Department for Communities and Local Government

Future of Local Public Audit

Options for transfer of the Audit Commission's in-house audit practice to the private sector

May 2013
FTI Consulting Limited
Department for Communities and Local Government

The findings and recommendations in this report are those of the consultant authors and do not necessarily represent the views or proposed policies of the Department for Communities and Local Government.

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Introduction

1. In 2011 the Department for Communities and Local Government appointed FTI Consulting Limited to provide us with expert research and advice relating to the transfer to the private sector of the Audit Commission's in-house audit practice.

2. A summary of FTI's report, published before outsourcing of the Audit Commission's audit work took place, can be found here: http://www.gov.uk/government/publications/future-of-local-public-audits-reportby-fti-consulting

3. It was not possible to immediately publish the report in full, as some of the information it contained was then commercially sensitive, and some information was likely to prejudice the achievement of value for money for taxpayers if made public.

4. Transfer of the Audit Commission's in-house audit practice has taken place; therefore it is now possible to publish FTI's report almost in its entirety.

5. Several small redactions have however been made to the report's text before publication. In accordance with section 41 of the Freedom of Information Act, information has been withheld to protect the identities of partners whose views were given to researchers in confidence, and in accordance with section 40 of the Act information has been withheld to protect information likely to disclose individual staff redundancy packages and the identities of individuals attending meetings.

6. Redactions to the report have been marked in red. These redactions are summarised in the table below.

Page	Description	Exemption
56, 60, 70	Part of table detailing potential Audit Commission redundancy costs.	**s40: Personal information**. Disclosure could result in individual redundancy packages for the Audit Practice Leadership team being identifiable.
103,105, 107, 112, 113	Identity of local authorities, and audit firms where appropriate, in case studies about experiences of transition process between audit practice and private audit firm.	**s41: Information provided in confidence**. Case studies are illustrative examples, rather than to highlight the specific authorities & auditors concerned.

112, 113	List of individuals attending meetings held by FTI Consulting.	**s40: Personal information**. Discloses identities of individuals. Identities of their organisations remain.

7. FTI Consulting Limited acted exclusively for DCLG and no other person in relation to its work and will not be responsible to anyone other than DCLG for its advice.

Contents

Glossary

AC or Commission	The Audit Commission
ACCA	Association of Chartered Certified Accountants
AIM	Alternative Investment Market
Audit year or annual audit cycle	1 April through the 31 March (However, in Local Government the audit is closed on 30 September)
Big 4	Big 4 auditing firms (PwC, Deloitte, Ernst & Young, KPMG)
BIS	Department for Business, Innovation and Skills
CIPFA	Chartered Institute for Public Finance and Accountancy
COSOP	The Cabinet Office Statement of Practice on Staff Transfers in the Public Sector (2000)
DCLG	Department for Communities and Local Government
EBIT	Earnings before interest and tax
EC	European Commission
EU	European Union
EV	Enterprise value
IHP	Financial Year 1 April to 31 March
FT	Foundation Trusts
FTSE	Financial Times Stock Exchange
FRC	Financial Reporting Council
GRE	Gross Revenue Expenditure
GP	General Practitioner
HMG	Her Majesty's Government
IHP or Audit Practice	In-House Practice of the Audit Commission
LPB	Local Public Body

LRO	Legislative Reform Order
Management	In House Practice Management
OFT	Office for Fair Trading
PCT	Primary Care Trust
PIR	Public Interest Reports
RBS	Royal Bank of Scotland
RTP	Request to Participate
TUPE	Transfer of Undertakings (Protection of Employment)
UoR	Use of Resources
VfM	Value for Money

I. Executive Summary

Introduction

The Secretary of State has announced a proposal to disband the Commission. DCLG is therefore currently examining ways in which the work of the IHP can be transferred to the private sector.

- The current system for the audit of local public bodies is operated and overseen by the Commission under the provisions of the Audit Commission Act 1998 (as amended). Since its inception in 1983, the Commission has acted as the regulator, commissioner and provider of local public body audit services.

- The three current roles of the Commission in England may be summarised as follows:
  - Regulatory: defining standards and guidance for audit of local public sector bodies, in addition to those published by the Auditing Practices Board;
  - Commissioning: conducting procurement tenders and appointing an auditor to each local public body; and,
  - Provider: providing auditors from the Commissions In-House Practice ("IHP") to undertake the audits and sign audit reports.
- The IHP is currently responsible for performing c.11,000 audits (c.70% of the market) across the public sector, including the auditing of Local Councils, Health Trusts, Police and various other smaller bodies. The remaining 30% is outsourced to private sector firms (principally KPMG, PwC, Deloitte, Grant Thornton and PKF).

- On 13 August 2010, the Secretary of State for Communities and Local Government announced his proposal to disband the Commission as part of a Government-wide review of 'Arms-Length' Bodies. The announcement stated that "*a range of options will be developed for converting the audit practice into a business independent of Government which could be sold off or otherwise transferred into the private sector*".

- In March 2011, DCLG published a consultation document "*Future of local public audit*" which set out proposals for all local public bodies with a turnover of over £6.5m to appoint their own auditor, based on the advice of an independent audit committee. Responses to the consultation document have been invited by 30 June 2011 and we understand that a summary of these, together with a Government response, will follow.

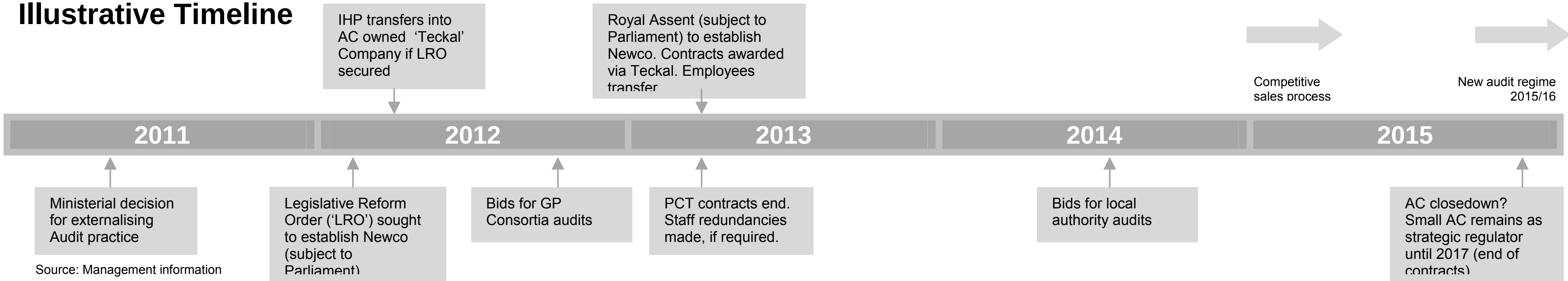
- As a sub-set of the broader review of the Future of Local Audit, DCLG has appointed FTI Consulting to provide high level advice relating to the transfer to the private sector of the IHP under 3 options:
  - Sale
  - Outsourcing; and
  - A hybrid (combination of outsourcing and sale).
- Our advice includes a high level summary assessment of the likely impact on the audit market of the 3 scenarios in terms of potential effects on public sector audit fees and the concentration, level of competition and contestability of the local public audit market.
- There are a number of potential evaluation criteria which are summarised in the table below. Some of the criteria conflict and therefore need to be weighed up against each other in forming a view of the potential options to effect the transfer of the IHP to the private sector.

Potential objectives / criteria
• Minimisation of any redundancy costs for the taxpayer
• Obtain potential capital receipt(s) for the benefit of the taxpayer
• Minimise local public audit fees
• Maintain quality of local public auditing
• Encourage competition within the audit market (including private sector)
• Minimise execution risk associated with delivery of reform
• Minimise timeline associate with the implementation
• Minimise disruption throughout transition period/arrangements
• Auditors chosen at local level in future
• Minimise other implementation costs

Sale Option

Whilst sale offers the prospect of a capital receipt, there are inherent risks and uncertainties as to timing, delivery and quantum of any such receipt. Redundancy costs would likely be higher than under the outsourcing option.

Illustrative Timeline



Source: Management information

Summary	Criteria	Considerations
• A new company (or companies) is formed by HMG. IHP staff and existing audits are transferred into Newco • IHP run as an arms length commercial business • Newco bids for audit contracts during 2014 in competition with private firms • If market share lost, Newco redundancies would be required (borne by taxpayer) • Newco sold during / after 2015 • Bidders might include private sector firms and an AC employee owned company	Redundancy costs	• Redundancy liabilities anticipated to be highest under this option and could outweigh any capital receipt • Risk that insufficient work will have been awarded to IHP at time of sale under this option • Bidders unlikely to acquire loss-making company with excess staff, implying risk of significant redundancies (borne by HMG)
	Capital receipt	• Opportunity for a capital receipt for the Government • A successful sale would be dependent on the private sector's appetite, and financial ability, to acquire the IHP • Quantum inherently uncertain as would depend on IHP's success in winning audits in competition prior to sale
	Market	• Market capacity retained - avoids loss of expertise that would result from straight dissolution • Allows for (but does not guarantee) entrance of a new player into the audit market – depends on identity of eventual buyer
	Employees	• Possibility of staff leavers ahead of completion of sale • Management argue that prospect of employee ownership currently holding down attrition but this is unclear • Possibility of management / employee owned company acquiring the IHP business
	Timetable	• The proposed sale would not be completed until 2015 at the earliest
	Execution risk	• Sale option subject to higher degree of delivery risk (e.g. delay, loss of audits, key staff departures, buyer appetite and funding) than outsourcing

EU procurement law means a sale would require IHP first to win audits in competition with private firms. To the extent market share was lost to the private sector, staff reductions would be required with associated redundancy costs.

Potential structure and timing

- During 2011/12, the IHP would transition to an arms-length commercial business. In 2013, after necessary legislation passed, the Commission would establish (one or more) government owned Newco(s) and make a direct award of contracts under the Teckal exemption for the whole of the 70% of audits currently carried out by the IHP and transfer all existing IHP staff into it (under TUPE terms). The IHP Newco would therefore inherit all of the current staff of the IHP.

- During 2014, Newco would bid to local public sector bodies for audit contracts in competition with the private sector firms. We understand from the Commission that current contracts with private sector firms run until 2016 but that these can be terminated by the Commission without associated cost. We recommend that DCLG confirm that this is the case if it has not already done so.

- The length of the new contracts remains to be determined but could be for, say, 3 to 5 years. We consider that longer audits will be more attractive to private sector firms as they would provide better ability to plan and greater assurance of future revenues.

- A sale process could be undertaken during 2015. Buyers would benefit from the audits secured by the IHP in competition during 2014. Management has prepared a forecast which assumes that half of the current market share (i.e. 35%) could be won through competitive tender.

- It would be necessary to conduct a competitive sales process in order to maximise any capital receipt from this process. We recommend that DCLG considers how to ensure that such a process benefits from sufficient commercial expertise, resource and oversight.

Potential structure and timing

- We understand from DCLG that the transfer of the IHP into Newco would rely on the Teckal exemption to EU procurement rules and that it is otherwise not possible to transfer work awarded without a public procurement exercise to such Newco.

- The Teckal exemption allows a public authority to award audits directly to a company without a public procurement process providing that it fully owns it and the company does the vast majority of its work for the parent. There must be no private investment in that company, or any intention that there will be any sale in the future of the awarded work. All such work under this scenario would expire and/or have been re-tendered in competition by the time of sale.

- If the sale option is being considered further, we recommend that DCLG takes further legal advice in respect of the Teckal exemption.

Redundancies

- We consider that the most likely outcome to a 2014 tender is that the Newco would win a significantly smaller share of the incremental work tendered than its current 70% share. To create a profitable Newco for sale therefore implies that there may be a need to make existing IHP staff redundant during the transition period if such staff have not left through natural attrition – such costs would be borne by the taxpayer.

- The IHP management has prepared forecasts which envisage IHP Newco winning a 35% share of the work in competition with private sector firms. On this basis they expect redundancies of 233 staff in 2014/15 with an estimated cost in the region of £11m to £17m.

- To put the market share assumptions into context, the Commission estimate that IHP wins approximately 25% of bids in the FT market where these can choose their own auditor.

- These estimates are inherently uncertain and to the extent that the IHP wins less work, they may need to make more redundancies to achieve profitability with consequently higher redundancy costs than currently estimated.

The size and value of the IHP business that would be sold is subject to significant uncertainty at this point, in addition to inherent ambiguity around buyers future appetite and ability to fund an acquisition.

Execution risk

- We set out below some of the potential constraints on a significant capital receipt via a sale of the IHP.

- *Appetite amongst major audit firms?* - The largest audit firms in the UK (typically referred to as the "Big 4") have significant positions in the private sector audit market. Most also have an existing position in the public sector, accounting for 30% of public sector audit market. It is possible that these larger firms feel that there is no strategic need for them to bid to acquire the IHP in the event of a sale. Further, the OFT may be concerned if the LPB audit market moved towards concentration for the largest existing participants and the knowledge of that may constrain bids by the biggest players (i.e. the Big 4 and Grant Thornton).

- *Ability to fund an acquisition?* - Other private sector audit firms, particularly amongst the mid tier accounting firms outside of the "Big 4", may feel that an acquisition of the IHP could provide a significant step to critical mass and assist in closing the gap with the Big 4 firms.
  - However, it should be noted that almost all of the major audit firms have ownership models based on partnership structures. This makes it challenging for them to fund significant acquisitions using external sources of equity capital.
  - We also consider that a management / employee owned company could find it challenging to obtain sufficient external funding to pay an acceptable price.
- Potential new entrants? It is possible that there are providers of outsourced professional services to the public sector that could have a strategic interest in entering a new market and building a presence in the public sector audit market. We set out some examples of private firms focussed on provision of professional services to public sector on the next page. We have not held discussions with these companies in preparing this report and there can be no certainty that any of these would participate in an auction of the IHP, given that they are not providers of audit services and may consider this market outside of their core business.

Capital receipt

- It is impossible to quantify potential proceeds with any degree of assurance as this depends on the result of future tenders and how successful the IHP Newco is at winning audits against the private sector.

- However we consider that any capital receipt would be limited under this scenario by a number of factors but principally by the size of the order book likely to have been won by Newco during 2014.

- Whilst we emphasise that the quantum and achievement of a capital receipt via a sale are inherently uncertain, we illustrate below for illustrative purposes the potential present value of such a future receipt, assuming completion in 2015 and based on IHP management's financial forecasts:

Illustrative value of sales proceeds

£'m	Multiples		
	3.0x	**4.0x**	**5.0x**
Forecast IHP Operating Profit (2014/15)[1]	13.0	13.0	13.0
Implied Enterprise Value in 2015[2]	39.1	52.1	65.1
Present value at varying discount rates			
20%	17.7	23.6	29.5
30%	12.5	16.7	20.8
40%	9.1	12.1	15.1

1. Operating profit based on the first year of stand alone audit business (Sept 2014 - Aug 2015) as forecast by IHP management. Management has assumed 35% market share (half of current share).
2. Implied EV calculated on the operating profit after one year of stand alone business.

- Management has estimated that approximately 35% (equivalent to half their current market share) will be won through the competitive tender process, providing an operating profit of £13m. We have used this to illustrate the potential sales proceeds which could be achieved with a sale of the IHP to a private firm.

- Multiples of 3x to 5x have been applied to operating profit and then discounted back to present value to reflect risk and the time value of money at varying discount rates (20% to 40%). These discount rates reflect the venture capital style risk associated with valuing a company which does not currently exist in a competitive market. On this illustrative basis, the present value of a potential future capital receipt from a sale based on 35% market share ranges from £9m - £30m before any buyer redundancy costs.

- To the extent that bidders expect to make further redundancies post-acquisition, this would have a cost which they would likely factor into their acquisition price. Such costs (if any) would in practice depend upon the individual buyer.

In addition to potential redundancy liabilities from a sale, the cost of separation may be significant and time consuming, impacting any capital receipt.

Bidders

- Potential bidders might include:
  - Private sector audit firms;
  - Other providers of outsourced services to public sector (i.e. new entrants); and
  - Employee owned company (referred to as the "mutual").

- The table below illustrates some of the potential external purchasers for the IHP. We have not held discussions with the firms regarding their appetite for an acquisition of the IHP.

Potential Purchasers: Illustrative examples

Big 4 accounting firms
Ernst & Young (Quality in Everything We Do); KPMG; pwc; Deloitte.
Mid-tier accounting firms
Grant Thornton; RSM Tenon; Mazars; BDO; Baker Tilly; Smith & Williamson; PKF (Accountants & business advisers); Moore Stephens (Chartered Accountants)
Public sector outsourcing firms
Capita; mouchel; Liberata; serco; civica; babcock; Tribal Helm
Financial buyers
Alchemy; Gresham Private Equity; HIG Capital; Close Brothers; Bridgepoint; Graphite Capital; Rutland; Electra; LDC

- We understand that "favouring" an employee owned firm would be open to challenge under State Aid and other legal considerations (including from unsuccessful participants in such auction) and moreover would be unlikely to maximise capital receipt from such a sale.

- It is unclear whether an employee owned “mutual” would have sufficient access to capital to acquire the IHP. It has been suggested that an employee owned Newco could fund a potential acquisition of the IHP by partnering with a private sector joint venture partner. However we consider this would entail drawbacks which include:
  - loss of additional competition if Newco was owned, controlled or influenced by an existing audit firm;
  - loss or compromise of mutual status / ethos; and
  - expectation that Newco would likely be sold to its joint venture partner as an exit route

Multiple sales

- It is theoretically possible that a sales strategy could be executed by way of multiple sales to different bidders (as opposed to a single sale). We consider that in practice this would give rise to additional complexity and delivery risk without necessarily delivering any material uplift in value but could have competition advantages.

Separation issues

- There are inherent issues under the sale option with the separation of the IHP from the Commission creating a number of practical considerations.

- We understand that DCLG and the Commission have not analysed potential separation issues and costs in detail, however, the core areas that will likely require focus include the following:
  - Migration of data and systems onto buyers systems;
  - Exit and establishment of property requirements to house the IHP and associated relocation costs;
  - Establishment of in house legal and regulatory support and subsequent novation of all contracts to the Newco entity; and
  - Migration of all employee contracts, benefits and pensions to Newco.

- Given the potential scope of the separation, we recommend that a more detailed review be conducted if the Sale option is considered, particularly under the Employee Ownership’ model, whereby a new infrastructure would be required. Further, consideration should also be given to potential TSAs (Transitional Service Agreements) and project management support that may be required to effect the separation.

Outsourcing Option

A move to 100% provision by private sector audit firms represents the quickest solution with relatively low risk involved to change from the current position where c. 30% of audits are delivered by the private sector.

Illustrative Timeline

Source: DCLG, AC Management information

Summary	Criteria	Considerations
• c. 30% of public sector audits currently delivered by private sector firms • This option would increase this proportion to 100% • A competitive tendering process would allow private sector firms to submit bids for audit contracts. • IHP staff transferred to winning private sector firms under TUPE	Redundancy costs	• Assuming outsourcing auction is managed appropriately, redundancy costs borne by DCLG (and the taxpayer) should be minimised and / or factored into outsourced audit fee • Some redundancy liabilities likely, relating to residual non-allocable technical and administrative staff of the Commission
	Capital receipt(s)	• Not precluded. In addition to evaluating on lowest audit costs, possible to ask firms to tender on the basis of any upfront capital payment that they would be prepared to make • Implications of COSOP treatment re Fair Deal on pensions may impact bids given the potential liabilities to the bidders
	Market	• Market capacity retained - avoids loss of expertise that would result from straight dissolution • Allows for (but does not guarantee) entrance of a new player into the audit market • Would not preclude an IHP Newco bidding for audits which would allow for a potential new entrant into the audit market • Would allow for the possibility of a reduction in audit fees, dependent on market forces
	Employees	• Possibility of staff leavers ahead of completion of outsourcing but no evidence to date of increased level of attrition • Possible management and employee owned company could be formed to bid for audits.
	Timetable	• Potential to outsource 2012/13 audits and firms would be awarded audits for 3 - 5 years • Outsourcing process should be achievable within a shorter timescale than a sale
	Execution risk	• Appears to be lowest risk option given experience and processes already in place

Outsourcing has the potential to minimise redundancy costs to the taxpayer and to preserve supply capacity and the skill base of existing IHP staff via TUPE transfers to the private sector.

Introduction

- During 2011/12, the Commission would, under its current powers, tender to private sector firms all audit work currently provided by the IHP. IHP staff would become employees of the successful private sector bidders pursuant to a TUPE transfer.

- We understand that under this option the Commission could divide England into a number of contract areas/Lots and invite bids from private sector firms. Firms would be able to bid for one, some or all Lots depending on the strategy developed.

- Based on the tenders received it might prove more beneficial to outsource to a number of firms on a regional basis or, potentially, to one firm nationally, were the terms sufficiently attractive (and subject to competition considerations).

- The Commission has not yet completed planning for the procurement proposal to maximise TUPE; however, it believes it should be possible to structure bundles of audits in such a way that audit staff could TUPE transfer, albeit to varying degrees dependent on the size of Lots. Proposed geographical Lot sizes vary from £15m to £1m.

- A privately owned Newco owned and managed by IHP employees could be allowed to bid for some or all of these audits, thereby potentially creating a new audit firm in the private sector. There would need to be safeguards in place to ensure that there is a level playing field with a Newco participating in the process.

Redundancy costs

- It is our opinion that such an outsourcing process should start from an objective of minimising any redundancy costs of the IHP staff borne by HMG and maximising the transfer of staff to private sector firms pursuant to the tender process.

- The Commission estimates that the irreducible redundancy costs that would be incurred under the outsourcing option at £11m. This is based on 157 IHP management and support staff redundancies. We have not validated this assumption during our review.

TUPE and COSP

- The Transfer of Undertakings (Protection of Employment) Regulations 2006 provide that on the transfer of an undertaking staff transfer with the work. TUPE will generally apply to the outsourcing of an in house service as long as the work is suitably packaged.

- Staff members associated with the undertaking have no choice as the transfer is automatic by law. Staff may choose to resign but would not be entitled to redundancy in such circumstances. The TUPE transfer is on current terms and conditions, including redundancy terms, but excluding pensions (the new employer must provide a minimum level of pension provision).

- It is important that DCLG reviews the implications of COSOP treatment of Fair Deal on pensions and obtains internal/external advice as appropriate. We consider that the number of parties willing to bid for audits under outsourcing would be significantly impacted if they are required to transfer staff on comparable pension arrangements, given the resultant liabilities.

Nature of audits

- DCLG has identified that 3 year audits would be the minimum duration to be commercially attractive to bidders and we consider this a reasonable conclusion. It is likely that the contracts will need “break” clauses that can be triggered in certain events e.g. negligence by the auditor.

- We consider, however, that longer audits (e.g. 5 years) would be more attractive to private sector firms as they would provide better ability to plan, greater assurance of future revenues and a longer timeframe over which to manage the transition of existing IHP staff transferred in.

Capital receipt(s)

- It would be commercially possible to ask bidders to tender not just on the basis of minimising cost (whilst maintaining audit quality) but also to invite firms to tender on the basis of an upfront payment they would be prepared to make to secure IHP staff and future contractual revenues. We recommend that DCLG take any legal advice needed to explore the feasibility of this approach.

- Whist offering scope for better overall value for money, if capital receipts were sought in addition to minimising audit costs then the tender process would likely be more complex than past exercises. However, given the timeframe proposed by the AC for the outsourcing process, this may not necessitate any further lengthening of the timetable.

- DCLG should ensure that it / the Commission has sufficient commercial resource, expertise and oversight to successfully project manage such a process.

Bidders

- We consider the principal bidders under outsourcing would be the existing audit firms that perform public audits plus potential other accounting firms (see page 10) and Lots could be structured to encourage bids from a mix of firms.

- Participants in the tender process are likely to require access to due diligence information to allow them to analyse and evaluate the nature of the staff resources and liabilities that they would be accepting under the transfers.

- In order to maximise value from the tender process it is important that the private sector firms have clarity in terms of the underlying audit regime including:
  - arrangement to re-appoint auditors at the end of the audits; and
  - scope and regulation of audits including the role of value for money opinion and any other proposed changes impacting auditors.

Hybrid Option

The "Hybrid" option combines a full tender of the existing c. 70% of audits currently performed by the IHP with a subsequent sale. An IHP "Newco" would compete for audit work in the tender and would be sold on the basis of work won.

Illustrative Timeline

IHP transfers into AC owned 'Teckal' Company if LRO secured

Royal Assent (subject to Parliament) to establish Newco to bid for audits under Outsourcing process

Competitive sales process

2011 | 2012 | 2013 | 2014 | 2015

Ministerial decision for externalising IHP

Commission tender process (2014/15 to 2016/17) to Private sector. Newco bids against private firms.

Newco commences audits won. Employees TUPE to audits lost to private firms. Redundancies occur

Commission closedown?

Source: Management information

Summary	Criteria	Considerations
• New company is formed by HMG. IHP staff and existing audits are transferred in to Newco • All 70% of audit work currently conducted by IHP is subject to competitive tender • Newco bids for all audit contracts during 2014 in competition with private sector • IHP staff reduced subject to result of tender and TUPE transfers • Newco sold during 2015 via auction to private sector bidders	Redundancy costs	• Redundancy liabilities potentially higher than outsourcing option but less than sale option • Amount of redundancy costs would be driven by extent to which IHP is successful in winning work
	Capital Receipt	• Opportunity for a capital receipt for the Government • A successful sale would be dependent on the private sector's appetite, and financial ability, to acquire the IHP • Quantum inherently uncertain as would depend on IHP's success in winning audits in competition prior to sale
	Market	• Market capacity retained - avoids loss of expertise that would result from straight dissolution • Allows for (but does not guarantee) entrance of a new player into the audit market – depends on identity of eventual buyer
	Employees	• Possibility of staff leavers ahead of completion of sale. No evidence to date of increased level of leavers • Commission argues that prospect of employee ownership currently holding down attrition but this is unclear • Possibility of management / employee owned company acquiring the IHP business
	Timetable	• The proposed sale would not be completed until 2015 at the earliest based on timetable proposed by the Commission • Process would take longer than the outsourcing option
	Execution risk	• Hybrid or sale options subject to higher degree of delivery risk (e.g. delay, loss of audits, key staff departures, buyer appetite and funding) than outsourcing

Under the Hybrid option, the IHP would compete with private firms in an outsourcing tender. To the extent that it lost market share, redundancies would be mitigated by staff transfer to the successful firms. The IHP would then be sold.

Introduction

- This option combines elements of the outsourcing and sale options. It is similar to the previous Sale option but differs primarily in the transfer of a significant proportion of IHP staff to the private sector upfront, dependent on the results of an initial outsourcing tender.

- In the sale option, the IHP Newco inherits all IHP staff and then would likely need to make redundancies as it lost work to the private sector firms over time.

- In the hybrid option, such redundancies would be mitigated by holding an outsourcing tender in respect of all of the 70% of audits currently performed by IHP. To the extent that the IHP Newco wins audits, it would keep the staff (and associated cost) and the level of audit work (and associated income).

- Conversely, to the extent that it loses audits to private firms, it would reduce headcount via TUPE transfers, thereby removing (or at least reducing) the need for redundancies.

- The primary disadvantage with this option would appear to be greater overall complexity together with a prolonged period of transition and uncertainty.

Outsourcing

- As with the Sale option, during 2011/12, the IHP is moved towards being run as an arms-length commercial business.

- In 2013, after necessary legislation passed, a Government owned Newco would be formed and IHP staff and work would be transferred into this company.

- The Commission would then run a full outsourcing tender process in respect of the 70% of audits currently carried out by IHP. Newco would participate in this tender process in competition with the private sector firms.

- As noted above, to the extent that Newco lost some or all of these bids, its redundancy costs would be mitigated by TUPE transfers of IHP staff to the successful private audit firms, with residual employees being made redundant.

Sale

- Under this option, it is envisaged by DCLG that a sale process could be undertaken during 2015. As with the sale option, it would be appropriate to conduct a competitive sales process in order to maximise any capital receipt from this process. Moreover, we also recommend that DCLG considers how to ensure that such a process has sufficient commercial resource and oversight.

- Whilst we emphasise that the quantum and achievement of a capital receipt via a sale are inherently uncertain, we have assumed that the present value of such a future receipt, assuming completion in 2015 and 35% market share, would be comparable to that achieved in the sale scenario of between £9m to £30m.

- No specific forecasts have been prepared in support of the Hybrid option. Management has estimated that approximately 35% market share (equivalent to half of the IHP current market share) will be won through the competitive tender process in the Sale scenario, however we consider that the percentage of market share won under the hybrid option could be less due to the IHP having less time to prepare and establish a standalone business (as opposed to the quicker Teckal transfer process in the sale option).

Management incentives

- Under the hybrid option, there are risks that IHP management incentives are either distorted or diluted.

- For example, there could be an incentive for IHP Newco bidding in the outsourcing tender to “lowball” to win work, with any losses still being borne by the taxpayer.

