



## **Competition Commission Audit Services Market Inquiry**

6 November 2012

### ***Deloitte response to the Competition Commission's working papers "Profitability – part one" and "Profitability – part 2"***

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## **Deloitte response to the Competition Commission’s working papers “Profitability – part one” and “Profitability – part 2”**

### **1. Introduction**

1.1 Deloitte is grateful for the opportunity to comment on the working papers published by the Competition Commission (the **CC**) on “Profitability – part one” (**Working Paper 1** or **WP1**) and “Profitability – part 2” (**Working Paper 2** or **WP2**) (together, the **Working Papers**). We set out our views on the matters considered by the CC in the Working Papers below.

### **2. Profitability and risk**

2.1 WP2 explains that the data across firms shows that the profitability of assurance work is within the range of profitability levels of the various activities carried out by audit firms<sup>1</sup>. We are pleased to note that the CC broadly agrees, subject to one caveat, that this demonstrates that the market is competitive. Specifically, WP2 explains that:

*“Deloitte’s view that audit is competitive as it has overlapping margins with non-audit (competitive) markets holds if we believe the risk profiles are the same.”<sup>2</sup>*

2.2 WP2 goes on, though, to state that:

*“However, it can be argued that the risk profile of audit is lower than that of consulting – the income stream is less lumpy, and the costs base is fairly stable, there is a high proportion of repeat business and significant long-term clients.”<sup>3</sup>*

2.3 This comment appears to be another manifestation of the surprising reluctance of the working papers to recognise the widely accepted understanding of the relative risks of audit and the other service lines operated by audit firms<sup>4</sup>. Given the consensus on the relative risks of these service lines, the analysis underpinning such a view would have to be particularly robust, since the CC appears to be seeking to second guess not only market participants but also regulators, industry bodies, industry analysts and the entire insurance market. In fact, we have seen no analysis from the CC that would support the view that the relative risk of the audit business is lower than that of other businesses.

### **The riskiness of the audit business**

#### *Deloitte’s view*

2.4 Deloitte has explained to the CC that its audit business is its most high risk line of business and that the CC’s apparent views to the contrary are absolutely inconsistent with our experience<sup>5</sup>.

2.5 In particular:

(a) Deloitte explained at its hearing with the CC that the nature of the risk faced in relation to its audit activities is of a different order to that faced in relation to its other activities<sup>6</sup>. Unlike

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<sup>1</sup> WP2, paragraphs 27, 32 and 41. At Deloitte’s hearing with the CC, the CC queried the relative margins of Deloitte’s [X] business, and requested further information on 12 October 2012. We attach at Annex 1 Deloitte’s response to the CC’s question concerning relative margins.

<sup>2</sup> WP2, paragraph 44

<sup>3</sup> Ibid.

<sup>4</sup> See further paragraph 53 of the Working Paper on *Liability, insurance and settlements* (the **Liability Working Paper**); and page 19 *et seq* of the transcript of Deloitte’s hearing with the CC.

<sup>5</sup> See Deloitte’s response to the Liability Working Paper.

<sup>6</sup> See page 19 *et seq* of the transcript of Deloitte’s hearing with the CC.

Deloitte's other activities, the liability risk it faces in relation to its audit activities is existential in nature: it is sufficient to put the entire firm's continued viability at risk; and

- (b) this is a function of the fact that, unlike the other areas of its business, Deloitte is not in practice able to limit its exposure in the audit business by contract<sup>7</sup>. The legislative reforms to allow auditors to introduce limitations of liability into their agreements with audit clients have been ineffective: Deloitte has no such arrangements in place with any of its FTSE 350 audit clients.

2.6 The CC's investigation is far from the first time that Deloitte has made this point. It has made the same observation through other channels:

- (a) **Deloitte's evidence to the House of Lords Economic Affairs Select Committee:** Deloitte's audit business "*carries the highest level of risk and regulation*" by comparison with its other service lines.
- (b) **Deloitte's evidence to the European Commission consultation on auditor liability reform:** "*Given the chasm between available commercial insurance and the size of many claims faced by the largest audit networks, our firms rely on a system of mutual self-financing and sharing of risks, to a certain limited extent. Ultimately, any claim in excess of the different limits in this mutual system and/or its available reserves, will need to be financed from partners' earnings. Unlimited liability is therefore widely viewed by audit firms as making it more difficult to retain experienced staff with a view to them becoming partners.*"<sup>8</sup>

#### *The views of other market participants*

2.7 Deloitte's view is shared by multiple other market participants who have been clear that risk is high and only significant reform would reduce that risk. For example,

