Bundling of audit and non-audit services

Introduction

1. Audit firms can provide a variety of services to clients in addition to the statutory audit. The nature of these non-audit services (NAS) differs and broadly refers to any non-statutory audit professional services provided by an audit firm to its client. Specific services provided in addition to an audit, but carried out by the audit team which closely relate to the audit are referred to as 'audit-related services'. The nature of audit-related services includes the role of reporting accountant for financial transactions and regulatory returns and providing additional information to those charged with governance. Other NAS include taxation, consulting and corporate finance advice among others.[1]

2. This paper considers if there is evidence of a barrier to entry caused by firms bundling or tying audit services with other audit-related services or NAS as permitted by the rules on auditor independence.[2,3] In our Issues Statement we noted that this could take three forms:

   (a) 'pure bundling' (ie refusing to supply any of the individual services separately);

   (b) 'mixed bundling' (audit and NAS are available separately or bundled together at a lower price than the sum of the individual prices); or

   (c) 'tying' (ie one of the services is available individually but the other is available only if bought in a bundle).

[1] See Nature and strength of competition working paper for further discussion of importance of NAS in selecting (or excluding a potential auditor).
[2] This includes a summary of the findings of the Law & Regulation working paper.
[3] The principal focus of the paper is ToH 2 as set out in the Issues Statement, the bundling or cross-selling of services to audit clients leads to a barrier to entry. ToHs 1 & 3 are also considered in whether regulation and customer actions lead to a barrier of entry.

3. In our Restrictions on entry or expansion working paper, we identified that such action could amount to a strategic barrier to entry.[4]

4. This paper considers the issues around bundling in three sections. We:

(a) refer to the applicable regulations;

(b) set out evidence from our case studies and review of tender documents with respect to the provision of NAS by the relevant auditor and any evidence of cross-selling during an audit tender process (including whether there is any indication of pure, mixed or tied bundling); and

(c) present quantitative analysis, to examine whether there is any evidence of price differentiation within the FTSE 350 on the basis of the level of NAS provided to clients. We use engagement profitability as a proxy for relative price in this analysis, to take account of differences in audit size and complexity. This gives insight into whether there is any evidence of 'mixed bundling' with respect to the fee charged for audit engagements.

Regulatory background

Ethical standards

5. In the UK, audit firms have been required to comply with ethical standards issued by the Auditing Practices Board (APB) (part of the Financial Reporting Council (FRC)), since December 2004.[5] The suite of standards requires auditors to exercise judgement as to an appropriate level of NAS provided to audit clients but do not restrict the general supply of NAS to audit clients. Firms are required to ensure

[4] See paragraphs 27 and 28 of the Restrictions to Entry or Expansion working paper.
[5] This was a consequence of the Co-ordinating Group on Audit and Accounting Issues, which was established by the UK Government. The suite of ethical standards was updated in 2008 and 2010. ES5 was also updated in 2011.

appropriate policies are in place and these policies are reviewed by the Audit Inspection Unit during its annual review of auditors of Public Interest Entities (PIE).[6]

6. *Ethical Standard 4: Fees, Remuneration, and Evaluation Policies, Litigation, Gifts and Hospitality* (ES4) covers the risks associated with financial dependence on clients. The standard states that: 'The audit engagement partner shall ensure that audit fees are not influenced or determined by the provision of non-audit services to the audited entity.'[7]

7. As a result, firms are not allowed to differentiate their pricing on the basis of NAS. ES4 does not, however, prohibit reductions in fees achieved through efficiencies in the provision of both statutory audit and NAS.[8]

Regulatory climate

8. The collapse of Arthur Andersen led to an impetus to strengthen corporate governance and to further regulate the relationships that auditors had with their clients. The Ethical Standards, discussed above, introduced into the UK were part of this global response but were predated by the USA's 'Sarbanes-Oxley' Act (2002) (SOX) which incorporated statutory requirements on corporate governance of listed companies and the nature of the relationship between auditor and client, including the types of NAS that an auditor can provide.[9]

9. SOX has had international repercussions, as foreign subsidiaries of US companies, and foreign companies listing on US stock exchanges must also comply with the act. Oxera in their 2007 report noted the view expressed by others that SOX influenced

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[6] There are, however, restrictions on the level of income that a firm can generate from a given client across all services as a proportion of total firm revenue.
[7] APB, ES4, *Fees, Remuneration, and Evaluation Policies, Litigation, Gifts and Hospitality*, paragraph 7.
[8] APB, ES4, *Fees, Remuneration, and Evaluation Policies, Litigation, Gifts and Hospitality*, paragraph 9.
[9] For a further overview of SOX, see *Ownership rules of audit firms*, Oxera, 2007, p5.

the UK Ethical Standards and that as a result there are similarities in the restrictions in NAS that an auditor can provide. Furthermore, Oxera noted that compliance with requirements of SOX has not been limited to the audits of US listed companies and subsidiaries, as audit firms worldwide have built them into their standard methodology.

