
On the face of the evidence presented and its own experience, EY agrees with the conclusions set out in the Working Paper that the fees per hour in 2005 prices ("real fees") decreased over the years 2006-2011\(^1\), that total profitability on FTSE 350 audit engagements have fallen\(^2\), and that the results of the analysis contained in the Working Paper suggest that efficiency gains leading to a reduction in the average number of hours per engagement have benefitted customers.\(^3\)

The practical test for whether the audit market is workably competitive is whether aggregate returns demonstrate normal profits. In particular, even if, in some narrow interval of time, gross margins rise, the true test of whether the market is competitive is long-run evidence on returns. Accordingly, EY contests any suggestion contained in the Working Paper that a rise in gross margin establishes the absence of effective competition.

Accordingly, the test for whether the audit market is competitive is whether the gross margins earned over all audit, minus the overheads of the business, generate a return on all capital employed (including working capital) that does not exceed the relevant cost of capital. There is no evidence to suggest that EY is making abnormal returns in this regard.

In this context, EY observes that in the relevant market as defined by the CC - in keeping with the vast majority of markets in practice - does not exhibit the characteristics of perfect competition and, as such, price is not likely to equal marginal cost.

In such a market:

(a) gross margins are not zero (indeed given the presence of fixed costs cannot equal zero in equilibrium). This is not inconsistent with a workably competitive outcome; and

(b) any marginal cost reductions would not necessarily be fully passed through to customers in the form of lower prices, although cost reductions will be partially be passed through, where the precise degree of pass-through that can be expected is highly sensitive to supply and demand conditions, and to the time horizon under investigation.

As a result, EY contests any suggestion contained in the Working Paper that a rise in gross margin establishes the absence of effective competition.


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\(^1\) Working Paper, paragraph 8(b).
\(^2\) Working Paper, paragraph 8(d).
\(^3\) Working Paper, paragraph 8(e).
The Working Paper acknowledges that real fees per hour decreased by 16.7% between 2006 and 2011. However, the CC concludes that the fall in real fees per hour was "almost completely driven by deflating the numbers", and that the general consumer price index might not be the most suitable deflator. This conclusion is reached on the basis of a comparison of the nominal fees per hour and the nominal average staff costs per hour. However, this approach is flawed:

(a) Although labour costs represent a significant proportion of costs, they are not the only cost, and an analysis based on labour costs alone will not be meaningful.

(b) The data used does not provide an accurate reflection of labour costs. In particular: (i) staff costs are calculated on the basis of averages over a firm's entire assurance practice, rather than FTSE 350 clients; (ii) the analysis does not include labour costs of partner and administrative grades; and (iii) non-chargeable hours are excluded.

(c) The analysis was performed by reference to real fees in 2005 prices. A time series analysis is different from an analysis calculating individual values (fees), and the exclusion of the highest and lowest 5% of engagements in terms of fee per hour by year and firm may not be appropriate for a time series analysis.

(d) On the basis of the flaws in the dataset acknowledged by the CC, one cannot exclude very significant deviations from the prediction of the development of the margin over the period using the appropriate cost data. It would be more prudent to draw conclusions from the generally accepted practice of discounting prices on the basis of price indices.

Furthermore, there are additional indications that the market is competitive and that efficiencies are being reflected in lower fees:

(a) The Working Paper states that cost reductions may be driven by a reduction in the cost per hour (for example, seniority of staff) and/or a reduction in total hour (volume of the work). One may expect an increase in the seniority of the staff performing the audit will generally result in a reduction in the number of hours required and vice versa. Therefore one should take both aspects into account, and not each in isolation. The results of the CC's analysis shows both the real cost per hour and the number of hours decreased, which suggests that real efficiencies have occurred.

(b) The Working Paper states that the average staff costs per hour remained roughly stable, and that the decreasing fee per hour in 2005 prices was almost completely driven by deflating the number. The adherence to nominal values to draw inferences runs counter to the standard practice of discounting values on the basis of an index. It is artificial to focus on nominal values that have no bearing to real life decision making. If the conclusion that nominal fees have remained constant is accepted, in a time of generally rising prices according to the general consumer price index this suggests a reduction in fees in real terms. Whereas one can

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4 Working Paper, paragraph 20. Without excluding the highest and lowest 5% of engagements in terms of fee per hour by year and firm, the percentage decrease would be 18.6%. Although the CC states that there are a small number of engagements with extreme values that are "implausible" (paragraph 18) it does not explain why it considers that the approach of excluding the highest and lowest 5% of engagements is an appropriate or proportionate approach to dealing with that issue, or why it did not omit those "implausible" engagements on an individual basis.

5 Working Paper, paragraph 48(e).

6 Working Paper, paragraph 48(a) to (d).


8 Working Paper, paragraphs 48(d) and (e).
undoubtedly construe a price index to obtain a required result, a thorough and objective analysis is necessary before deviating from the general consumer price index – no such analysis is contained in the Working Paper.

As the Working Paper acknowledges, EY has been unable to verify the accuracy of the data presented in this Working Paper.⁹

⁹ However, we note that on pages 5 and 19 of the Working Paper it is stated that the mean fee increased until 2009. This appears to be inconsistent with Table 1 of the Working Paper, which indicates that the mean fee decreased in 2007.