- (a) **Kingston Smith:** "*A fraud in a company might have been the result of management failing to have the right systems in place. It was common practice now to claim from the auditors as they typically had the most financial resources available and it was a joint and several liability. While the directors might have been found by the judge to be culpable, if they did not have funds available, the whole claim would be financed by the auditors, or the insurers.*"<sup>9</sup>

*"Kingston Smith explained that no firm, including the Big 4, had the total amount of cover necessary to withstand a very large claim. Kingston Smith said that the price of insurance was too high for medium-sized firms."*<sup>10</sup>

- (b) **Grant Thornton:** "*The current system in some Member States of unlimited liability is clearly inequitable, allowing as it does the possibility that an audit firm could fail as a result of disproportionate litigious activity responding to unauthorised actions of a small number of employees.*"<sup>11</sup>

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<sup>7</sup> See further Deloitte's response to the Liability Working Paper.

<sup>8</sup> Deloitte, submission to the European Commission consultation on auditor liability reform, March 2007.

<sup>9</sup> Summary of hearing with Kingston Smith, paragraph 7

<sup>10</sup> Ibid, paragraph 11.

<sup>11</sup> Grant Thornton, submission to European Commission consultation on auditor liability reform, March 2007.

- (c) **BDO:** *“BDO believes that reform grounded on the principle of ‘proportionate liability’ would reduce the risk of any audit firm being forced out of existence due to the fault of others but would not provide unfair protection against one’s own errors or mistakes.”*<sup>12</sup>
- (d) **Ernst & Young Global:** *“Unlimited auditor liability is the single biggest threat to the sustainability of the audit profession.”*<sup>13</sup>

2.8 The same view is expressed by regulators and industry bodies:

- (a) **CBI:** *“No other organisation is faced with the threat of unlimited liability if a claim by a client should ever be made, and we feel that it is appropriate that audit firms are not unduly discriminated against.”*<sup>14</sup>
- (b) **FRC:** *“As companies have become larger and their activities global, and as society has become more litigious, auditors have faced an increasing number of claims, including many that, if they were successful, would be beyond their financial resources.”*<sup>15</sup>
- (c) **ACCA:** *“Radical change must recognise the risk of exposing auditors to unreasonable levels of liability and prohibitive insurance costs.”*<sup>16</sup>
- (d) **ICAS:** *“The auditors of large multinational companies are potentially exposed to legal claims the size of which could threaten the very existence of the firm... There is a high risk attached to auditing multinational companies which is due to the auditor being exposed to potentially very high claims compared to the profits of the auditing entity concerned.”*<sup>17</sup>
- (e) **ICAEW:** *“Consider a possible scenario: there has been a fraud, lots of people have been sued and the case has gone to court. The court has found: an employee say 80% responsible, on the sensible grounds that he actually perpetrated the fraud; a software company 10% responsible because a control supposedly in place did not work; and the auditors 10% responsible for failing to spot the fraud after the event. Quite probably the employee has few assets and the software company has gone out of business, so the auditors are presented with the bill for 100% of the damages. The auditors have been held liable not only for the consequences of their own actions, but those of everyone else too.”*

*“Leaving aside the fairness or otherwise of this, there are practical consequences: everyone ends up paying for the actions of a few, through insurance premiums and audit fees; and, particularly at the larger end of the market, it has become impossible to get enough insurance to cover the size of claims flying around.”*<sup>18</sup>

2.9 The same view is expressed by other bodies who have studied the market:

- (a) **London Economics:** *“The level of auditor liability insurance available for higher limits have fallen sharply in recent years in terms of both the level and amount of insurance and the conditions under which the insurance cover is effective. The current level of commercial*

<sup>12</sup> BDO, submission to European Commission consultation on auditor liability reform, March 2007.

<sup>13</sup> Ernst & Young Global, submission to the European Commission consultation on auditor liability reform, March 2007.

<sup>14</sup> CBI, comment in World Financing, *Limiting auditor liability*, 14 November 2008.

<sup>15</sup> FRC, *Guidance on auditor liability limitation agreements*, June 2008.

<sup>16</sup> ACCA, *Audit reform: aligning risk with responsibility*, May 2011.

<sup>17</sup> ICAS, evidence to the House of Lords Economic Affairs Select Committee.

<sup>18</sup> ICAEW, *Auditors liability conundrum*, see <http://www.icaew.com/en/technical/audit-and-assurance/working-in-the-regulated-area-of-audit/audit-liability/auditors-liability-conundrum>.