10. The Literature Review that we commissioned from Professor Vivien Beattie noted that post-Enron prohibitions on the provision of certain types of NAS led to large reductions in the amount of NAS provided by incumbent auditors. One study by Deloitte (2009) reports NAS provision to FTSE 100 audit clients dropping from a peak of over 300 per cent of audit fees in 2001 to 75 per cent in 2008.[10]

11. Beattie (2009) examined the factors that had affected NAS decisions made by UK finance directors and noted four factors that have acted to decrease NAS fees. Firstly, the enhanced role of the audit committee in developing policies for purchasing NAS, following the Combined Code (2003) and Smith Report (2003), has made audit committees more conscious of the importance of auditor independence and therefore reluctant to buy services from their auditor. Second increased scrutiny from activist investors and risk of adverse publicity. Third, ES5 has restricted auditors' ability to provide many services. Fourth, the UK audit inspection regime has deterred inappropriate NAS provision by auditors.[11]

12. Our analysis below (see Annex 1, Table 4) shows that whilst the level of NAS performed by auditors has decreased, audit fees have not fallen to the same extent (and indeed increased slightly in the FTSE 100 in the period 2006 to 2011).

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[10] See *Initial Review of relevant academic literature on the Audit Market*, Professor Vivien Beattie, 2012.
[11] ibid.

Findings from the case studies, tender information and Market Financial Questionnaire responses

Case studies

13. Our case study interviews did not indicate any evidence of price differentiation, or bundling of services at the point of tender. Several companies stated that they wished to maintain NAS at a low level and where NAS were purchased, there were policies and procedures in place to oversee this—these policies were focused on ensuring auditor independence.

14. The ACC of Company F said that the audit should not be a loss leader in the hope of the audit firm obtaining other work. It was not in the interests of the company or the auditor for the audit to be unprofitable.[12]

15. Other interviews highlighted that some NAS work would be cheaper for the auditor to perform than another firm, for example:

    (a) At Company J, the AEP said that there were some services where it would be more cost-effective to use the auditor. These services were where an understanding of the systems and controls of the business were needed, for example tax compliance, tax advice, and client money reports to the FSA.[13]:

    (b) The ACC at Company H said that Class 1 transaction work was given to the external auditor, and whilst it could be done by another firm there was so much overlap with the audit that it made no sense for another firm to do it—'they would have to re-audit the thing'. From his experience as an auditor the ACC had undertaken this work instead of the external auditor and thought it was extremely inefficient.[14]

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[12] Company F, paragraph 61.
[13] Company J, paragraph 86.
[14] Company H, paragraph 87.

(c) The GFC at Company G said that it was important that PwC maintained independence and so the Company was careful about the nature of non-audit work provided by PwC. This was limited to work that was assurance in nature, and where the auditor would already be up to speed through its audit work (there might also be a pricing benefit to the non-audit work as the auditors were familiar with the business area).[15]

Tender information

16. Our review of tenders noted a small number of examples of audit firms offering NAS at a discount of up to [✂].[16] However, as firms do not provide standardized services, it is not clear what benchmark of price this discount relates to. If the discount relates to standard charge-out rates, the discount might not be very significant when considered with respect of the average revenue recovery rates achieved by the firm in question.[17]

Survey

17. Our survey of purchasers of audit services found that NAS was not a significant influence in the decision to select an auditor or as a reason to switch auditor:

(a) 12 per cent of FTSE 350 purchasers of audit considered NAS expertise as important (and 57 per cent considered NAS expertise as not important)[18].

(b) 11 per cent of FTSE 350 purchasers of audit thought that a disagreement or problem with the provision of NAS was 'likely' to prompt serious consideration of switching auditors.

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[15] Company G, paragraph 47.
[16] Auditor Selection, paragraph 69
[17] [✂].
[18] [✂].

Responses to Market and Financial Questionnaire

18. Our review of responses to our Market and Financial Questionnaire (MFQ) found no references to discounting the audit fee if a client also bought NAS. However, there were some instances where NAS were offered at a discount if that firm was selected as auditor.[19]

Quantitative analysis

19. To investigate the effect of the level of NAS provision on profitability, we analysed a dataset of engagement level data supplied by the firms for all periods from 2006 to 2011. This included information on audit and NAS revenues and the revenue recovery rate achieved on the audit.