- Alternatively, there is a risk that their prospect of winning work in competition and then ending up as the successful acquirer is so remote that their incentive to stay and drive forward this option are significantly reduced.

Other options

Other options include a dissolution but this would entail high redundancy costs and likely loss of market capacity. DCLG has been advised that an immediate sale is precluded by EU procurement law.

Dissolution

- Under this option the Commission would be closed down (or at least the entire IHP element thereof). This would entail redundancy for all of the 758 field staff of the IHP as well as the 157 remaining IHP management and administration staff with redundancy costs of approximately £65m incurred, as calculated by the Commission (assuming an average cost of £71k per head). These costs would be borne by the taxpayer.

- In future, local public sector bodies would choose their own auditor and this function would be performed by private sector firms – including (but not necessarily limited to) the 5 main firms currently providing this function in England.

- This option would have the benefit of structural and legal simplicity and should therefore be relatively rapid to implement, subject to any necessary legislative approval.

- We understand that the existing audits between the Commission and the private sector firms would need to be terminated but this could be implemented without additional cost. We have not seen legal advice confirming this situation.

- There would likely be an uneven impact on the staff of the IHP with some benefiting from redundancy payments then getting jobs (some perhaps with private sector audit firms) but others then finding it difficult to obtain jobs in the private sector.

- Under this option, there would be a likely loss of market capacity as a significant proportion of the skills and experience built up within the IHP were lost to the local public audit market. All other things being equal, this would likely have an upward impact on audit costs.

- The value is largely driven by the audit contracts, however to the extent that there is intrinsic value in the IHP, this would be lost to the taxpayer. Some compensatory gains might be picked up by the private firms that recruited staff and benefitted from the additional audit revenues.

- This option would clearly not provide a new player into the audit market and therefore would be unlikely to generate any significant increase in market competition.

Immediate sale

- It would in principle be possible for HMG to conduct an immediate transfer of the current audits and staff into a new company (Newco) owned by HMG, with a view to this company being sold to private sector firms as soon as practicable.

- However, we understand that this would contravene EU procurement law as the Government can not transfer work to a company with a view to sale unless that company has won that work in competition. We understand that DCLG have previously taken legal advice on this.

- Accordingly we understand that procurement law dictates that, absent a fresh competitive tender process, the Commission / DCLG could not sell the Newco until after the transitional period of directly awarded audits, thus delaying any capital receipt.

Two-stage approach

- An alternative approach could be to sell a minority share of the IHP to a strategic partner followed by a subsequent sale at a later date of either of the remaining majority shareholding or 100% of the share capital.

- In the event that it were considered practicable from a legal perspective to sell a minority stake in an IHP Newco as the first part of a two stage process, we consider that there would be commercial disadvantages to so doing. The principal disadvantage would be that once an external strategic or financial investor had taken such a stake, it would be hard to ensure that value was maximised on the eventual sale of the remaining shares. This is because the initial investor may be able to exercise its influence to prevent, frustrate or restrict an open competitive sale process to third parties.

- DCLG would therefore have less ability to plan, control and execute a full competitive sale process in the manner of its own choosing. In extremis, the risk would be that a situation was created where the only realistic buyer for the remaining shares was the initial investor.

Alternative Mutual

- In the discussions we have had, the “mutual” option has referred to an employee owned IHP. An alternative mutual concept would be to have an IHP owned by public sector bodies themselves. In addition to complexity, this would not result in a full transfer to the private sector and would give rise to potential conflicts / risks to auditor independence and so we have not explored this further.

Status quo

- Whilst the current status quo is a potential theoretical alternative, it is beyond the scope of our work and clearly will not meet Ministers stated aims and objectives. Accordingly we have not analysed this option.

Market considerations

Overall, maximising competition will be only one of the criteria upon which decisions will be made. Our analysis suggests that the differences between the options are not clear or strong enough in this area to be the decisive factor.

We set out below a summary of our findings in relation to market considerations:

- To date the market for local public bodies audits has been managed by the Commission, which has managed both prices and firm selection. Fees charged appear to be lower than those charged to the private sector, and whilst this may reflect many factors, it is also consistent with economic theory – the Commission is a monopsony buyer. However, the Commission is also a public sector monopoly provider and theory suggests it may be less efficient than a private sector provider.

- The research and academic literature on audit markets provides some useful pointers but is not decisive. Much focuses on the private sector and/or overseas markets. The main implications are: higher auditor concentration leads to higher fees; brand/reputation is an important driver for choosing an audit firm; size, complexity and location are important drivers for audit fees; mandatory audit firm rotation may lead to higher audit market concentration; and there are significant barriers to entry, and switching, in the UK audit market.

- In respect of competition, there is a question as to how the OFT would define the market – which could be as narrow as LPBs in a geographical area or as wide as the whole audit market. The OFT may have concerns if there was a move towards replication of the structure of the private sector audit market. We note that on 17 May 2011, the OFT announced that it had "*provisionally decided that there are competition problems in the audit market that pass the statutory test for referral to the Competition Commission. However, it is now to discuss with interested bodies whether, in practice, potential remedies exist that could allow the Commission to resolve these problems… Having reached this provisional view, the OFT needs to decide whether or not to exercise its discretion to make a reference of the market to the Competition Commission. The provisional decision on whether or not to refer the market to the Competition Commission will be subject to a statutory consultation.*"

- There are major barriers to entry in the market for audit services, particularly in the FTSE 100 and FTSE 250 segments and competition may be limited. Barriers exist because of brand/reputation, client inertia, scale and scope factors, amongst others.

- Barriers to entry also exist in the LPBs audit market, and there are some additional ones, but overall barriers appear to be lower than for large companies' audits. Two of the main providers currently active in LPB audit are 'mid-tier' firms.

- In future, the market is likely to be imperfect owing to both demand-side and supplyside factors. In respect of the demand-side, LPBs are likely to be guided by brand / reputation and size, not just price. On the supply-side, the difficulty of new entry and of expansion limit the competition and contestability of the market.

- There are useful lessons from other markets. Experience in the NHS Foundation Trusts audit market since it opened up to competition suggests tendencies to concentration – but also fee reductions (at least in the short run).

- Stakeholders views are quite variable. While most see trends to concentration they differ on the impact on prices. Much depends on other factors including how the market emerges in terms of demand aggregation, scope of audit and regulation.

Our appraisal of the options suggests:

- There is a potential tendency to concentration that will apply in all options. Since we know from research that concentration in audit markets leads to higher prices over the longer run, that is something to be avoided.

- The OFT would be likely to be concerned if the LPB audit market moved towards further concentration for the 3 largest existing participants (i.e. the Big 4 less Ernst & Young) and the knowledge of that may constrain behaviour by the bigger players.

- There is a strong argument that the nature of the dynamics in this market will lead to concentration so that for the longer run it does not matter which option is chosen. We do not dismiss this view.

- The option of trying to create many small players through careful design of outsourcing looks more likely to lead to a number of weak players who may not survive in the medium-term in a free market.

- Overall, maximising competition will be only one of the criteria upon which decisions regarding the transfer of the IHP to the private sector will be made. Our analysis suggests that the differences between the options are not clear or strong enough in this area to be the decisive factor.

- We therefore consider that the focus in relation to competition / market considerations should be to avoid reinforcing the concentration in the wider audit market, in the absence of compelling reasons to the contrary. Maintaining or increasing competition should be one of the considerations but not the sole or overriding criteria in assessing the options.

- We consider that outsourcing is more likely to increase competition and constrain fees in the short term, principally because more players would likely be introduced to the market. In the long-run, there may be consolidation so the long term effect on fees is more uncertain however it is possible that a sale option may be more likely to lead to the creation of one or two substantial firms that can compete against the larger firms.

Summary comparison of options

Whilst there are significant inherent uncertainties in attempting to quantify the net financial impact of the three principal options, we present a quantitative summary comparison below for illustrative purposes.

Illustrative summary of net financial impact

£'m - All figures stated as net present values	Sale	Outsourcing	Hybrid
Redundancy costs for HMG	(21) - (31)	(10) - (24)	(10) - (30)
Capital receipt (before buyer redundancies)	nil - 30	nil - 9	nil - 3
Potential post-transaction buyer redundancy costs	0 - (10)	nil	0 - (10)
Net Financial Impact	(41) - 9	(24) - (1)	(40) - (7)

Redundancy costs for HMG	*Low end of range assumes redundancies totalling £16.5m in 2014/15 based on IHP projected financial model and market share of 35% (see Page 54). An additional £6.6m of redundancy costs have also been included to reflect IHP management's targeted cost cutting measures in 2012/13. (Originally, £4.7m, however it has been revised upwards to £6.6m based on AC guidance that average redundancy is £71k - see Page 52). High end assumes a lower market share of 15%, resulting in £28.4m redundancy costs, plus the additional £6.6m above (see Page 54) totalling £35m.* *A discount rate of 3.5% has been applied to present value the redundancy costs based on direction from DCLG*	*Assumes Option 2 is selected for Audit Bundles (see Potential Outsourcing Bundles table Page 56).* *Low end of range assumes IHP Management and Central redundancies totalling £10.6m in 2012/13 (see Potential Redundancy Cost table on Page 56).* *High end of range assumes all field staff associated with NHS audits are also made redundant, totalling £15.8m in 2013/14 in addition to the IHP management and central redundancies, totalling £26.4m.* *A discount rate of 3.5% has been applied to present value the redundancy costs (as for Sale option)*	*Low end of range assumes IHP Management and Central redundancies totalling £10.6m in 2014/15 (see Page 56).* *High end of range assumes all field staff associated with NHS audits are also made redundant (£15.8m) in 2013/14 , along with other cost cutting initiatives targeted by IHP management in 2013/14 (£4.7m revised upwards to £6.6m based on £71k per head - see Page 54) and IHP management and central redundancies to give a total of £33m* *A discount rate of 3.5% has been applied to present value the redundancy costs (as for Sale option)*
Capital receipt (before buyer redundancies)	*Assumes IHP Operating Profit of £1.5m - £13m based on market share of 15% and 35% respectively, with multiples of 3x and 5x discounted to a present value using 20-40% discount rates to reflect venture capital style risk, given that the business does not currently exist in commercial form (see Pages 45 and 54).*	*Assumes zero at low end to £9m (based on low end of sale valuation).*	*Range assumes 15% market share and operating profit of £1.5m based on the premise that the business would be formed after outsourcing / TUPE transfer of employees. Multiples of 3x and 5x discounted back by 20-40% have been applied to reflect venture capital style risk as per Sale option (see Pages 45 and 54).*
Potential post-transaction buyer redundancy costs	*A range of redundancies from £0-10m have been illustrated based on potential further cost cutting by a buyer post transaction. Under a sale scenario, such estimated future redundancy costs would be likely deducted from the Enterprise Value, lowering the effective sales proceeds.*	*N/A*	*A range of redundancies from £0-10m have been illustrated based on potential further cost cutting by a buyer posttransaction. Under a sale scenario, such estimated future redundancy costs would be likely deducted from the Enterprise Value, lowering the effective sales proceeds.*
Market Fee Impact	*Not quantified*	*Not quantified. More likely to increase competition and constrain fees in the short term, principally because more players would likely be introduced to the market.*	*Not quantified*

NB: Net Financial impact illustrated above excludes other costs that may be incurred, such as pensions liabilities, separation and implementation costs

We summarise below the 3 principal options, evaluated against multiple criteria.

Criteria	Sale	Outsourcing	Hybrid
Redundancy costs	• Redundancy costs potentially higher than outsourcing option • Quantum uncertain, dependent upon market share and profitability of IHP	• Assuming managed appropriately, redundancy costs borne by taxpayer should be minimised	• Redundancy liabilities potentially higher than outsourcing option • Potential further redundancies in period after outsourcing, before sale.
Capital receipt(s)	• Opportunity for a capital receipt. • Quantum inherently uncertain • Further redundancy costs may be deducted from sale price dependent on individual buyers	• Capital receipt(s) not precluded. • In addition to evaluating on lowest audit costs, can ask firms to tender any upfront capital payment they would be prepared to make • Longer audits have more value to bidders	• Opportunity for a capital receipt. Quantum inherently uncertain • Further redundancy costs may be deducted from sale price dependent on individual buyers • Longer audits have more value to bidders
Market	• Market capacity retained • Allows for (but does not guarantee) entrance of a new player – depends on eventual buyer • No presumption of material net impact on audit fees	• Market capacity retained • Would not preclude an IHP Newco bidding for audits - would allow for a new entrant • Strongest possibility of fee reduction in short-term, dependent on market forces, but no presumption of material impact	• Market capacity retained • Allows for (but does not guarantee) entrance of a new player – depends on eventual buyer • Possibility of fee reduction, dependent on market forces, but no presumption of material impact
Employees	• Possibility of employee owned Newco acquiring the IHP business • Managements preferred option	• Possibility of employee Newco bidding for audits but need to consider its credibility and resources • Will AC management facilitate outsourcing?	• Possibility of management / employee owned company acquiring the IHP business • Risk that management incentives diluted / distorted
Timetable *(Dependent on legislative approval)*	• Proposed sale would not be completed until 2015 at the earliest	• Shortest. Potential to outsource 2012/13 audits	• Longest? Proposed sale would not be completed until 2015 at the earliest
Execution risk	• High execution risk	• Potentially lowest execution risk, subject to cooperation and support from AC management	• Potentially highest execution risk
External implementation cost	• Higher than outsourcing?	• Potentially lowest external costs?	• Higher than outsourcing?

Conclusions

Outsourcing has potential to achieve the transfer of the IHP to private sector within shortest timescale and with lowest execution risk. Outsourcing also has potential to minimise redundancy costs and capital receipts are not precluded.

Conclusions

- We consider that the Outsourcing option is likely to be the quickest, most effective and lowest risk option given that c. 30% of local public audits are already delivered via private sector firms and that there is no obvious lack of appetite on behalf of these firms to increase their share from the current status quo.
- Outsourcing via a process subject to TUPE is in our view likely to achieve the objective of minimising the redundancy cost of the IHP borne by the taxpayer. It is important however that DCLG reviews and clarifies the implications of COSOP treatment of Fair Deal on pensions given the impact it may have on the interest of the bidding firms.
- We consider that the Outsourcing option is commercially consistent with the possible achievement of capital receipts although we highlight that legal advice should be obtained and note that this will result in a more complex commercial process than that conducted previously. Accordingly it will be important that the body executing this has access to sufficient commercial expertise to maximise the value resulting from this process.
- In relation to market and competition considerations, we conclude that maximising competition will be only one of several criteria on which a decision in relation to the options is made. Our analysis suggests that the difference between the options is not strong enough for market / competition aspects to be the decisive factor.
- We do however recommend that consideration be given under the outsourcing option to ensuring that mid tier firms are not effectively precluded by virtue of the size of Lots from participating and winning audits. An outsourcing process that resulted in Lots being awarded to a range of firms (including a number of mid tier firms) would help ensure market diversity and competition.
- We consider that such an outsourcing process which allows a successor to the IHP to bid for audits is possible (subject to conflict safeguards) and could potentially provide competitive benefits of developing an additional player in the market. In relation to the 3 principal options, we consider that outsourcing is more likely to increase competition and constrain fees, principally because more players would likely be introduced to the market

in the short-term. In the long-run, there may be consolidation so the long term effect on fees is more uncertain.

- There are, in our opinion, uncertainties as to the appetite and ability of private sector firms to acquire the IHP in its entirety in its current form and therefore the achievability and quantum of a capital receipt from such a sale is not clear.

- Whilst certain firms may welcome the chance to acquire the IHP in the aim of achieving a significant increase in scale within the audit market, these players may not have the capital structure or access to external funding to pay the intrinsic value of the IHP. Furthermore, an acquisition by one of the larger audit firms of the IHP may raise competition concerns.

- In any of the above options for moving the IHP into the private sector there is a question as to whether the end point regime should be appointment of auditors by the public bodies themselves or whether the Commission or a small successor body should perform this role. The announcement by the Secretary of State of 13 August 2010 indicated a preference for local decision taking including public sector bodies choosing their own auditors.

- Whilst consideration of the above issue is beyond the scope of this review, it is possible that factors such as the future appointment regime and any other future changes to the regime (e.g. to audit scope or regulation) could affect the level of public sector audit fees, irrespective of the mechanism chosen to transfer the work of the IHP into the private sector.

II. Regime and Current Regulatory Framework

Development of the regulatory environment

The Commission was formed in 1983 although it has roots dating back to 1844. The statutory powers of the Commission are detailed in the Audit Commission Act 1998 and include the preparation of an Audit Code of Practice.

History and Powers

- The Commission has roots dating back to 1844 when it existed in partial form as the District Audit Service. The District Audit Service was absorbed into the Commission upon its establishment in 1983 to work with Local Authorities. In 1990, the Commission scope was extended to include the audit of the NHS. The Audit Commission Act 1998 (the "Act") brought all statutory provisions of the Commission together in one act.

- In 1999, the Local Government Act extended the Commissions powers to include "Best Value" inspections.

- Foundation Trusts were given the power to appoint own auditors from end 2003 (H&SC(CH&S)Act 2003)

- On 13 August 2010, the Secretary of State for CLG announced the Government's intention to abolish the Commission.

Regulatory environment

- The Act requires the Commission to prepare and keep under review a Code of Audit Practice (the "Codes") prescribing the way in which auditors are to carry out their functions. The Code embodies the Commission's view of best professional practice with respect to the standards, procedures and techniques to be adopted by auditors in discharging their functions.

- The Codes define the scope, nature and extent of local audit work and prescribes the way in which auditors of local government and health bodies appointed by the Commission should carry out their functions under the Act. The Commission also issues guidance to auditors on a weekly basis as a minimum.

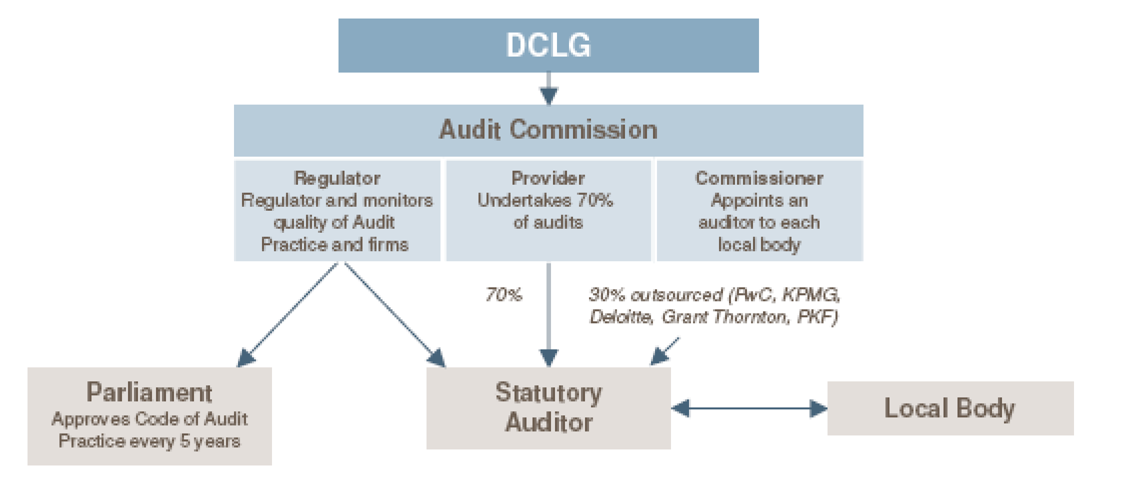
- Auditing Practices Board (“APB”) Practice Note 10 contains guidance on the application of auditing standards issued by the APB to the audit of public sector bodies in the UK. In addition, International Standards on Auditing (ISAs) are applied through the Commission's Codes of Audit Practice, which have statutory force (i.e. their application is the result of an explicit policy decision by the Commission).

- Auditors’ principal objectives are to review and report on, to the extent required by the relevant legislation and the requirements of the Code, the audited body’s:
  - financial statements; and
  - arrangements for securing economy, efficiency and effectiveness in its use of resources.

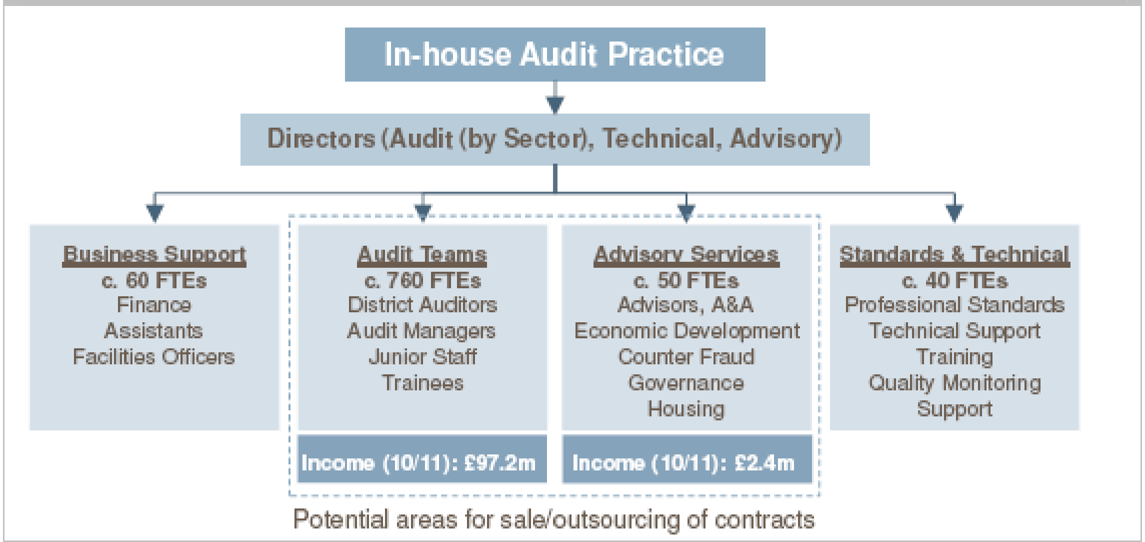
Audit Commission

The current regime covers c.11,000 public bodies and the IHP has a market share of c.70%. The majority of personnel within the regime reside in the IHP which generated revenues of £125m in 2010/11, with the remainder of the body acting in a Regulatory capacity.

Audit Commission Overview



Current Audit Practice Structure



Overview

- The Audit regime currently covers c.11,000 bodies, including:
  - 357 local authorities;
  - 268 NHS bodies;
  - 38 police authorities;

  - 144 other ‘principal bodies’ (e.g. ‘fire and rescue’);
  - 65 other ‘non-principle’ accounts such as joint committees; and
  - 9,800 ‘small’ bodies (e.g. parish councils).

- The Commission consists of 1,379 employees (976 in the IHP), and is structured to support three main areas:
  - Regulator: defining standards and guidance;
  - Commissioner: appointing an auditor to each of the bodies above; and,
  - Provider: providing auditors via the Audit Practice, currently covering c.70% of the audits (revenues of £124.8m generated in 2010/11).

- The core function of the provision of audit services within the Commission resides in the IHP which the Commission states is currently managed on an arms length basis.

- We show a high level overview of the IHP above, with the Commission appointing its auditors to c.70% of the market and the remaining 30% being contracted to private sector firms, primarily PwC, KPMG, Deloitte, Grant Thornton and PKF.

- Revenues generated by the Audit Commission, primarily through the IHP, in FY10/11 comprise the following:
  - Audits: c. £97.2m
  - Advisory: c. £2.4m; and,
  - Other c. £25.2m (including £12.1m grant work and £13.1m inspection work).

Audit Scope

The framework for performing audits is defined by the Commission and is aligned with UK Standards on Auditing. The regulation of the audits is part of maintaining audit quality - a role currently performed by the Commission.

Scope

- The scope of audits performed on the various bodies comprises two main areas:
  - Providing an independent opinion on financial statements; and,
  - Review and reporting on the adequacy of audited bodies' arrangements in relation to the use of resources, in support of Value for Money.
- The Commission has produced a set of guidelines and criteria for performing the audits (the "Codes"), which are aligned with International Standards on Auditing ("ISAs") (UK and Ireland). APB Practice Note 10 provides further guidance on the application of audit standards for auditing public sector bodies in the UK.
- The Codes require auditors to issue a conclusion on whether the audited body has put in place proper arrangements to secure economy, efficiency and effectiveness in its use of resources. In recognition of the potential issues associated with providing a conclusion on whether a body has made proper arrangements for Value for Money, the Commission has specified criteria for measuring bodies, as follows:
  - The organisation has proper arrangements in place for securing financial resilience; and
  - The organisation has proper arrangements for challenging how it secures economy, efficiency and effectiveness.

Audit deliverables

- Four deliverables are produced from an audit, including:
  - A planning document outlining the scope and process in relation to the audit of a body;
  - A report to those charged with governance, in accordance with ISA (UK&I) 260, which will include the auditor's draft opinion on the financial statements and VFM conclusion;
  - Final auditor's report comprising the opinion and conclusion and a certificate of completion of the audit; and,
  - An annual audit letter for the body.

- Local bodies do not submit their accounts to any central regulator, however they are required to publish their financial statements by 30 September each year. The audited accounts must be published by the local authority and the audit opinion (and code conclusion) and any certificate must be published with the accounts.

- We understand that the auditors are not covered by the Freedom of Information Act, however proposals are currently being developed which may require bodies to publish information related to the audit conclusions in future.

Regulation

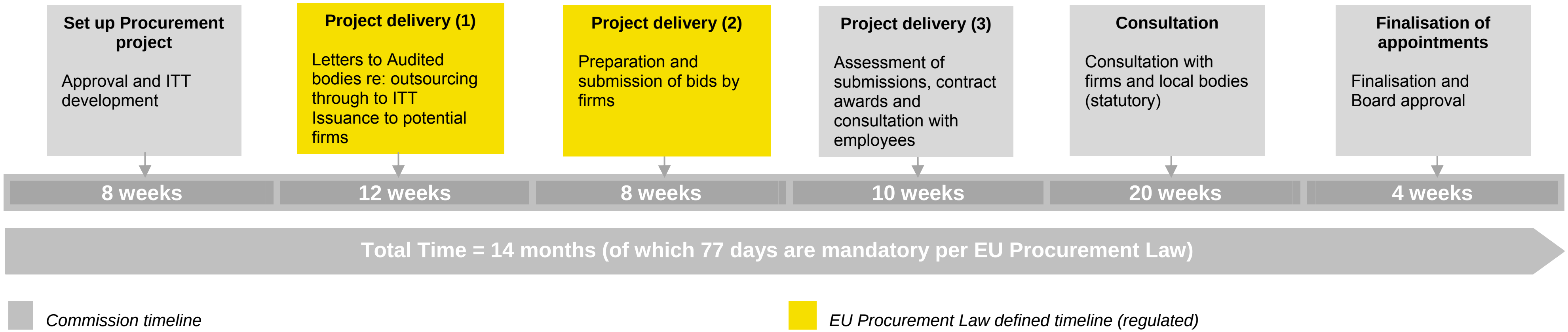
- The Commission monitors and communicates with the auditors on a continuous basis, reviewing quality through regular meetings and producing an Annual Review seeking to ensure quality standards are achieved.

- The Commission summarises the results of auditors work annually in the ‘Auditing the Accounts’ publication. The most recent report published in 2010 (covering 2009/10 audits) indicated the following results in relation to the audits that failed to meet the defined standards:
  - Opinions:
    - 12 Local Government bodies and six NHS bodies (regulatory);
  - Value for Money:
    - One Probation, 77 Local Government bodies and 57 NHS bodies.

Audit procurement and appointment

The Commission has stated that the procurement and statutory appointments processes take approximately 14 months in total.

EU Procurement Process



Procurement process

- The Commission coordinates the procurement of auditors in line with EU Procurement Law. Stages in the Procurement process comprise:
  - Set, design and approval: Project initiation, procurement proposals, Board approval and ITT development;
  - Project delivery: Review and reporting on the adequacy of audited bodies' arrangements in relation to the use of resources, in support of Value for Money.
    - This includes the regulated 37 days. The whole process covers: Notification letters to bodies, Equality Impact Assessment, contract notice and RTP development, evaluation criteria, contract notice issuance, TUPE information on audit staff, finalise ITT (including TUPE information), RTP evaluation, shortlist those firms to be sent the ITT, ITT (and TUPE) issuance;

  - Regulated 40 day process for firms to ask questions, review materials including TUPE information, prepare and submit bids;
  - Assessment of tenders, proposal development for Board approval, contracts awarded by Commission Board; and
  - Regulated 10 day standstill period.
- Consultation: staff on TUPE, successful firms and to ensure no independence issues, auditor appointments with audited bodies (statutory consultation for which the Commission allows a minimum period of 4 weeks), appointment revision and additional consultation if necessary.
- Finalisation of appointments: formal approval by Board, correspondence to audited bodies

There are a number of factors that are currently considered during the appointment process in order to maintain auditor independence, quality and price.