*insurance is such that it would cover less than 5% of the larger claims some firms face nowadays in some EU Member States.*<sup>19</sup>

*“The profession is already viewed as not very attractive and risky, and, in their replies to the survey, audit firms have indicated that unlimited liability makes it more difficult to retain professional staff with a view to becoming partners.”*<sup>20</sup>

#### *The views of insurers*

- 2.10 Most strikingly, in concluding that the audit market is not a high risk environment in which to operate, the CC appears to be second guessing the entire insurance market. It is not possible to obtain commercial insurance for the totality of the potential exposure of Deloitte’s audit business, and we understand that the position is the same for other major firms.
- 2.11 If the CC were correct that the actual level of risk faced by Deloitte’s audit business was not material, it is hard to understand why the market would not offer to insure that risk.
- 2.12 For completeness, the CC should be aware that the ability to self-insure on the part of at least some firms cannot be understood as being comparable to the ability to obtain commercial insurance. In particular, Deloitte (in common, we understand with other firms) is able to obtain commercial reinsurance for only part of the risk that it self-insures.

#### ***The relative riskiness of non-audit businesses***

- 2.13 By way of comparison with this existential risk posed by the nature of auditor liability, the Working Papers cite certain commercial risks that arise in the context of non-audit businesses undertaken by audit firms. Even ignoring the qualitatively different nature of some of the risks involved in its audit work (as explained above), the points made in the Working Papers do not provide support for the notion that audit business is lower risk than non-audit business.
- 2.14 First, WP2 ignores the fact that audit relationships are “all or nothing” in nature: save for the tiny minority of companies which share their audit between two firms, there is only one audit relationship per company. That means that the totality of the audit revenue from a client is always at risk. This is not the case for non-audit work, where companies will generally appoint more than one provider and opportunities arise more frequently (because there are a larger number of separate mandates). This significantly reduces the risk of non-audit work: if a firm fails to win one mandate, it retains the possibility to win the next which may come up for tender relatively shortly. This reduces the risk of non-audit relationships relative to audit relationships.
- 2.15 Second, WP2 states that “*there is a high proportion of repeat [audit] business*”<sup>21</sup>. This does not distinguish audit business from non-audit business. Deloitte has non-audit relationships with substantially all FTSE 350 companies, and would expect to generate repeat business from a large proportion of this group. Our expectation is that the other major firms (including the largest mid-tier firms) would have the same relationship with their FTSE 350 non-audit clients. This reflects, in part, the point above that the nature of non-audit work means that a multiplicity of mandates is available.
- 2.16 Third, the working paper states that audit work is characterised by “*significant long-term relationships*”<sup>22</sup>. Again, this does not distinguish audit business from non-audit business. For the same reasons as those set out above, Deloitte (and, it believes, other major firms) have long-term relationships with their non-audit clients, just as they may do with some audit clients. Indeed,

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<sup>19</sup> London Economics, *Study on the Economic Impact of Auditors’ Liability Regimes: final report to DG Internal Market and Services*, September 2006 (page xxi). See also, in particular, chapters 13 to 19.

<sup>20</sup> *Ibid*, page xxii.

<sup>21</sup> WP2, paragraph 44

<sup>22</sup> *Ibid*.

Deloitte (and, we understand, other major firms) have non-audit relationships with a larger number of FTSE 350 companies than audit relationships.

- 2.17 Fourth, WP2 states that, in the audit business, “*the income stream is less lumpy, and the costs base is fairly stable*”<sup>23</sup>, implicitly by contrast with non-audit work. In fact, it is clear that the level of volatility of audit margins (which are a function of income and cost) is similar to that of non-audit margins, as is apparent from data which Deloitte has supplied to the CC.

Table 1 below presents the net margins for Deloitte’s audit service line and for the average of the non-audit service lines (tax, corporate finance and consulting). Whilst the range of audit net margins is 2 percentage points lower than that of non-audit service lines, the level of variation is still significant.

**Table 1: Deloitte net margins**

Year	FY06	FY07	FY08	FY09	FY10	FY11	FY12
Audit	[<]	[<]	[<]	[<]	[<]	[<]	[<]
Non-audit	[<]	[<]	[<]	[<]	[<]	[<]	[<]
Total	[<]	[<]	[<]	[<]	[<]	[<]	[<]

  

	Min	Max	Range
Audit	[<]	[<]	4.6%
Non-audit	[<]	[<]	6.7%
Total	[<]	[<]	5.3%

- 2.18 Finally, the CC’s analysis of the riskiness of audit work takes account of the steps Deloitte takes to mitigate that risk. The CC must also therefore take account of the multiplicity of steps that Deloitte takes to mitigate the commercial risks with respect to its non-audit work. These include:
- (a) long-term planning to assess likely conditions of supply and demand in the future;
  - (b) careful management of the cost base, including with respect to staff costs; and
  - (c) diversification to ensure that Deloitte can exploit counter-cyclical opportunities, such as restructuring opportunities when traditional M&A levels are low.
- 2.19 The combination of these steps means that the Deloitte’s other business lines cannot be said to be more risky than its audit business from a commercial standpoint.