20. An additional field, the ratio of non-audit to (UK) audit revenue (herein referred to as 'non-audit ratio'), was calculated by CC staff.[20,21]

Proportion of companies receiving NAS from their auditor

21. Our engagement dataset was used to assess what proportion of statutory audit clients receive NAS from their auditor and the results of this are shown in TABLE 1.[22] In this analysis, if the non-audit ratio for a client was less than 5 per cent, a client was classified as not receiving NAS.[23] Of the FTSE 100 companies, the average proportion receiving NAS from their auditor was 87 per cent in the period 2006 to 2011, and 83 per cent of companies in the FTSE 250.

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[19] Auditor Selection, paragraph 69.
[20] If no NAS are provided, this would give a figure of 0, if non-audit revenue was equal to UK firm audit revenue, the ratio would be 1, and if non-audit revenue was higher than UK firm audit revenue the figure would be greater than 1.
[21] Additional data cleansing was performed on the data set to eliminate outliers of profitability.
[22] See annex 2 for details of data cleansing.
[23] It is necessary to set the threshold above zero, as there may be some delay in revenue recognition between years, which in practice means that very few entries in the dataset show absolutely zero NAS revenue in a given year.

22. The proportion of the FTSE 100 companies buying some level of NAS from their auditor was consistently higher than in the FTSE 250 index for the whole period: with between 1 and 8 per cent more of the FTSE 100 companies doing so and the difference over the period being five percentage points. There had been a decrease in the proportion of both FTSE 100 and FTSE 250 companies buying NAS, with a fall of six percentage points in both the FTSE 100 index and in the FTSE 250 index.

23. The proportion of other companies included in the dataset that have bought NAS from their auditor was similar to the proportion of FTSE 350 companies but does not exhibit any trend over the period.

TABLE 1 **Companies receiving NAS from their auditor (5% NAS ratio threshold)**

per cent

	2006	*2007*	*2008*	*2009*	*2010*	*2011*	*Period*
FTSE 100	90.4	86.9	87.6	88.0	86.9	84.5	87.4
FTSE 250	85.8	86.1	85.1	80.2	79.0	79.5	82.5
FTSE 350	87.2	86.3	85.8	82.4	81.3	80.9	84.0
Other	85.2	86.9	88.7	84.3	82.5	83.9	85.2

Source: CC analysis.

Notes:
1. A threshold of NAS accounting for 5 per cent of the audit fee was used for this analysis to allow for any NAS revenue recognized by auditors in the year after the work was performed as a number of data points included revenue with few or no hours reported.
2. The number of firms in each FTSE index is not consistent due to changes in the index composition and differences in reporting years of each audit firm and their clients, which may lead to over- and under-counting in different periods.
3. 'Other' includes other listed companies that were members of the FTSE 350 at some point during this period and includes large private companies in the 'top track 100'.

24. As shown in Annex 1, Table 1, the proportion of FTSE 350 companies paying any amount to their auditor for NAS also fell, with a similar trend for companies outside of the FTSE 350.

Value of NAS received from auditor compared with audit fee

25. We considered the relative value of NAS to audit fees over the period 2006 to 2011 (see Annex 1, Tables 2 and 3). The median ratio of NAS fees to statutory audit fees for FTSE 350 companies was less than 50 per cent (Annex 1, Table 3). NAS fees were lower than the UK audit fee for 74.4 per cent of FTSE 350 companies (Annex 1,

Table 2). NAS fees for 54.2 per cent of FTSE 350 companies were less than half the UK audit fee (Annex 1, Table 2).

26. The data showed a steady upwards trend in the proportion of FTSE 350 companies where the value of NAS revenue was less than 10 per cent of the UK audit fee; increasing from 16.5 per cent to 23.1 per cent in the period 2006 to 2011.[24] Conversely, the proportion of FTSE 350 companies buying NAS valued at more than 50 per cent of the audit fee fell by 12.9 percentage points (to 40.4 per cent), of which 8.2 percentage points of this decrease related to companies buying NAS with a value higher than the audit fee (Annex 1, Table 2).

27. We analysed the median NAS ratio (see Annex 1, Table 3) and found that the median for FTSE 100 companies was lower than for FTSE 250 companies. The median has decreased over the period 2006 to 2011 in the FTSE 100 and the FTSE 250.

Initial view/discussion

28. The downwards trend in the proportion of companies buying NAS (see Table 1 above) and the level of NAS fees relative to audit fees (Tables 2 and 3 in the annex) appears to be consistent with the trend identified in the literature (see paragraphs 10 to 12).

29. The continuing downwards trend is also coincident with recent corporate governance requirements including the FRC's *Guidance on Audit Committees* which was reissued in 2008 and required audit committees to disclose the basis for their

[24] Note that in this analysis, only clients where zero NAS revenue is recorded are included as 'no non-audit'.

decision in appointing their auditor and any policies on the level of NAS.[25] In March 2009 the FRC also opened a consultation on revising the 'Combined Code' (which was subsequently replaced by the 'UK Governance Code'.

