

Comments on Competition Commission working paper: 'Evidence on trends in audit fees'

Note prepared for BDO

July 29th 2013

1 Introduction

- 1.1 The Competition Commission (CC) working paper 'Evidence on trends in audit fees' evaluates two arguments put forward by the Big Four:¹
- 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.
- 1.2 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
- 1.3 In this note, two further points are made:

¹ Competition Commission (2013), 'Statutory audit services market investigation: evidence on trends in audit fees', July 15th, para 3, available at http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/130715_evidence_on_trends_in_audit_fees_wp.pdf.

² *Ibid.*, para 8(e).

³ *Ibid.*, para 8(c).

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- that a substantial degree of cost pass-through can occur in oligopoly, and even monopoly settings and, in any case, the gross margin indicator over six years is not a robust measure of whether customers benefit from efficiencies;
- 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 the degree of competition. It is well known in the economic literature that cost pass-through can be substantial in an oligopoly, or even monopoly, setting, depending on the market characteristics.⁵
- 2.3 In the CC's working paper there is no clear direction for the evolution of gross margin (FTSE 100 margin *increases*, FTSE 250 margin declines).⁶ Moreover, where the CC observes a decline in costs, it comments that 'It is not clear to us what is driving the decline'.⁷
- 2.4 It follows that the evidence contained in the CC's working paper is not sufficient to determine the degree of competition, as it cannot control for all the factors which determine cost pass-through. It should therefore be considered in conjunction with the evidence available in the CC's Provisional Findings Report,⁸ and not in isolation.

3 Audit fee increase

- 3.1 Table 1 of the CC's working paper shows the evolution of audit fees from 2001 to 2010.⁹ Over that period, in real terms, average audit fees for FTSE 350 companies 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 2005 and 2009.¹⁰
- 3.3 These changes, both the overall increase and recent decrease, could be of significant value to competition analysis if causally linked to a change in the conditions of competition. However, the CC has found that:

⁴ Ibid., para 4.

⁵ See, for instance, European Commission (2011), 'Draft guidance paper quantifying harm in actions for damages based on breaches of Article 101 or 102 of the Treaty of the Functioning of the European Union: public consultation', June, paras 150 and 151, available at http://ec.europa.eu/competition/consultations/2011_actions_damages/draft_guidance_paper_en.pdf.

⁶ Competition Commission (2013), 'Statutory audit services market investigation: evidence on trends in audit fees', July 15th, paras 35 and 36.

⁷ Ibid., para 37.

⁸ European Commission (2013), 'Statutory audit services for large companies market inquiry: provisional findings report', February, available at http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/provisional_findings_report.pdf.

⁹ Ibid., para 12.

¹⁰ Ibid., para 12.

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.¹¹

- 3.4 The CC has also not observed any significant changes in FTSE 350 switching rates (see Provisional Findings Appendix 5, Table 4 (paragraph 41)), which remain in the region of 2% throughout the period.
- 3.5 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).
- 3.6 As such, it may be difficult to link changes in audit fees to a competition analysis. The CC reached a similar view 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.¹²

- 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.

4 Minor comments

- 4.1 It appears that the CC's statement at paragraph 26 of the working paper, that 'the average engagement fee in 2011 was 14.4 per cent lower than in 2006 (in 2005 prices)', should be amended. Table 4 indicates that it was the fee *per hour* which fell by 14.4% between 2006 and 2011. Engagement fees over the same period fell by only 4.8%.
- 4.2 A similar amendment should be made to paragraph 45, where the CC's remark that 'Banks accounted for...20.2 per cent of audit hours in 2011 compared with 14.9 per cent of audit hours in 2006' is not consistent with the data in Table 6. According to Table 6, banks accounted for 20.3% of FTSE 350 audit fees in 2011, compared with 14.9% of audit fees in 2006.

¹¹ European Commission (2013), 'Statutory audit services for large companies market inquiry: provisional findings report', February, para 7.7.

¹² Ibid., para 7.56.