External Audit Fee Levels in NHS Trusts

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This article discusses the external auditing regime of NHS trusts and analyses the fees charged by their auditors. It adapts approaches developed in the private sector to investigate audit fees paid by NHS trusts and finds that, while similar factors are associated with the audit fees of trusts, there is no evidence of a ‘Big 6’ premium and trust audit fees are significantly lower than those of similar private sector organizations. Explanations for this are sought in the different natures of public and private sector audits, which indicate that differences in fees might be anticipated in the public sector, especially with the presence of a quasi-regulator in the form of the Audit Commission.

Every set of annual accounts published by National Health Service (NHS) Trusts includes a report from its auditors. If the auditors are satisfied with the probity of the accounts, they report that the financial statements provide a true and fair view of the state of affairs of the trust at the end of the financial year and of its income and expenditure for the year then ended. Although the audit report represents a small proportion of a trust’s annual report, underpinning it is an important, well-defined structure which identifies and allocates significant responsibilities.

A primary distinction can be drawn between internal and external audit, although they are interrelated. A trust’s director of finance is responsible for ensuring that an internal audit service is provided which is sufficiently resourced so that an appropriate level of quality can be achieved. This article is concerned with the external audit of trusts, which is a statutory requirement, and one of the key responsibilities of the Audit Commission which oversees the appointment and remuneration of external trust auditors.

The Cadbury Report (CR, 1992, p. 36) stated that ‘the annual audit is one of the cornerstones of corporate governance’. In the context of the public sector, ‘external audit is, at least in part, a mechanism for calling government to account on behalf of citizens’ (Hollingsworth et al., 1998, p. 79) and therefore constitutes an integral part of the democratic process. Concordant with this, the use of external auditors by trusts ensures that their financial stewardship is subject to independent scrutiny, in line with the Audit Commission’s Code of Audit Practice. The auditor assesses not only the financial statements, but also the financial systems, including procedures for preventing and detecting fraud, together with the trust’s general financial standing and the adequacy of its managerial arrangements. Finally, the auditor is also obliged to review the arrangements established to achieve value for money in terms of economy, efficiency and effectiveness.

On completion of the audit, the report included in the published accounts is just one element of the feedback provided by the auditor. A formal management letter is sent to the trust, together with reports on the trust’s ‘value for money’ studies. A meeting (from which executive directors are excluded) is also held with the chair of the trust’s audit committee to discuss any issues arising from the audit. In the event of any material deficiencies being detected by the auditor, a report must also be forwarded to the Secretary of State. In addition, the auditor may also issue a ‘Public Interest Report’ to be discussed at a public meeting.

Surprisingly little research has examined the market for audit services in the public sector, even though this has been studied extensively in the private sector (see, for example, Beattie and Fearnley, 1992; Yardley et al., 1992; Moizer, 1997). A prime area of investigation for private sector research has been to identify factors associated with variation in the level of audit fees (see, for example, Brinn et al., 1991; Pong and Whittington, 1994). Two key findings of research on the determinants of private sector audit fees of both quoted and unquoted companies is that their level is positively associated with auditee size (usually proxied by turnover) and that ‘Big 6’ firms (now the Big 5) appear able to command a premium for their audit services (Brinn et al., 1994; Chan et al., 1993; Ezzamel et al., 1996; Pong and Whittington, 1994).

Based on data derived from trust annual reports, this study investigates the level of fees paid to external auditors by the population of trusts in England and Wales. The article presents information on auditor concentration, together with new evidence on the level of, and variations in, audit fees by reference to trust size and type of auditor. A key focus of the article is a comparison of the audit fees paid by trusts, relative to their counterparts in the private sector. This research is particularly interesting in that the public sector has
assimilated modes of accountability previously associated with the private sector (see, for example, Humphrey, 1994; Broadbent and Guthrie, 1992) and therefore offers an opportunity to investigate the role and remuneration of NHS auditors vis-à-vis private sector auditors. This is followed by a description of the data and research methods, before the empirical findings are presented. The article concludes with a discussion of the salient points to emerge from the research.

The Role, Appointment and Remuneration of NHS External Auditors

Following the NHS and Community Care Act (1990), the Audit Commission had its responsibilities extended to include the appointment of auditors of trusts, so that it acts as a single supervising purchaser of external audit services in the NHS. The audit of trusts may be conducted by either an approved private sector firm, or by District Audit, the agency wholly-owned by the Audit Commission and charged with supplying audit services. This contrasts with the private sector model where auditors are appointed by the audited body’s shareholders, with the result that there are numerous purchasers and suppliers who meet, and set fees, in the market for the supply of audit services.

The Audit Commission may appoint private sector auditors, who have met qualifying criteria, drawing on these ‘minority suppliers to ensure that there is a competitive market in the supply of audit’ (AC, 1995a). At the time of the study, the Commission employed eight private sector audit firms, five of which were ‘Big 6’ auditors (Coopers & Lybrand, Deloitte and Touche, Ernst & Young, KPMG and Price Waterhouse) with the remainder being mid-tier firms (Binder Hamlyn, Kidson Impey and Robson Rhodes). Although the Audit Commission is ultimately responsible for appointing auditors, it consults trusts and takes their views into account before an appointment is made. The duration of the appointments is five years, which may be extended at the trust’s request. However, the Commission: ‘seeks to rotate a small number of audits (1–2%) each year between District Audit and the (private sector) firms so that, over time, there is a reasonable degree of change and the system does not stagnate. The Audit Commission consults the audited bodies concerned and will normally not impose a new auditor where the audited body is opposed to such a rotational change’ (AC, 1995a).