### **Conclusion on profitability and risk**

- 2.20 In summary, there is no basis for the CC’s suggestion that audit work is lower risk than non-audit work. Audit work is characterised by a significantly elevated litigation risk which is sufficient to put the existence of the firm at risk, as well as similar commercial risks to those present with respect to non-audit work.
- 2.21 For this reason, the CC’s caveat to the conclusion that the audit market is competitive is not applicable: the audit service line is, if anything, more risky than non-audit service lines. For that reason, the conclusion that the audit market is competitive must hold.

## **3. Reviewing measures of profitability**

- 3.1 We have previously submitted views on the challenges that would be faced by the CC in attempting to measure returns against an appropriately measured capital base<sup>24</sup>. Such challenges have been recognised by the CC in its guidelines<sup>25</sup>, and rightly, led the CC to

<sup>23</sup> Ibid.

<sup>24</sup> See “Summary of Deloitte’s response to the Competition Commissions’ questionnaire” Paragraphs 7.6 *et seq*

<sup>25</sup> See Annex A2 to the CC’s *Guidelines for Market Investigations* (draft).

conclude in the Working Papers that *‘the book value of capital may bear little relationship to the economic value because of significant intangibles<sup>26</sup> and that it is ‘unable to reliably measure the appropriate capital employed<sup>27</sup> that would enable it to undertake a reliable assessment of return on capital.*

- 3.2 The proposed ‘return on capital invested’ metric which the CC is currently considering also suffers from significant measurement and interpretation challenges, to the extent that it cannot provide a basis on which the CC could rely in drawing conclusions on the reasonableness of returns achieved in the reference market. For completeness, we attach our response to the CC’s email on this topic as Annex 2.
- 3.3 Those limitations mean that the conclusions set out in WP1 apply equally to an assessment based on partner invested capital: the Working Papers are correct to conclude that it is not possible to calculate an economically meaningful measure of the capital base of firms in the reference market.
- 3.4 However, this does not mean that no evidence is available to the CC upon which to reach a conclusion on profitability in this market. The CC’s assessment should be informed by the relative profitability of audit in the reference market compared with useful benchmarks such as audits of non-FTSE 350 companies, non-audit services provided by Deloitte and profitability of other professional services organisations (see below). These comparators provide the CC with strong evidence that the returns achieved reflect the highly competitive conditions in the reference market, and do not provide any evidential basis for the CC to conclude that returns are excessive.

#### **4. Sales-based profitability metrics**

- 4.1 WP1 correctly notes that firms are not organised in such a way that FTSE 350 audits are undertaken by separate units.<sup>28</sup> It further notes that FTSE 350 statutory audit revenues represent less than 20% of assurance revenues for the Big 4 firms.<sup>29</sup> It concludes, and we concur, that the complex and multiple layers of cost within the business would make any allocation of the costs to a hypothetical FTSE 350 statutory audit division unreliable.<sup>30</sup>
- 4.2 However, the Working Papers proceed to analyse various profitability metrics that apply to the assurance divisions or service lines of the major firms, without any discussion of the limitations of using metrics that apply to a broad set of services (the vast majority of which are outside of the reference market). As we have provided to you in response to your follow up questions after our hearing (which we have reproduced in Annex 1), [§<]. Therefore any reference to assurance service line profitability as a proxy for profitability in the reference market is overstated.
- 4.3 As explained above, there is persuasive evidence available to the CC on the profitability of the reference market which the CC should take into consideration:

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<sup>26</sup> WP1, paragraph 53

<sup>27</sup> WP1, paragraph 58

<sup>28</sup> WP1, paragraph 4

<sup>29</sup> WP1, paragraph 27

<sup>30</sup> Ibid.

### Relative revenue recovery rates

- 4.4 The business metric that firms use to assess relative financial performance of different projects is the Revenue Recovery Rate (**RRR**). RRRs are used in our business as a method of reporting relative profit performance between engagements.
- 4.5 Analysis of Deloitte's RRRs set out in Table 2 below shows that [redacted].

