



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

30 November 2012

### ***Deloitte response to the Competition Commission's working paper "Econometric analysis of audit costs"***

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## **Deloitte response to the Competition Commission’s working paper “Econometric analysis of audit costs”**

### **1. Introduction**

- 1.1 Deloitte is grateful for the opportunity to comment on the paper published by the Competition Commission (the **CC**) on “Econometric analysis of audit costs” (the **Working Paper**).
- 1.2 This response comments on the following areas:
- (a) Economies of scale with respect to auditor size
  - (b) Economies of scale with respect to client size
  - (c) Economies of scope
  - (d) Cost of audits over time
- 1.3 We have already addressed some of these issues in our response to the CC’s working paper on “Restrictions on entry and expansion” (the **Barriers to Entry Working Paper**) and in our Response to the Issues Statement. We have noted in our response to the Barriers to Entry Working Paper that:
- (a) No audit firm has suggested that they are concerned about being unable to meet the prevailing audit prices (paragraph 4.3); in fact, mid-tier auditors’ responses suggest that they expect to be able to undercut the larger firms on audit price (paragraph 4.4).
  - (b) The drivers of engagement staff costs are multiple and complex, and audit complexity is one of the key drivers of audit costs (paragraph 4.5).
  - (c) Market participants have not raised concerns about economies of scope, and mid-tier auditors already possess significant scale in their non-audit work (paragraph 4.12)

### **2. Economies of scale and scope**

- 2.1 The Barriers to Entry Working Paper suggests that the CC will investigate whether there are any economies of scale and/or scope in engagement level staff costs that give rise to intrinsic barriers to entry. Analysis of economies of scale and scope would be relevant to the CC’s investigation insofar as it may suggest that certain audit firms may have a cost advantage in bidding for audit engagements. In fact, there is no evidence from any market participant of such an advantage: no audit firm has indicated that it is impeded for cost reasons from bidding competitively in audit tenders.
- 2.2 The evidence put forward in this working paper further demonstrates that there are no economies of scale or scope in audit costs that would act as a barrier to entry to the statutory audit market. On the contrary, the economies that are present in the provision of audit services are available on an engagement by engagement basis and are therefore achievable by all audit firms, regardless of their current client portfolios.

#### *Economies of scale: auditor size*

- 2.3 Evidence of economies of scale would be present if the econometric analysis found significant and negative impacts of the size of the auditor on the labour costs specific to an engagement. The Working Paper notes that the estimate of the economies of scale with respect to auditor size

is noisy<sup>1</sup>, pointing out that most of the variation in auditor size is “soaked up by the dummies for each of the Big 4 auditors”. In fact, we would encourage the CC to strengthen the conclusion, as the results presented in the Working Paper do not provide robust evidence of economies of scale with respect to auditor size.

- 2.4 For the evidence on economies of scale in auditor size to be reliable, the auditor size and/or the Big 4 auditor dummies would need to be robustly estimated across the various model specifications. In fact, model ‘I – base case’ shows that neither the auditor size nor any of the Big 4 auditor dummies<sup>2</sup> are statistically significant at the 10% level of confidence, and one therefore cannot conclude that there is any statistically significant effect of auditor size on audit costs. In addition, there is no systematic evidence of auditor size or the Big 4 dummies being statistically significant in the other model variations presented in the Working Paper.
- 2.5 Therefore, on the basis of the evidence presented in this Working paper, there are no economies of scale with respect to auditor size. In other words, mid-tier auditors are not at a cost disadvantage relative to major auditors due to their size (defined in the model as the size of their existing client bases). The relative positions of the Big Four and mid-tier auditors therefore can have no impact on the costs that the mid-tier firms would need to incur in order to compete effectively for the supply of audit services to FTSE 350 companies.

#### *Economies of scale: client size*

- 2.6 The Working Paper demonstrates that there are economies of scale in audit costs with respect to client size<sup>3</sup>: an increase in client size by 10% is estimated to increase an auditor’s costs for that audit by less than 5%.
- 2.7 Mid-tier auditors are therefore able to achieve economies of scale of equal magnitude to the larger firms, simply by winning engagements with larger clients, rather than by increasing the number or size of the companies that they audit. The presence of economies of scale with respect to client size therefore makes it less costly for the mid-tier firms to audit larger clients than would be the case if those economies did not exist. This enhances the feasibility of mid-tier auditors implementing a strategy of incremental expansion, if they can persuade companies that they have the requisite skills and expertise to undertake those audits.
- 2.8 There is also a weak “sector-specialisation” effect that mid-tier auditors may wish to exploit: specialising in a given sector tends to reduce costs (although this effect appears to be statistically weak). This suggests that some degree of sector specialisation may benefit mid-tier auditors by enabling them to expand their client bases by starting off in specialised niche sectors while reducing their average costs further. Mid-tier auditors can then continue expanding from the specialised client base. However, we emphasize that sector specialisation alone is not sufficient for the expansion strategy to be successful.
- 2.9 We note that the “sector-specialisation” effect is not a barrier to entry and expansion per se: mid-tier firms have made it clear that they consider themselves to have expertise across nearly all relevant sectors (potentially excluding the banking and insurance sectors). Even to the extent that they have fewer FTSE 350 clients in a given sector, they have explained that they can draw on the experience gained from working for non-FTSE 350 clients in similar sectors which they say are of similar size and complexity.<sup>4</sup>

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<sup>1</sup> Paragraph 67

<sup>2</sup> The one exception to this is one auditor, whose identity has been redacted. However, as noted by the CC at paragraph 81, and as evidenced in model ‘II – sector1 8980 excluded’, this is due to the fact that this auditor takes on relatively more clients in the specific Equity Investment Instruments sector.

