



Grant Thornton Response to the Competition Commission ("CC") working paper entitled "Evidence on trends in audit fees"

1 Introduction

- 1.1 This memorandum sets out the response by Grant Thornton to the Competition Commission's ("CC") working paper entitled "Evidence on trends in audit fees" ("the working paper") which was issued on 15 July 2013.
- 1.2 The working paper evaluates two arguments put forward by the largest four firms¹:
 - that audit fees have declined in line with cost reductions, demonstrating cost pass-through;
 - that lower profitability, consistent with intense competition, has been the consequence of the audit fee decline.
- 1.3 We note that the CC accepts that neither of these arguments is well-supported by the empirical evidence, noting that:
 - 'there is no strong evidence for a reduction in the nominal cost per hour, or the pass-through of such an efficiency.'² ;
 - 'gross margin per hour remained roughly stable'³.
- 1.4 This note sets out two further reasons why the evidence assessed in the working paper does not support the proposition that trends in audit fees are consistent with "intense competition" :
 - first, a substantial degree of cost pass-through can occur in oligopoly, and even monopoly settings, and in any case, the gross margin indicator over 6 years is not a robust measure of whether customers benefit from efficiencies;
 - second, that audit fees have gone up substantially over the time period observed in the data (2001 to 2010), with the average (mean) FTSE 350 audit fee rising by 52% before inflation.

2 Cost pass-through

- 2.1 As the CC points out, 'In a competitive market we expect reductions in marginal costs to be passed on to customers. However, this could also be observed in a situation where suppliers have market power.'⁴
- 2.2 The degree of cost pass-through is affected by several factors, including whether efficiencies are achieved in fixed or variable costs, whether efficiencies are firm-specific or industry-wide, and by the degree of competition.

¹ CC working paper, para 3.

² CC working paper, para 8(e).

³ CC working paper, para 8(c).

⁴ CC working paper, para 4.

- 2.3 In the CC's working paper there is no clear direction for the evolution of gross margin (for example, FTSE 100 margin increases, while FTSE 250 margin declines),⁵ and moreover where the CC observes a decline in costs it comments "It is not clear to us what is driving the decline."⁶
- 2.4 It follows that the evidence contained in the CC's working paper is not sufficient to determine the degree to which competition is affecting cost pass-through (if at all), as it does not control for all the factors which determine cost pass-through. Accordingly, that evidence cannot, in isolation, support a conclusion that competition is intense.

3 *Audit fee increase*

- 3.1 Table 1 of the working paper shows the evolution of audit fees from 2001 to 2010.⁷ Over that period, in real terms, average audit fees for FTSE 350 companies have increased by 52% (mean value) and 23% (median value).
- 3.2 The CC observes a small decline in the mean fee between 2009 and 2010, and a more marked decrease in the median fee between 2006 and 2009.⁸
- 3.3 These changes, both the overall increase and recent decrease, could be of significant value to a competition analysis if causally linked to a change in the conditions of competition. In other words, a decline in fees following a period of sharp increases in fees, might be informative if correlated, for example, to changes in the structure of the market. However, there is no such correlation. As the CC has found: Between 2001 and 2010 the Big 4 firms consistently had a share of over 95 per cent of FTSE 350 audits and over 99 per cent of FTSE 350 audit fees.⁹
- 3.4 Further, the CC has also not observed any significant changes in FTSE 350 switching rates (see Provisional Findings Appendix 5, Table 4 (paragraph 41)), which remained in the region of 2% throughout the period.
- 3.5 In short, the conditions of competition, judging by these structural indicators, have remained approximately the same since 2001 (other than the increased concentration caused by the demise of Arthur Andersen – which cannot be expected to lead to an increase in competition).
- 3.6 In such circumstances, snapshot observations of changes in trends in audit fees cannot inform an analysis of the strength of competition. The CC reached a similar conclusion in deciding not to pursue an econometric analysis of the relationship between price and concentration "For the reasons given in Appendix 13, while we had data to carry out a price concentration analysis (PCA), we were not persuaded that the results would be reliable."¹⁰

⁵ CC working paper, paras 35 and 36.

⁶ CC working paper, para 37.

⁷ CC working paper, para 12.

⁸ CC working paper, para 12.

⁹ CC provisional findings report, para 7.7.

¹⁰ CC provisional findings report, para 7.56.

3.7 The overall observation that can be made is that FTSE 350 audit fees have increased significantly since 2001 while the structural features of the market have remained similar over time. Far from being illustrative of intense competition, this is suggestive of a lack of effective competition, particularly when considered alongside other evidence set out in the Provisional Findings.