**Table 2: Deloitte RRRs**

Year	FY06	FY07	FY08	FY09	FY10	FY11	Average
FTSE 350 audit	[redacted]						
Non FTSE 350 audit	[redacted]						
Non-audit	[redacted]						

- 4.6 This shows [redacted]<sup>31</sup>.
- 4.7 Such an approach, it should be noted, is consistent with the CC's guidelines, which explain that, in situations where capital cannot be accurately assessed (a situation which the CC therefore actively envisages); "a comparison with businesses operating in different but similar markets may on occasion be helpful"<sup>32</sup>. This is just such an occasion, and the evidence clearly shows that profits are no more than reasonable.

### Relative gross margins

- 4.8 The same analysis holds at gross margin level. Table 3 shows that:
- (a) [redacted]; and<sup>33</sup>
- (b) [redacted].<sup>34</sup>

**Table 3: Deloitte gross margins**

Year	FY06	FY07	FY08	FY09	FY10	FY11	Average
FTSE 350 audit	[redacted]						
Non FTSE 350 audit	[redacted]						
Non-audit	[redacted]						

### Comparison with other professional services

- 4.9 In WP2 the CC appears to reject the benchmarking of profit per audit partner against the profit per partner of law firms on the grounds that legal and auditing firms should not necessarily be equivalent<sup>35</sup>. Deloitte has not sought to assert any such necessary equivalence in order to justify this benchmarking. Rather, given similarities in terms of the provision of professional services based on extensive training and methodologies to a similar client base, such comparisons are still instructive, and it is, as explained above, an approach which is consistent with the CC's guidance.

<sup>31</sup> [redacted]

<sup>32</sup> See Annex A2 to the CC's *Guidelines for Market Investigations* (draft), paragraph 14.

<sup>33</sup> [redacted]

<sup>34</sup> [redacted]

<sup>35</sup> WP2, paragraph 18

- 4.10 Most importantly, this benchmarking shows that competitively justified gaps in the quality of professional service providers will be reflected in premium returns for the highest quality firms. The CC recognises this in its working paper.<sup>36</sup>
- 4.11 WP1 focuses on profitability *'as an indicator of whether prices are too high'*<sup>37</sup>. The evidence described above, plus the corporate information which exists on the relative performance [3<], shows that profits generated from the supply of services in the reference market are not only *not* 'too high', but are normal and consistent with competitive outcomes.

## **Conclusion**

- 4.12 As part of its investigation into the reference market, the CC has considered different methodologies to establish whether unduly high profits are not being made. It has concluded (and we agree) that it cannot reliably assess economic profits and whether profits are being made in excess of cost of capital. However there is a wide range of other data points on profitability together with appropriate benchmarks relating to unambiguously competitive markets available to the CC which provide persuasive evidence that the levels of profits generated in the reference market are not unduly high.
- 4.13 This evidence must be appropriately taken into account by the CC. This is exactly the type of situation envisaged by the CC's guidance where such evidence is appropriate. Moreover, the CC has already indicated that it agrees that this evidence supports the view that audit is competitive, as long as it is clear that audit work is no less risky than non-audit work. The evidence very clearly shows that, if anything, it is more risky.
- 4.14 For all of these reasons, the only reasonable and properly evidenced conclusion open to the CC is that profits in the FTSE 350 statutory audit market are not unduly high.

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<sup>36</sup> WP2, paragraphs 16-17

<sup>37</sup> WP1, paragraph 1

**Annex 1: Deloitte's response to Question 1 of the questions following the hearing, in relation to the relative margins of its [X] businesses**

[X]

## **Annex 2: Deloitte’s response to the request for comment on return on equity calculations**

### **1. Introduction**

- 1.1 The Competition Commission (CC) has asked for comments on a calculation methodology it has proposed with respect to return on capital invested.<sup>38</sup> We are grateful for this opportunity to comment on this specific methodology, and provide comments below. We also confirm that we will be addressing broader issues raised in the CC’s Working Papers on profitability in separate submissions.
- 1.2 The CC’s working paper “Profitability – part one” sets out a discussion on the merits and demerits of profitability calculations of return on sales and return on capital employed. The working paper does not contain any discussion on the merits and demerits of a profitability calculation based on return on invested capital. Such an analysis is not present in any of the other material that has been published by the CC. This removes any transparency about the CC’s thinking in this regard and whilst we provide our initial comments on such a methodology in this response, we stress that it is incumbent on the CC to publish (and allow comments on) specific reasoning in support of a view that such a methodology would be appropriate.