A further characteristic of the NHS audit arrangements is the central determination of audit fee rates by the Audit Commission. Three hourly rates are set and revised annually, with the highest being for London, followed by the south east and then the remainder of England and Wales. While these rates are not compulsory (since trusts are permitted to negotiate their audit fees with the auditor on a fixed basis) they are used by the majority (75%) of trusts. The number of hours spent auditing a trust is also monitored by the Audit Commission which conducts an annual review by type of trust and requires explanation of any ‘outliers’ by the relevant auditors (AC, 1999).

An additional mechanism of control over the fees paid to external auditors is the market testing carried out by the Audit Commission. This regime is designed to ensure that audit fees are reasonable, to demonstrate that audit appointments are subject to competition (including the appointment of private sector auditors), to provide an incentive for auditors to strive to improve working methods and practices and to promote the maintenance of a mix of auditor suppliers (AC, 1998). This market testing is conducted as part of the Commission’s annual Quality Control Review, with 1–2% of auditors’ work being tested against ‘outside (private) firms which have been able to demonstrate the necessary capacity and capabilities… the results of the market tests will inform the Commission’s expectations of other audits’ (AC, 1998). However, despite these monitoring and guidance measures, the Audit Commission is not required to approve external audit fees (both on the fixed fee and ‘hourly basis’), rather ‘this is a matter for consultation between the auditor and the trust’ (AC, 1999).

In addition to the appointment and remuneration of NHS auditors, the Audit Commission is responsible for setting out auditors’ duties and responsibilities in the Code of Audit Practice (AC, 1995b). As noted above, the responsibilities of NHS auditors contained in this code extend beyond the essential requirements in the private sector for an expression of opinion on the truth and fairness of the financial statements prepared by company directors. The more extensive responsibilities of NHS auditors include ensuring that economy, efficiency and effectiveness have been secured (AC, 1995b) and reviewing trusts’ arrangements for the prevention and detection of fraud (DoH, 1997). These additional responsibilities reflect the wider scope of accountability in the public sector and the need to ‘provide assurance in the absence of the disciplines of the market’ (CIPFA, 1998, p. 12).

Given the special characteristics of the appointment, remuneration and responsibilities of NHS auditors, audit fees could potentially differ from those in the private sector in two ways. The first relates to the presence of the Audit Commission as a regulator and monitor of auditors’ remuneration which, prima facie, would result in lower audit fees in the public sector — that is, to the extent that the Audit Commission acts as a more effective restraint on audit fees of trusts than the shareholders of companies who carry out a similar function in the private sector. The second involves the more onerous duties and responsibilities of NHS auditors which, ceteris parabas, should have the opposite effect of a relatively higher audit fee being charged.

Data and Method

Using the Fitzhugh Directory (FD, 1997; 1998), data (external audit fees, trust revenue and auditor) for the financial years ended in 1996 and 1997 was
collected for all 459 trusts in England and Wales. Similar data was also obtained for a matched sample of companies operating in the private health care sector, matched by size and year of data, to examine whether the level of trust fees differed from their private sector counterparts.

The FAME (Financial Analysis Made Easy) CD-ROM corporate database, which contains information on over 200,000 British companies, was utilized to generate the sample of firms in the health care sector. Companies were selected if they met the following criteria:

- Data was available for the financial year ends falling in 1997 (that is, the same year as the trusts).
- Companies had their primary activities in the health care sector (1992 SIC code 85: hospitals/human health).
- Companies had revenue in the size range £2,431,000 to £302,898,000 (that is, the same size range as the trusts examined in this article).

This procedure produced 98 firms in the private health care sector. The revenue figures for trusts and private firms were then matched as closely as possible (±5%). This produced a matched sample (by size) of 46 trusts and 46 private firms (59% of the private firms were matched to within 1% of the revenue of trusts, with the maximum difference being only 3.9%). There are a number of possible characteristics by which the size of an organization may be measured, with the most frequent being total revenue and the recorded value of assets. This analysis uses total revenue, as it is reported in the accounts of both trusts and companies and is not subject to measurement distortion, or affected by the differing accounting valuation methods between the two sectors. NHS fixed assets are revalued annually, whereas fixed assets in the private sector are valued on a historical or modified historical cost basis.

**Results**

Tables 1 and 2 provide descriptive statistics on the audit fees and revenue of the trusts, together with an analysis of audit fees by type of auditor. In total, 311 (67.8%) of the 459 trust audits were conducted by a public sector (district) auditor, with 26.6% and 5.6% being audited by Big 6 and middle size (mid-tier) private sector audit firms respectively. Table 1 shows that the average revenue generated by trusts in 1997 was £56.249M, and that the average audit fee amounted to £43.330. As measured by the coefficient of variation (standard deviation/mean) the table shows that revenue varies more widely than audit fees. However, in common with private sector studies, trust size (revenue) and audit fees are highly positively correlated ($r = 0.618; p = 0.000$).