Audit Market (2010/11)		
£'m	**£'m**	**%**
In-house Audit Practice(1)	124.8	72%
Deloitte	7.0	4%
Grant Thornton	12.2	7%
KPMG	12.2	7%
PKF	4.7	3%
Pw C	11.8	7%
Firms auditing Limited Assurance public bodies	1.7	1%
Total Market (2010/11)	**174.4**	100%

1. Audit Practice also includes Inspection and Assessment in 2010/11, and Advisory and Foundation Trusts. These are not included in the Firms' figures

Source: Audit Commission – 'Spreadsheet on firms' income, costs and contributions' and 'In-house arrangements for the delivery of audit and other fee earning activities (2009/10 - 2011/12)'

Appointments

- The total Public Sector Audit Market is worth c.£174m and the duty to appoint auditors to audit local government and NHS bodies is the Commission's core statutory function.
- The Commission does not appoint auditors to NHS Foundation Trusts ("FTs") which are not subject to the public audit regime, however FT's do have the power to appoint the IHP if they choose and the IHP currently holds c. 38% of the FT market.

Appointments policy

- Managed in conjunction with the procurement process, the Commission states that the management and appointment of auditors involves reconciling the often competing and very different perspectives of the IHP, the firms and audited bodies.
- As a result, in 2007/08 the Commission published a list of policies in relation to the appointment of auditors. These consider and prioritise a number of strategic, professional and practical factors as follows:
  - Strategic factors:
    - Some appointments have been reserved for the IHP (i.e. strategic health authorities);
    - Promoting a greater degree of specialisation in certain bodies;
    - Aligning audits either vertically within geographical areas or horizontally across sectors.
  - Professional and practical factors:
    - Upholding the independence of auditors and rotating firms used;

- Understanding the audited bodies preferences;
- Reviewing operational implications of different portfolios.

Process

- Audits are combined into “Lots”, typically based on the appointment process and contract areas of focus, whilst balancing the more valuable audits with those that would be less commercially attractive for firms.

- The Lots are assigned a notional contract value on the basis of the various audits contained within them. The Commission typically compiles Lots with a notional value of £2m to ensure they are viable and attractive to bidding firms.

- Firms are invited to bid for the various contracts, based on the value of the audits they would hope to retain. We understand from the Commission that historically firms recovered c.90% of the value, however since 2007, this has fallen to c.78%

Current market

- Through the procurement and appointment process, audits are assigned to those audit suppliers which the Commission believes best fits the requirements of the local bodies, whilst ensuring that a minimum number of providers are present in the market. We show above the market share of firms operating in the public sector.

- Only firms that can meet the Commission’s quality standards are invited to bid. In practice, quality becomes a 'hurdle test' and work is allocated on the basis of the best combination of price and quality.

- The IHP financial year starts on the 1 April and runs through the 31 March. However, in Local Government the audit is closed on the 30 September (10 June for Health audits and 27 June for Probation audits) if by then an auditor issues his/her opinion and certificate. Local government audit contracts are currently assigned until 31 August 2016 (approximately 71% of audited bodies with the IHP portfolio).

- Proposed changes in the structure of the NHS envisage, subject to Parliament, that PCT audit appointments would finish in 2013. Contracts with firms would be amended to reflect the change but the IHP does not (currently) have any contracts as such.

Audit fees

The Commission currently coordinates the role of setting fees as one of its statutory functions. A move towards LPBs appointing their own auditors would likely increase the range of fees charged.

Scale of Audit Fees for Local Government bodies (2010/11)

Audited body (£'000)	Fixed element (£'000)	% of 2010/11 planned gross expenditure[1]
London borough councils	151	0.03%
Metropolitan borough councils	200	0.02%
Unitary authorities	136	0.03%
County councils	133	0.01%
District councils	80	0.05%
National parks authorities	21	0.03%
Integrated transport authorities	15	0.02%
Passenger transport executives	45	0.02%
Police authorities	75	0.01%
Fire and rescue authorities	62	0.03%
Other bodies (£1m <> £5m)	11	0.10%
Other bodies (>£5m)	23	0.03%

1. The scale fee for each individual body includes an element related to the audited body's planned gross expenditure and a regional premium for audits in London and the South East.
Source: Work programme and scales of fees 2010/11

Overview

- Fees for audits are the principal means by which the Commission currently finances its activities. In law, they are not a fee for audit services, but a levy to fund the costs of the Commission.

- Fees are payable to the Commission itself, however where firms are appointed as auditors, they collect the fees on the Commission's behalf. Firms are paid an agreed proportion of the relevant scale fee.

Process

- Scales of fees are set annually and apply for the relevant audit year (they are not fixed other than for the limited assurance audits up to £1m). The fees have largely been determined by the historical cost of performing the audit for a local body and comprises:
  - A fixed element which is specified for the different types of audited bodies;

- A variable element related to planned Gross Expenditure; and,
- Regional premium for specific audit locations.

Future appointments

- The Government has proposed that LPBs should appoint their own auditors in future. This would likely lead to a wider range of fees being charged compared to the current regulated approach.

III. Options Analysis - Sale

Overview

EU procurement law means a sale would require IHP first to win contracts in competition with private firms. To the extent market share was lost to the private sector, staff reductions would be required with associated redundancy costs.

Potential structure and timing

- During 2011/12, the IHP would transition to an arms-length commercial business. In 2013, after necessary legislation passed, the Commission would establish (one or more) government owned Newco(s) and make a direct award of contracts under the Teckal exemption for the whole of the 70% of audits currently carried out by the IHP and transfer all existing IHP staff into it (under TUPE terms). The IHP Newco would therefore inherit all of the current staff of the IHP.

- During 2014, Newco would bid to local public sector bodies for audit contracts in competition with the private sector firms. We understand from the Commission that current contracts with private sector firms run until 2016 but that these can be terminated by the Commission without associated cost. We recommend that DCLG confirm that this is the case if it has not already done so.

- The length of the new contracts remains to be determined but could be for, say, 3 to 5 years. We consider that longer contracts will be more attractive to private sector firms as they would provide better ability to plan and greater assurance of future revenues.

- A sale process could be undertaken during 2015. Buyers would benefit from the contracts secured by the IHP in competition during 2014. Management has prepared a forecast which assumes that half of the current market share (i.e. 35%) could be won through competitive tender.

- It would be necessary to conduct a competitive sales process in order to maximise any capital receipt from this process. We recommend that DCLG considers how to ensure that such a process has sufficient commercial expertise, resource and oversight.

Procurement law

- We understand that the transfer of the IHP into Newco would rely on the Teckal exemption to the EU procurement rules. We understand that otherwise it is not possible to transfer work awarded without a public procurement exercise to such Newco.

- The Teckal exemption allows a public authority to award contracts directly to a company without a public procurement process providing that it fully owns it and the company does the vast majority of its work for the parent. There must be no private investment in that company, or any intention that there will be any sale in the future of the awarded work. All such work under this scenario would expire by the time of sale.

- If the sale option is being considered further, we recommend that DCLG takes further legal advice in respect of the Teckal exemption.

Redundancies

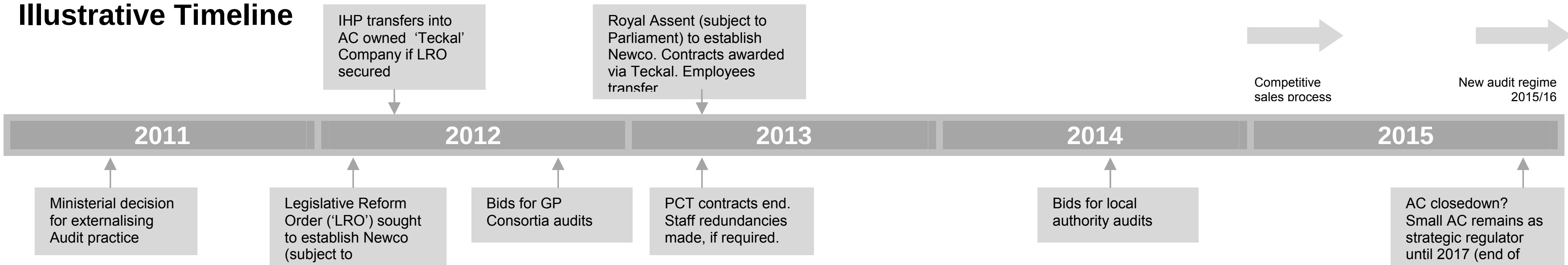
- We consider that the most likely outcome to a 2014 tender is that the Newco would win a significantly smaller share of the incremental work tendered than its current 70% share. To create a profitable Newco for sale therefore implies that there may be a need to make existing IHP staff redundant during the transition period if such staff have not left through natural attrition – such costs would be borne by the taxpayer.

- The IHP management has prepared forecasts which envisage IHP Newco winning a middle range 35% share of the work in competition with private sector firms. On this basis they expect redundancies of 233 staff in 2014/15 with an estimated cost in the region of £11m to £17m.

- These estimates are inherently uncertain and to the extent that the IHP wins less work, they may need to make more redundancies to achieve profitability with consequently higher redundancy costs than currently estimated.

Whilst sale offers the prospect of a capital receipt, there are inherent risks and uncertainties as to timing, delivery and quantum of any such receipt. Redundancy costs would likely be higher than under the outsourcing option.

Illustrative Timeline



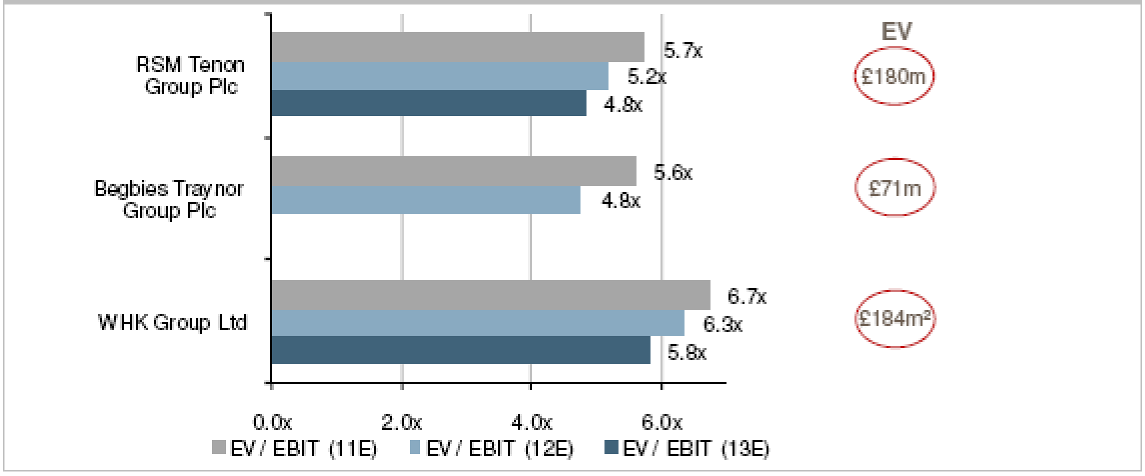
Source: Management information

Summary	Criteria	Considerations
• A new company (or companies) is formed by HMG. IHP staff and existing audits are transferred into Newco • IHP run as an arms length commercial business • Newco bids for audit contracts during 2014 in competition with private firms • If market share lost, Newco redundancies would be required (borne by taxpayer) • Newco sold during / after 2015 • Bidders might include private sector firms and an AC employee owned company	Redundancy costs	• Redundancy liabilities anticipated to be highest under this option and could outweigh any capital receipt • Risk that insufficient work will have been awarded to IHP at time of sale under this option • Bidders unlikely to acquire loss-making company with excess staff, implying risk of significant redundancies (borne by HMG)
	Capital receipt	• Opportunity for a capital receipt for the Government • A successful sale would be dependent on the private sector's appetite, and financial ability, to acquire the IHP • Quantum inherently uncertain as would depend on IHP's success in winning audits in competition prior to sale
	Market	• Market capacity retained - avoids loss of expertise that would result from straight dissolution • Allows for (but does not guarantee) entrance of a new player into the audit market – depends on identity of eventual buyer
	Employees	• Possibility of staff leavers ahead of completion of sale • Management argue that prospect of employee ownership currently holding down attrition but this is unclear • Possibility of management / employee owned company acquiring the IHP business
	Timetable	• The proposed sale would not be completed until 2015 at the earliest
	Execution risk	• Sale option subject to higher degree of delivery risk (e.g. delay, loss of audits, key staff departures, buyer appetite and funding) than outsourcing

Indicative valuation analysis

Assessing future sales value is inherently uncertain. However we illustrate the present value of a potential future capital receipt on sale, based upon the current market valuation of RSM Tenon, the only significant UK publicly quoted audit firm.

Quoted company trading multiples: EV / estimated EBIT[1]



Notes

1. We have calculated EBIT in 2013 for RSM Tenon and the WHK Group by assuming that the D&A total in 2013 is the average of the D&A totals of the respective entities from 2010 to 2012 .
2. The enterprise value for the WHK Group has been translated from AUD (source currency) to GBP using exchange rates sourced from www,xe.com as at 3 May 2011.
3. We have calenderised quoted company trading multiples to get June year ends.

Valuation considerations

- We present below EV/EBIT multiples for publicly quoted comparables and for precedent M&A transactions involving comparable businesses.
- There are only a few quoted comparators. Arguably, the closest is RSM Tenon, an AIM quoted audit and accounting services firm, albeit one which operates in the company audit market.
- RSM Tenon currently trades at an enterprise value of 4.8x 2013 consensus estimate EBIT and 0.6x 2013 consensus estimate sales.
- Based on this, we illustrate above the potential EV of the IHP based on a range of EBIT multiples from 3x to 5x.
- There are very few potentially comparable recent M&A transactions involving audit firms. Two potential examples include:
  - Sale of Bentley Jennison to RSM Tenon (8.4x reported EBIT)
  - Sale of certain businesses to RSM Tenon by the Administrators of Vantis Plc. The pricing of this transaction reflects a low valuation multiple (estimated at 1.8x reported EBIT) based on the distressed nature of the sale out of an insolvency process.

Illustrative value of sales proceeds			
£'m	**Multiples**		
	3.0x	**4.0x**	**5.0x**
Forecast IHP Operating Profit (2014/15)[1]	13.0	13.0	13.0
Implied Enterprise Value in 2015[2]	39.1	52.1	65.1
Present value at varying discount rates			
20%	17.7	23.6	29.5
30%	12.5	16.7	20.8
40%	9.1	12.1	15.1

1. Operating profit based on the first year of stand alone audit business (Sept 2014 - Aug 2015) as forecast by IHP management. Management has assumed 35% market share (half of current share).
2. Implied EV calculated on the operating profit after one year of stand alone business.

Potential sales proceeds

- Management has estimated that approximately 35% (equivalent to half their current market share) will be won through the competitive tender process, providing income of £52.5m in the first year of ownership (2014/15) and an operating profit of £13m. We have used this to assess the potential sales proceeds which could be achieved with a sale of the IHP.

- We have assumed that Management's EBIT forecast (detailed on page 54) will be representative of performance should a sale be completed to a private firm.

- Multiples of 3x to 5x have been applied to operating profit and then discounted back at varying discount rates (20% to 40%) to provide an indicative present value. The discount rates applied reflect the time value of money and venture capital style risk based on higher uncertainty given that the business does not currently exist in commercial form, and is subject to limited competition in the current market structure.

- On this illustrative basis, the present value of a potential future capital receipt from a sale ranges from £9m - £30m assuming 35% market share. We highlight that this result is very sensitive to the assumption on future market share won by the IHP. On the basis of 15% market share, the value would decrease to £1m - £3m assuming an Operating Profit of £1.5m (see page 54).

- To the extent that bidders expect to make further redundancies post-acquisition, this would have a cost which they would factor into their acquisition price. Such costs (if any) would in practice depend upon the individual buyer.

Potential purchasers

There are a number of organisation that could be interested in bidding for the practice; however, the degree of participation and ability to fund a future acquisition are uncertain.

Big 4 accounting firms

Mid-tier accounting firms

Public sector outsourcing firms

Financial buyers

Bidders

- Potential bidders might include
  - Private sector audit firms;
  - Other providers of outsourced services to public sector (i.e. new entrants);
  - Employee owned “mutual”; and
  - Financial buyers (private equity).
- We understand that “favouring” an employee owned firm would be open to challenge in relation to State Aid and other legal considerations (including from unsuccessful participants in such auction) and in any event would be unlikely to maximise capital receipt from such a sale.
- There can be no certainties about the degree of participation by potential Public sector outsourcing firms purchasers in a future sale given the various market factors (which are discussed on pages 86 to 89), nor in the ability of certain of the likely interested

parties to be able to fund the acquisition price. It is unclear whether an employee owned “mutual” would have sufficient access to capital.

- For illustrative purposes, we set out above some potential purchasers of the IHP in the event of a sale.

- We have not spoken to any of the firms mentioned here in relation to their appetite to acquire the IHP.

- We have not tested market appetite directly during our review. It would be possible to undertake some form of consultation / market testing to gauge interest of potential bidders prior to pursuing the sale option.

Advantages and disadvantages

The Government may realise some capital receipt from sale of the IHP, however this could be outweighed by redundancy costs. We consider that there is higher execution risk and longer timetable when compared to the outsourcing option.

Criteria	Advantages	Disadvantages / Key Risks
Redundancy costs	• N/a	• Redundancy liabilities anticipated to be highest under this option and could outweigh any capital receipt. • Risk that insufficient work will be awarded to IHP at time of sale. • Bidders unlikely to acquire loss-making company with excess staff, implying risk of significant redundancies (borne by HMG)
Capital receipt(s)	• Opportunity for a capital receipt for the Government.	• A successful sale would be dependent on the private sector's appetite, and financial ability, to acquire the IHP. • Quantum inherently uncertain as would depend on IHP's success in winning audits in competition prior to sale.
Market	• Market capacity retained - avoids loss of expertise that would result from straight dissolution • Allows for (but does not guarantee) entrance of a new player into the audit market – depends on identity of eventual buyer	• Given that the public sector accounts for less than 10% of the total audit market in the UK, it is unlikely that the addition of a new market entrant will have a significant impact on overall competition.
Employees	• The Commission argue that prospect of employee ownership currently holding down attrition but this is unclear • Possibility of management / employee owned company acquiring the IHP business	• Possibility of staff leavers ahead of completion of sale. No evidence to date of increased level of leavers
Timetable	• N/a	• The process means that the Commission will continue largely in its current form until the sales process is complete (likely 2015).
Execution risk	• N/a	• Sale option subject to higher degree of delivery risk (e.g. delay, loss of audits, key staff departures, buyer appetite and funding) than outsourcing.

Other considerations

Separation issues have not yet been considered in detail and may add additional cost and time to the process, impacting any capital receipt.

Sale of parts

- The current assumption of DCLG is that the IHP would be sold whole to the private sector. Another potential option could be multiple sales to sell the elements of the IHP on a sector or regional basis to different purchasers.
- Further, the central parts of the IHP covering Standards and Technical, and Advisory Services may have some value if sold as separate entities, particularly to advisory firms that do not perform audits in the public sector at present (although these units may be too small or insufficiently profitable to attract significant value).
- Given the additional complexity and execution risk, we do not recommend a sale of parts in the absence of compelling reasons to the contrary.

Separation issues

- There are inherent separation issues under the sale option, with the separation of the IHP from the Commission creating a number of practical considerations.
- We understand that the Commission and IHP have not considered potential separation issues and costs to date, however, the core areas that will likely require focus include the following:
    - Migration of data and systems onto buyers systems;
    - Exit and establishment of property requirements to house the IHP and associated relocation costs;
    - Establishment of in house legal and regulatory support and subsequent novation of all contracts to the Newco entity; and
    - Migration of all employee contracts, benefits, pensions to Newco.
- Given the potential scope of the separation issues, we recommend that a more detailed review be conducted if the Sale option is considered further, particularly under the Employee Ownership' model, whereby a completely new structure will be required. Further, consideration should also be given to potential TSAs (Transitional Service Agreements) and program management support that may be required to effect the separation.

Employee ownership

Management has considered establishing an independent, employee-owned Audit Practice which would ultimately compete as a private firm in the open market.

Management / Employee ownership

- IHP Management have researched the possibility of establishing the IHP as an independent business, owned and controlled by its management and employees, which would ultimately compete with private sector firms in an open market.

- Whilst Management have stated that they would wish to acquire the IHP pursuant to the Sale option, we understand that their interest is relevant under the outsourcing option as well in that Management would consider establishing a company to bid against private sector firms.

- We were informed that, prior to our appointment, IHP Management had engaged in initial discussions with the Royal Bank of Scotland, Co-Operative Bank and Baxi Partners to develop an IHP standalone business model and potential financing options.

- Management has stated that they believe the new company could be financed via:
  - Sale of 55% of shares to employees, whereby 50% of the shares would be held in an Employee Ownership Trust financed by a bank loan, and 5% of the shares would be financed by individual Employee Shareholdings; and,
  - The remaining 45% would be converted into preference shares held by the Government which the company would aim to acquire following repayment of the bank loan. This may also present the potential for capital receipt for the Government once the company has been established.

- Further, Management is also willing to explore the possibility of establishing a strategic alliance or joint venture with an existing private firm to stabilise their position as an independent entity in the open market, however it should be noted that, under Teckal, we understand private investment is prohibited. The IHP are aware of this and under the Teckal option they are not proposing to seek private investment until in the private sector. Any partnership arrangement prior to then would be publicly procured and relate to operational support.

- We have recommended to DCLG that such external discussions be postponed pending consideration of different structures and that Commission and IHP management obtain prior written consent to conduct any further discussions of this nature. This is important given the potential conflicts of interest faced by IHP management during this transition period.

- IHP Management have stated that they have carried out a survey of existing personnel in order to gauge support for the employee ownership option and that c.88% of staff were in favour of this.

Execution risks

- The establishment of a Management / Employee led Newco which is the able to continue to run the underlying business and deliver audits without disruption whilst co-ordinating the preparation of a business plan, the raising of finance and the commercialisation of a public sector organisation is subject to execution risk.

- The scale of the task that would face IHP Management should not be underestimated. The challenges involved in delivering this outcome include, but are not limited to the following:
  - Funding of early stage costs in relation to establishing the Newco business plan
  - Funding of the early stage transaction costs in bidding for the IHP Practice
  - Funding of the acquisition price on a sale of the IHP.
  - Maintaining audit delivery quality through a period of significant upheaval and structural change
  - Need to allocate the ownership proportions between Management and Staff and between individuals – such negotiations can be complex;
  - Management's experience (or lack thereof) of running a private firm in a competitive environment;
  - Risks around client acceptance of a IHP Newco which did not have the brand / scale / resources of competing private sector firms with consequent impact on trading performance, need for redundancy costs and impact on sales proceeds;
  - Potential conflicts of interest for management on an eventual sale. How would they support and facilitate an open auction process to maximise sale value given their interest in acquiring for a low value?
  - How would Management be able to introduce a commercial ethos throughout the staff of the IHP?
  - What would the new infrastructure requirements and separation issues (see below) be on a sale of the IHP to Management / Employees – how would Management address these requirements?

Financial implications

A financial forecast has been prepared by IHP management which assumes employee ownership will occur in 2014/15 after a forecast 35% market share is won through competitive tender.

IHP Budget under Sale Scenario (Commercially Confidential)						
£'m (Audit Year)	**2011/12**	**2012/13**	**2013/14**	**2014/15**	**2015/16**	**2016/17**
Market Share (%)	70%	70%	70%	35%	35%	35%
Income						
Local government	60.9	56.9	56.9	29.5	29.5	29.5
Health	29.3	27.6	14.8	11.9	11.5	11.1
Grant claims	11.5	10.7	9.9	4.6	4.3	4.0
A&A	4.3	4.7	5.2	5.7	6.3	6.9
New markets	-	-	-	0.7	1.1	1.6
Total Income	**106.0**	**100.0**	**86.9**	**52.5**	**52.7**	**53.2**
Expenses						
Staff Costs	(45.7)	(44.1)	(35.7)	(23.1)	(23.2)	(23.4)
Other Direct Costs	(17.0)	(15.9)	(14.5)	(6.6)	(6.5)	(6.4)
Indirect Costs	(22.4)	(21.5)	(14.6)	(9.7)	(9.7)	(9.7)
Bid Costs	-	-	(2.0)	-	-	-
Operating Profit	**20.9**	**18.5**	**20.1**	**13.0**	**13.3**	**13.6**
Operating Profit %	*19.7%*	*18.5%*	*23.2%*	*24.8%*	*25.3%*	*25.5%*
Redundancy Cost - DCLG[1]	-	(4.7)	(11.7)	-	-	-

1. Redundancy costs have been calculated by management using an average redundancy estimated cost of £50k per employee.
Source: Management information
We have not completed any diligence on the financial forecast prepared by management.

Employee Ownership - Financial Forecast

- IHP Management has developed a financial forecast to reflect their proposal to establish an employee-owned entity to acquire the IHP. The table above summarises the forecast which covers the period 2011 – 2017, by audit year. We have not completed any diligence on the financial forecast prepared by management.

- The forecast assumes that 2011/12 trading will follow the current budget prepared by the IHP. The following two years are based on the newly established Teckal company being awarded the entire 70% of the current in-house share of the market. It is then assumed that 35% (half the current share) will be won in competitive tender from 2014/15.

- We have assumed that Management's forecast will also be representative of performance should a sale be completed to a private firm rather than an employeeowned entity.

- It should be noted that IHP management would be faced with inherent conflict(s) of interest through the transition period. For example, the more bids they win in competition the more they would likely have to pay to win in a subsequent competitive sales process.

- Management forecast a reduction in fee income between 2012/13 and 2013/14, primarily due to the loss of PCT income. However, this is not forecast to reduce operating profit due to significant cost reductions, including a headcount reduction of £4.7m to be funded by DCLG.

- To mitigate the loss of fee income and smooth staff workload, it is suggested by Management that Newco plan to offer new services (such as internal audit and advisory services) to the existing market, as well as attempting to enter new sectors (housing associations, educational institutions, charities).

- The estimated redundancy costs have been calculated at a high level by practice management, based on the volume of staff required to complete audits for 35% of the market and an average £50k redundancy package per person (based on direction from the Commission, we understand this figure is closer to an average of £71k per employee). DCLG funded redundancy costs are forecast at £11.7m during the transition year (2014/15). This liability could vary significantly depending on the number of audits won and mix of redundant employees.

- Managements forecast fails to factor in transaction and separation costs discussed in further detail later in this section.

The potential success of an employee-owned company is dependent on market share. If the assumed IHP market share falls, the profitability and the value of the IHP business will decline while redundancy costs increase.

Market Share Implications (Commercially Confidential)			
	Audit Year 2014/15		
£m	**Mgmt forecast**	**Scenario 1**	**Scenario 2**
Market Share (%)	35%	25%	15%
Income			
Local government	29.5	21.0	12.6
Health	11.9	10.7	8.3
Grant claims	4.6	3.3	2.0
A&A	5.7	5.7	4.3
New markets	0.7	0.7	0.7
Total Income	**52.5**	**41.4**	**27.9**
Expenses			
Staff Costs	(23.1)	(18.8)	(13.1)
Other Direct Costs	(6.6)	(5.2)	(3.6)
Indirect Costs	(9.7)	(9.7)	(9.7)
Operating Profit	**13.0**	**7.7**	**1.5**
Operating Profit %	*24.8%*	*18.6%*	*5.3%*
Number of Redundancies	*233*	*313*	*400*
Average Redundancy (£)[1]	*1 71,038*	*71,038*	*71,038*
Est Redundancy Cost (2014/15) (£'m)[2]	**16.5**	**22.2**	**28.4**

1 Avg. redundancy calculated by Audit Commission. This differs to the financial forecast presented on previous page which assumes the average to be £50k, a 'best estimate' by IHP.

2 Redundancy cost for 2014/15 only. Additional £4.7m is forecast to be incurred in 2013/14.

Source: Management information and financial model

We have not completed any diligence on the financial forecast prepared by management. The alternative scenarios 1 & 2 show impact on profit of varying the market share assumption -indirect costs are assumed constant although in practice Management might seek to reduce these further in such circumstances

Management forecasts

- In 2003, Foundation Trusts ("FTs") were given the ability to appoint their own auditors rather than have the Commission make appointments on their behalf. The position with FTs therefore offers a useful precedent as to the ability of the IHP to win work in competition with private sector firms.

- The IHP currently holds c. 38% of the FT market, with the Commission estimating c. 25% of bids are won. IHP Management claims that the announcement of the abolition of the Commission has had a detrimental impact on recent success rates.

- Management has based their forecast on an assumption of winning half of the current market share of the IHP (i.e. c.35% of the whole market). This appears optimistic in relation to the IHP's track record of work won through competitive tender in the FT market.

- Operating profit is forecast by Management at £13m in the first year of trading with redundancy costs of approximately £12m anticipated by Management (with additional redundancy costs of £5m incurred in 2013/14 reflecting cost cutting measures).