### **2. The value of partners interests**

- 2.1 The question from the CC includes the following observation:

*“Our understanding is that partners do not pay market value for their investment in the firm and hence do not put a significant amount of capital at risk, but appear to receive returns on capital commensurate with much higher levels of investment.”*

- 2.2 The observation fundamentally misunderstands the way many professional partnerships operate in the UK. The market value of the partnership represents the sum of tangible and intangible assets of the firm. To maintain and grow the market value of the firm, the partnership identifies candidates for partnership who the existing partners believe can contribute to the development of the value of the partnership.
- 2.3 The investment requirements for candidates to become partners in the firm are set by the partnership. Partners at Deloitte are not required to pay “market value” for their interest in the firm but nor do they receive “market value” when they retire<sup>39</sup>. Notwithstanding this, an equity partner is a full owner of the business and therefore has a legitimate interest in the market value of the firm (including both tangible and intangible assets). Furthermore the fact that current partners are not required to pay for the accumulated intangible value in full does not mean that the intangible value does not exist, or that partners should not earn a return on the intangible value or, crucially, that it is not at risk<sup>40</sup>.
- 2.4 In looking at return on capital invested, the CC is trying to link returns to partners to only one element of their total interest in the firm<sup>41</sup> and is therefore a fundamentally misconceived analysis. Furthermore, there are other critical methodological flaws in the proposed approach which we set out in Section 4 below. For these reasons, it is not open to the CC to reach any conclusion on the profitability of audit firms based on this methodology: to do so would be to take into account demonstrably irrelevant evidence and would be demonstrably unreasonable.

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<sup>38</sup> E-mail from Dipen Gadhia to James Williams, 23<sup>rd</sup> October 2012.

<sup>39</sup> A partner cannot sell his/her interest in the firm back to the partnership or to a third party.

<sup>40</sup> If the levels of profits generated by the partnership are reduced (for whatever reason), the intangible value would be diminished and partners would receive reduced cash flows as would successor partners.

<sup>41</sup> We discuss this point further in paragraphs 4.7 et seq

### 3. Confirmation of average capital invested by Deloitte audit partners

- 3.1 The CC has requested the average capital invested by Deloitte audit partners in 2011. We can confirm that this figure stood at £[><] in 2011. This figure includes invested capital, retained earnings and amounts set aside to cover income tax liabilities. All these amounts are:
- (a) True cash balances invested in the firm which require personal financing by the partners;
  - (b) Required to finance the firm, which would have to find alternative sources of financing in the event that they were not available;
  - (c) Non-ring fenced, and at risk in the event that the firm suffers losses<sup>42</sup>.

### 4. The principles underpinning the calculation

- 4.1 In accordance with its own guidelines, any measure of profitability relied on by the CC should be an 'economically meaningful measure of profitability'.<sup>43</sup> The CC does not define 'economically meaningful' but we consider that it would be reasonable to interpret an economically meaningful measure as one which:
- (a) relates directly to the services in the reference market;
  - (b) may be interpreted in a way which is relevant to the wider issues under investigation;
  - (c) can be compared against relevant benchmarks;
  - (d) is based on unambiguous assumptions; and
  - (e) consistent with the approach taken by market participants and analysts.
- 4.2 We consider these aspects in turn below.

#### *Relationship to the reference market*

- 4.3 As previously noted by Deloitte in its submissions to the CC, audits of large companies are not provided by a distinct business unit within the audit service line. Partners and staff in the audit service line provide audit and non-audit services to a broad range of clients, from the largest FTSE100 companies to small, private companies. The CC itself notes in its Profitability Part One Working Paper, and we concur, that '*given the multiple layers of cost allocation required to analyse FTSE350 audits as a sub-division of accounting firms (and the hypothetical nature of the exercise), the accuracy of any such analysis is questionable. ... We therefore think that obtaining profitability measures for FTSE350 audits as a subset of the Assurance businesses is unlikely to be a robust analysis.*'<sup>44</sup>
- 4.4 Further, as the CC notes, for the Big 4 on average, revenues from FTSE350 audits represent less than 20% of assurance revenues over the period 2007–2011. Any measure of profitability that relates to the audit/assurance line as a whole will therefore reflect the performance of the broader business, meaning that it is not a robust assessment of the financial returns in relation to services within the reference market.

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<sup>42</sup> Income tax liabilities are personal tax liabilities of the partners. The firm acts as an administrator to help partners settle their tax liabilities and cash amounts equal to estimated liabilities are retained in the firm. These cash amounts are used a financing sources for the firm until they are paid to the tax authorities and are not ring fenced. In the event of the firm making losses, the cash would be used to pay for the losses requiring the partners to find an alternative source of income to meet the tax liabilities, meaning that this element is similarly at risk.