<sup>3</sup> Paragraph 93

<sup>4</sup> See, for example, paragraph 18 of the summary of BDO’s hearing with the CC, paragraph 1.7(c) of Grant Thornton’s response to the Issues Statement, and paragraph 7 of the summary of Grant Thornton’s hearing with the CC

### *Economies of scope*

- 2.10 Evidence of economies of scope would be present if the econometric analysis found significant and negative impacts of the size of non-audit services on the audit engagement costs. The results presented in the Working Paper do not provide such evidence and we concur with CC's conclusion that there is "*no evidence of complementarities, or economies of scope, between audit and non-audit services*"<sup>5</sup>.
- 2.11 In all the models presented in the Working Paper (models I to XI), it is either the case that the non-audit services are not significant at standard confidence levels, or they have a *positive* impact on the audit costs.<sup>6</sup>
- 2.12 For the avoidance of doubt, this does not mean that provision of audit services and non-audit services is entirely unrelated. While provision of non-audit services does not reduce audit costs (as demonstrated in the Working Paper), we believe that Deloitte's ability to offer a broad range of high-quality non-audit services contributes in a crucial manner to our ability to offer high quality services to audit clients. For example, as mentioned in Deloitte's Response to the Issues Statement, we use non-audit staff to contribute their specialist knowledge, expertise and insight into the delivery of high quality audits.<sup>7</sup>

### **3. Cost of audits over time**

- 3.1 The Working Paper contains evidence that audits are becoming less costly over time, by around 2 per cent per year, up to the tenth year of tenure<sup>8</sup>. Finding that audit costs reduce over time is consistent with our submissions that clients demand increased efficiency over the course of an engagement.
- 3.2 These findings should be read in the context of the findings in the working paper entitled 'Engagement level profitability analysis' (the ***Engagement Level Profitability Working Paper***)<sup>9</sup>. This paper demonstrates (and we have commented on the findings in a separate response) that, once familiarisation costs have unwound, profitability of individual engagements does not increase. This implies that the cost reductions that auditors are able to achieve through the learning-by-doing process are not retained by the auditors. Rather, the efficiency savings are shared with clients, consistent with what would be expected in a well-functioning and competitive market.
- 3.3 These findings are also significant in the context of the claims made by certain mid-tier firms in their responses to the CC's working paper on the 'Nature and strength of competition in the supply of FTSE 350 audits' (the ***Nature and Strength of Competition Working Paper***) in relation to audit fees in each year following a switch of auditor<sup>10</sup>. BDO and Grant Thornton allege (in identical terms) that the fact that total audit fees have risen materially on average by year 5 following a switch of auditor shows that the bargaining power of companies lessens over time. In fact, the data show that the audit fees per £ of turnover do not rise as materially<sup>11</sup>, suggesting that the rise in total audit fee is related to changes in the structure of the companies in question. Furthermore, the findings in the Working Paper and the Nature and Strength of Competition

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<sup>5</sup> Paragraph 70

<sup>6</sup> In the latter case, the naïve interpretation would be that there are *diseconomies* of scope in the sense that auditors who provide more non-audit services tend to have higher audit costs. As the CC discusses at paragraph 80, an alternative explanation might be that the variable log(NONAUDIT) is in fact proxying for other variables such as, inter alia, audit complexity.

<sup>7</sup> Deloitte response to the Issues Statement, section 5.3

<sup>8</sup> Paragraph 2

<sup>9</sup> Engagement Level Profitability Working Paper, paragraph 41 *et seq*

<sup>10</sup> See paragraph 1.9 of BDO's response to the Nature and Strength of Competition Working Paper' and paragraph 4.1 of Grant Thornton's response to the same working paper.

<sup>11</sup> See Figure 6 of the CC's 'Descriptive Statistics' working paper.

Working Paper make it clear that audit firms do not, and are not able to, exploit longer relationships and that companies continue to exert material bargaining power over time.

#### **4. Conclusion**

- 4.1 The evidence presented in the Working Paper has a crucial bearing on Barriers to Entry Working Paper. While the Working Paper shows that there are economies of scale in client size (but no economies of scale in auditor size and no economies of scope), we would encourage the CC to note that such economies do not constitute a barrier to entry to the large company audit market.
- 4.2 The evidence on the audit cost function put forward in the Working Paper demonstrates that mid-tier auditors either face no barriers to expansion, or, in the case of economies of scale with respect to client size, the cost function attributes actually work in their favour.
- 4.3 The CC had suggested in the Barriers to Entry Working Paper that it would investigate how engagement-related staff costs vary with output<sup>12</sup>. The evidence presented is that there are no economies of scale or scope in engagement-specific labour costs that would give rise to intrinsic barriers to entry, and we would encourage the CC to conclude this particular line of investigation.

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<sup>12</sup> Paragraph 20 of the Barriers to Entry Working Paper