30. Auditors have also been subject to more stringent ethical standards on NAS with ES5 (originally issued in 2004) having been reissued in 2008 and revised in 2010. There has been a gradual increase in clarification over what services are appropriate for auditors to provide and how fees are charged (such as prohibiting contingent fees).

Nature of NAS provided

31. Our dataset captures eight different types of NAS and TABLE 2 shows the value of the revenues from each of these.[26] Not all firms were able to categorize their NAS into these categories and as a result there may be some differences in classification between firms.[27]

32. Revenues from five of the eight categories have decreased over the period 2006 to 2011, including both Tax and Transactions, the two largest sources of NAS revenue. The three services that have shown positive growth in the period, IT, Restructuring and Risk assurance are also the three smallest categories with respect of revenue (both at the beginning and end of the period), although as noted in paragraph 31 not all firms could identify these as separate service lines.

33. Due to the disparate nature of NAS and the large number of suppliers of NAS/professional services (which may be considerably greater than existing and

[25] FRC, *Guidance on Audit Committees*, October 2008, paragraphs 4.26–4.34 and which had been in consultation prior to publication. The revised guidance was in response to Market Participants Group's report on promoting choice in the audit market, published in October 2007. The guidance was again revised in December 2010 and September 2012.
[26] The eight are: Tax, Transactions, Corporate Finance, Restructuring (including Forensics and Business Recovery Services), Consulting, Risk Assurance Services, IT, and Other.
[27] DEL, GT and PwC could not identify IT separately; DEL, GT and [✂] could not identify risk assurance separately; BDO and [✂] could not identify consulting separately; and EY could not identify corporate finance separately. This is due to the data structure of firms' business systems which categorise specific products differently and also because of well as changes in the way this data is recorded over time.

potential audit market participants), the proportion of the total value of NAS/professional services market undertaken by companies' statutory auditors is not easily calculated. Whilst a large number of companies may use their auditors for some NAS, the value of this may be small in comparison with the total value of NAS/professional services supplied to the company.[28]

TABLE 2 **Level of NAS provided by audit firms to their FTSE 350 audit clients**

£'000

	2006	*2007*	*2008*	*2009*	*2010*	*2011*
Values						
Tax	92,188	89,217	89,617	79,799	75,815	71,314
Transactions	80,143	83,773	78,652	74,137	73,284	54,031
Corporate Finance	11,920	7,661	14,493	6,936	3,797	5,691
IT	1,965	1,888	3,232	2,596	2,379	3,565
Restructuring (including Forensics and Business Recovery Services)	2,051	2,109	2,461	6,115	3,194	2,886
Risk Assurance Services	7,604	6,848	9,972	8,365	10,189	12,953
Consulting	12,217	9,917	9,988	10,283	8,722	9,920
Other	37,857	22,217	22,096	14,482	22,864	21,327
Total	245,947	223,631	230,512	202,713	200,245	181,689
Indexed (2006=100)						
Tax	100	97	97	87	82	77
Transactions	100	105	98	93	91	67
Corporate Finance	100	64	122	58	32	48
IT	100	96	164	132	121	181
Restructuring (including Forensics and Business Recovery Services)	100	103	120	298	156	141
Risk Assurance Services	100	90	131	110	134	170
Consulting	100	81	82	84	71	81
Other	100	59	58	38	60	56
Total	100	91	94	82	81	74

Source: CC analysis.

34. Table 3 shows that the relative contribution of each service line to NAS revenue has remained largely steady with a movement of at most four percentage points for any of the eight service lines over the period. Tax and transactions, the two largest service lines have together generated between 69 and 77 per cent of NAS revenue over the period.[29]

[28] Financial statements of companies may report the value of professional services, but this will include a much broader range of services than those provided by the firms supplying audit.
[29] When 'other' is included with tax and transactions, the range is between 81 and 87 per cent of NAS.

TABLE 3 **Composition of NAS provided to FTSE 350 companies by the company's audit firm (% of total NAS)**

	2006	*2007*	*2008*	*2009*	*2010*	*2011*	*Movement*
Tax	37	40	39	39	38	39	2
Transactions	33	37	34	37	37	30	–3
Corporate Finance	5	3	6	3	2	3	–2
IT	1	1	1	1	1	2	1
Restructuring (including Forensics and Business Recovery Services)	1	1	1	3	2	2	1
Risk Assurance Services	3	3	4	4	5	7	4
Consulting	5	4	4	5	4	5	0
Other	15	10	10	7	11	12	–4

Source: CC analysis.