<sup>43</sup> CC (2012), Guidelines for Market Investigations (draft subject to consultation), Annex A, paragraph 8

<sup>44</sup> CC working paper Profitability Part One, Paragraph 27

- 4.5 Moreover, in relation to the return on capital invested measure that the CC is seeking to explore, not only does this not relate specifically to the reference market, it does not even relate specifically to the assurance/audit service line. Partners are elected to Deloitte LLP, and not to any corporate structure that corresponds solely with an assurance/audit business. Decisions on the capital required to be invested by Partners are taken across Deloitte LLP as a whole, and not in relation solely to the audit/assurance line. It cannot be assumed that the financial requirements and structure of a standalone audit/assurance business would be the same as those of Deloitte LLP as a whole, and the CC has presented no analysis on the point. At the very least, this introduces considerable uncertainty about the accuracy of any calculation of equity invested in the assurance business.
- 4.6 In summary, the data that the CC is seeking to rely upon are not specific to the reference market and so cannot be relied upon to draw conclusions about returns with respect to the reference market.

*Relevance to the issues under consideration*

- 4.7 In order for a financial ratio to be economically meaningful as a measure of profitability, it is necessary for the numerator and the denominator used in the ratio to capture all relevant factors and to be consistent with each other. In this context, there are significant doubts about the relevance of using invested equity as an appropriate denominator when assessing the reasonableness of returns to partners which undermine its evidential value.
- 4.8 To use invested capital as a denominator for calculating the reasonableness of returns would require that invested capital reflects one of the following criteria:
- (a) The sum of invested capital represents the market value of the capital base of the firm; and
  - (b) The sum of the invested capital represents the totality of the financial loss that the Partners risk losing.
- 4.9 Neither of these criteria is met.
- (a) A partnership such as Deloitte LLP is not a traded enterprise; hence, unlike traded equity listed on a stock market (ownership restrictions aside) the sum of the invested capital does not represent the amount that a purchaser would have to pay in order to purchase the firm. Invested capital therefore does not provide an appropriate measure for the capital base for the firm.
  - (b) For partners, the invested capital does not represent the value of capital that is at risk. What is at risk for partners is their share of the equity value of the firm – their right to future profits generated from a profitable firm. Furthermore, audit partners are faced with additional legal and regulatory risks in the form of potential unlimited fines from regulators as well as the potential for criminal sanctions in some circumstances. The sum of invested capital is therefore an arbitrarily low figure on which to base any assessment of the reasonableness of returns.
- 4.10 For these reasons, partner invested capital cannot be used as a measure of exposed value that enables it to be used as a relevant measure for the returns achieved by partners.

*Comparison against a relevant benchmark*

- 4.11 Notwithstanding the intractable interpretational issues examined above, if a meaningful, unbiased measure of return on invested capital could be calculated that was closely related to the provision of services on the relevant/reference market, the CC would have to compare this against a robust benchmark in order to assess its reasonableness. It certainly is not open to the CC simply to suggest that returns are unreasonable in the abstract.

- 4.12 In making such a comparison, the CC would need to take into account the specific risks that are associated with the investments in an audit firm.
- 4.13 The cost of equity is mostly commonly determined by implementing the capital asset pricing model (“CAPM”). The CAPM states that the cost of equity is equal to the risk free rate of borrowing plus an equity risk premium adjusted by the company specific risk parameter  $\beta$ .