- Management has used an estimated average cost per employee of £50k to calculate the redundancy liability; however, this is not based upon a detailed review of the likely total figure. The Commission has subsequently reviewed the potential liability in more detail and estimate the average to be £71k. On this basis, we suggest redundancy cost could increase to approximately £17m in 2014/15 (£7m in 2013/14).

- The table above provides an illustration of the potential impact market share has on the forecast profitability of the new employee owned company and estimated redundancy cost if the IHP is less successful in an open market than assumed.
  - Scenario 1 reflects the potential performance of the company if it wins 25% of the market in line with FT bid wins. Operating profit declines by £5m, with an increase of £6m in redundancy costs; and,
  - Scenario 2 shows a further deterioration in both profitability and higher redundancy costs if a 15% market share is won.

- We highlight that these scenarios are derived using Management's financial model and in particular by varying the input assumption re market share won. We have not verified or otherwise checked the accuracy or integrity of the model or its underlying assumptions.

- We discuss wider market considerations in relation to sale on pages 86 and 89.

IV. Options Analysis - Outsourcing

Overview

Outsourcing has the potential to transfer the IHP to the private sector with shortest timescale and lowest execution risk whilst minimising redundancies and preserving the skill base of existing IHP staff via TUPE transfers to the private sector.

Potential Outsourcing Audit Bundles - Illustrative

		Number		£'m	
Option	Lot size (approx.)	Staff per Lot	Total TUPE Staff (est.)	Salary Cost per bundle	Redundancy cost (est.) incl. NHS
1) Large geographical lots	4 x £15.0m	135	540	8.4	26.4
2) Large geographical lots	7 x £9.0m	77	539	4.8	26.4
3) Smaller geographical lots	13 x £5.0m	31	403	1.9	36.0
4) Mixed lots	2 x £10.0m	48		3.0	
	7 x £5.0m	24	324	1.5	41.8
	3 x £2.0m	10		0.6	
	6 x £1.0m	5		0.3	

The above table assumes LPB contracts outsourced. All NHS audit staff assumed to be made redundant.
Source: Audit Commission

Potential Redundancy Costs - Audit Commission (at Feb 2011)

	Number of Staff			Redundancy Costs (£'m)					
Staff - by level	**LG**	**NHS**	**Total**	**Max.**	**LG 1**	**LG 2**	**LG 3**	**LG 4**	**NHS[1]**
Field Staff									
District Auditor/Engagement Lead									
Senior Audit Manager									
Audit Manager									
All other audit staff (inc. trainees)									
Total Field Staff	**538**	**220**	**758**	**54.4**	**-**	**-**	**9.7**	**15.4**	**15.8**
Audit Practice Management									
Leadership Team									
Dir. Professional Practice									
Advisory and Assurance									
Support Staff									
Total AP Management	**111**	**46**	**157**	**10.6**	**7.5**	**7.5**	**7.5**	**7.5**	**3.1**
Audit Practice Total	**650**	**265**	**915**	**65.0**	**7.5**	**7.5**	**17.2**	**23.0**	**18.9**

1 NHS PCT audits expire in April 2013 with GP Consortia contracts starting after this date.
Assumptions: The maximum redundancy liability for the Audit Practice is estimated at £65m, as calculated by the Commission.
• The volume of local government or NHS auditor redundancies is dependent on the ability to outsource PCT audits. Due to the expiry of these audits in 2013 it is assumed that all NHS auditors will be made redundant.
• It is assumed that all support/management staff will be made redundant.

Overview

- Under current powers, during 2011/12 the Commission would tender out to the private sector all the audit work currently provided by the IHP from 2012/13.

- Under this scenario, audits would be awarded to private firms on the basis of set criteria defined by the Commission which would result in the employees being transferred to the firms on TUPE terms.

- We understand that under this option the Commission could divide England into a limited number of contract areas and invite bids from private sector firms for each. Firms would be able to bid for one, some or all contract areas depending on the strategy developed. We consider that mid-tier should be able to compete for Lots under this option, thereby potentially developing / maintaining competition.

- Based on the tenders received it might prove more beneficial to outsource to a number of firms on a regional basis or, potentially, to one firm nationally, were the terms sufficiently attractive. In other words, firms would be invited to submit bids for Lots but have the ability to submit additional variant bids giving them the option to accept lower fees / pay higher amounts for Lots.

- DCLG has identified that 3 year audits would be the minimum duration likely to be commercially attractive to bidders and we consider this a reasonable conclusion. However, we consider that longer contracts (e.g. 5 years) would be more attractive to private sector firms as they would provide better ability to plan, greater assurance of future revenues and a longer timeframe over which to manage the transition of existing IHP staff transferred in. This should allow for the firms to be able to offer lower fees / a higher capital payment, or a combination thereof.

- Contracts would be bundled accordingly into Lots (different potential structures developed by the Commission are illustrated above) with less profitable bodies combined with the more profitable ones. Depending on the bundles, redundancies and the number of staff to TUPE would vary.

- The Commission considers that, although employees would be transferred to the winning bidders, a number of redundancies would be inevitable. However it is our opinion that such an outsourcing process should start from an objective of minimising any redundancy costs of the IHP staff borne by HMG and maximising the transfer of staff to private sector firms pursuant to the tender process.

- Assuming the total outsourcing of the audits, other elements of the IHP would remain and be redundant, impacting the leadership team, Advisory Services, Standards and Technical and Business Support. It is possible that elements could either be retained and sold off as separate entities or included within an outsourcing offer from a private firm.

The Commission has proposed various outsourcing scenarios with a range of TUPE and market competition implications. Larger contract bundles would maximise TUPE and minimise potential redundancy liabilities.

Considerations

- The Commission has previously distributed c.30% of audits to external competitors. The principles behind outsourcing 100% of the market could be undertaken under guidelines which are already in place and could therefore be a less risky, more straightforward option. Clearly, outsourcing would differ from prior tender exercises by virtue of the fact that IHP staff would be transferred pursuant to TUPE and would therefore need to be allocated between the different Lots.

- It would be possible to ask bidders to tender not just on the basis of minimising cost (whilst maintaining audit quality) but also to invite firms to tender on the basis of any upfront payment they would be prepared to make to secure IHP staff and multi-year contracted revenues.

- Whist offering scope for better overall value for money, if capital receipts were sought in addition to minimising audit costs then the tender process would likely be more complex than past exercises. DCLG should ensure that it / the Commission have sufficient commercial resource, expertise and oversight to project manage successfully such a process.

Impact of longer term contracts - illustration

£'m	**Contract**	**1**	**2**	**3**	**4**	**5**	**Total**
Profit		**1.5**	**1.5**	**1.5**	**1.5**	**1.5**	**n/a**
NPV of Income							
Three Year Contract		1.4	1.2	1.1	-	-	3.7
Four Year Contract		1.4	1.2	1.1	1.0	-	4.7
Five Year Contract		1.4	1.2	1.1	1.0	0.9	5.7
N.b. Assumed discount rate		*10%*					

- The table above illustrates the increased potential attractiveness of longer length contracts to private sector firms. The 5 year contract illustrated would have approximately 54% higher present value (being (5.7 - 3.7) / 3.7) in comparison to a 3 year contract.

- Larger contracts should provide firms with a better ability to plan, greater assurance of future revenues and a longer timeframe over which to manage the transition of existing IHP staff transferred in and thus should allow for the firms to be able to offer lower fees / a higher capital payment, or a combination thereof.

TUPE

- The Commission has reviewed TUPE legislation and have concluded that if an IHP staff member spends over 50% of his/her chargeable time on audits falling within one of the proposed regional Lots, there would be sufficient justification to apply TUPE regulations. The employee would then be obligated to transfer to the winner of an award of an outsourcing contract or resign. We understand this is consistent with advice received by DCLG based on other outsourcing exercises.

- The Commission has not completed any planning on the procurement proposal to maximise TUPE; however, it should be possible to structure bundles of contracts in such a way that the great majority of audit field staff could be TUPE transferred to the relevant private firms upon the award of the Lots. A high level proposal has been prepared by the Commission which considers the various Lot sizes for local government audit contracts, shown on the table above, including the number of staff to TUPE and total salary costs associated with each Lot or bundle.

- In any scenario where TUPE applies, the acquirer takes over the liability for all statutory rights, claims and liabilities arising from the contract of employment, for example liabilities in tort, unfair dismissal, equal pay and discrimination claims. A potential acquirer could adjust its bid to account for these additional costs which could result in higher audit fees or a reduced/nominal capital receipt.

- The Cabinet Office Statement of Practice on Staff Transfers in the Public Sector (2000) (COSOP) required public sector bodies outsourcing services to impose certain additional contractual obligations. This regulation could make an acquisition unattractive to an external firm due to its requirement to provide comparable pension entitlements, a factor which became apparent in the Cornwall/Cumbria procurement process We have been asked by DCLG to undertake our work under the assumption that COSOP no longer applies.

- Under TUPE, if the previous employer provided a pension scheme then the new employer has to provide some form of pension arrangement for employees who were eligible for, or members of the old employer's scheme. It will not have to be the same as the arrangement provided by the previous employer but will have to be of a certain minimum standard specified under the Pensions Act.

- All of the scenarios include redundancy costs for support staff in the IHP who are unlikely to be eligible for TUPE transfer. The associated costs are discussed in more detail later in this section.

- It could be possible to ask bidders to provide variant bids for Lots on the basis that additional designated staff transfer, even if TUPE did not apply. In such cases, staff consent would also be required but could not be guaranteed.

Financial implications

AC estimate that maximum potential redundancy cost for the IHP is c.£65m. These costs will be minimised with larger Lots and a higher number of TUPE transfers; however, the AC consider a residual cost of £11m for central staff to be irreducible.

Potential Redundancy Costs - Audit Commission (at Feb 2011)

	Number of Staff			Redundancy Costs (£'m)					
Staff - by level	**LG**	**NHS**	**Total**	**Max.**	**LG 1**	**LG 2**	**LG 3**	**LG 4**	**NHS[1]**
Field Staff									
District Auditor/Engagement Lead									
Senior Audit Manager									
Audit Manager									
All other audit staff (inc. trainees)									
Total Field Staff	**538**	**220**	**758**	**54.4**	**-**	**-**	**9.7**	**15.4**	**15.8**
Audit Practice Management									
Leadership Team									
Dir. Professional Practice									
Advisory and Assurance									
Support Staff									
Total AP Management	**111**	**46**	**157**	**10.6**	**7.5**	**7.5**	**7.5**	**7.5**	**3.1**
Audit Practice Total	**650**	**265**	**915**	**65.0**	**7.5**	**7.5**	**17.2**	**23.0**	**18.9**

1 NHS PCT audits expire in April 2013 with GP Consortia contracts starting after this date.
2. LG1 refers to local government audit staff redundancy costs under outsourcing using Lot structure 1
Assumptions:
• The maximum redundancy liability for the Audit Practice is estimated at £65m, as calculated by the Commission.
• The volume of NHS auditor redundancies is dependent on the ability to outsource PCT audits. Due to the expiry of these audits in 2013 it is assumed by the AC that all NHS auditors will be made redundant.
• It is assumed that all support/management staff will be made redundant.

Redundancy costs

- The maximum potential redundancy cost of the in-house audit practice have been estimated at £65m by the Commission, as shown on the table above. These include approximately £54m connected with field staff and approximately £11m connected with IHP management and support staff.

- Commission staff have been excluded from this estimate as they are liabilities of DCLG; £25m was incurred in 2010/11 with a further £13m forecast in 2011/12.

- The Commission has prepared some analysis based upon the outsourcing of various sized Local Authority Lots. The Commission analysis assumes that all NHS/PCT audits are kept in house due to the short term nature of the audits (estimated split 71% local government / 29% NHS based on number of public bodies).

- The associated redundancy costs are shown above:
  - £8m audit practice management/support staff connected with local government audits incurred in all scenarios in 2012/13;

- NHS field staff redundancies are dependent on whether the Commission is asked by the Department of Health to make the initial appointments to GP consortia. Due to the expiry of these audits in 2013, it is assumed by the Commission that all NHS auditors will be made redundant. Redundancy costs have therefore been estimated at £16m for field staff and £3m audit practice management/support staff connected with NHS audits, incurred in all scenarios in 2013/14; and
- Range of local government field staff redundancies from nil to £15m dependent on Lot sizes which would be incurred in 2012/13.

- This high level analysis is based on various assumptions on the proportion of staff that will be able to TUPE under each of the respective Lots. Further analysis will be required by the Commission to calculate the likely TUPE and redundancy implications.
- Potential bidders could be asked / may wish to tender for Lots on the basis that additional designated staff be invited to transfer, even if TUPE did not apply, for example audit practice management or support staff. We recommend that DCLG take further legal advice on this.

Potential implementation process

The Commission estimates that it will take 14 months to complete an outsourcing process. This would imply that the earliest completion date would be September 2012, although this remains subject to further discussion.

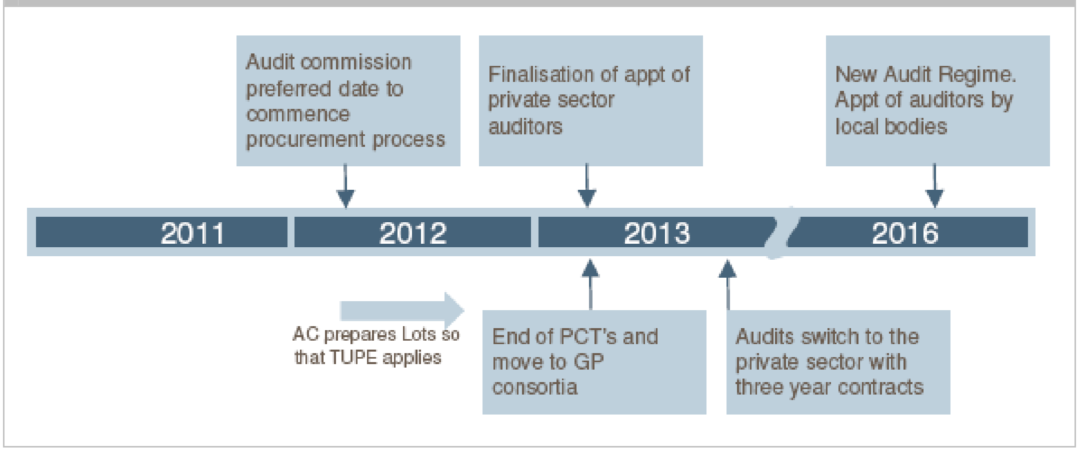
Outline Procurement Timetable as per AC

	2012/13	2013/14
1. Setting up and design of procurement process	2 mths	
2. Procurement process (EU procurement regulations apply)	6-7 mths	
3. Consultation period	5 mths	
4. Finalisation of appointment		1 mth

The Commission's best estimate is that the procurement process can be completed in a period of 14 months.

Source: *Transfer of Audit Practice: Practical Implications of outsourcing (8 April 2011)*

Potential illustrative timeline



Source: *Transfer of Audit Practice: Practical Implications of outsourcing (8 April 2011)* and *Future of Local Audit – Audit Practice Work stream (April 2011)*

Process

- The Commission has prepared a document outlining the practical approach to outsourcing the audits held by the in-house practice[1]. It concludes that a procurement process could not be completed by April 2012.
- The earliest date by which the Commission has stated the process could be completed is September 2012; however, they have stated that this option would be complex, has

1. Transfer of Audit Practice: Practical Implications of outsourcing (8 April 2011)

a number of risks and requires a decision to be made by June 2011 in order to complete the 14/15 month process detailed in the table above. April 2013 has been recommended by the Commission as a more appropriate date for the appointment of new auditors.

- The set-up and design phase involves analysing individual workloads and creating Lots so that TUPE will apply, a process estimated by the Commission to take two months. Certain timescales with the procurement process are prescribed by EU procurement regulation and cannot be shortened for example 37 days must be given from contract notice to request to participate, 40 days for bidders to ask questions and submit bids, 10 days for unsuccessful bidder challenge, as illustrated in section II of our report.

- The Commission will then have to complete a matching process whereby bids are matched to audits. Once an appointee has been decided the Commission consults with the Local bodies for a minimum period of 4 weeks. The Commission states this can only commence once the new supplier is selected.

- We understand that the Commission proposed timetable is currently under discussion with DCLG, with the possibility of reducing the process timeline. It appears to us that there may be scope to reduce elements of the Commission timetable.

Advantages and disadvantages

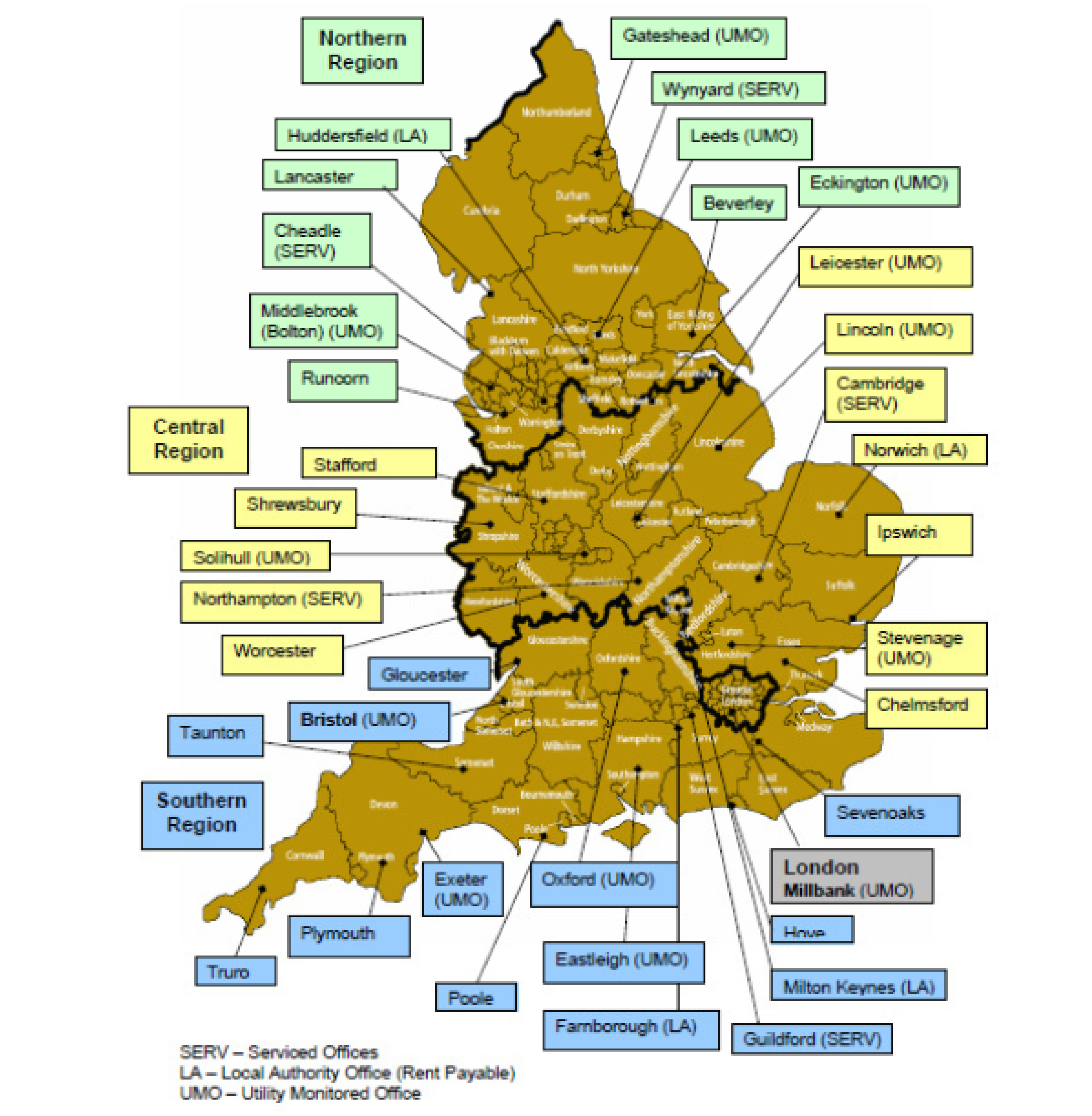
A move to 100% delivery via private sector audit firms represents the quickest solution with relatively low risk involved to change from current position where 30% of audits are delivered by the private sector.

Criteria	Advantages	Disadvantages / Key Risks
Redundancy cost	• Assuming outsourcing auction is managed appropriately, redundancy costs borne by DCLG (and the taxpayer) should be minimised and / or factored into outsourced audit fee	• Some redundancy liabilities likely, relating to residual nonallocable technical and administrative staff of the Commission
Capital receipt(s)	• Not precluded. In addition to evaluating on lowest audit costs, possible to ask firms to tender on the basis of any upfront capital payment that they would be prepared to make.	• Appetite of private firms to pay a capital amount to acquire contracts on the basis of the required TUPE terms and pricing requirements may be limited. • Implications of COSOP treatment re: Fair Deal on pensions may impact bids given the potential liabilities
Market	• Market capacity retained - avoids loss of expertise that would result from straight dissolution • Would not preclude an IHP Newco bidding for contracts which would allow for a potential new entrant into the audit market. • Would allow for the possibility of a reduction in audit fees, dependent on market forces.	• Limited opportunity to create a new player
Employees	• Majority of employees would retain their jobs and be transferred on current terms • Possible management and employee owned company could be formed to bid for contracts	• In the interim period, there is a risk that employees may leave the IHP
Timetable	• Potential to outsource 2012/13 audits and firms would be awarded contracts for 3 - 5 years • Outsourcing process should be achievable within a shorter timescale than a sale • The Government would be able to demonstrate that the process is underway, whilst reporting on progress and defined milestones based on outsourcing strategy	• N/A
Execution risk	• Appears to be lowest risk option given experience and processes already in place.	• N/A

Other considerations

A phased approach may be adopted towards Outsourcing but would add complexity to the process and may lead to a potential loss or reduction of volume discounts in bidders prices.

Audit Commission – Prior Regional Boundaries



- The above map shows the regional boundaries that have previously been used by the Commission for allocating audits.

Phased Outsourcing

- The Commission's current time estimate for outsourcing is based on transferring all audit practice contracts in one procurement exercise over a 14 month period.
- Another potential alternative would be to undertake a phased process, possibly on a regional basis.
- Under this scenario, Lots currently outsourced could be extended for a period, allowing the Commission to focus on outsourcing the audits currently performed by the in-house practice.
- Whilst phasing of the outsourcing process would presumably allow the process to start earlier and would therefore demonstrate initial progress, we consider that the key disadvantage would be the potential loss or reduction of volume discounts in bidders prices, as these are likely best secured by running a procurement on a national basis.

Outsourcing - Employee Ownership Model

- Under the outsourcing option, an employee-owned Newco could have the opportunity to bid for the outsourced contracts against the other firms in the private sector.
- This option would potentially allow the establishment of another player in the market and potentially increase competition thereby helping exert downward pressure on future fees.
- It is not yet clear at the point whether such an employee / management owned Newco would be in a position to provide credible bids on whether the potential conflicts from this could be managed satisfactorily.
- It would be necessary to put in place safeguards to maintain independence in the procurement and appointment process if the IHP was competing with private sector firms for such contracts.

V. Options Analysis - Hybrid

Hybrid option

Under Hybrid option, IHP would compete with private firms in an outsourcing tender. To the extent that it lost market share, redundancies would be mitigated by staff transfer to the successful firms. A capital receipt is achievable but uncertain.

Introduction

- This option combines key elements of the outsourcing and sale options. It is similar to the previous Sale option but differs primarily in the transfer of a significant proportion of IHP staff to the private sector upfront, dependent on the results of the initial outsourcing.
- In the sale option, the IHP Newco inherits all IHP staff and then would likely be forced to make redundancies as it lost work to the private sector firms over time.
- In the hybrid option, such redundancies would be mitigated by holding an outsourcing tender in respect of all of the 70% of audits currently performed by IHP. To the extent that the IHP Newco wins contracts, it would keep the staff (and associated cost) and the level of audit work (and associated income).
- Conversely to the extent that it loses contracts to private firms it would reduce headcount via TUPE transfers, thereby removing (or at least reducing) the need for redundancies
- The primary disadvantage with this option would appear to be greater complexity together with a prolonged period of transition and uncertainty.

Outsourcing

- As with the Sale option, during 2011/12, the IHP is moved towards a position of being run as an arms-length commercial business.
- In 2013, after necessary legislation passed, the Commission or HMG would establish a Government owned Newco.
- The Commission would then run a full outsourcing tender process in respect of the 70% of audits currently carried out by IHP. Newco would participate in this tender process in competition with the private sector firms.
- As noted above, to the extent that Newco lost some or all of these bids, its redundancy costs would be mitigated by TUPE transfers of IHP staff to the successful private audit firms, with residual employees being made redundant.

Sale

- Under this option, it is envisaged by DCLG that a sale process could be undertaken during 2015. As with the sale option, it would be appropriate to conduct a competitive sales process in order to maximise any capital receipt from this process. Moreover, we also recommend that DCLG considers how to ensure that such a process has sufficient commercial resource and oversight.

- Whilst we emphasise that the quantum and achievement of a capital receipt via a sale are inherently uncertain, we have assumed that the present value of such a future receipt, assuming completion in 2015 and 35% market share, would be comparable to that achieved in the sale scenario of between £9m to £30m.

- No specific forecasts have been prepared in support of the Hybrid option. Management has estimated that approximately 35% market share (equivalent to half of the IHP current market share) will be won through the competitive tender process in the Sale scenario, however we consider that the percentage of market share won under the hybrid option could be less due to the IHP having less time to prepare and establish a standalone business (as opposed to the quicker Teckal transfer process in the sale option).

Management incentives

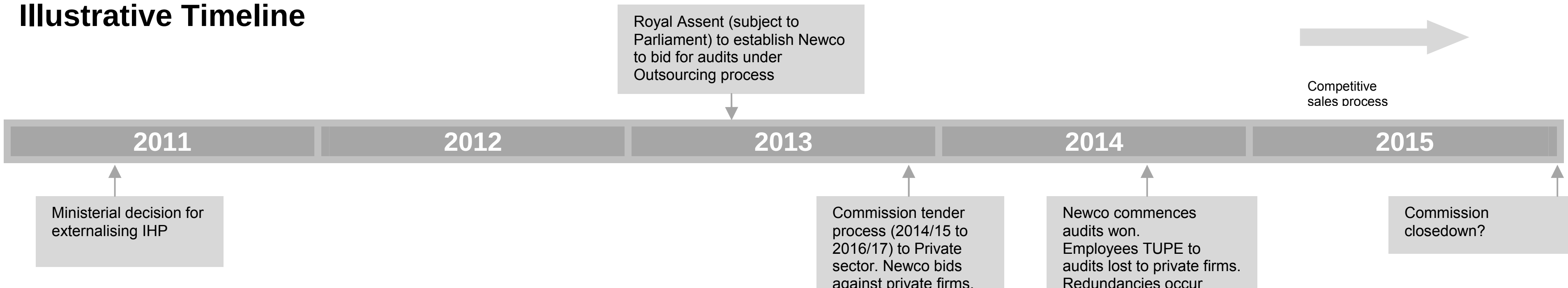
- Under the hybrid option, there are risks that IHP management incentives are either distorted or diluted.

- For example, there could be an incentive for IHP Newco bidding in the outsourcing tender to “lowball” to win any work with losses still being borne by the taxpayer.

- Alternatively, there is a risk that their proposal of winning work in competition and then ending up as a successful firm is so remote that their incentive to stay and drive forward this option are significantly reduced.

The "Hybrid" option combines a full tender of the existing 70% of audits currently performed by the IHP with a subsequent sale. An IHP "Newco" would compete for audit work in the tender and would be sold on the basis of work won.

Illustrative Timeline



Source: Management information

Summary Description	Criteria	Considerations
• New company is formed by HMG. IHP staff and existing contracts are transferred in to Newco • All 70% of audit work currently conducted by IHP is subject to competitive tender • Newco bids for all audit contracts during 2014 in competition with private sector • IHP staff reduced subject to result of tender and TUPE transfers • Newco sold during 2015 via auction to private sector bidders	**Redundancy costs**	• Redundancy liabilities potentially marginally higher than outsourcing option but less than sale option • Amount of redundancy costs would be driven by extent to which IHP is successful in winning work
	Capital Receipt	• Opportunity for a capital receipt for the Government • A successful sale would be dependent on the private sector's appetite, and financial ability, to acquire the IHP • Quantum inherently uncertain as would depend on IHP's success in winning contracts in competition prior to sale
	Market	• Market capacity retained - avoids loss of expertise that would result from straight dissolution • Allows for (but does not guarantee) entrance of a new player into the audit market – depends on identity of eventual buyer
	Employees	• Possibility of staff leavers ahead of completion of sale. No evidence to date of increased level of leavers • Commission argues that prospect of employee ownership currently holding down attrition but this is unclear • Possibility of management / employee owned company acquiring the IHP business
	Timetable	• The proposed sale would not be completed until 2015 at the earliest based on timetable proposed by the Commission • Process would take longer than the outsourcing option
	Execution risk	• Hybrid or sale options subject to higher degree of delivery risk (e.g. delay, loss of contracts, key staff departures, buyer appetite and funding) than outsourcing

Financial implications

Redundancy liabilities and financial forecasts under the Hybrid option are less certain and will be dependent on the level of work won by the IHP. Accordingly, any potential Capital Receipt is also subject to uncertainty.

