategic barrier to entry would exist if incumbent firms responded aggressively to new entrants, such as targeting clients of mid-tier firms who have the potential to move into the FTSE350 with aggressively priced tenders ("low-balling"). We do not know if other firms have aggressively marketed to our clients as a means to prevent our further penetration of the listed market. We have commented elsewhere that in times of lower economic activity (such as the present) the four largest firms seek to expand into smaller listed and large private companies as a means to shore up their revenues.

4 Switching costs

4.1 In paragraph 25, the CC focuses its attention regarding switching auditor on the costs of doing so, and indicates that "becoming fully acquainted with a company may also take some time (between one and three years) which may introduce a risk of error or omission during this period". Whilst some put forward arguments that changing auditor reduces audit quality (due to the knowledge of the business which the existing auditor possesses), there is no reliable evidence that this is true. We note also that the CC ignores in

1 OECD Competition Committee Report: Competition and Regulation in the Auditing and Related Professions; http://www.oecd.org/dataoecd/8/8/44762253.pdf
2 Proposal for a regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities
its analysis the benefits of switching auditor. If done properly a change in auditor can increase audit quality as a fresh pair of eyes may uncover a latent problem in the financial statements which may otherwise be missed by a more "stale" approach used by the incumbent auditor. We provided examples of this in our original oral submission to the CC.

4.2 To investigate this area further, we suggest that it might be helpful for the CC to elicit the views of the National Audit Office (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 of many entities where such a change has occurred.
A Auditor clauses in loan agreements and other forms of pressure from advisors

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