Oxera

# Response to working paper on Profitability—parts 1 and 2

## Note prepared by Oxera on behalf of Grant Thornton and BDO

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## 1 Introduction

This note is a response to the Competition Commission's (CC) working paper on Profitability, parts 1 and 2, published on October 3rd and 22nd respectively. In this note we also include comments on the methodology behind material supplied by the CC to BDO and Grant Thornton regarding the measure of profitability of individual audit assignments. Apart from the general comments in section 2, the comments in this note follow the headings of the CC working paper.

Some of Oxera's comments could have significant implications for the analysis and conclusions reflected in the working paper. Oxera has therefore suggested another informal or formal face-to-face meeting with the CC staff to discuss these matters directly, which may be more effective than exchanging written comments.

## 2 General comments

As nearly all the results in the paper have been redacted, it is difficult to understand precisely what the CC has done in terms of analysis and, more importantly, the implications of this analysis and its robustness. This has made it difficult for Oxera to respond effectively, as it is often difficult to understand the implications of a number of the potential methodological issues without there being any, or limited, indication of the significance of the specific factor. It is against this background that the following comments are made, focusing mainly on methodology.

The CC has concluded, in a number of places, that it cannot undertake a reliable assessment of profitability:

> our initial view is that we are unable [to] undertake a reliable or meaningful assessment of economic profitability in this market. Hence we are likely to be unable to conclude as to whether firms representing a substantial part of the FTSE 350 audit market have earned profits that are persistently in excess of their cost of capital. (Profitability working paper part one, paragraph 8)

Similar conclusions are reached in part 1 paragraph 58 and part 2 paragraph 46.

Oxera considers that these conclusions, and the implication that the CC will not undertake the analysis needed to generate any indications of profitability, seem to be inconsistent with the CC's overall approach as set out in paragraph 1 of part 1 of the working paper.

> Whilst this paper focuses on profitability (as an indicator of whether prices are too high), the CC considers the evidence on market outcomes in the round, rather than individually. Hence any results from this analysis will be assessed alongside other evidence on competition and outcomes.

Although there may be some difficulties in undertaking a profitability analysis of audit firms, such an analysis is not necessarily without evidential value. In particular, if an analysis is carried out that is conservative, but still indicates higher-than-normal levels of profitability, and this is consistent with other indicators of problems with competitive dynamics, this would give such an analysis evidential value.

Indeed, the CC has not shied away from carrying out profitability analysis in previous market investigations which have raised similar issues as those expressed by the CC in this case. For example, in the PPI market investigation, the CC faced similar issues regarding the allocation of common and central costs across different product lines, and intangible assets were considered to account for a significant proportion of the asset base. Similarly in the local buses inquiry, there was significant uncertainty regarding the valuation of bus depots and the allocation of revenue from travelcards to individual bus routes. Despite these issues (which commonly arise in almost all market investigations), the CC still placed significant weight on the results of its profitability analysis.

Overall, the apparent conclusion—that profitability analysis will not have any evidential value—would seem to be misplaced. The relevant question to consider is not whether the profitability analysis gives a 'perfect' answer (which it hardly ever will), but whether the results of the analysis (combined with the other quantitative and qualitative evidence available) are sufficiently robust to provide an indication of the workings of the market. Notwithstanding the difficulties involved, analytical techniques exist which are likely to deliver results that are useful, in that they allow the CC to measure some of the competition effects that are discussed in the various other working papers it has issued recently. These techniques are set out in more detail below.

# 3 Part 1

## 3.1 Firms' approaches to assessing profitability

Although the CC has found that different firms assess the profitability of assignments in different ways, and has concluded that it would be unwise to use these firm specific metrics as a means of comparison, they could still be used to indicate whether different parts of the same firm have similar levels of profitability. Given the use of metrics for internal management control functions, in a well-run firm such explanations of differential performance would be expected to have been generated already, and that the firms would have a good understanding of the causes.