Potential Redundancy Costs - Audit Commission (at Feb 2011)

	Number of Staff			Redundancy Costs (£'m)					
Staff - by level	**LG**	**NHS**	**Total**	**Max.**	**LG 1**	**LG 2**	**LG 3**	**LG 4**	**NHS[1]**
Field Staff									
District Auditor/Engagement Lead									
Senior Audit Manager									
Audit Manager									
All other audit staff (inc. trainees)									
Total Field Staff	**538**	**220**	**758**	**54.4**	**-**	**-**	**9.7**	**15.4**	**15.8**
Audit Practice Management									
Leadership Team									
Dir. Professional Practice									
Advisory and Assurance									
Support Staff									
Total AP Management	**111**	**46**	**157**	**10.6**	**7.5**	**7.5**	**7.5**	**7.5**	**3.1**
Audit Practice Total	**650**	**265**	**915**	**65.0**	**7.5**	**7.5**	**17.2**	**23.0**	**18.9**

1 NHS PCT audits expire in April 2013 with GP Consortia contracts starting after this date.
Assumptions:
• The maximum redundancy liability for the Audit Practice is estimated at £65m, as calculated by the Commission.
• The volume of NHS auditor redundancies is dependent on the ability to outsource PCT audits. Due to the expiry of these audits in 2013 it is assumed by the AC that all NHS auditors will be made redundant.
• It is assumed that all support/management staff will be made redundant.

Redundancy costs

- As detailed previously, the maximum potential redundancy cost of the in-house audit practice has been estimated at £65m by the Commission, as shown on the table above, including approximately £54m connected with field staff and approximately £11m connected with IHP management and support staff.

- The level of redundancies will largely be determined by the IHP's ability to win work as an independent supplier in the private sector during the Outsourcing process.

- As a result, it is assumed that the majority of IHP management and support staff would initially remain in place, however IHP's success at winning audits will determine the level of field staff that would be made redundant. Conversely, to the extent that it loses contracts to private firms, it would reduce headcount via TUPE transfers, thereby removing (or at least reducing) the need for redundancies.

- However, it should be noted that redundancies may increase further over time in both field and central support levels, depending on IHP's success at winning future work, whether IHP management intends to reduce headcount (e.g. £5-7m savings targeted under the Employee ownership model) and its ability to operate independently in the commercial sector on a profitable basis prior to completion of any sale.

- In the event of a significant period between the outsourcing process and the subsequent sale of the business, it is possible that additional redundancy costs might be incurred. Therefore, it is our opinion that the redundancy liabilities under this scenario could potentially be somewhat higher than the Outsourcing option.

Financial forecast

- In the financial forecasts developed by IHP management under the Sale option, it is assumed by the IHP management that 35% of the market would be retained.

- We consider that our comments in relation to the risks of winning 35% market share in the sale option apply equally in this option.

Potential implementation process

The Hybrid option will take longer than Outsourcing, combining both an outsourcing tender process with a subsequent sale process targeted for completion in 2015.

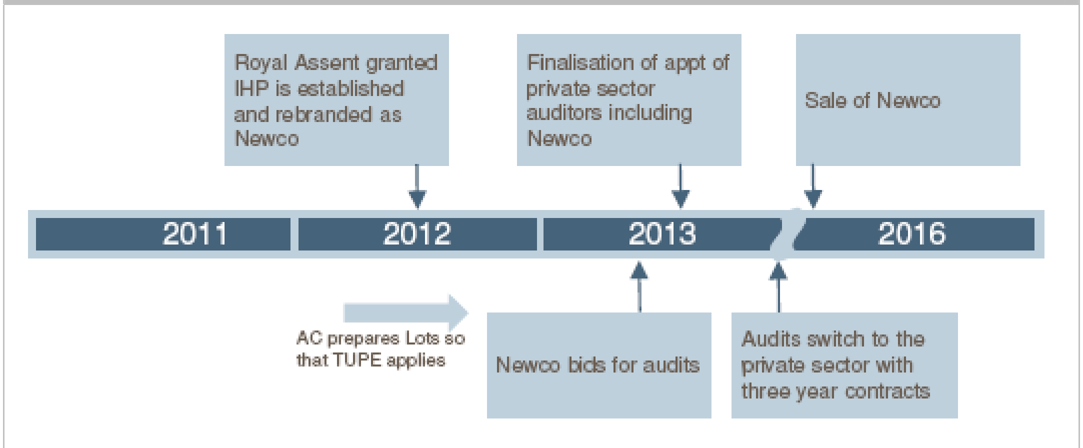
Outline Procurement Timetable as per AC

	2012/13	2013/14
1. Setting up and design of procurement process	2 mths	
2. Procurement process (EU procurement regulations apply)	6-7 mths	
3. Consultation period	5 mths	
4. Finalisation of appointment		1 mth

The Commission estimate that the procurement process can be completed in a period of 14 months.

Source: *Transfer of Audit Practice: Practical Implications of outsourcing (8 April 2011)*

Potential illustrative timeline



Source: *Transfer of Audit Practice: Practical Implications of outsourcing (8 April 2011)* and *Future of Local Audit – Audit Practice Work stream (April 2011)*

Process

- The process that would be followed is a combination of the Outsourcing and Sales options detailed previously.
- First of all, the IHP would be run at an arms-length basis during 2011/12 and following legislative approval, would be established as a Government owned Newco shortly thereafter.

- Based on the Future of Local Audit paper produced by DCLG, under the Hybrid option, Newco would be able to tender for work for audit years 2014/15 to 2016/17 (assuming three year contracts) in respect of the 70% of audits currently carried out by the IHP, at which time, Newco would bid for the Lots as an independent provider in the private sector.

- On the basis of Lots won, Newco employees would either be TUPE transferred to the successful private sector firms, retained by Newco, or made redundant (costs borne by HMG).

- Newco would then be in a position to operate on an independent basis and would be valued on the basis of contracts won ahead of a potential sale following completion of the tendering process.

- It is anticipated that a sales process would be conducted during 2015, however this may be delayed as a result of the procurement process and Newco’s performance operating as an independent firm.

Advantages and disadvantages

The Hybrid option seeks to balance the potential gains and liabilities of the Outsourcing and Sale options, however there is a high degree of uncertainty and inherent risk to the process.

Criteria	Advantages	Disadvantages / Key Risks
Redundancy cost	• Redundancies under this scenario may be similar to or marginally higher than Outsourcing option due to the ability to TUPE transfer staff to private bidders if the Newco is unsuccessful	• Redundancies will be driven by the extent to which IHP is successful winning work creating a large degree of uncertainty
Capital receipt(s)	• Opportunity for a capital receipt, although the quantum of which is unknown	• A successful sale is based on Newco's ability to win work and the private sector's appetite and financial ability to acquire the IHP
Market	• Market capacity retained - avoids loss of expertise that would result from straight dissolution • Allows for (but does not guarantee) entrance of a new player into the audit market. • Would allow for the possibility of a reduction in audit fees, dependent on market forces.	• Given that the public sector accounts for less than 10% of the total audit market in the UK, it is unlikely that the addition of a new market entrant will have a significant impact on overall competition.
Employees	• Appears to be better than Sale option given that employees would retain their jobs via TUPE to private sector or being retained in Newco structure • Possible management and employee owned company could be formed to bid for contracts	• Redundancies will still occur and will be largely driven by Newco success in winning contracts during outsourcing process
Timetable	• The Government would be able to demonstrate that the process is underway, whilst reporting on progress and defined milestones based on outsourcing strategy	• Procurement regulations followed by a sales process determine a lengthy process which is unlikely to be completed until 2015 at the earliest
Execution risk	• N/a	• Combination of Outsourcing and Sale means this alternative is more complex and subject to a higher degree of delivery risk.

VI. Other Options

Other options

Other options include a dissolution but this would entail high redundancy costs and likely loss of market capacity. DCLG has been advised that an immediate sale is precluded by EU procurement law.

Dissolution

- Under this option the Commission would be closed down (or at least the entire IHP element thereof). This would entail redundancy for all of the 758 field staff of the IHP as well as the 157 remaining IHP management and administration staff with redundancy costs of approximately £65m incurred, as calculated by the Commission (assuming an average cost of £71k per head). These costs would be borne by the taxpayer.

- In future, local public sector bodies would choose their own auditor and this function would be performed by private sector firms - including (but not necessarily limited to) the 5 main firms currently providing this function in England.

- This option would have the benefit of structural and legal simplicity and should therefore be relatively rapid to implement, subject to any necessary legislative approval.

- We understand that the existing audits between the Commission and the private sector firms would need to be terminated but this could be implemented without additional cost. We have not seen legal advice confirming this situation.

- There would likely be an uneven impact on the staff of the IHP with some benefiting from redundancy payments then getting jobs (some perhaps with private sector audit firms) but others then finding it difficult to obtain jobs in the private sector.

- Under this option, there would be a likely loss of market capacity as a significant proportion of the skills and experience built up within the IHP were lost to the local public audit market. All other things being equal, this would likely have an upward impact on audit costs.

- The value is largely driven by the audit contracts, however to the extent that there is intrinsic value in the IHP, this would be lost to the taxpayer. Some compensatory gains might be picked up by the private firms that recruited staff and benefitted from the additional audit revenues.

- This option would clearly not provide a new player into the audit market and therefore would be unlikely to generate any significant increase in market competition.

Immediate sale

- It would in principle be possible for HMG to conduct an immediate transfer of the current audits and staff into a new company (Newco) owned by HMG, with a view to this company being sold to private sector firms as soon as practicable.
- However, we understand that this would contravene EU procurement law as the Government can not transfer work to a company with a view to sale unless that company has won that work in competition. We understand that DCLG have previously taken legal advice on this.
- Accordingly we understand that procurement law dictates that, absent a fresh competitive tender process, the Commission / DCLG could not sell the Newco until after the transitional period of directly awarded audits, thus delaying any capital receipt.

Two-stage approach

- An alternative approach could be to sell a minority share of the IHP to a strategic partner followed by a subsequent sale at a later date of either of the remaining majority shareholding or 100% of the share capital.
- In the event that it were considered practicable from a legal perspective to sell a minority stake in an IHP Newco as the first part of a two stage process, we consider that there would be commercial disadvantages to so doing. The principal disadvantage would be that once an external strategic or financial investor had taken such a stake, it would be hard to ensure that value was maximised on the eventual sale of the remaining shares. This is because the initial investor may be able to exercise its influence to prevent, frustrate or restrict an open competitive sale process to third parties.
- DCLG would therefore have less ability to plan, control and execute a full competitive sale process in the manner of its own choosing. In extremis, the risk would be that a situation was created where the only realistic buyer for the remaining shares was the initial investor.

Alternative Mutual

- In the discussions we have had, the “mutual” option has referred to an employee owned IHP. An alternative mutual concept would be to have an IHP owned by public sector bodies themselves. In addition to complexity, this would not result in a full transfer to the private sector and would give rise to potential conflicts / risks to auditor independence and so we have not explored this further.

Status quo

- Whilst the current status quo is a potential theoretical alternative, it is beyond the scope of our work and clearly will not meet Ministers stated aims and objectives. Accordingly we have not analysed this option.

VII. Market Considerations

Our approach

Our approach to the economic assessment comprised desk research, stakeholder consultation and analysis. In conducting our work, we considered a number of key issues relevant to the scope of the options to be assessed.

Our approach in relation to market considerations comprised:

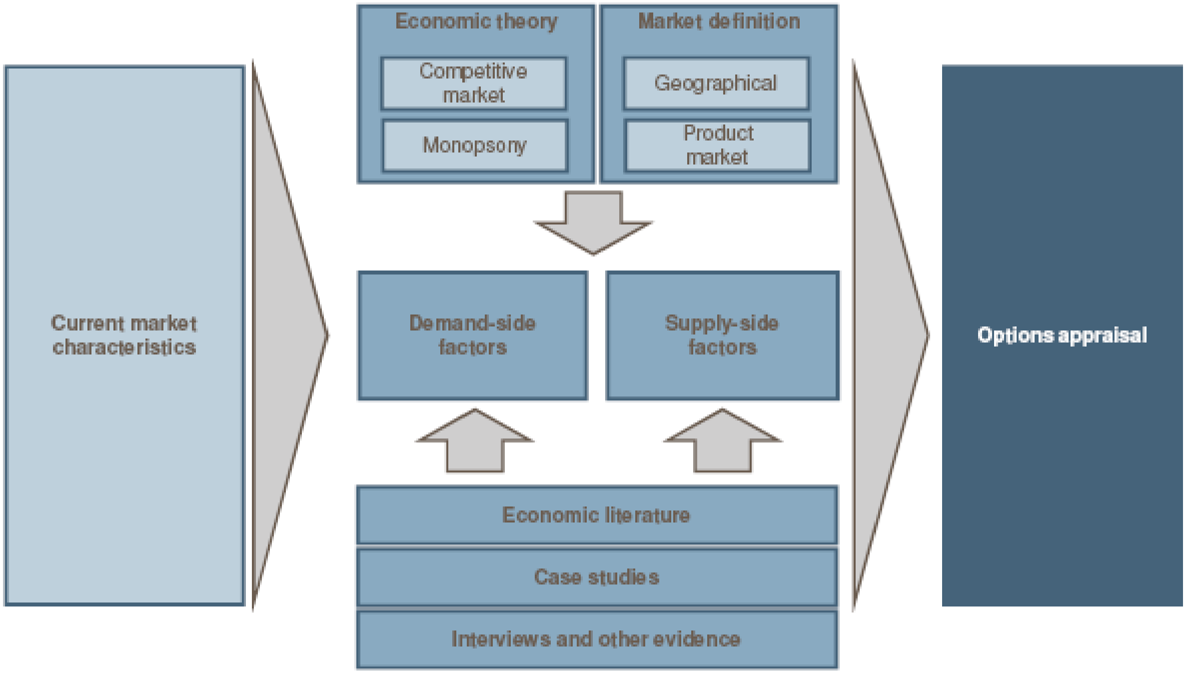
- Review of documents provided by DCLG and the Commission (including working papers on options; the Commission's options assessment, medium term financial plan and financial models and the consultation on the future of local audit).

- Review of relevant literature on competition in audit markets (e.g. market studies such as Oxera's "Competition and choice in the audit market", academic papers on audit markets, including the market for public audits in the UK and overseas, submissions to the DCLG Select Committee on local audit, specific submissions to the European Commission consultation on audit and the House of Lords' consultations on audit).

- The development of a high-level framework for analysis including:
  - an assessment of current market management and mechanisms;
  - consideration of market definition (product and geographic) i.e. local public bodies vs. the total public sector, national or regional etc;
  - appraisal of demand and supply–side factors including: what factors might influence local councils in making their decisions on who to hire, barriers to entry (in audit markets generally and in local public bodies market in particular), level of concentration, ease of switching, the likely behaviour of incumbent and potential new entrants;
  - an evaluation of the economic characteristics of the sector and the implications of the options; and
  - an understanding of how the options may have differential effects.

- Analysis based on our economic framework, relevant literature and interviews with stakeholders, including an assessment of the 30% currently out to 'market' segment and whether fees have been lower in the presence of contestability. Stakeholders consulted included representatives from councils, the Commission, CIPFA, Monitor, providers of audit services and competition experts (see list in Appendix).

- We note that our assessment is not a comparison of the market and fee levels today with those in the future; we are comparing competition and prices between the alternate futures. However, in order to do so, we need to understand how the market currently works and how it may work in the future (when LPBs procure audit services in the future).



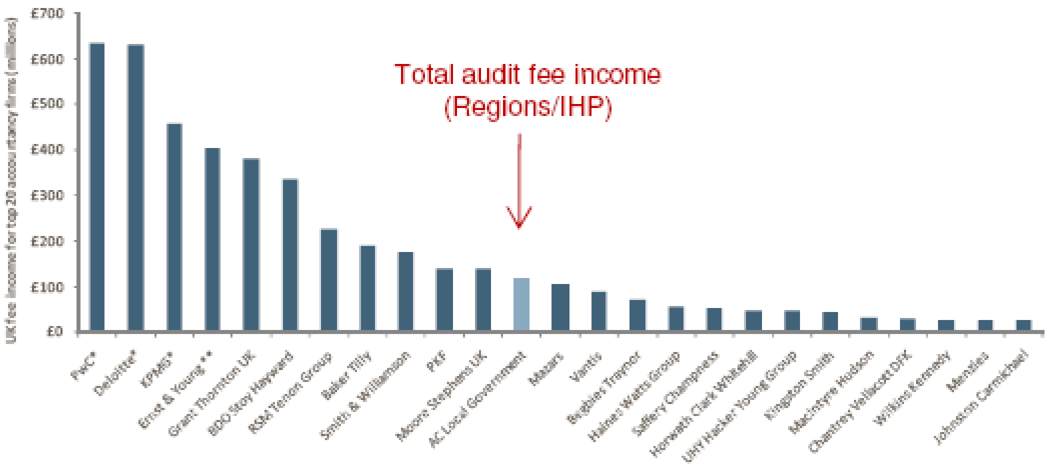
The principal issues that we considered included:

- Will the new market that evolves over time differ materially depending on the option that is chosen, both in the long-term and during the transition?
- How might the demand side evolve under different options (i.e. the behaviour of local public bodies purchasing audit services directly)? How might this affect competition and price?
- How might the supply side evolve under different options (i.e. the behaviour of suppliers of audit services)? How might this affect competition and price?
- Are any of these issues likely to depend on what the government decides to do in reforming local public audit rules, scope etc?

Overview of current market

The development of the wider audit market has been characterised by consolidation and an increase in concentration. Market concentration is highest amongst large companies in the UK audit market.

UK income for accountancy firms and Audit Commission (2010)



** Only audit income included for PWC, Deloitte and KPMG; Source: Accountancy Age, PwC, Deloitte, KPMG*
*** E&Y assurance income includes statutory audit, accounting advisory, forensics and other assurance services. Source: E&Y*

- The global audit market has been characterised by consolidation and an increase in concentration since the 1980s. Since the collapse of Arthur Anderson in 2001/02, the then “Big 5” audit firms have reduced to the “Big 4.” This is the same in the UK audit market.

- The Big 4 are larger than their mid-tier and smaller competitors in terms of revenue and client base. The Big 4 audit 99% of the FTSE 100, of which PwC is the biggest, with 41 clients. BDO is the only other firm with a FTSE-100 client. Overall KPMG has 391 listed audit clients in the UK, ahead of PwC on 332. Outside of the Big 4, Grant Thornton has the largest number of listed audit clients with 271. Grant Thornton is the biggest auditor on the AIM market with 186 clients, ahead of Deloitte on 152.

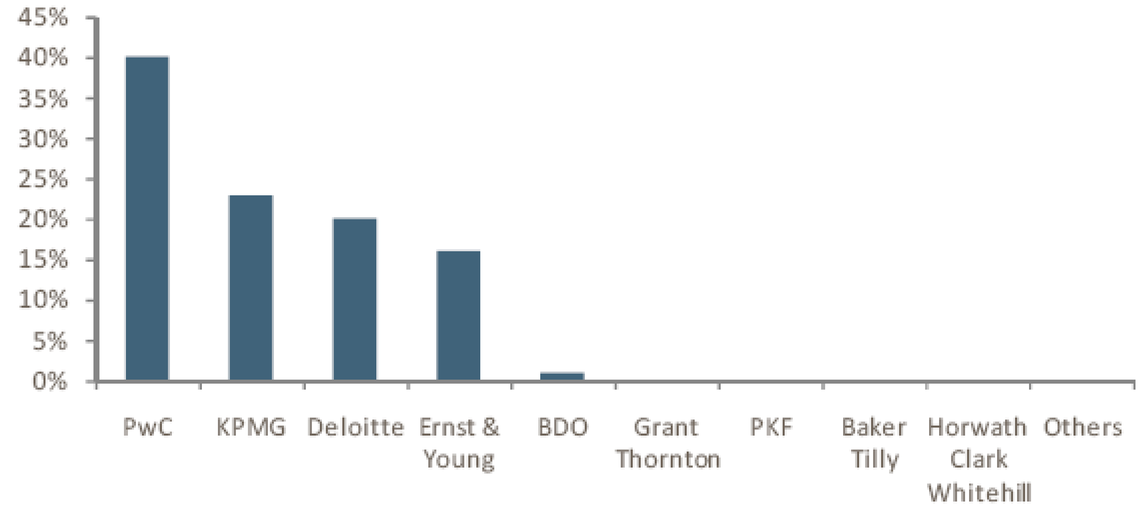
- As the figure above shows, the size of the Commission’s audit fees place it as the twelfth largest of the audit firms in the UK.

Observations

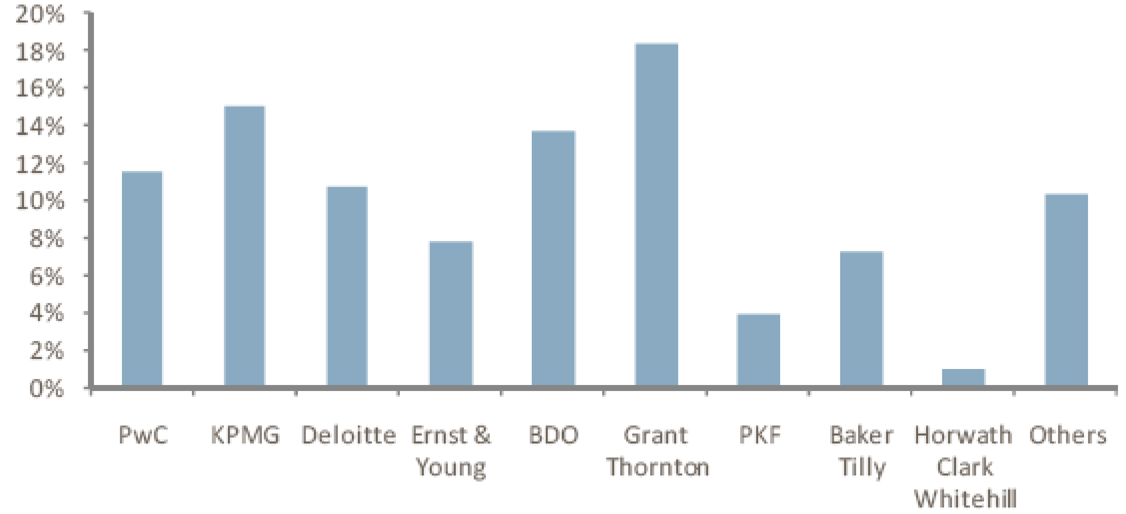
- The FSA’s Financial Risk Outlook (2007) states “A market with three or fewer audit firms would be unsustainable in the medium term … sufficiently serious to pose a risk to the smooth functioning of the financial markets.”

- The Commission's management of the LPB market appears to have helped avoid the degree of concentration seen in the FTSE 100 audit market.

Market concentration – FTSE 100 (2010)



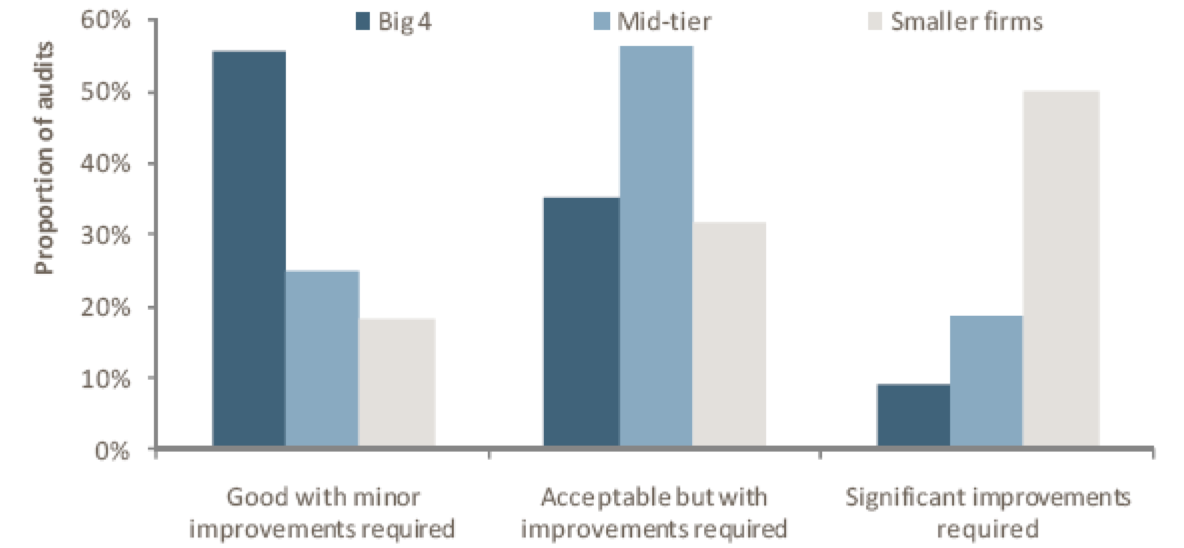
Market concentration – AIM (2010)



Source for both FTSE 100 and AIM figures: Appendix C, Memorandum by the Financial Reporting Council to House of Lords Economic Affairs Select Committee.

The size of the market for public sector audit is c. £175m per annum, around 10% of the overall audit market.* Private sector firms currently provide around 30% of this; the remainder is conducted by the Commission. Market structure is determined by, amongst other factors, quality.

Private Sector Audit quality – FRC inspection results (2009-10)



Source: Appendix B, Memorandum by the Financial Reporting Council to House of Lords Economic Affairs Select Committee.

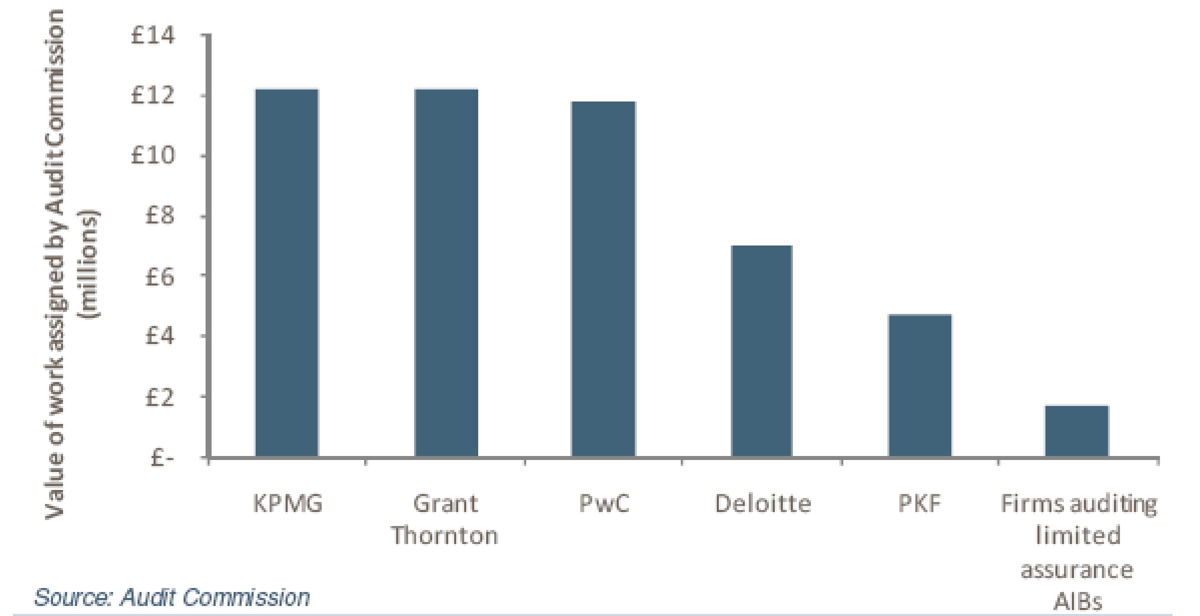
- Compared to the mid-tier firms (Baker Tilly, BDO, Grant Thornton, Horwath Clark Whitehill and PKF), the audit quality of the Big 4 is higher in the private market. According to the FRC inspection results. “Smaller firms” that have the worst quality record include those firms that audit between one and ten public interest entities.

- In addition to three of the Big 4 auditors**, mid-tier firms such as PKF and Grant Thornton also provide LPB audit services on behalf of the Commission. Grant Thornton is a major player, having purchased Robson Rhodes in 2007 to “boost...efforts to break down those market perceptions which would not naturally associate Grant Thornton with the larger public audit market” (CEO Michael Cleary).

- The Commission has also employed smaller firms such as BDO, Clement Keys, Mazars and Moore Stephens for regional contracts for audits such as forlocal parishes. They carry out 70% of small audits, with the remaining being conducted by the IHP.