$$r_e = r_f + \beta \times ERP$$

- 4.14 However, as audit firms, including Deloitte, operate as partnerships there is no publically traded equity from which a value of  $\beta$  can be estimated. In any case, the partners’ investments in a large audit firm merit a significant premium relative to a diversified benchmark.<sup>45</sup> This is for a number of reasons:
- (a) **Idiosyncratic risk.** Partners are required to invest a significant amount of capital in their firm. This means that they may not be as diversified as a ‘normal’ investor. This is analogous to the premium required by entrepreneurs investing in private businesses.
  - (b) **Illiquidity.** Partners’ capital contribution to an audit firm cannot be traded or transferred. This requires an illiquidity premium.
  - (c) **Financial exposure and time horizon.** Partners have a limited timeframe over which to earn a return – the duration of their partnership. This restriction increases the risk that they may not be appropriately remunerated during this period and so raises the cost of their equity. This is analogous to the returns required by private equity investors.
  - (d) **Scale.** Numerous empirical studies have assessed the relationship between scale and required returns. While Deloitte is larger than many audit firms, it may still merit a premium given its scale.<sup>46</sup>
  - (e) **Ownership and management restrictions.** Current restrictions in the UK require control of an audit firm to be in the hands of relevantly qualified individuals. Such a restriction, where applied to external investors in analogous situations (such as restrictions on voting rights), require significant premia on the cost of equity. In other words, the restrictions on audit firms’ access to capital need to be reflected in premium returns on partners’ capital.
  - (f) **Liability risk.** There is limited commercial insurance available to cover audit liability risks.<sup>47</sup> Investors are likely to be averse to investing in businesses that face catastrophic risk; this also means that partners require significant premia on the cost of equity.
- 4.15 Oxera has estimated that the possible uplift to required returns above a diversified benchmark may be up to c12% in respect of corporate structure and up to c24% in respect of ownership and management restrictions (though these uplifts may overlap to some extent). These premia are clearly of fundamental importance to estimating an appropriate WACC but, as with intangibles, are difficult to measure directly.

*Consistency with the approach taken by market participants and analysts*

- 4.16 The CC’s (draft) guidelines explain that the assessment of what may constitute an “economically meaningful” measure of profitability will be informed by the approach taken by “industry participants, including firms, analysts, and investors”.

<sup>45</sup> Oxera (2007) *Ownership rules of audit firms and their consequences for audit market concentration* Final report to DG Internal Market and Services pp 117-162.

<sup>46</sup> Ibbotson estimate a premium of 1.2% for mid-cap companies with capitalisations in the range \$1.78bn to \$6.8bn. See 2011 Ibbotson’s risk premia over time report – estimates 1926-2010 published by Morningstar.

<sup>47</sup> London Economics (2006) *Study on the economic impact of auditors’ liability regimes* Final report to DG Internal Market and Services p92.

- 4.17 There is no support for the approach being suggested by the CC in any industry practice. Deloitte does not make use of a metric based on return on partner invested capital, and it is not aware that any other firm (still less the audit practice of any firm) would do so given that it is economically meaningless.
- 4.18 Furthermore, in a market that is widely analysed and commented on, we are not aware of any analyst or commentator who has considered this metric as being economically meaningful – even at firm level, to say nothing of the audit practice level or the reference market level. If the CC is able to find any such analysis, we would be happy to address it.

## **5. Accuracy of salary imputation assumptions**

- 5.1 Any measure of profitability which involves a salary imputation is necessarily subjective as it is sensitive to the assumptions used. The following points are examples of issues which would require resolution as part of any decision to use salary imputation as a proxy for partner salaries:
- (a) The CC has proposed a low benchmark value of £[><] which is a FTSE 250 median, excluding additional remuneration and national insurance. The 2010 FTSE 250 mean salary was £[><]. The mean is superior to the median because it better reflects the extremes of FTSE 250 salaries, which are also present in audit partner remuneration.
  - (b) The Financial Director salary survey identified by the CC as an industry benchmark 48 does not consistently capture pensions, bonuses and other incentive programmes and so the average of the full remuneration packages received by FTSE 250 directors would be even higher than the reported £[><]. This is also a conservative benchmark because it excludes the FTSE 100 FD remuneration from consideration.
  - (c) Any salary calculation should factor in employer NI, being a mandatory payroll tax that all companies face. The employer NI rate for 2011 is set at 13.8%.
  - (d) We note that the CC is focused on 2011 partner remuneration. Market forces and economic conditions are reflected in the firm performance and remuneration packages, and consequently cause them to vary considerably from year to year. For example, the FTSE 250 FD salary average has varied by £[><] over the 2006-2011, we would expect the 2011 mean FD salary to be greater than the 2010 figure identified by the CC. This again suggests that the mean 2010 figure of £[><] is conservative.

## **6. Conclusion**

- 6.1 The CC's emailed proposal to assess reasonableness of profitability on the basis of return on partner capital invested is fundamentally flawed. In particular, it:
- (a) Does not reflect the value of partners interest (i.e. the value at risk);
  - (b) Does not relate to the reference market;
  - (c) Does not relate to the issues under consideration by the CC;
  - (d) Does not correctly reflect other relevant commercial factors and risks, which any benchmark would similarly have to reflect; and
  - (e) Does not reflect how market participants, analysts and commentators look at profitability in this market.
- 6.2 In the light of these basic flaws, it is not open to the CC to assess the reasonableness of profitability of firms in the reference market based on the methodology proposed in its email.

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<sup>48</sup> CC Working Paper Profitability Part One, paragraph 33 (d)