Assessment of effect of NAS on profitability

35. To establish whether there is any evidence of firms strategically pricing their audits to obtain NAS work, we applied average hourly staff cost rates calculated by the firms to the engagement database, which includes the number of hours of staff time by grade employed on audit engagements.

Method

36. The level of NAS was considered for each year's audit engagement and compared with the UK audit fee (net of any international costs). Each year's engagement was classified as either being under 10 per cent, 10 to 25 per cent, 25 to 50 per cent, 50 to 100 per cent and over 100 per cent. The average engagement profit was then calculated for each category and each year, and summarized.

Analysis

37. Table 4 shows this relationship for the six largest firms. The highest engagement margins from audit engagements in nearly all cases (five out of six years) were from audit engagements where no NAS were supplied. Margins then appear to decrease as the level of NAS increases. The range in average engagement profitability is at most 8.6 per cent in a given year, and 5.0 per cent on average.

38. Based on this data, there appears to be a link between increased NAS and decreased audit profitability.

TABLE 4 **Engagement profitability by level of NAS (Big 6, all clients, total hours, including partners)**

							per cent
	2006	*2007*	*2008*	*2009*	*2010*	*2011*	*Average*
No NAS	64.9	61.5	63.7	62.2	62.7	62.4	62.9
Under 10	58.8	61.4	59.0	60.8	61.8	59.0	60.2
10–25	63.2	59.4	61.7	61.7	63.0	61.1	61.6
25–50	59.9	56.8	62.6	59.5	62.4	58.0	59.8
50–100	56.3	60.3	58.2	57.6	58.4	56.5	57.9
100+	56.8	57.8	57.3	58.4	57.5	60.4	58.0
Average	58.7	58.9	59.6	59.6	60.2	59.3	59.4

Source: CC analysis.

39. Table 5 repeats the analysis above, for FTSE 350 clients, and a similar trend is observable, albeit with a less pronounced relationship between profitability and the level of NAS provided.

TABLE 5 **Engagement profitability by level of NAS (Big 6, FTSE 350, total hours, including partners)**

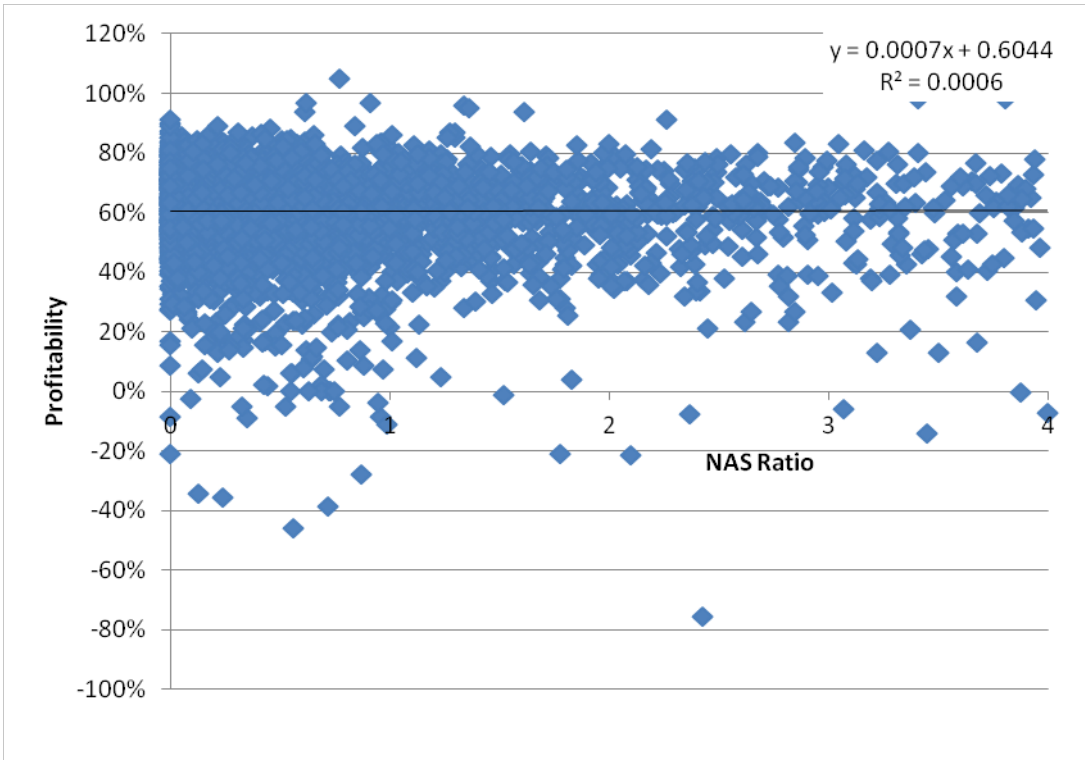
							per cent
	2006	*2007*	*2008*	*2009*	*2010*	*2011*	*Average*
No NAS	65.8	63.6	65.3	65.0	65.3	61.1	64.1
Under 10	59.2	61.5	57.2	60.2	61.2	57.4	59.5
10–25	63.2	59.8	62.6	63.6	61.4	59.5	61.6
25–50	57.9	57.3	61.3	59.4	60.6	58.8	59.3
50–100	54.9	59.4	58.3	58.2	57.9	54.7	57.2
100+	58.6	56.5	57.9	58.0	55.8	59.6	57.7
Average	58.7	58.7	59.7	60.1	59.6	58.4	59.2