**Excluding central Government audit. ** Big 4 includes PwC, Deloitte, Ernst & Young and KPMG. In the LPB audit market, Ernst & Young pulled out several years ago. We refer to the remaining firms as the “Big 3.”*

Value of audit fees commissioned by Audit Commission (2010)



Source: Audit Commission

Observations

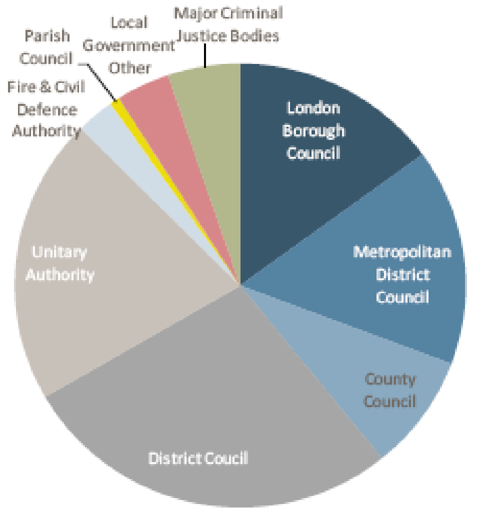
- Academic literature (see Appendix D) and other sources, show that the Big 4 charge higher audit fees than other firms in the private market because of the higher perceived quality of their audits. The reputation of Big 4 firms stems from this perception which, in turn, increases barriers to switching to a mid-tier firm of lower reputation. The figure above left shows that quality is indeed higher at bigger firms. This market characteristic may also be present in the LPB market.

- Although KPMG, Grant Thornton and PwC have similar market shares, geographical splits can be very different. For example, Welsh language audits are required in North Wales, which mean firms without Welsh speakers do not operate in that part of the country. In 2007, for example, it was recommended to the Commission Board that Deloitte was awarded contracts mainly in Northern and London areas, whereas KPMG awards were more evenly distributed across the country.

- During the Wales Audit Office (WAO) procurement process in 2006, Robson Rhodes was due to be chosen as the preferred third supplier, alongside PwC and KPMG, when they merged with Grant Thornton.

The highest fees come from larger authorities, which are considered the most attractive audit engagements. Indicative evidence suggests that pricing of audits in the public sector may be lower than private sector audit markets.

Total planned (2010/11) and average (2008/09) audit fees



Average Audit Commission audit fee (2008/09)	
London Borough Council	£261,254
Metropolitan District Council	£229,941
Unitary Authority	£183,097
County Council	£180,790
District Council	£75,242
Fire and Civil Defence Authority	£65,189
Transport Executive	£63,955
Police Authority	£58,347
Transport Authority	£48,036
Waste Disposal and Regulation Authority	£34,017
Probation	£21,433

Source: Audit Commission

- The total audit fees for the c. 9,800 public bodies with income or expenditure of £1m or less is £2.5m, or just over 1% of the Commission's income. These smaller audits are typically not conducted by the larger audit firms.
- To participate in the market, firms need specialist public sector auditing skills. For example, 44% of Commission staff are CIPFA-qualified, which is the professional audit qualification focussed on public sector audit. 15% of staff are, however, ACCA qualified, which is a professional qualification also suited to the private sector. To work in the NHS Foundation Trusts market, a CIPFA qualification is not needed.
- The Commission has had a significant role in setting fees historically. This has included a consideration of price changes in the private sector.
- We were informed by the Commission that its procurement exercise in 2006/07 realised savings of £30m over five years. Further, the Commission renegotiated these contracts in 2010, which are estimated to have generated savings of c. £11m through to 2016/17.

Audit fees – Audit Commission vs. FTSE (2008/09; exc. outliers)

Source: Audit Commission

- Data from the Commission suggest that audit fees charged by the Commission for audit opinions are lower than the fees charged in similar-sized organisations in the private sector. The underlying data exclude outliers, and the split between Use of Resources ("UoR") fees and opinion fees is not available.

- There may be a number of valid reasons for this difference, and the Commission cautions against using these data to draw firm conclusions about the current audit market, because of changes, for example, in the approach to local Value for Money ("VfM") work from 2009/10. They nevertheless provide a useful directional indication of the variance in fees between the public and private sectors.

Observations

- London bodies, unitary authorities and county councils are bigger, more complex clients that pay significantly higher fees. They are also more profitable for large audit firms. Smaller firms tend to carry out audits of smaller bodies, which is a scenario that could persist regardless of disposal option chosen.

- According to Prospect, the cost of auditing FTSE 100 companies has risen by 121% since 1997. According to the Commission, LPB audit fees have increased 31% since 1999.

Proposals for the future of local public audit

The changes proposed in the DCLG consultation "The Future of Local Public Audit" are independent of the option chosen for privatising the Commission's IHP. They may, however, have different impacts on competition in each option.

Key points from DCLG consultation process	Key considerations
Changes in income thresholds: All LPBs with an income/expenditure of over £6.5m would be required to appoint their own auditor. Bodies with income/expenditure of £1m-£6.5m would be subject to independent examination rather than a full audit. **Some will no longer be subject to audit**: Bodies with income/expenditure lower than £1m would not be subject to external examination or audit. The total fees for this last sector are £2.5m, or just over 1% of the Commission's income.	**Procurement costs**: These will increase if individual LPBs look for audit services individually. Running a procurement process will entail costs for all relevant local bodies, unless there is "demand aggregation." If demand is aggregated, larger councils may regard part of the aggregated fee as subsidising smaller, less profitable audit bodies. If instead there is "procurement aggregation," LPBs could run a joint procurement process, saving the procurement costs, but inviting individual prices from firms. **Market will be potentially segmented**: If neither type of aggregation occurs, smaller LPBs will face high procurement process costs in an already relatively unprofitable sector for the Big 4.
Independence: The auditor must be appointed in an independent manner probably on the recommendation of an "audit committee" that is independent of the authority. The final decision may though rest with the Council.	**Recommendation criteria unclear**: Not clear on what basis audit committees would recommend auditors. Some may be more likely to focus on reputation, and others on price and perceived quality. As auditors build up relationships with local bodies, there is a risk of 'capture' by the auditors. If councillors take the final decision then reputation may be a stronger determinant. Lessons from opening up market for NHS Foundation Trusts may not be applicable, as the Trusts have financial reporting procedures more comparable to those in the private sector, and therefore expertise to deal with this issue.
Term limits: Any firm's appointment must be limited to a maximum of two consecutive 5-year periods with a tender after 5 years.	**Added expense and uncertainty**: Likely to increase procurement and tender costs. However, given the relatively long time period (10 years) of relatively low-risk fees, these costs may be easily absorbed by firms. However, from the LPB perspective, the market segmentation argument may remain. NHS Foundation Trusts, for example, do not currently have tenure limits.
Scope of audit: There are several options for the scope of the audit regarding VfM, which may increase or decrease the current scope.	**Impact on barriers to entry**: Increased scope may increase barriers to entry as private sector auditors not able to transfer into LPB audit market as easily.
Liability: Local authorities should individually agree liability limitation arrangements whereas the Commission currently indemnifies auditors for the costs they incur where they are engaged in litigation arising from the exercise of such powers.	**Increased risk**: Increased liability will make LPB audit riskier.
Supervisory role: The FRC becomes the supervisory body for local public audit, with responsibility for monitoring quality.	**Risk for Framework and Regulator**: An overseeing role is required so that councils can choose auditor freely, switch more easily and avoid having to use price as a guide to quality.
Public involvement: The public may no longer be allowed to make individual complaints but will be more involved in the selection of auditors, including being able to make representations to this committee. All expenditure over £500 must be published.	**Auditor of last resort**: Councils that are conflicted, procure advisory services from several audit firms, have had issues with local objectors in the past or are in geographically remote areas are likely to find it difficult to procure audit services in a free market. They may otherwise be faced with higher fees.

Impediments to market entry and growth

Major barriers to entry and other 'imperfections' exist in the wider audit market. Many of these would also apply in the LPB audit market.

Why the general audit market does not have rigorous competition (based on OFT response to House of Lords Committee 24/10/10)	Which factors also likely to apply to audit market for Local public bodies	Commentary
'Established reputation' is a key factor in auditor choice: Because it is difficult to differentiate quality, companies select auditors on the basis of established reputation, which discriminates against mid-tier firms.	Reputation likely to be important for similar reasons; also some desire not to go for lower tier firms than neighbouring rivals.	New/smaller players disadvantaged.
Limited switching of auditor: Fees are small in relation to companies' overall finances, therefore demand is price inelastic. Owing to asymmetric information, it is difficult to distinguish between audit offerings. Possible negative signal to shareholders of switching auditors.	Similar resistance to switching although DCLG consulting on mandatory switching after 5/10 years.	Mandatory switching may open up some possibilities for new players. However, economic literature says mandatory switching leads to higher short-term costs. Oxera's (2006) survey of 50 audit committee chairs found management time and tendering costs involved was the most significant factor in discouraging switching of auditor.
Large firms want audits conducted by firms with extensive international networks: As a result it is difficult for those outside the Big 4 to enter the market – requires a significant step-change.	Nor relevant in this market although larger councils may want audit firm that has audited other large councils.	Large councils unlikely to procure from small players.
Industry knowledge, specialisation and the ability to provide additional professional services often valued: Difficult to enter local government audit market if not already present because of specific professional technical expertise requirements. Entry barriers for those outside the Big 4.	Firms need expertise in local public services - even more so the wider the scope of the audit (i.e. VfM audits).	Managed "apprentice" approach has worked historically to bring in new entrants, for example, PKF. This mechanism will not exist in the future.
Investment requirements: The cost of capital is higher for mid-tier firms because of ownership restrictions and the impact of corporate structure.	Barriers to expansion also difficult in this segment.	New provider through Newco would be on a similar scale to mid-tier firms.
Audit liability insurance: Large audit firms are able to absorb liability claims and respond to objectors on large engagements more easily than mid-tier firms.	Commission currently provides liability insurance for £10m, which would be lost under sale or outsourcing.	Likely to lead to concentration.
Rules regarding the provision of non-audit services: For example, restrictions on the ratio of audit to non-audit fees and stringent Ethical Standards for Auditing Practices Board on maximum level of fees an audit firm can receive from a single client (10% for listed, 15% unlisted companies).	Rules depending on outcome of DCLG consultation may have implications.	This may have a significant implication on the size and make-up of lots, as well as a potential employee-ownership model. Lots would have to be large enough for this constraint not to apply. New/smaller players would be disadvantaged.
Ability to spread bid overhead costs: Economies of scale, scope and market expertise.	Difficult to provide audit services absent regional 'centre of excellence'/lack of critical mass and if bid costs are high.	Potential barrier to effective competition from small firms.

Summary of principal market characteristics

We summarise the principal market characteristics that will determine the impact on competition and pricing once the IHP is privatised and LPBs are free to select their auditor (independent of the Option selected).

Feature	Current	Future	Commentary
Market mechanism and pricing	Managed market with an effectively regulated price based on the costs of the Commission.	"Free" market; prices determined by the extent of competition.	Evidence, for example Oxera (2006), suggests that higher concentration associated with higher prices.
Minimum efficient scale	Minimum scale of revenues required to attract the supply side owing to training and investment costs.	Minimum scale of revenues required to attract the supply side owing to training and investment costs - now more important barrier as market less managed so risk of losing contracts post investment higher.	Total market scale may be sufficient to support several participants in the short term. There may be consolidation in the long-term, depending on the Option selected and size of Lots in the outsourcing option.
Returns	Low margin but secure revenue stream with limited risks.	Margins dependent on competition, so may vary by contract area and size of LPB; secure revenue stream; increased risk.	Unlikely that returns will increase substantially attracting new entrants. Aggressive pricing by major incumbents possible in the short-term.
Barriers to entry	Some barriers to entry as this is specialised work (for example, CIPFA qualification required).	Some barriers to entry as this is specialised work (for example, CIPFA qualification required).	New entry remains difficult all other things being equal.
Switching	Incumbency benefits important.	Incumbency benefits important.	No inherent feature of market for public body audits to suggest that significant switching will occur owing to nature of product, except for small bodies, which will be most price sensitive.
Brand	Reputation important for medium and large public bodies.	Reputation important for medium and large public bodies.	Tendency for Big 3 (plus Grant Thornton) to secure medium and larger audits.
Market structure	70% Commission; 30% private sector supply comprising Big 3, mid-tier and small firms.	Dependent on option in the short to medium term. Total market unlikely to comprise only Big 3 (plus Grant Thornton) as mid-tier and smaller firms already active. But segment for larger public bodies may tend towards Big 3 only.	Regulations on the amount of advisory work permitted by auditors together with the threat of competition authority investigation likely to deter Big 3 players from wanting to secure excessive market shares.
Market segments	Currently on a regional basis. Audit Lots combine small, medium and large public bodies.	Depends on how local public bodies procure audits. Could segment into small, medium and large public bodies.	Tendency for Big 3 to gain proportionately larger increases in market shares of larger public body audits (subject to countervailing forces as per cell above). Supply limited for remote, very small, or highly risky public bodies.

Demand-side factors

The most important factors in influencing the choice of auditor for an LPB purchaser are reputation, quality and price. Additionally, inertia and familiarity appear to play a part.

Factor	Case for this being a significant factor in influencing choice of auditor	Case against this being a significant factor in influencing choice of auditor
Brand / reputation of audit firm	• Reputation is one of the most important determinants of audit appointment. Safe option and higher perceived quality. • Rational response to lack of understanding or knowledge (asymmetric information) on quality.	• Price will dominate (in some market segments). • If there is an assurance of quality (for example, a framework agreement) LPBs can choose based on VfM. • Quality, rather than reputation, is key.
Avoid firms with reputation for being critical	• Councils likely to choose firm that is less critical in its audit, especially financially '"difficult" councils. • In the NHS Foundation Trusts market, possibly because of both the appointment process and reduced scope of audit, there have been no Public Interest Reports (PIRs) since 2008.	• Audit committee unlikely to select auditor based on the same criteria as councillors (and unlikely to be over-ridden by councillors). • Section 151 Officer will want robust audit, especially in an economic environment of budget cuts.
Select Big 4 especially if need to, for example, raise capital or create joint ventures	• Third parties may be more confident if audit conducted by one of Big 4 because of reputational and quality factors.	• Unlikely to be an important factor for many LPBs. • No evidence that funders do not trust non Big 4.
Inertia and familiarity	• Councillors may prefer existing auditors who 'know their area/council' or already have an established relationship, as per submissions to the CLG Select Committee. • Switching costs are high.	• Audit committee unlikely to select auditor based on the same criteria as councillors (and unlikely to be over-ridden by councillors). • Likely to be mandatory audit firm rotation and term limits as per the DCLG consultation.
Try to continue to use district audit/employee-ownership model	• Some councils may want to avoid fully commercial players. • May be pressure from councillors in some areas to support an employee-ownership model.	• Audit committee unlikely to select auditor based on the same criteria as councillors (and unlikely to be over-ridden by councillors), • Price and VfM considerations may dominate.
Price	• Councils more price conscious in current tough financial times (if confident of regulation). • Increasing openness in council data and public accountability means they have to justify if not buying the cheapest audit services.	• May not trust original tender to be final price. • "Market for lemons" argument i.e. using tender price as an indicator of quality. New entrants who try to gain market share through low prices may be perceived as having low quality.

Supply-side factors

Supply-side factors are important determinants of effective competition. There are a number of factors that may influence audit firms' desire to enter or expand /bid keenly in the LPB audit market.

Factor	Case for this being an important factor in audit firms decisions	Case against this being an important factor in audit firms decisions
Profitability of audit	• Safe income stream. • Diversify income streams across public and private sectors.	• Low returns (relative to private sector audit). • Risks may increase once a 'free market' (for example as a result of limited liability requirements and associated reputation risk).
Supply additional services to this market	• Non-audit services relatively lucrative.	• Caps on level of non-audit fees. • Market demand currently constrained due to finance pressures. • Conflict of interest risk if providing audit and non-audit services.
Bid costs	• Commission procurement process keeps bid costs relatively low. • Bid costs will increase if procurement is conducted at individual public body level. • Bidding costs will be higher than for private sector (particularly large, listed, companies) because switching is much lower in that market segment. • Small providers may find it hard to put in bids for many councils simultaneously. 2-3 year contracts are likely to be prohibitively short for smaller providers.	• Likely to be some form of demand aggregation or procurement aggregation. • Bid costs likely to occur only every 5 years. • Larger firms can absorb costs more easily.
'Block' rivals from expanding	• Incentives to guard market share – especially from new entrants who might lever into private sector audit market.	• No real likelihood of a new entrant being able to gain critical mass because of higher cost of capital required, lack of expertise and qualifications for the private market (for example, ACCA rather than CIPFA), especially if Lot sizes are small.
Fears of attracting attention of OFT	• 'High' market share - OFT may intervene with unwelcome spotlight (even if not blocked in the end).	• Unlikely to have any impact on competition in the overall audit market because of different entry requirement for that market detailed above. • Not clear the OFT would intervene unless market share in LPB market rises significantly (for example, KPMG has only 7% currently).
Spread costs and risks	• Useful to have presence in public markets to help smooth out private sector troughs.	• Less important for Big 4 than mid-tier. • For those only in LPB sector, significant problem of seasonality of the work.

Likely to be strong competition which might include some loss-leader pricing, but firms with advisory practices will seek to balance their audit and non-audit market shares.

Possible future structures

Over time, there are a number of possible scenarios for the market structure. These are difficult to project with certainty.

Supply side	Remote public bodies	Small public bodies	Medium public bodies	Large public bodies
Auditor-of-last-resort	●	○	○	○
Large number of small competing providers	○	◐	◐	○
Mid-tier players only	○	◐	◐	○
Mixed market, similar to today's private sector provision	○	◐	●	◐
Big 3 plus Grant Thornton only	○	○	◐	●
Commentary	Remote public bodies unlikely to be served, especially if rules proposed in the DCLG Consultation are introduced.	Small public bodies most likely to be served largely by small providers with some mid-tier provision.	Mid-tier firms currently active in the medium-sized LPB market. Resistance towards switching may maintain market structure similar to today.	Mid-tier firms currently active in the market. Resistance towards switching may maintain market structure similar to today. Segment analogous to private market for audit – may tend towards high concentration.

Arrangements for an auditor of last resort may need to be considered for small, unprofitable audits, and large public bodies will probably be audited, in the long run, by the existing large players in the market, unless there is another large entrant.

● Probable ◐ Possible ○ Unlikely

Which is the best route to sustainable competition?

As a starting point, we consider an Outsourcing Option designed to get many new players into the market and a Sale Option to introduce just one large new player into the market. Numerous permutations in between could also be considered.

Option 1: Many new entrants in (via outsourcing)	Option 2: One large new entrant (via sale)
• Under current powers, the Commission would tender out to the private sector all the audit work currently provided by the IHP. • Under this scenario, audits would be awarded to private firms on the basis of set criteria defined by the Commission which would result in the employees being transferred to the firms on TUPE terms. Contracts would be bundled accordingly into geographical or mixed lots.	• It is envisaged that a phased approach would be adopted, ultimately resulting in the existing IHP being established as an independent, private company, competing with others in the market to perform the audits of the LPBs. • Management anticipates that this can be achieved through the establishment of a supporting financing structure and interim Government support through exercising a Teckal exemption which would provide a platform to transition the practice accordingly.
Arguments for this Option in relation to competition considerations • Get many new players in (through appropriate Lot size). • Reduces concentration and more diverse supply side created. • Firms have chance to entrench themselves and grow. • Could ensure competition is introduced across geographical contract areas as well as less profitable LPBs.	**Arguments for this Option in relation to competition considerations** • One big new player in (through sale). • Reduces concentration. • Allows bodies to choose among a wider set of firms. • Also possibly helps a little with concentration in private sector audit if the new player reaches critical mass.
Issues in relation to competition considerations • Maximising number of players does not necessarily lead to effective competition. • Will smaller players really compete for big councils? • No new player with the critical mass to provide effective competition to Big 3 (plus Grant Thornton)? • Over time, there may be consolidation as big players pick up contracts and market concentration goes back up.	**Issues in relation to competition considerations** • What if existing big player buys the business? Will OFT stop them? Can smaller player buy instead, or is employee-ownership possible? • At best Big 3 (plus Grant Thornton) plus one – concentration similar to FTSE 250 market. • Good for big councils but not enough mid-tier and small players to make smaller council market competitive. • Given that public sector accounts for less than 10% of the total audit market in the UK, this is unlikely to make any difference in private market (unless tips some marginal clients to looking again at former mid-tier if it is the new owner of the IHP).

Option 1: If market likely to tend to a few players this is only an interim position

Long run outcome may be the same under both options?

Option 2: At best, ensures another big player in the market, but still high concentration

The starting point/transition is important

In the long run outcomes may be similar irrespective of outsourcing or sale unless the original structure influences greatly the final 'equilibrium'. During the transition there may be significant differences for competition and prices depending on, for example, on the size and make-up of Lots in the outsourcing option and how demand is aggregated.

	Disposal options		Size of client	Transition	Medium-term		Long-term
	Outsourcing	Sale			Disaggregated demand	Aggregated demand	
Many new entrants (A)	✓	✗	Large	◕	◑	◑	• Same as option (B) or (D), depending on what degree consolidation occurs.
			Mid	◕	◑		
			Small	◕	◕		
Few large new entrants (B)	✓	✓	Large	◕	◕	◕	• Market concentration to Big 3 (plus Grant Thornton) plus one or more. • Possibility of OFT investigation. • Prices lower than in Option C.
			Mid	◕	◕		
			Small	◕	◔		
One large new entrant (C)	✗	✓	Large	◑	◑	◑	• Market concentration to Big 3 (plus Grant Thornton) plus one. • Highest possibility of OFT investigation if new entrant purchases all of IHT. • Prices lower than in Option D.
			Mid	◑	◑		
			Small	◑	○		
No new entrants (D)	✓	✗	Large	◔	◔	◑	• Possible further market consolidation to Big 3 (plus Grant Thornton). • Highest possibility of OFT investigation if any of Big 3 (plus Grant Thornton) purchase all of the IHP. • Prices higher than under options (A), (B), (C).
			Mid	◔	◔		
			Small	○	○		

✓ Preferred method

✗ Not preferred method

Very beneficial for competition ← → Not beneficial or uncertain

● ◕ ◑ ◔ ○

Evaluation of the options

Options appraisal for sale, outsourcing, hybrid summarising assessment of likely impact on competition, fees (short-term and long-term) and distribution of fees

	Outsourcing		Sale	
	Non-employee ownership option	**Employee ownership model**	**Non-employee ownership option**	**Employee ownership model**
Impact on competition	↑ Best option in short-term due to likelihood of several players being introduced to the market initially. ↔ Uncertain in longer term - possible move to concentration.	↑ Good in short-term. ↔ Uncertain in longer term - possible move to concentration.	↑ Good in short term depending on acquiring party. ↑ Good in longer run as may lead to sustainable competition.	↑ Good in short-term as adds a new player to the market. ↑ If model protected from takeover, could provide sustained competition in longer term. Competition may be higher if model retains nonprofit maximising approach.
Impact on competition: OFT interest	↑ Unlikely in short term (unless Lots large) but may be consolidation in the long-term.	↑ Unlikely (unless Lots large) but may be consolidation in the long-term. An employee owned firm would be a new entrant.	↓ More likely if Big 3 (plus Grant Thornton) purchase all or most of IHP and therefore seen to have excessive market power (most likely scenario). ↑ Unlikely if new entrant.	↑ If sale was to an employee-owned firm, unlikely to be competition issue.
Impact on fees: Medium-term	↔ Depends on size and make-up of Lots. If Lots small, and mid-tier players able to purchase, then good, but TUPE implications may impact. If Lots are large and only Big 3 (plus Grant Thornton) purchase, then low, or uncertain, impact.	↔ No positive impact on fees if LPBs not keen to employ a "new" player because perceived quality and reputation critical in audit appointments. However, some qualitative evidence from interviews suggests some large LPBs like idea of employee-ownership.	↑ Good in medium-term as compete away from new entrant. ↔ Commission expertise transferred to purchaser therefore possibly greater competition.	↔ No positive impact on fees if LPBs not keen to employ a "new" player because perceived quality and reputation critical in audit appointments. However, some qualitative evidence from interviews suggests some large LPBs like idea of employee-ownership.
Impact on fees: Long-term	↓ If smaller players absorbed over time, then long-term prices may be higher than short-term. ↔ If smaller players consolidate amongst themselves (unlikely), then possibly sufficient countervailing price-making power to maintain positive impact on fees.	↓ All health and LPB audits end at similar time – therefore significant issues with utilisation at other times in the year may increase costs. ↑↔ Depends on size of the employee owned firm. Large firm will be more likely to pursue bigger (more profitable) LPBs. Small likely to compete in less profitable market segment, therefore uncertain impact on prices.	↑ If new entrant survives, then positive. ↓ If consolidation over time, then long-term prices will be higher than short-term.	↓ All health and LPB audits end at similar time – therefore significant issues with utilisation at other times in the year which may increase costs. ↑ If new entrant survives, then positive. New entrant more likely to survive than if not employee-owned, if assisted by regulation in the medium-term. ↓ If consolidation over time, then long-term prices will be higher than short-term.
Impact on fees: Distributional impact	↔ Large LPBs may see more closely contested prices. Remote and smaller LPBs may see higher prices.	↔ Large LPBs may see more closely contested prices. Remote and smaller LPBs may see higher prices. Commission has more experience of smaller LPBs, therefore possible it competes more strongly in that market in short-term and long-term.	↔ Large LPBs may see more closely contested prices. Remote and smaller LPBs may see higher prices.	↔ Large LPBs may see more closely contested prices. Remote and smaller LPBs may see higher prices. Commission has more experience of smaller LPBs, therefore possible it competes more strongly in that market in short-term and long-term.
Hybrid	We understand that this option was put forward on the basis that it may reduce redundancy costs associated with the sale option whilst still allowing for a capital receipt. Short-term fees may be comparable with outsourcing if Commission staff leave to join Big 4 or mid-tier players. Uncertainty in the transition period could lead to detrimental impact on competition if LPBs choose quality and certainty of Big 3 (plus Grant Thornton) over employee-ownership model. Market capacity is retained because this option avoids loss of expertise that would result from straight dissolution.			

↑ Positive ↓ Negative ↔ Uncertain

Conclusions

Overall, maximising competition will be only one of the criteria upon which decisions will be made. Our analysis suggests that differences between the options is not clear or strong enough in this area to be the decisive factor.

We set out below a summary of our findings in relation to market considerations:

- To date the market for local public bodies audits has been managed by the Commission, which has managed both prices and firm selection.
- Fees charged appear to be lower than those charged to the private sector, and whilst this may reflect many factors, it is also consistent with economic theory – the Commission is a monopsony buyer. However, the Commission is also a public sector monopoly provider and theory suggests it may be less efficient than a private sector provider in a competitive market.
- The research and academic literature on audit markets provides some useful pointers but is not decisive. Much of the literature focuses on the private sector and/or overseas markets. The main implications are: higher auditor concentration leads to higher fees; brand/reputation is an important driver for choosing an audit firm; size, complexity and location are important drivers for audit fees; mandatory audit firm rotation may lead to higher audit market concentration; and there are significant barriers to entry, and switching, in the UK audit market.
- In respect of competition, there is a question as to how the OFT would define the market – which could be as narrow as LPBs in a geographical area or as wide as the whole audit market. The OFT may have concerns if there was a move towards replication of the structure of the private sector audit market.
- There are major barriers to entry in the market for audit services, particularly in the FTSE 100 and FTSE 250 segments and competition may be limited. Barriers exist because of brand/reputation, client inertia, scale and scope factors, amongst others.
- Many of these barriers to entry also exist in the LPBs audit market, and there are some additional ones, but overall barriers appear to be lower than for large companies' audits. Two of the main providers currently active in LPB audit are 'midtier' firms but this has been in the context of a managed market'.
- In future, the market is likely to be imperfect owing to both demand-side and supplyside factors. In respect of the demand-side, LPBs are likely to be guided by reputation, size and knowledge and not just price. On the supply-side the difficulty of new entry and of expansion limit the competition and contestability of the market.
- There are useful lessons from other markets. Experience in the NHS Foundation Trusts audit market since it opened up to competition suggests strong tendencies to concentration - but also fee reductions (at least in the short run).
- Stakeholders views are quite variable. While most see trends to concentration they differ on the impact on prices. Much also depends on, for example, what decisions are

made and how the market emerges in terms of demand aggregation, scope of audit, regulation.

Our appraisal of the options suggests:

- There is a potential tendency to concentration that will apply in all options. Since we know from other research that concentration in audit markets leads to higher prices over the longer run, that is something to be avoided.

- The OFT would be likely to be concerned if the LPB audit market moved towards further concentration for the 3 largest existing participants (i.e. the Big 4 less Ernst & Young) and the knowledge of that may constrain behaviour by the bigger players.