If the CC has not already done so, Oxera suggests that the CC asks for such information, in particular in relation to audit services compared with other service lines and, perhaps more importantly, audit services provided to the FTSE 350 companies and audit services provided outside the FTSE 350.

In addition, it would seem to be open to the CC to ask the audit firms to reanalyse their own data on a more comparative basis using the same, or at least a similar, methodology. This could be expected to produce more comparable results.

## 3.2 Cost allocation

Oxera understands that cost allocation can be an issue when carrying out this type of analysis. However, where the objective is to compare the *relative* profitability of activities *within* a firm (see above), standardisation of cost allocation between firms is not necessary.

At paragraph 27 in part 1, the CC concludes:

> Given the multiple layers of cost allocation required to analyse FTSE 350 audits as a subdivision of accounting firms (and the hypothetical nature of the exercise), the accuracy of any such analysis is questionable. For the Big 4 firms, FTSE 350 audit fees represented on average 19 per cent of Assurance revenues over the period 2007 to 2011. We therefore think that obtaining profitability measures for FTSE 350 audits as a subset of the Assurance businesses is unlikely to be a robust analysis.

As this is the type of exercise that sector regulators and indeed the CC itself undertake frequently, and is an area of activity within which the large audit firms profess to have some expertise, the CC's a priori negative conclusion would seem to be premature. In particular, the CC has not shied away from this issue in previous market investigations (e.g. in the PPI market investigation where the allocation of common and central costs across different product lines was central to the analysis). In this regard, the CC has previously used a number of different approximations to allocate costs between different service lines/businesses and been prepared to used ranges where there is significant uncertainty as to the correct approach to use. Oxera thinks that this exercise is both possible and could deliver robust outputs. (However, in the absence of any clear indication of the proportion of unallocated costs and at what level they occur, it is difficult to ascertain how significant this problem actually is.)

## 3.3 Partner remuneration

The approach whereby an equivalent salary cost for partners is included in costs would seem appropriate when measuring the returns for ownership. However, given the large range in salaries put forward by PwC, and the sensitivity to this value for at least some return metrics, it would seem appropriate for the CC to conduct its own research to establish robustly the appropriate equivalent salary for partners carrying out FTSE 350 audits. As indicated in paragraph 41, although the CC has not carried out its own evaluation of the equivalent partner salary, to deliver a robust analysis of this type would seem to require that the CC does indeed undertake this. Indeed, Oxera finds it unusual that the CC has not indicated that it either has, or will, undertake its own analysis to underpin any analysis requiring this information as an input.

As both BDO and GT have indicated that, with their current skill mix, they are capable of auditing most FTSE 350 companies, and that there are significant parts of the audit market outside the FTSE 350 that require similar levels of skill, the implication in paragraph 43, that FTSE 350 audit partners will overall command average salaries of at least £473,000 compared with the mid-tier average of £264,000, does not, at first sight, look realistic.

## 3.4 Capital base

As indicated in paragraph 53 the CC has established a methodology for estimating the cost of intangible assets, as first developed in the SME banking inquiry and the CC has used this methodology in a number of subsequent inquiries.[1] There are sound economic reasons for this methodology (there has been some debate about where to draw the boundaries of what to include as relevant costs, but the principle has been commonly accepted).

In this methodology, if (as noted in paragraph 54 of the working paper) it is hard to identify expenditures that would meet these requirements, this indicates that most of the types of expenditure that might qualify would fall under the exclusion as a result of paragraph 53 (b):

> *(b)* this cost must be additional to costs necessarily incurred at the time in running the business;

Therefore, using this logic, the relevant cost of intangible assets that should be included in the capital base is small. The CC has taken this relatively strict approach in the past: if the cost cannot be identified, the CC does not include it as an intangible, and measures the asset base without it. Indeed, the CC has previously stated that:

> we do not consider it correct to include a value for intangibles in the capital base (which, by itself, would reduce measured returns on equity) if those intangibles cannot be **sufficiently identified or measured**. [emphasis added] [2]

Oxera infers from the working paper that a rather different perspective is being taken here—ie, the CC is saying that if the cost cannot be identified, the CC concludes that measuring the asset base is too difficult and hence does not intend to rely on profitability analysis at all. This is inconsistent with the established approach used by the CC in a number of its recent market investigations.