Source: CC analysis.

40. However, the above analysis depends on arbitrary bandings of NAS and the categorization of each data point. If there are outlying profitability figures, these will skew the relative profitability of that category. If the level of NAS is plotted against audit profitability, as shown in Figure 1, there does not appear to be any meaningful relationship between the level of NAS and engagement profitability, with an R^2 value of 0.06 per cent, indicating that there is not a clearly observable link.

FIGURE 1

Relationship between engagement profitability and NAS provision



Source: CC analysis.
Note: Scale truncated and visible chart area excludes some data points to prevent identification of profitability of companies which purchase very high levels of NAS.

41. We performed a final analysis which considered the median level of NAS (as a percentage of UK audit fee) in each year in the FTSE 350 from the six largest audit firms and compared this with the profitability achieved in audit engagements. Engagements in each year where NAS provision was above the median were labelled as 'high' and those where NAS provision was below the median we labelled 'low'.

42. Table 6 shows the result of the analysis. For the period 2006 to 2011, the average engagement profitability for engagements where provision of NAS provision was classified as 'high' was between 1.4 and 4.4 percentage points less than for 'low' NAS provision each year, with an average difference of profitability of 3.1 percentage points. This is consistent with the results shown in Table 4 which indicated a broad trend in decreasing profitability with increasing level of NAS.

TABLE 6 **Average engagement profitability for high and low provision of NAS (Big 6, FTSE 350)**

							per cent
	2006	*2007*	*2008*	*2009*	*2010*	*2011*	*Total*
High	57.1	57.3	58.6	58.0	57.0	57.4	57.6
Low	60.6	60.3	61.2	61.6	61.4	58.8	60.6
Difference	3.5	2.9	2.6	3.6	4.4	1.4	3.1

Source: CC analysis.

43. However, the FTSE 350 is not composed of homogenous companies, and apparent differences in profitability as observed in Table 6 may be driven by underlying differences in the nature of companies. We examined the data by industry as shown in Annex 1 and we compared engagements with 'high' and 'low' levels of NAS for each industry (to see if any trend was evident when only considering engagements in a single industry); however, this did not show any conclusive evidence of a link.

Initial views

Regulation

44. The regulations in Ethical Standard 4 surrounding NAS provision create a restriction on NAS acting as a barrier to entry, as firms are not permitted to alter the pricing of an audit on the basis of provision of NAS (see paragraph [7]).

45. The regulatory climate has resulted in increased scrutiny on auditors providing NAS and so the opportunities for firms to bundle products have been reduced. A number of factors are at play to both discourage companies from buying NAS from their auditors (corporate governance requirements) and to discourage audit firms from supplying them (ethical requirements).

Case studies and tenders

46. Companies stated that they had adopted policies regarding the purchase of NAS from their auditor. These policies included limits on the level of NAS and the need for

audit committee authorization, and the use of multiple suppliers. Some companies in the case studies stated that they actively chose not to use their auditor for non-audit work. However, they noted that for some types of non-audit work, such as acting as a reporting accountant, the use of the existing auditor was the most practical option. The companies' policies were focused on ensuring auditor independence—this focus may reduce the opportunities for firms to bundle audit work and NAS.

47. Some of the case study respondents considered that for certain NAS it was more efficient and less costly for the auditor to do the work (see paragraph [15]).

48. In our auditor selection work we have found examples of firms offering discounts on NAS (if coupled with the audit), but not on the audit fee itself. These discounts would reduce the overall profitability of a firm's relationship with the client, but the audit fee is not contingent on NAS being provided, so this does not appear to support our theory of harm. Furthermore, we do not believe that the level of discount offered on NAS is in practice a discount on the open market rate that a firm might charge for those services and we are not able to comment on whether such discounting excludes firms which are not the auditor from providing these services to develop a client relationship.