- The way that demand aggregates itself will be influential but may overall increase the tendency to concentration.

- There is a strong argument that the nature of the dynamics in this market will lead to concentration so that for the longer run it does not matter which option is chosen. We do not dismiss this view.

- The option of trying to create many small players through careful design of outsourcing looks more likely to lead to a number of weak players who will not survive in the medium-term in a free market.

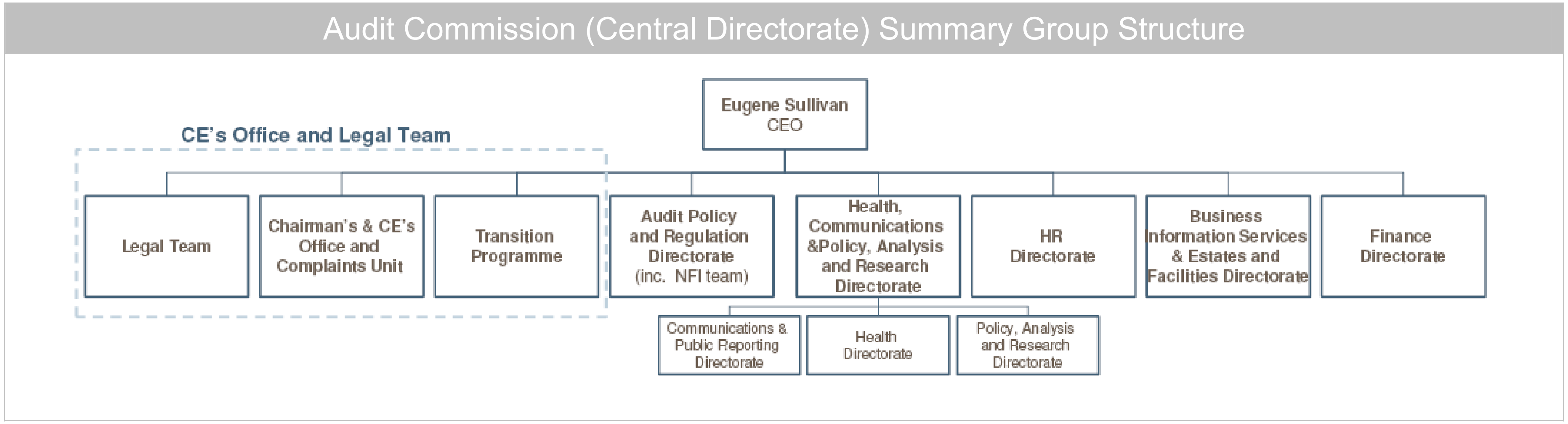
- Overall, maximising competition will be only one of the criteria upon which decisions regarding the transfer of the IHP to the private sector will be made. Our analysis suggests that the difference between the options is not clear or strong enough in this area to be the decisive factor.

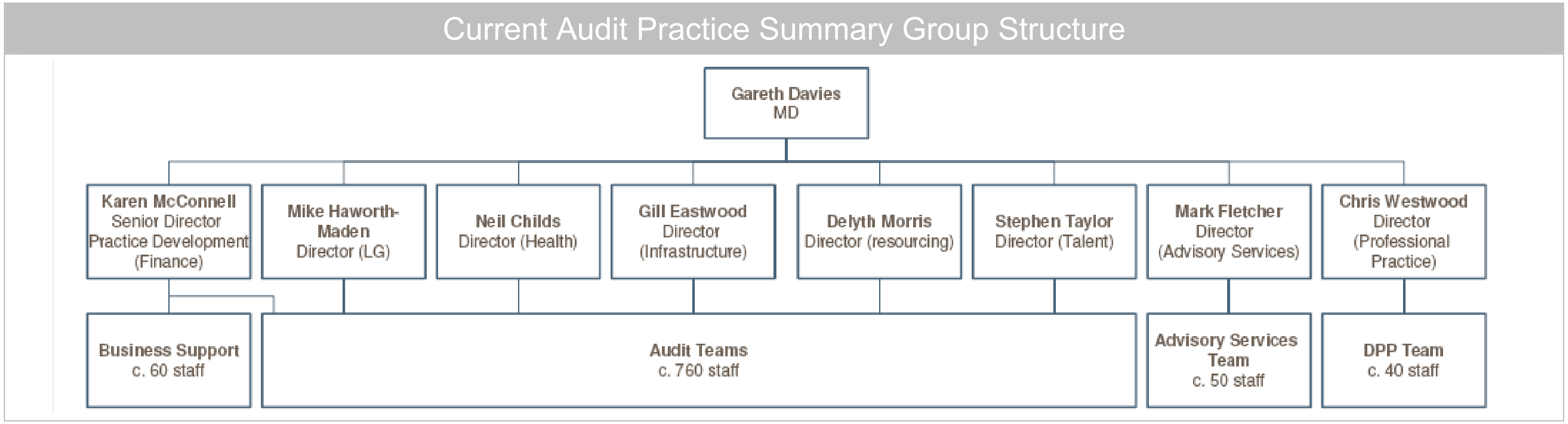
- We therefore consider that the focus in relation to competition / market considerations should be to avoid reinforcing the concentration in the wider audit market, in the absence of compelling reasons to the contrary. Maintaining or increasing competition should be one of the considerations but not the sole or overriding criteria in assessing the options.

- We consider that outsourcing is more likely to increase competition and constrain fees in the short term, principally because more players would likely be introduced to the market. In the long-run, there may be consolidation so the long term effect on fees is more uncertain however it is possible that a sale option may be more likely to lead to the creation of one or two substantial firms that can compete against the larger firms.

Appendix A: Group Overview

Audit Commission structure





Appendix B: Financial Position

Historical performance

The Commission has consistently managed the market to ensure a 70% share for the IHP. Fees have reduced in 2010/11 mainly due to the new approach to VFM. In addition, the Commission has returned income in the form of rebates.

Audit Commission - Profile			
	FY08/09	**FY09/10**	**FY10/11**
Employees (#)			
Audit Commission	653	681	403
IHP/Regions	1,290	1,302	976
Total	1,943	1,983	1,379
Market Share (%)			
In-house	70%	71%	69%
External	30%	29%	31%
IHP - Audits Performed (#)			
Local Government	411	399	382
NHS	201	186	183
Police	31	33	33
Foundation Trust	48	55	53
Other	19	13	12
Total	**710**	**686**	**663**
AC Income (£'m)			
Total Audit Fee Income (IHP/Regions)	123.9	125.4	115.4
Total inspection income (Firms)	52.2	50.1	51.7
Total inspection income	37.5	35.2	13.1
Total AC other income	2.1	2.4	3.4
Total AC Income	**215.7**	**213.1**	**183.6**
Audit Practice Contribution/Gross Margin (%)	44%	42%	39%
Audit Practice Contribution/Net Margin (%) (after support and overhead costs)	n/a	9%	8%

Audit Commission Profile

- The table above has been compiled by the Commission to provide a profile of the IHP and the Commission.

- The Commission has consistently maintained a split of local public audit market between the IHP and external firms of 70% to 30%.
- Approximately 64% (or £175.5m) of the Commission's total audit income for FY09/10 came from the local government sector including police, fire and rescue authorities. The balance came from the health sector.
- Grants received from central government departments (the majority from DWP) accounted for c.10% of the Commission's local government sector income.
- Income reduced in in FY10/11 following the in-year loss of c.£21 million government grant and inspection fees.
- Staff numbers have reduced significantly since FY09/10 due to headcount reduction and cost cutting measures in both the Commission and the IHP, with FTEs decreasing from c.2000 to approximately 1,400 in FY10/11. As a result, total salary costs for FY09/10 included redundancy costs of £5.3m.
- We understand from the Commission that a further £25m of redundancy costs have been incurred in 2010/11, with an additional £13m forecast through 2011/12.
- Further cost reductions are forecast in FY11/12 for the Audit Practice to improve net margin to 22% (from 8% in FY10/11) in order to attempt to make the IHP more competitive with external firms.

P&L forecast

The FY11/12 forecast for the IHP estimates total income at c.£112m, with a net margin of 41%. Recent cost reductions have been implemented to make the IHP more competitive with external firms.

Forecast Profit and Loss (FY11/12)

£'m	Audit	A&A	Total
Income			
Total Audit Income	96.2	-	**96.2**
Grant Certification	11.5	-	**11.5**
Advice & Assistance	-	4.3	**4.3**
Other Income	-	-	-
Total Income	**107.7**	**4.3**	**112.0**
Direct Costs			
Payroll	(45.9)	(2.9)	**(48.8)**
Contractors	(5.8)	(0.3)	**(6.0)**
Car & Travel	(3.8)	(0.2)	**(3.9)**
Accommodation	-	-	-
Computing	-	-	-
Other direct costs	(1.7)	-	**(1.7)**
Total Direct Costs	**(57.2)**	**(3.4)**	**(60.6)**
Gross Margin	**50.5**	**0.9**	**51.4**
Gross Margin %	*47%*	*22%*	*46%*
Other Indirect Costs			
Total Practice Support Costs	(5.6)	(0.2)	**(5.8)**
Total Indirect Costs	**(5.6)**	**(0.2)**	**(5.8)**
Net Margin	**44.9**	**0.8**	**45.6**
Net Margin %	*42%*	*18%*	*41%*

1. Audi Practice in place from 01/04/2011; however, budget accounts for staff serving out notice.
Source: Audit Commission

Overview

- The table above sets out the Audit Practice budget for the financial year running from 1 April 2011 to 31 March 2012.

- The IHP derives revenue from three main income streams:
  - audit from 70% market share (£96.2m);
  - grant certification (£11.5m); and
  - advisory income (£4.3m).
- The Commission plans to make rebates of up to £2m to ensure all audited bodies experience a net reduction of at least 2% on fees from 2010/11. These rebates are proposed to be paid in 2011/12.
- In addition to the proposed c£2m rebates, the Commission may be able to commit to a further rebate of £8 million, taking the total rebates in to at 10m. This is reported to be as a result of the savings achieved by restructuring the Commission. It should be noted however, that this is subject to confirmation from the NAO that no provision is required in 2011/12.
- The IHP aims to deliver a net contribution to the Commission of 22% (or 41% excluding costs to support the IHP provided by the Commission), an improvement of 14% on FY10/11 in an attempt to make the IHP more competitive with external audit providers.
- Cost cutting measures have included:
  - a reduction in senior management costs after moving to a national structure;
  - a lower cost skill mix after the departure of performance and inspection staff;
  - lower support staff costs following restructuring; and
  - savings in overheads from the Commission and other permanent savings achieved.
- There has also been no increase in basic pay and allowances within the forecast period.

Appendix C: Case Studies

Cumbria and Cornwall

The Commission has previously attempted to outsource audits for Cornwall and Cumbria including staff transfers. Interest was received from a number of external competitors; however, COSOP made the tenders uncompetitive.

Background

- In January 2010, the Commission agreed to carry out a procurement exercise in order to rotate the appointment of specific long-standing auditors at remote locations, i.e. Cornwall and Cumbria (equivalent to approximately 2% of market share).

- Audits were structured in such a way that the associated audit staff would TUPE transfer to the winning firm. This was the first time that an outsourcing tender had been conducted on this basis. Firms were asked to submit bids on the basis that TUPE (and COSOP[1]) both did and did not apply; however, the latter was only requested to enable the benchmarking of offers.

Process

- It was proposed that the audits would start in 2011/12 for a length of 5 years, with the option for the Commission to extend them for another 5 years. Audit sizes were between £450k - £850k.

- The Commission believed that Lots would need to be at a minimum of £2m to support one full-time partner and support staff across wide geographical areas. However, as appointments would be identified in advance in tightly defined areas, they smaller size was deemed acceptable.

- The Commission issued a Contract Notice inviting expressions of interest in May 2010 and nine pre-qualification questionnaires were received (including BDO, Deloitte, Grant Thornton, KPMG, Mazars, Moore Stephens, PKF, PwC and RSM Tenon).

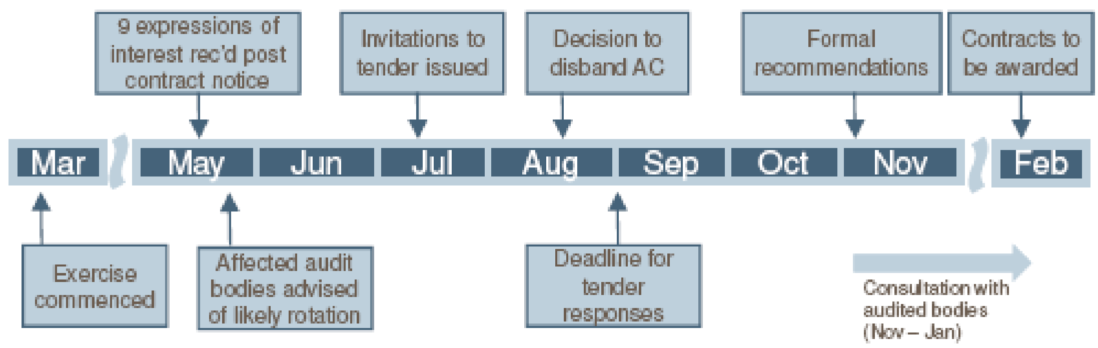
- Invitations to tender were issued to the nine firms on 16 July with deadlines for submission on 1 September (later extended to 28 September).

- Four responses to the ITTs were received from BDO, Grant Thornton, KPMG and PwC for both Cornwall and Cumbria. Deloitte submitted a tender for Cumbria only.

- Only two tenders were deemed to be compliant (Grant Thornton and KPMG).

1. Under COSOP, staff should be offered an actuarially equivalent pension to their existing pension arrangement, or be equivalently compensated by the firm if not.

Est. timeline on commencement of procurement (2010/11)



Source: Management information

Results

- The compliant tenders were deemed to be at a higher cost than the equivalent inhouse costs. The Commission has noted that COSOP has reduced the competitive nature of offers.
- The Commission therefore chose not to continue with awarding the audits to an external party as it was considered that VfM criteria were not met.
- It was felt that the announcement of the abolition of the Commission in August 2010 created uncertainty for prospective firms tendering for the audits and impacted the process as audits could not be guaranteed beyond the 2011/12 audit year. After the notification, four prospective firms withdrew from the process.
- In summary, we consider that pension obligations will be critical for future outsourcing processes. It is therefore essential that DCLG seek advice and clarity regarding COSOP implications prior to pursuing an outsourcing option.

Large, unitary Council

[-] Council transitioned from the Audit Practice to [Audit Firm] in 2007.

Based on telephone interview with [-] Council on 26 April 2011.

Background

- Following the procurement in 2006, when the Commission made new appointments from 2007/08, [Audit Firm] were appointed as the auditor to [-] Council.
- The Council believed that they had not been appropriately consulted on the change, and were initially opposed to the appointment of [Audit Firm] given that they had recently changed the lead auditor in the commission and desired a period of stability.
- Further, the Council's experience with the Audit Practice had been positive as they worked against set protocols and had a clear methodology in relation to what should be measured, which the Council felt may change under a new auditor.
- Following additional consultations and being satisfied the transition could be handled properly, the Commission proceeded with the appointment.

Process

- The Council states that the transition process itself went well and took approximately six weeks, however it should be noted that a significant effort was required by both the incoming auditors and the [- Council] team in order to:
  - Educate [Audit Firm] about the council and processes;
  - Raise understanding regarding what had been done previously so that [Audit Firm] could work from a clean slate; and,
  - Provide clarity regarding interpretations relating to financial reviews which differed marginally between [Audit Firm] and the Audit Practice.

Results

- Overall, the Council has been satisfied with the work conducted by [Audit Firm].
- Whilst the Council recognises the importance of price in audit appointments, they informed us that they place a higher premium on:
  - Adherence to standards that the audits are performed against; and,
  - Engaging a strong auditor that brings value to the organisation by challenging the right areas during the course of their review.

To that end, it is the Council's view that the identity of the auditor is not a matter of importance but their ability to perform against the standards is critical.

Other Considerations

- The Council views the abolition of the Commission as an opportunity to improve the current audit platform, where they feel that the Commission has lost some contact and understanding with the bodies, particularly in the area of Value for Money, which they view as being superfluous.

- To that end, it is the Council's view that Value for Money is central to the role of the Section 151 Officer and is being reviewed on a regular basis as part of their responsibilities.

- Secondly, it is viewed that the 151 Officer will be critical to the regime under abolition of the Commission, carrying a major influence in the quality and appointment of auditors to local bodies in the new regime.

- In support of this however, it is also recognised that the overall standards by which audits are performed must be set and measured by an 'umbrella' function, whether it be within the NAO or a new, smaller form of Commission. It is the Council's view that this will be critical in the new regime.

[-] Borough Council

[-] Borough Council transitioned from a private firm to the Audit Practice in 2010.

Based on telephone interview with [-] Borough Council on 10 May 2011.

Background

- Over the last 15 years, [-] Borough Council ([-] BC) has been audited by [three private audit firms].

- In 2009/10, the council received notification from the Commission that its auditor had been changed to the Commission. According to [-] BC, this process was not consultative, and the council did not have the opportunity to discuss the prospective change. The council went through the appeal mechanisms available, but were unsuccessful.

Process

- The process of switching between private sector auditors to the IHP was generally smooth, with the auditors producing high quality working notes and handover documentation.

Results

- The council regards the private sector auditors' approach to audit as better than that of the Commission's IHP, especially with regard to proportionality of audit.

- After changing auditors to the IHP, the Council stated that the scope of audit has decreased, however costs have increased. It is the Council's view that this is a result of the approach taken by the IHP and they have suggested that some of the neighbouring councils have had a similar experience.

Other Considerations

- The Council has suggested that it would not, under a possible future free market, jointly aggregate demand with a county council because of the different audit requirements between the two differently-sized bodies. It would, however, consider forming a framework contract with other "like-minded" bodies, which could also include GP consortia (One GP consortium has already approached the Council for assistance in managing their audit procurement process).

Other Considerations

- It is the Council's opinion that Big 4 audit firms are better placed than mid-tier players to provide specialist, technical audit advice and to assist with the interpretation of complex LPB-specific audit issues.

- Mid-tier firms are not perceived by the Council to have the same breadth and depth of expertise. However, the Council acknowledges that making the choice between a Big 4 versus a smaller player also depends on where the anticipated technical difficulties lie, because it may be possible, as the council has done in the past, to procure the specialist advice separately to the general audit.

- The council considers that the audit culture of the Commission would need to be more closely aligned with private providers before many LPBs employed the Commission, instead of the Big 4, under a free market.

- A key consideration for the Government, according to [-] BC, was to consider how an "approved LPB auditor" list would be formed, and who would compile and manage this list. The current Commission role of monitoring and supervising standards could transfer to an alternate body, but it is unclear which body this role would be most appropriate.

[-] County Council

[-] County Council transitioned from a private firm to the Audit Practice in 2009.

Based on telephone interview with [-] County Council on 10 May 2011.

Background

- [-] County Council were previously audited by the IHP up to 2003/04 before changing to [-] for the audit years 2005-09. In 2009/10, the IHP were re-appointed as the auditor for the council.
- The Council has stated that they had not been appropriately consulted on the change back to the IHP and had been extremely satisfied with the work performed by [-]. It is the council's view that [-] clearly understood the nature of the work and demonstrated a high level of technical expertise.

Process

- We understand that the transition process was seamless and took approximately four weeks, mainly due to IHP's experience and knowledge of the local public sector which meant that minimal effort was required by the Council to support the incoming auditors.
- The only issues of note that arose during the process were in relation to some differences in treatment of various accountancy procedures, however these were largely driven by changes to standards.

Results

- Overall, the Council has been satisfied with the work conducted by the IHP.
- The Council stated its preference for appointing its own auditor going forward, and whilst it recognises the importance of price in audit appointments, it places a higher premium on:
  - Professional and technical expertise; and,
  - Engaging an auditor that challenges the right areas during the course of their review
- To that end, it is the Council's view that the identity of the auditor is not a matter of importance but their technical support and ability is critical.

Other Considerations

- The Council recognises the value the Commission brings to the local public sector and believes that a central body should remain in some form, whether it be part of the NAO or LGA for example, to continue to set and define standards for the execution of audits.

- The Council also considers that a ‘Mutual’ IHP would be able to compete as a private entity, however it may be more suited to Tier 2 audits initially, which typically have less requirement for technical support.

- Finally, the Council considers Outsourcing to be the best option for maintaining pricing levels, and would expect them to decrease in the short to medium term.

Literature review and wider research

Literature review for the private sector audit market; municipal audit; public bodies audit; NHS trusts audit.

Private sector audit market

- There are several academic studies that find that higher auditor concentration leads to higher fees:
  - **Oxera (2006)** finds that in the UK higher concentration leads to higher audit fees and that because of significant barriers to entry, the current market structure of the Big 4 is likely to persist. Auditor switching rates for the average listed company are around 4% a year, whereas for clients of leading audit firms, this is even lower.
  - **Clatworth and Peel (2007)** find that, for over 51,000 UK firms, reputation is an important driver for choosing a Big 4 auditor, higher auditor concentration led to higher fees and there are significant barriers to entry for mid-tier audit firms in the FTSE 100 and 250.
  - **Lee (1996)** finds that in Hong Kong larger auditors charge higher fees for small auditees, but not for large auditees, which is associated with product differentiation in the small auditee market.
- **Lowensohn *et al* (2007)** also finds a positive relationship between audit and advisory fees, with a possible explanation cited as being that companies experiencing problems or organisational change may require increased amounts of both audit and advisory services services.
- An extensive literature review by **Cameran, Di Vincenzo, Merlotti (2005)** including 26 reports by regulators from around the world and 34 academic studies concluded against the benefits of mandatory audit firm rotation. On specifically the impact on competition, they state that *"mandatory rotation leads to higher market concentration in the larger client segment … moreover, mandatory rotation increases the probability of collusion among audit firms."*
- **Ghosh and Moon (2005)** use a large US dataset spanning 11 years, and find that imposing mandatory limits on the duration of the auditor-client relationship may impose unintended costs on capital market participants: *"analysts are more likely to rely on reported earnings to predict future earnings with longer tenure. Thus, the results from analyst earnings forecasts also suggest that analysts perceive earnings quality as improving with longer auditor tenure."* The authors recognise it is possible that results are consistent with an alternate hypothesis – that high-quality auditors terminate engagements with firms that prefer lowquality audits.
- A **2003 US General Accounting Office (GAO)** study *"found that almost all of the largest public accounting firms and Fortune 1000 publicly traded companies believe that the costs of mandatory audit firm rotation are likely to exceed the benefits."* Using figures based on this study, in its Response to the EC Green Paper on audit, the UK Government argued the regulatory burden on UK companies could increase by more than £55m.

- **Oxera (2007)** finds employee-owned audit firms are likely to have lower access to capital and require additional returns unique to this corporate form – "potentially around 6 percentage points or more above those a diversified benchmark." This is made up of, approximately, one third the impact of ownership restrictions and two-thirds the impact of corporate structure. This presents barriers to entry for smaller audit firms seeking to expand into the market for larger audits.

Municipal audit

- **Thorne *et al* (2001)** used North Carolina local government data to examine the extent to which audit contract types explain variations in fees. They find fixedfee contracts have generally lower fees than time-and-expenses contracts. In addition, higher auditor public-sector expertise and higher auditee risk were found to be associated with higher probability of fixed-fee contracts.

- **Bandyopadhyay and Kao (2001)** examined the Ontario, Canada municipal audit market and found that the Big 6 audit firms were able to command a price premium both before and after the removal of entry barriers. This suggested premiums were as a result of reputation and brand rather than oligopoly pricemaking power.

- **Remayne *et al* (2010)** used data on New Zealand public sector companies for the period 1998-2000 and found that as political visibility of public sector audits increases, the fees also increase monotonically, which "*is because of more audit effort, rather than increasing the level of expertise in the audit team … or charging a risk premium."* Increased accountability leads to higher cognitive effort.

Public bodies audit

- In terms of direct costs from retendering, a study by **Boon *et al* (2005)** based on 126 local councils in Australia found that between 1993 and 2002, the introduction of compulsory audit tendering significantly reduced audit fees, and that this reduction was non-transitory. The study acknowledged that wider evidence on whether cost savings from competitive tendering were transitory or long-term were mixed, but that this depended on the contestability of the market. For example, initial prices could be low because of incomplete information, or loss-leading pricing strategies. The study also finds big firms earned a fee premium.

- **Lowensohn *et al* (2007)** conduct a survey of 241 finance directors from Florida local governments and find that the Big 5 audit firms charge higher audit fees even though they are not uniformly associated with higher quality (the firms specialising in government audit have higher perceived quality). Increased specialisation from auditors improves the quality, but not price, of the audit.

- **Giroux and Jones (2007)** analysed the audit fee structure specifically for local authorities in England and Wales. They found, in contrast to the private sector literature, a Big 4 discount for local authority audits compared to district auditors. The results from this study are not immediately comparable to others, because it acknowledges that auditors have to perform other audit-related procedures for additional fees, such as value-for-money studies and the audit of 'best value' performance plans. They found also that client size was a primary driver for fees, that there was a London fee premium.

NHS Foundation Trusts and university audit

- **Clatworthy et al (2000)** says *"there is no evidence of a 'Big 6' premium and NHS trust audit fees are significantly lower than those of similar private sector organisations."* It highlights market testing by the Commission as a control mechanism over the fees paid to auditors. An additional reason for lack of audit premium is that audits are of a lower quality compared to the private sector because "as a consequence of perceived audit risk being lower" – should a trust be dissolved for any reason, its liabilities are transferred to another NHS body, and therefore the trust appears not to benefit in the same way that private sector companies do from high-quality audits.

- **Basioudis and Ellwood (2002)** find that the Big 5 charge an audit fee premium, with PwC charging a higher premium than other firms. However, they also find that mid-tier firms are not priced at a premium to district auditors, and that specialisation in the local body audit market does not enable Big 5 firms to charge higher fees. As with other studies, client factors such as size and complexity are also important in determining fees.

- **Clatworthy et al (2002)** looks at 459 NHS Trusts in England and Wales, and find that switching auditors does not necessarily lead to lower fees and neither does employing a Big 6 auditor. A possible reason for this is given as large auditors looking to, primarily, improve their profile/expertise in the field and are Literature review for general audit market; municipal audit; public bodies audit; NHS trusts audit therefore not concerned with charging short-term fee premiums. Furthermore, they find that for the Big 6 audit firms, as well as the mid-tier and district auditors, higher advisory fees were associated with lower audit fees, which they say is in contrast to the private sector literature. Longer auditor tenure was negatively related to audit fees.

- **Mellett *et al* (2007)** find that, for 110 universities in the UK, based on mainly 2001 data, the Big 4 dominated both the audit market (87% of audits), as well as the non-audit (consultancy including IT consultancy, merger advice, taxation advice) services (89% of non-audit services). PwC is the biggest provider, with 37% and 33%, respectively, of the two markets. The study shows that the Big 4 commands an audit fee premium of almost a quarter over mid-tier firms, but that mid-tier firms charge no premium over smaller firms. Universities are charged significantly lower fees than comparable private sector audits, possibly because university audits are less risky. Auditors based in London charge higher fees.