Given i) the information asymmetry between the audit firms and the CC; ii) the multiple references that the Big Four audit firms have made to substantial investments in reputation; and iii) the undoubted expertise of the audit firms in dealing with issues of costs, the burden of proof would seem to be on those being investigated to show what costs should be included in the intangible asset base and why.

Although difficult, this task would not seem to be impossible, and Oxera considers this line of inquiry to be an important one to pursue. This is particularly the case if the CC also carries out an analysis which seeks to establish what the intangible asset base would have to be to produce a return on capital equal (or close) to the WACC. See section 3.5 below.

## 3.5 ROCE

It is not clear from the working paper whether the CC has understood the approach suggested by Oxera (paragraph 68). The CC states:

> Oxera hypothesized that the asset base *to support a suitable IRR* would be comparatively large. [emphasis added]

[1] Earlier, in paragraphs 49 and 50, the CC refers to the fact that Oxera had mentioned this methodology to the CC and had used it in the pay-TV inquiry. What is not clear from this text is that what Oxera mentioned to the CC is very much the same methodology for intangibles that the CC has developed in the past and discusses in paragraph 53 onwards. The CC could clarify this in paragraph 49.

[2] Competition Commission (2002), 'The supply of banking services by clearing banks to small and medium-sized enterprises: A report on the supply of banking services by clearing banks to small and medium-sized enterprises within the UK', paragraph 2.258. (Also cited in: Competition Commission (2011), 'Local bus services market investigation, A report on the supply of bus services in the UK (excluding London and Northern Ireland)', paragraph 20 of Appendix 10.1.)

The words 'to support a suitable IRR' should really read 'that would result in an IRR in line with the cost of capital'.

The approach suggested by Oxera is to establish robustly all the elements of the analysis *other* than the intangible asset base (ie, recognising the difficulties of doing so). With the other elements in place, a calculation can be made of the order of magnitude of the intangible asset base that would be required for the return on capital to be in line with the WACC. That number can then be evaluated to assess whether it is plausible, given the general levels of expenditure on elements that might fall within the CC's definition of potentially creating an intangible asset. If the level of intangible assets is implausibly large, this would have evidential value in terms of indicating a competition problem. While this approach does not calculate the actual return on capital, nor will it produce a precise value of the intangible assets, it can identify whether there is a significant issue in relation to profitability and competition.

If, as indicated in paragraph 1, the CC is evaluating these issues 'in the round', an indication that there is a significant issue (or not, as the case may be) would appear to be useful to the CC. Undertaking such an analysis would therefore be worthwhile.

## 3.6 The PwC approach

Oxera has provided the CC with comments on this approach in a separate document.[3]

However, in addition, in the light of references to law firms and having spoken to a small number of the Magic and Silver circle firms for another client relating to market definition, it is Oxera's understanding that there is little overlap in terms of customers between these groups of firms and other law firms outside the City of London.[4] This would appear to be reflected in the different topological distribution of offices. For example, Clifford Chance states that it has 34 offices in 24 countries, and only one office in the UK.[5] PwC on the other hand has in excess of 30 office locations (counting all London offices as one location) in the UK alone. In addition, PwC and the other Big Four firms are active in the supply of audit services to all public listed and unlisted companies, while the City law firms' clients would tend not to overlap with those law firms located outside the City of London[6] (and, where they do overlap, the types of work and/or size of transactions done for those clients by different types of firm tend to be different).

In any benchmarking comparison, this apparent structural difference between the Magic and Silver circle law firms and the audit firms should be taken into account. As an example, it would seem more appropriate to compare profit per partner on the basis of those audit partners supplying audit services to the FTSE 350, or even FTSE 100, with partners in Magic or Silver circle law firms, to reflect that, at the level of the firm, there are no equivalents in these law firms of audit services provided to small companies out of the Armagh office, for example.