Quantitative analysis

49. Almost all companies in the FTSE 350 receive some level of NAS from their statutory auditor. 87 per cent of the FTSE 100 companies receive NAS to a value of more than 5 per cent of their UK audit fee and the figure for the FTSE 250 companies is 83 per cent. The median ratio of non-audit to audit services for FTSE 100 companies is 44 per cent and 53 per cent for FTSE 250 companies.

50. The proportion of companies that buy NAS from their statutory auditor is declining, and the value of those NAS is also declining. Tax and transactions generate the largest value of NAS revenue for statutory auditors and revenues from these services have declined. Restructuring, Risk Assurance and IT consulting have all increased, but generate relatively low revenues.

51. No robust or consistent evidence was found to indicate that firms differentiate their audit prices on the basis of the level of NAS provided. The data shows that the average level of NAS varies significantly by industry and profits generated in each industry also vary. Regardless of any link between NAS and engagement profitability, there is no evidence to indicate that audit does not make a profit, even where NAS is relatively high.

Overall

52. We have found no evidence to support the view that the bundling of NAS with the statutory audit acts as a barrier to entry. Companies may request firms to include the price for certain services in their tender but we do not believe that these services exclude any of the largest challenger firms. Furthermore, evidence from the survey of purchasers of audit services does not indicate that NAS is a significant consideration when selecting an auditor.

Additional quantitative analysis

Proportion of companies receiving NAS from their auditor

1. Table 1 shows the proportion of all companies paying any amount of fee to their auditors for NAS. Analysis of the distribution of the data points indicates a relatively large number of companies paying close to zero fees for NAS (rather than an equal distribution within the 0 to 5 per cent band).

TABLE 1 **Companies receiving any NAS from their auditor**

per cent

	2006	*2007*	*2008*	*2009*	*2010*	*2011*	*Period*
FTSE 100	99.0	98.9	99.0	98.0	99.0	95.1	98.2
FTSE 250	91.8	92.6	90.2	88.9	87.9	86.5	89.6
Other	94.0	94.4	92.8	91.5	91.2	89.0	92.1

Source: CC analysis.

Level of NAS purchased by companies from their auditor

2. Table 2 shows the level of NAS purchased by companies in the FTSE 350 index.

TABLE 2 **Level of NAS purchased by FTSE 350 from their auditors**

per cent

	2006	*2007*	*2008*	*2009*	*2010*	*2011*	*Total*
Nil	6.0	5.6	7.2	8.5	8.8	11.0	7.9
0–10	10.5	10.0	12.5	16.2	15.6	12.1	12.9
10–25	13.5	16.5	14.5	15.3	14.8	14.4	14.8
25–50	16.8	16.8	18.0	19.0	18.8	22.0	18.6
50–100	24.0	19.5	21.2	18.8	18.8	19.2	20.2
100+	29.3	31.6	26.7	22.2	23.3	21.2	25.6
Data points	334	339	345	352	352	354	2,076

Source: CC analysis.

Median non-audit ratio

3. Table 3 shows that the median non-audit ratio for the different categories of companies. In the period 2006 to 2011, the median non-audit ratio in the FTSE 100 index fell by 8.7 percentage points to 41.4 per cent, whilst the decline in the FTSE 250 index was even more marked with a 26.2 percentage point decrease. Within

these trends have been a number of significant year-on-year changes, such as in 2008, when the median non-audit ratio for the FTSE 100 increased by 14.0 percentage points before falling by some 20.4 percentage points in 2009. Also in 2008, the FTSE 250 median non-audit ratio fell by some 12.7 percentage points. This may have been triggered by certain companies moving between the FTSE 100 and 250, or another underlying reason.[1]

4. In non-FTSE companies there was less evidence of any specific trends, but more year-on-year volatility in the non-audit ratio.

TABLE 3 **Median level of NAS revenue as a proportion of UK audit fee (excluding companies not receiving NAS)**

per cent

	2006	*2007*	*2008*	*2009*	*2010*	*2011*	*Period*
FTSE 100	50.1	44.0	58.0	37.6	38.6	41.4	43.9
FTSE 250	72.0	64.1	51.4	40.7	48.4	45.2	52.7
FTSE 350	63.1	57.3	54.4	39.7	44.2	44.1	49.8
Other	76.1	89.6	71.2	62.0	69.0	80.8	75.2

Source: CC analysis.

5. Table 4 shows the relative movement in audit fees and non-audit revenue for those companies that receive NAS from their auditor. NAS revenue for both the FTSE 100 and FTSE 250 showed similar trends, and decreased by 25 and 28 per cent respectively in the period 2006 to 2011. Audit fees in both the FTSE 100 and FTSE 250 did not show such a strong pattern of decline, with the FTSE 100 increasing slightly indicating that the decrease in the NAS ratio in Table 3 is due to decreases in NAS revenue rather than significant increases in audit fees.