Appendix D: Sources of Information

Meetings held by FTI

Meeting	Attendees (excluding FTI)	Date
Introductory Meetings with Audit Commission and Audit Practice		7 April 2011
Meeting with Shareholder Executive		7 April 2011
Meeting to review proposed Audit Practice Mutualisation option and financials		12 April 2011
Meeting to review AC historical, projected financials and liabilities		12 April 2011
Meeting to review TUPE		13 April 2011
Meeting to review Audit Commission's assessment of the privatisation options and models		13 April 2011
Meeting with Dept for Business Innovation and Skills		14 April 2011
Follow-up meeting on Audit Regime, Procurement, Fees and Market		19 April 2011
Meetings with Audit Wales		20 April 2011
Meeting with Office of Fair Trading		20 April 2011
[-] Council		26 April 2011 (by conference call)
Meeting with BDO		26 April 2011 (by conference call)
Meeting Grant Thornton		27 April 2011 (by conference call)

Meeting	Attendees (excluding FTI)	Date
Meetings with Audit Scotland		27 April 2011 (by conference call)
Meeting PwC		28 April 2011
Meeting with CIPFA		28 April 2011
Meeting KPMG		28 April 2011
Meeting with Mazars		3 May 2011
Meeting with Society of County Treasurers and Society of Municipal Treasurers		4 May 2011 (by conference call)
Meeting with PKF		4 May 2011 (by conference call)
Meeting with Monitor		5 May 2011
[-] County Council		10 May 2011
[-] Council		10 May 2011
Meeting with Deloitte		13May 2011

Sources of information

- Audit practice business plan and financial model for employee-owned IHP
- Audit Commission financial information, historic and projected, and liabilities, including Annual Report for 2009/10, Mid-term Financial Plan and 2011/12 Budget. Spreadsheet data on income, costs and contributions
- Audit Commission's assessment of the various privatisation options and models, including initial options analysis, board papers, legal advice and initial draft working models
- "Future of local public audit," Consultation, 2011, Department for Communities and Local Government
- Transfer of Audit Practice: Practical implications of outsourcing. Memo to David Prout dated 8 April 2011
- Briefing notes on auditor appointments, terms of engagement, various types of audit, procurement, Cornwall and Cumbria procurement, audit fees, GP consortia, independence issues, audit eligibility, qualification of auditors, assurance engagements, grant certification and 2010 Annual Report on certification work, plus examples of IHP output
- Briefing notes fees and associated documents for limited assurance audit regime
- Briefing note – Potential redundancy cost implications for outsourcing the audit-practice (plus supplementary papers)
- Audit Commission Board Paper: Using the Market to procure audit services, May 2005
- The procurement of audit and related services - Presentation to the Board - 1 June 2006
- 2006 ITT – Procurement of Audit and related services
- Audit Commission Board Paper - Contracts for Audit and Related Services – July 2006
- Audit Commission Board Paper -Procurement of audit services - September 2006
- Audit Commission Board Paper: Contracts for audit and related services and framework agreement – March 2007
- Audit Commission Board Paper: Learning the lessons from the recent procurement of audit services, December 2007
- Contracts for Audit services
- Quality Review Programme 2010 and associated briefing note
- Audit Commission Board Paper: Contracts for Audit Services - January 2010
- Audit Commission Board Paper: Procurement of Audit Services in Remote Geographical Locations – March 2010
- Audit Commission Board Paper on Strategic Options: Timetable for the procurement of audit services – July 2010
- "The future of local audit: issues for consideration," Issues paper, September 2010, Audit Commission
- Audit Commission Board Paper: Cornwall and Cumbria Procurement - November 2010
- "UK Government Response: European Commission's Green Paper on Audit," December 2010, Department for Business, Innovation and Skills.
- Schedule of 2010/11 appointments; 2010/11, 2011/12 work programme and fees documents

Literature review and wider research

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- "The market for external audit services in the public sector: an empirical analysis of NHS trusts," Mark Clatworthy, Howard Mellettt, Michael Peel, pp.1399-1439, 29(9) and (10), November/December 2002, Journal of Business Finance and Accounting
- "Public Accounting Firms: required study on the potential effects of mandatory audit firm rotation Report to the Senate Committee on Banking, Housing and Urban Affair and the House Committee on Financial Services," November 2003, United States General Accounting Office
- "Auditor Tenure and Perceptions of Audit Quality ," Ghosh and Moon, Vol. 80, No. 2, 2005, pp. 585–612, The Accounting Review
- "The audit firm rotation rule: a review of the literature," Mara Cameran, Dino Di Vincenzo, Emilia Merlotti, 20 September 2005, SDA Bocconi, Bocconi School of Management.
- "Audit Market Failure," Economic Viewpoints, Benedikt Koehler, 2006, Institute of Economic Affairs
- "Competition and choice in the UK audit market, Prepared for Department of Trade and Industry and Financial Reporting Council , April 2006, Oxera
- "Auditor specialization, perceived audit quality, and audit fees in the local government audit market," Suzanna Lowensohn, Laurence Johnson, Randal Elder, Stephen Davies, pp. 705-732, 2007, Journal of Accounting and Public Policy
- "Investigating the audit fee structure of local authorities in England and Wales," Vol. 37, No. 1, pp. 21-37, Gary Giroux, Rowan Jones, 2007, Accounting and Business Research
- "The effect of corporate status on external audit fees: Evidence from the UK," Mark Clatworthy, Michael Peel, pp. 169-201, 34(1) and (2), January/March 2007, Journal of Business Finance and Accounting
- "Ownership rules of audit firms and their consequences for audit market concentration." prepared for DG Internal Market and Services, October 2007, Oxera
- "The effect of political visibility on audit effort and audit pricing," Nives Botica Redmayne, Michael Bradbury, Steven Cahan, pp. 921-939, 50, 2010, Accounting and Finance
- Howard Mellet, Michael J Peel, Yusuf Karbhari, "Audit fee determinants in the UK university sector," Volume 23, Issue 2, pages 155-188, May 2007, Financial Accountability and Management

Further research/supporting documentation

- "The future of Local Audit – Audit Practice Workstream. Principal options for privatising the Audit Commission's in-house practice", April 2011, note prepared by DCLG
- Communities and Local Government Select Committee , "Audit and the inspection of local authorities," 2011
- Evidence taken before the Economic Affairs House of Lords Select Committee, "Auditors: market concentration and their role," 2010/11
- Financial Services Authority, "Financial Risk Outlook 2007", 2007
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- Accounting and Finance Association of Australia and New Zealand (AFAANZ), "The Development of the Value for Money (VFM) Auditing Jurisdiction: the case of the Victorian
- Auditor-General's Office (VAGO) in Australia," undated
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- "The Top 50 in 2010," Accountancy Age, http://www.accountancyage.com/static/top50-this-year
- "PwC tightens grip on FTSE 100," 2 June 2010, Accountancy Age
- "Audit Commission's demise may see Big Five emerge ," 4 November 2010, Accountancy Age
- Memorandum by the Financial Reporting Council to House of Lords Economic Affairs Select Committee
- "Efficiency Review by Sir Philip Green: Key Findings and Recommendations," 11 October 2010, Sir Philip Green, Cabinet Office
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- "Memorandum submitted by Deloitte LLP," Submission to the Communities and Local Government Select Committee , "Audit and the inspection of local authorities," prepared 10 February 2011, Deloitte LLP
- "Audit and the inspection of local authorities," Second Report, 15 March 2011, House of Lords Select Committee on Economic Affairs
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- "UK Government Response: European Commission's Green Paper on Audit," December 2010, Department for Business, Innovation and Skills

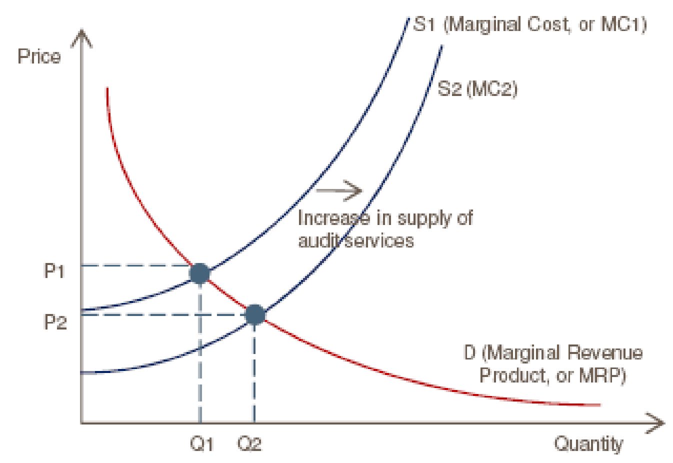
- Response by Professor David Heald, Professor of Accountancy, University of Aberdeen Business School, to Q31, Evidence taken before the Communities and Local Government Select Committee , “Audit and the inspection of local authorities,” Uncorrected oral transcript HC 763-i, 7 February 2011
- Response by Michael O’Higgins (Chairman, Audit Commission) to Q250, Evidence taken before the Communities and Local Government Select Committee , “Audit and the inspection of local authorities,” Uncorrected oral transcript HC 763-iii, 14 March 2011

Appendix E: Additional Market Considerations

Economic framework

Conventional economic theory states that, all other things equal, competition leads to low prices. Under a single buyer, however, there are lower prices than under a competitive market.

Competitive market – shift in supply curve



- In a competitive market, the unit price of a good is determined at the point where the quantity demanded is equivalent to the quantity supplied by producers (Q1P1).

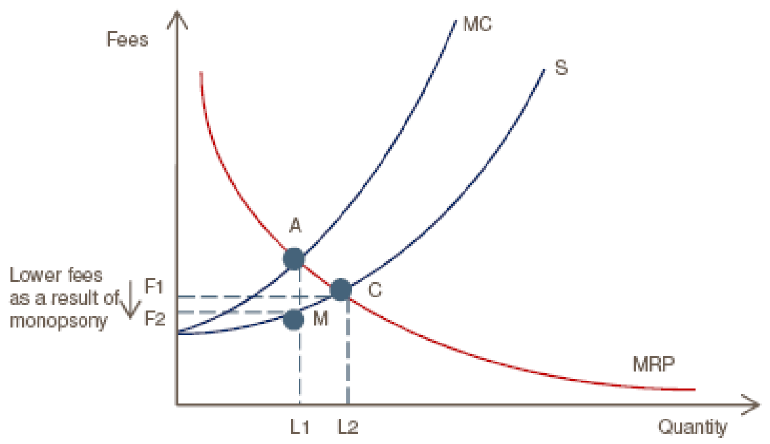
- The extent to which changes in price are responsive to changes in quantity depends on the slope of the respective curves, as well as other factors, such as the availability of substitutes.

- In the short-run, supply may be less responsive to changes in prices than in the long-run (i.e. supply curve may be steeper, or vertical).

- For this model to apply, say in the market for the provision of audit services, several conditions need to apply, including:
  - All firms aim to maximise profits (at MRP=MC);
  - Lots of small buyers and sellers for products that are identical;
  - No entry or exit barriers;
  - The price and quality of all products is known by all buyers; and
  - There are no transaction costs.

- Under these conditions, an increase in supply of audit services (i.e. new entrant) would reduce audit fees from P1 to P2.

Monopsony – lower price than a competitive market



- However, the model of perfect competition does not apply to the England audit market.
- For example, there are very few sellers of local body audit services, and the Commission is the only buyer of these services (a “monopsony” buyer).
- A monopsony buyer of local body audit services has a similar demand curve to that in the competitive market. Audit firms supply it will audit services along a supply curve similar to that in the competitive market.
- Under both models, firms seek to maximise profit. However, a monopsony faces a different marginal cost curve than in the competitive market. It must pay a higher wage to each additional worker it hires – the MC cost curve is steeper than the average cost, or S, curve. Under a competitive market, competition would bid wages up to the MRP=MC equilibrium at C.
- The profit-maximising point under monopsony is where MRP=MC at A.
- Therefore the fees paid under monopsony, F2, are lower than in a competitive market, F1.
- Therefore, a single buyer of local body audit services leads to lower audit fees charged than under a competitive market.

However, the Commission also operates as a monopoly provider. Economic theory says this leads to inefficiencies which cause prices to be higher than under a competitive market.

Economic framework - summary of academic literature

The academic literature on the audit market indicates that it is likely that large audit firms charge a price premium, that size and complexity of client matters when setting fees, and that switching auditors does not necessarily lead to lower fees.

- Higher auditor concentration leads to higher fees, according to several academic papers from the UK, USA and elsewhere.

- Oxera (2006) says that because of low switching rates and significant barriers to entry, the current UK market structure of the Big 4 auditors is likely to persist. Client size and complexity are also significant drivers of fees.

- Reputation is an important driver for choosing an audit firm, both in the public and private sectors markets. Given the extensive international networks, industry specialisation and ability to offer additional professional services of Big 4 firms, they can often command higher price premiums. These factors all contribute to high barriers to entry for mid-tier firms, whose cost of capital is significantly higher than the Big 4, according to Oxera (2007).

- There is some evidence that the provision of audit services is beneficial for large audit firms in cross-selling opportunities for their advisory businesses. It may be that there are knowledge spillovers in some sectors such as the NHS between audit and non-audit work, leading to a negative relationship between audit and non-audit fees.

- Even within the Big 4, there is an element of product differentiation and specialisation, although it is not clear whether this uniformly increases premiums charged. One study (Basioudis and Ellwood (2002)) found that for NHS trusts, even within the Big 4, PwC could command the highest premium, even though, as per Lowensohn et al (2007), premiums are not uniformly associated with higher quality. Clatworthy et al (2000) finds there is no evidence of a Big 6 premium in the UK NHS trusts market. In the university audit market, Mellett et al (2007) found that PwC did not charge a premium over the other Big 4 firms.

- Giroux and Jones (2007) is the only paper to conduct an econometric analysis specifically of the audit fee structure for local authorities in England and Wales. They found the Big 4 audit firms give a discount for local authority audits compared to district auditors and that geography matters – auditors charged a London fee premium.

- The literature indicates that size, complexity and location of client are important drivers for audit fees. London and South-East England clients, for example, are charged higher fees. Some evidence shows also that if auditors are based in these regions, they charge higher fees.

- There is a significant body of literature from regulators and academics that concludes mandatory audit firm rotation leads to higher market concentration (with large clients), and may increase collusion amongst audit firms. Other studies show that it may impose a net regulatory burden, and there is some evidence that longer auditor tenure may improve perceived financial reporting. These studies, however, focus on the private sector.

- The differences in conclusions in the literature may be explained by :
  - The timing of the studies: If, as market concentration increases, fees increase, there would be a difference in conclusions reached about fee premiums charged by the Big 4 versus Big 6 or Big 8.
  - The private sector and non-UK markets are different from the England local public audit market: The major difference is that in other markets, mid-tier firms have a near-zero market share, whereas in the local authority audit market, midtier firms are already present.

Observations

- While much of the literature focuses on the private sector and/or overseas markets, the main implications relevant to our work are:
  - Mandatory audit firm rotation leads to higher audit market concentration;
  - Higher auditor concentration leads to higher fees;
  - Reputation is an important driver for choosing an audit firm;
  - Size, complexity and location are important drivers for audit fees; and
  - There are significant barriers to entry, and switching, in the UK audit market.
- We also observe that much of the literature relates to markets where mid-tier firms do not already exist. With the LPB audit market in the UK, several mid-tier and smaller firms have operated for several years.

Economic framework - competition policy issues

The OFT has discretionary powers to investigate markets - potential triggers for an OFT investigation include mergers and acquisitions, action under the Competition Act 1998 and market studies (including market investigation references).

- The OFT has been keeping the market for external audit services in the UK under review since November 2002. As per its submission to the House of Lords Select Committee on audit:

  "The OFT considers that competition in the market for audit services in the UK may be limited. Some aspects of the audit market giving rise to this concern include companies' lack of clear incentive to switch auditors; the focus on established reputation in companies' choice of auditor; high switching costs; the established competitive advantage of the 'Big Four' over mid-tier auditors; the limited choice of auditors to appoint; and the difficulties mid-tier firms face in raising funds to finance expansion.

  The OFT considers that these aspects of the audit market may explain low levels of switching of audit contracts; very high market concentration, with high and stable market shares for the Big Four being maintained at least as far back as 2002; and potentially high fees."

- The OFT states that while it has a preference for market-led solutions, "certain improvements may also be sought through regulatory or legislative change, at least in the short term."

Market definition

- While not an end in itself, market definition is an important consideration in assessing the competitiveness of markets - ranging from an existence of a dominant position and its abuse to the likely impact of mergers that could potentially reduce the intensity of competition.

- The market definition process usually starts from looking at a narrow potential definition and asks whether a hypothetical monopolist could profitably sustain prices a small and significant level above competitive levels.

- In respect of defining the relevant market, in principle, the market may be national because if there are a number of local / regional public bodies requiring these services one might expect chains of substitution to exist, although this would depend on whether there needs to be a local presence to undertake audits.

- On the product market definition, it is possible that the market for audit services provided to local public bodies might be distinct from the market for audit services provided to companies. Depending on a detailed assessment of demand and supply-side factors, the market may be defined more narrowly by type of audit client i.e. local authorities, police, health etc.

- The main triggers for an OFT investigation once the Commission is abolished would include any indications suggesting that competition in the market is limited (such as market shares).This could occur via either of the two options (outsourcing and sale), with the former ex post and the latter ex ante.

Observations

- The main implications of the above are that the OFT may have concerns if there was replication of the structure of the private sector audit market in the market for local public audit. While it has not intervened in the private market it continues to observe it and the Commission privatisation process may serve as a trigger. A sale may be preferable to outsourcing and indeed it might be preferable if Commission staff were reconstituted into more one company.

Useful lessons from other markets

Market testing has had different effects on fees, perceived accountability, perceived risk of audit and competition in different markets.

	NHS foundation trusts	Further education	Cornwall and Cumbria
Background	The NHS foundation trust board of governors is responsible for appointing auditors. The forms of governance and financial reporting are closer to those in the private sector. The Commission competes with private firms for these audits. There are 137 Foundations Trusts. Most contracts are 2/3 years in length, although some can be for up to 5. There is no time limit on tenure. The IHP submitted tenders for 103 foundation trusts and was successful in 26. The win rate for the Commission has been stable between 25-30% during the period 2004-2010. More recently, this has decreased to 22% following uncertainty about the Commission's future. There are no formal limits on non-audit work that can be sold to audit clients.	Audit Code of Practice (ACP) specifies auditors should be able to demonstrate a record in providing audit services to organisations outside the university sector. This is in contrast to the appointment of auditors in the NHS and LPBs, but similar to private sector. Appointment of auditors is normally for 7 years (longer than NHS and LPBs normal tenure of 5 years). Auditor selection is, primae facae, according to Mellett et al (2007), driven by price, subject to minimum quality level.	Procurement exercise in 2010 to outsource £2.2m of audits in Cornwall and Cumbria, to enable rotation of long-standing appointments. Firms were asked to submit a price on the basis that TUPE and COSOP applied. Before the tenders were received, the abolition of the Commission was announced, which created uncertainty for prospective bidders.
Results	The Commission's average fees at the earliest Trusts was £61,000, compared to £78,000 for private firms. Demand cannot be aggregated. In 2004/05, the Commission audited 53% of Foundation Trusts. By 2009/10, this had fallen to 41%. PwC is the biggest private firm with 22%, whereas KPMG's market share has increased from 9% to 22%. However, a number of criticisms have been made of this deregulation. Although fees have fallen, "other audit costs" excluding fees (Prospect House of Commons Select Committee response) have risen, meaning audits are now more expensive. There have been no PIRs since 2008 as a result of auditors being disincentivised to do so. Incumbency has been an big issue – the market has not expanded further than the existing 6 suppliers, which, in turn, have not expanded outside their historic geographical areas.	According to the study, the Big 4 dominates the market, conducting 87% of audits, with PwC conducting 37%. It carries out 89% of all nonaudit work, with PwC at 33%. The study also says that the Big 4 commands an audit fee premium. Universities charged significantly lower fees than comparable private sector audits, possibly because university audits are less risky. The compulsory nature of university internal audit functions may explain why fees are lower for external auditors than in the private and public sector audit markets.	Five tenders were received, three of which were rejected as noncompliant. The bids from the compliant firms showed that they regarded 10-30% of the fee amount to consist of TUPE and COSOP costs. The percentages of the prescribed fees for audit that the two compliant firms indicated they would retain were equal or higher than would have been the case with the IHP. Therefore, the Commission Board decided not to proceed with the procurement.

Sweden

In 1996, KOMREV, the Swedish equivalent of the Audit Commission was sold. PwC purchased this body, in a transaction that was cleared by the Swedish competition authorities. At that time, KOMREV had c.90% of the local government audit market share with private firms with the remaining 10%. Currently, PwC's share of the same market is c.65%.

Politically elected Public Auditors within each municipality are responsible for contracting private auditors to carry out audits, with reports made public to the municipal assembly. The private audit firms work directly for the Public Auditor, not the municipality/council, as in England.

The Auditor determines the Best Value (i e VfM in England) scope of work, based on an analysis of risk and materiality. Performance audits are far more frequent in Sweden than in England, and there are annual political, financial and legal accountability process for the Auditors.

Private audit firms, which assist the Auditor, are procured for 4 years. This is regarded by Auditors and firms as too short because of the re-procurement costs involved. Audit fees charged for large bodies are comparable to equivalent English LPBs. The BV report fee is often many times higher than the financial report fee. There is demand aggregation of LPBs that are commercially unattractive to firms with more profitable LPBs. There is a limit set on advisory work.

State of Victoria, Australia

The right to conduct audits was removed from the Victorian Auditor-General's Office (VAGO) and transferred to private firms, with the aim to make all state audits contestable. The principal functions of were transferred to a statutory body that competed with private firms. However, this was reversed subsequently as a result of negative public comments regarding accountability.

Stakeholder perceptions of future market outcomes (I)

Stakeholders have very different perspectives of the future of the LPB audit market, depending on whether they are a small or large provider, or a purchaser of audit services.

	Competition and entry	Prices	Long-run market structure
Providers	Deloitte: "The Companies Act provisions relating to proportional auditor liability and to liability limitation agreements (including a negotiated cap) would be equally appropriate here." Nigel Johnson (Assurance and Advisory Partner, Deloitte): "I think making local appointment will create greater choice and greater competition…If it is freed up, and it has been, as I say, a very severely managed market up until now with that large inhouse share, I think it will create serious competition." Gervase MacGregor (Head of Advisory Services, BDO LLP): "I think inevitably, where this will end up is that that work is going to end up being shared among a larger group of audit providers. I think that is inevitable over time." "The market is a closed shop." "Lots of £1m would be attractive but there should be a plurality of contract sizes. Some firms would come in at Lots of as little as £250k." "The bidding process is onerous – EU procurement rules are a big barrier." "Need to ensure capability is important rather than track record or major barrier to entry" "Limited switching." "Need decent length contracts or set up costs too large." "The trend has been for a small and diminishing number of players." "A new entrant such as Accenture or Capita is possible but conflicts issues are not clear LPBs will buy from them." "If people want more new entry or to help mid tiers then they need to be managed in to a degree and given incentives and a little protection to start with." "The middle market (£6.5m-£100m) is where the real competition will take place – there could be over 10 providers." "If previous experience is given too much weight it is a major barrier to entry." "If all councils are out to tender at the same time then that is a sort of barrier to entry for smaller firms." "The length of the contracts is crucial to our decisions on whether to bid for Lots. 3 years is very short with no guarantee of winning the contract after that."	Deloitte: "it needs to be recognised that audit costs may increase for any audited body where, either through its location or perceived risk, a number of audit firms are reluctant to take on the audit appointment." "Pricing has been and will be aggressive; the players bid keenly." "AC pricing is formulaic and not how it works in the real world." "AC prices sensibly for the packages." "Prices will fall – the AC is a public sector monopoly provider." "Prices will fall – as per audit fees for Foundation Trusts." "Pricing is brutally competitive in LBP audit at present and it is very hard for a new player to build itself up." "The big boys will price very aggressively in either option." "The in-house practice is behind on commerciality and quality and has all its eggs in this basket." "Without doubt audit fees will fall as the market is opened up and as firms try to grow market share."	Deloitte : "There is some advantage to spreading the phasing of local audit tendering over a transition period, but not over such a long period that the potential benefits of the new local audit appointment regime are delayed unduly." "If you start with a more plural market, you end up with a more plural market/" "The market will segment into large, medium and small public bodies. Large public bodies will mainly be served by the Big 3; and the medium tier by a combination of Big 3 and mid-tier players. Uncertain who will supply the small bodies." "The market will be dominated by the Big 3 owing to the power of the brand – better quality, resources and IT." "As today and maybe some new entrants. The bottom 10% of the market could have lots of suppliers." "The mid-tier players have the ability to increase share/" "An employee-owned ex-DA could play a decent role." "Matters a great deal as to whether you have proper regulation and somebody overseeing a framework contract." "There is a tendency to concentration – it has already happened in the FT market." "A mutual has no chance - what are they going to do for the other 8 months?" "Big councils will gravitate towards the Big 4."

Quotes are from interviews conducted by FTI with relevant stakeholders, unless otherwise stated. Quotes where respondent is named are from responses to the DCLG Select Committee on audit, unless otherwise stated.

Stakeholder perceptions of future market outcomes (II)

Stakeholders have very different perspectives of the future of the LPB audit market, depending on whether they are a small or large provider, or a purchaser of audit services.

	Competition and entry	Prices	Long-run market structure
Purchasers	Essex County Council (ECC): "The opportunity to choose external auditors creates a system where authorities can select auditors on the basis of their expertise, knowledge of local circumstances and the value for money tools they can offer. The competitive pricing structures that market competition encourages are welcome." Staffordshire County Council (SCC): "Another proposal would be for councils to collaborate with other public sector bodies to jointly commission a single auditor on an area basis." District Councils Network: "The commissioning by District Councils, separate from Unitaries and County Councils in two-tier areas, will ensure that the specific complexities and nuances of District Council activity can be given full and effective consideration by external auditors." Kent County Council (KCC): "To ensure improved value for money and accountability, we would prefer to see local selection and appointment from a pool of approved auditors." "Very hard for new entrants unless they are already doing public sector and local government work."	County Councils Network : "There is a significant possibility that competition will be limited, creating the potential for price rises." "We would be prepared to pay a little more for a firm that would do a proper job." "If free to choose [in Scotland] LPBs would split – some would see the audit as a commodity and go for price(subject to a minimum quality threshold) while others would see it as a different product especially if the scope is wider than core audit."	ECC: "Services with less severe failure consequences should not be subject to inspection. These areas should be left to local discretion with judgement of performance left to the electorate." Count Councils Network: "A joint procurement process may help make auditing … simpler and more cost-effective … It would be useful to have some sort of framework contracts." SCC: "Is supportive of … a system of external audit in which groups of authorities with shared characteristics join together to procure external audit services." KCC: "We may need to explore collaboration of procurement amongst groups of authorities of similar types or on an area basis… as a way of keeping costs down."
Other	Professor Heald (Professor of Accountancy, University of Aberdeen Business School): "Objections are very time-consuming and costly for the auditor, particularly if they are argumentative or technically difficult." Memorandum by the Institute of Chartered Accountants in England and Wales to House of Lords committee: "Economies of scale certainly create barriers to entry." CIPFA: "Reputational problems might not be attractive to private sector." CIPFA: "This market needs a critical mass of relevant expertise and so there is a danger of consolidation in a small number of players." ACCA: "If a local authority is performing poorly it will be less likely that a firm would want to undertake the audit because of the risk and costs involved." "Local government accounts are the most complex after insurance companies." "The only way a small player can get in is to acquire a bit of DA." "If we get more local authority owned companies then we will need more private type audit skills."	Professor Heald (Professor of Accountancy, University of Aberdeen Business School): "There is a danger that audit fees will go up quite sharply for some authorities. It may be that local authorities that are geographically remote or regarded as politically risky are particularly hit." ACCA: "According to an LSE (2002) study audit fees increased by 2.4% following the reduction from five large firms to four] and have continued to grow since then." CIPFA: "This could either lead to a reduction in the frequency or increase in the cost of public interest reports and other similar work." CIPFA: "Larger bodies are likely to be particularly attractive clients, and this will be reflected in fee proposals." Prospect: "Commission auditors may have contributed significantly to holding fees down."	Professor Heald: "Clients prefer a Big 4 firm as that reduces the chances of being criticised for the choice of auditor, and provides valued blame reflection." House of Lords Select Committee Second Report Volume II: "In some cases reputational considerations have hardened into restrictive covenants or, as Ms Helen Brand, Chief Executive of the ACCA said: "Banks or organisations themselves are stipulating upfront that they will only employ a Big Four firm." CIPFA: "The Audit Commission was able to award significant block of work to auditors, and to guarantee appointments for five years. Firms were thus able to offer lower fees than they would have charged to clients." Professor Heald: "Having an in-house provider allows for benchmarking against external providers and also provides the operational knowledge base [sic] on which the performance… can be evaluated."

Future demand structures will affect prices and competition

The government would like local public bodies to have the freedom to procure their own audit services but the bodies may want to aggregate demand. This may affect the way the market works in practice.

Demand side				Issues
Same as current	**Some bundling**	**Some bundling of procurement only**	**Free-for-all**	
• Bundle of authorities (varying by size and type) on a regional basis.	• By region. • By type of authority. • By region and type of authority.	• By region. • By type of authority. • By region and type of authority.	• Public bodies procure audits on an individual basis.	**If LPBs group together to bid; there is a high probability of conflicts of interest for at least one body as a result of, for example, provision of non-audit services or covenants that require Big 4 auditor.**
• Will require sophisticated procurement exercise with an supervisory body that splits bundles according to redundancy costs	• One or more of these models highly likely – similar to current procurement exercises	• By region most likely. • Procurement, not demand, aggregated, therefore procurement costs saved but demand disaggregated.	• Most likely appropriate model for larger public bodies.	
• By Cross-subsidy (larger bodies subsidising less profitable audits of smaller bodies) remains. • Needs supplier that can supply to all types of public body. • Therefore most likely appropriate model for large audit firms.	• Cross-subsidy could unwind depending on the combination of models chosen. • This will determine to what extent auditor-of last-resort appointed by supervisory body is required.	• Cross-subsidy removed. • Suppliers compete for specific size segments. • Auditor-of-last-resort appointed by supervisory body required.	• Cross-subsidy removed • Suppliers compete for specific size segments. • Auditor-of-last-resort appointed by supervisory body required.	**How demand is aggregated (if at all) has major implications for prices and competition. Aggregation may present practical issues, such as if a subset of the aggregated bodies want to change auditor earlier than others, because of local issues.**