[3] Oxera (2012), 'Comments on the PwC document: "Observations on the assessment of audit profitability"', August 30th.

[4] In the provision of legal services within the City, there are a significant number of small, niche, firms that compete in that particular niche with the Magic or Silver circle firms. However, these firms do not tend to provide services outside that niche.

[5] See Clifford Chance's website: http://www.cliffordchance.com/offices.html, accessed 01/11/2012.

[6] Strictly speaking, there are law firms located in London that are the equivalent of law firms located outside London. The term 'City law firms', however, is used in the legal profession to identify the Magic and Silver circle firms (and some others) that have distinct characteristics as a result of the type of work they do and the type of clients they have. The Legal Services Board has identified them as a distinct category of law firm. See CRA (2011), Benchmarking the supply of legal services by city law firms', August, available at: http://www.legalservicesboard.org.uk/news_publications/latest_news/pdf/benchmarking_city_law_firms_final_report_v3.pdf

As identified by the CC, there are also differences in the stability of demand conditions, which could, for example, create a differential in the cost of capital. Oxera also considers that it is appropriate to take this type of difference into account.

# 4 Part 2

## 4.1 Profits per partner

See section 3.6 above on the PwC approach.

## 4.2 Other issues in part 2

As most information and analysis have been redacted in part 2, there is little that can be said about it. One methodological issue relates to a number of the comparisons that the CC has made between audit and non-audit services (for example, paragraphs 32 and 34, Table 4, Table 6 of the annex). Ideally, unallocated costs should not be allocated on the basis of revenue because, as a matter of mathematics, such an approach brings the margins of different activities closer to the mean and/or could result in a circularity problem of hiding monopoly profits (something the CC and others have emphasised in the past). Alternative cost drivers would appear to be available that are less prone to this problem and should be adopted, particularly where the *relative* profitability of different lines of activity is important.

# 5 Other profit-related issues

The CC has indicated that it will be analysing the profitability of specific engagements. If this measure is to be used to compare the profitability of assignments between firms or with some external benchmark, some of its characteristics would need to be taken into account, The rationale for this conclusion is set out in more detail in the Appendix. In particular, the measure would seem to be influenced by:

– the pay rates of different staff grades;

– the efficiency with which those staff undertake non-chargeable work; and

– the firm’s policy on recording hours spent on non-chargeable work.

# A1 Profitability of assignments.

The CC has indicated that it will be analysing the profitability of specific engagements using the following approach:

gross profits = UK audit fee – direct non staff costs – staff costs

Where staff costs are defined as:

the sum of hours spent per grade of staff * average hourly cost of that grade

Where the average cost per hour of that grade of staff is defined as:

total employment costs of that grade/the total number of hours recorded in the timesheets of the relevant staff

Two important characteristics of this approach should be taken into account when using the results of this type of analysis.

1) The approach is likely to produce high levels of apparent profitability because, as a result of staff recording time that is not chargeable to clients, there is likely to be a large differential between cost per hour and the necessary charge per hour needed to sustain a firm.

   Although such a metric may be comparable between audit firms (as the necessary non-chargeable hours to maintain a business are likely to be similar), a comparison between activities or against external benchmarks may be complex to interpret.

2) Comparisons between audit firms may not be robust because the metric will also vary. If firms have a different approach to the recording of time that is work-related but not chargeable, artificial differences in profitability will arise. The stricter the requirement to record work-related but non-chargeable time, the *higher* the apparent level of profitability. (This arises because recording more non-chargeable time has the effect of reducing the apparent cost per hour of staff.)

Before alighting on the use of total hours in the calculation of staff costs, alternatives such as chargeable hours should be further explored to see whether such an approach would be less susceptible to distortions caused by different approaches to internal organisation in different firms.