[1] The median should be less susceptible to individual data points than the mean.

TABLE 4 **Audit and non-audit fees in the FTSE 100 and FTSE 250 indexed (2006=100)**

	2006	*2007*	*2008*	*2009*	*2010*	*2011*
FTSE 100						
Audit fee	100	106	103	107	111	107
NAS fee	100	81	101	84	91	75
FTSE 250						
Audit fee	100	104	100	101	87	90
NAS fee	100	105	82	80	68	72
FTSE 350						
Audit fee	100	105	102	105	104	101
NAS fee	100	91	94	82	81	74
Other						
Audit fee	100	120	134	139	127	120
NAS fee	100	151	121	112	117	126

Source: CC analysis.

The effect of NAS on profitability

6. If the FTSE 350 for the years 2006 to 2011 is examined by industry as shown in Table 5, then it appears that the level of NAS relative to UK audit fees varies hugely by industry, with the average level of NAS in healthcare companies being 47 per cent, whilst in consumer services the figure is 248 per cent of UK audit fee.

7. Reviewing the relative number of data points for each industry (which is a function of the number of companies in that industry that were in the FTSE 350 in each year in the period 2006 to 2011), it appears that three categories of industry dominate the composition of the FTSE 350 (consumer services, industrials, and financials), accounting for some 1,472 of the data points (69.6 per cent of data points) and as such, it means that the profitability of these industries (the average engagement profitability of each industry varies from 53 to 65 per cent) will have a significant effect on average profitability for the category in which those engagement lie (eg ‘high’/‘low’, or other bandings as above). There may be other relationships driven by the structure of the FTSE 350.

TABLE 5 **Average level of NAS and engagement profitability by FTSE 350 industry**

			per cent
	NAS	*Profit*	*Data points*
Consumer services	248	58.6	421
Basic materials	213	61.9	113
Utilities	150	59.7	68
Industrials	138	53.0	443
Consumer goods	115	55.7	168
Oil and Gas	107	59.6	109
Technology	103	58.9	95
Financials	81	64.6	608
Telecommunications	67	59.1	42
Health care	47	56.9	47
Total	139	58.6	2,114

Source: CC analysis.

8. Taking this analysis a step further and comparing engagements with ‘high’ and ‘low’ levels of NAS for each industry (to see if any trend is evident when only considering engagements in a single industry) shows that some industries, such as Oil and Gas exhibit a wider difference in engagement profitability between ‘high’ and ‘low’ NAS companies, whilst other such as telecommunications show almost no difference in average engagement profitability.

TABLE 6 **Profitability by level of NAS by industry**

	per cent	
	High	*Low*
Oil and Gas	54	65
Basic materials	64	60
Industrials	52	54
Consumer goods	54	59
Health care	56	57
Consumer services	57	60
Telecommunications	59	59
Utilities	57	62
Financials	64	65
Technology	57	62

Source: CC analysis.

Data cleansing

1. Engagement profitability was calculated on the following basis:

   (a) Revenue = UK element audit fee less international costs (unless firms had not included these costs in their audit fee).

   (b) Costs = Staff costs plus direct non-staff costs.

   (c) Staff costs = number of hours for each grade of staff multiplied by the staff cost rate for that grade.

2. Partners' profit shares will include an element relating to remuneration for their labour and a return on their capital; though in practice these are not readily identifiable. To counter this issue, we have included partner costs at twice that of Directors for all firms. We believe the actual ratio may vary, but we do not have adequate information to calculate this, so have made a blanket assumption to ensure some representation of partner time is included.

3. Our initial review of the data indicated that there were a number of outliers with respect of both revenue and profitability. We filtered data points on the following areas:

   (a) where market segment was blank (FTSE 100/250/Other)—735 data points;

   (b) negative revenue—43 data points;

   (c) profit margin of more than 100 per cent—716 data points;

   (d) profit margin of less than 100 per cent—12 data points;

   (e) manual exclusions—12 data points (Camden Motor Group as it does not have a parent company and L'Oreal as it is a French company);

   (f) any audit fee less than £5,000—685 data points (excludes negative audit fees);

   (g) any engagement data which pre-dates that auditors appointment in the public dataset by more than one year—112 data points; and

(h) any engagement where the relationship between the company and the auditor is not present in the public data set—173 data points.

4. In total, 1,147 out of 4,616 data points were excluded from the engagement dataset.

5. Of the 2,273 data points in the raw data set labelled as FTSE 100/250, 148 were excluded on the above criteria, of which 119 were excluded for a low or negative audit fee, with 98 of these reporting no audit fee.