Table 1 also reveals that the mean increase in audit fees of trusts between the years ending in 1996 and 1997 amounted to 5.28%, but that after controlling for inflation, this increased to only 2.61%. However, a key finding reported in table 1 is that trust size, audit fees and changes in audit fees do not differ significantly with reference to auditor type. Unlike the private sector, therefore, there is no evidence that Big 6 auditors earned higher fees (an audit premium) relative to both the district auditor and mid-tier private sector auditors.

The key explanation put forward for the observed Big 6 premium in the private sector is that

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**Table 1. Summary statistics for NHS trusts by auditor category.**

<table>
<thead>
<tr>
<th>variables</th>
<th>Big 6 (N = 122)</th>
<th>Mid-tier (N = 26)</th>
<th>District (N = 311)</th>
<th>All (N = 459)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean Standard deviation Coefficient of variation</td>
<td>Mean Standard deviation Coefficient of variation</td>
<td>Mean Standard deviation Coefficient of variation</td>
<td>Mean Standard deviation Coefficient of variation</td>
</tr>
<tr>
<td>1997 revenue (£000)</td>
<td>54475 35346 0.65</td>
<td>50535 47777 0.80</td>
<td>56670 41048 0.72</td>
<td>56249 39958 0.71</td>
</tr>
<tr>
<td>1997 audit fees (£000)</td>
<td>43.46 16.13 0.37</td>
<td>45.23 28.20 0.62</td>
<td>43.12 21.09 0.49</td>
<td>43.33 20.33 0.47</td>
</tr>
<tr>
<td>% change in audit fee (1996/97)</td>
<td>5.28 30.81 5.84</td>
<td>3.55 23.86 6.72</td>
<td>5.57 46.81 8.40</td>
<td>5.38 42.00 7.81</td>
</tr>
<tr>
<td>% change in real audit fee (1996/97)</td>
<td>2.61 30.03 11.51</td>
<td>23.25 25.00 2.89</td>
<td>45.65 15.79 2.71</td>
<td>40.94 15.11 7.11</td>
</tr>
</tbody>
</table>

*None of the variables differed significantly (at $p<0.10$) across the three samples on the basis of analysis of variance tests.*
such auditors offer a differentiated (superior) product (audit) and are therefore able to command a higher fee. In addition to paying a premium for a higher audit quality, auditees may also be willing to pay a premium for the ‘reputation effect’ of a Big 6 auditor, in that parties dealing with the auditee, such as bankers, creditors, suppliers of capital and other users of financial statements, feel more assured of the financial accuracy of accounts audited by a Big 6 auditor. As noted by Moizer (1997, p. 67) the hypothesis here is that ‘the Big Six have established a reputation for performing higher quality audit work and the premiums reflect the greater confidence felt by the readers of the audited financial statements when a Big Six audit name is attached to them’.

Although Big 6 trust auditors could (at least in theory) charge a higher total audit fee (either via the fixed fee method, or by increasing the number of hours worked at the imposed hourly rate, to reflect a ‘higher quality audit’), this is unlikely to occur in practice for two main reasons:

- It is unlikely that trusts would demand a higher quality audit (as shareholders are assumed to do in the private sector), since it is not obvious which parties, if any, would benefit; that is, trust creditors are effectively underwritten by the government, and there appears to be no other direct beneficiaries of ‘reputational effects’
- Even if trusts and Big 6 auditors agreed higher fees, it is unlikely that this situation would persist, given the ‘regulatory’ role of the Audit Commission, together with the fact that the National Health Service Executive conducts its own analysis of trust audit fees and discusses its findings with the Audit Commission.

In addition, although only 1-2% of audits are subject to the annual market testing regime described above, this exercise may have a more widespread impact on trust fees in general—since trust chief executives and finance directors are extensively networked. Consequently, it would be difficult for any premium rate audit fee to persist.

Table 2 provides further evidence of the level of trust audit fees. It examines the relationship between audit fees, in bands of £20,000 and type of auditor. The table reveals that the lowest audit fee was £5,000 with 10.46% of all trusts having audit fees in the range of £5,000 to £20,000. The largest audit fee, paid to a district auditor amounted to £159,000 and only one additional trust, audited by a mid-tier auditor, had an audit fee in the top fee band of £140,000–£159,000. Overall, table 2 shows that 97.5% of Big 6, 96.14% of mid-tier and 95.49% of district auditors charged fees in the range of £5,000–£80,000.
and are, therefore, unwilling to pay the requisite benefit in the way that private sector companies do. NHS trusts (and their stakeholders) do not pay a premium for their audit services, since it appears circumstances, Big 6 firms may be unable to charge to another NHS body. In these circumstances, Big 6 firms may be unable to charge. In these circumstances, Big 6 firms may be unable to charge.

Liabilities (Liabilities) Act 1996, which ensures that, should a trust be dissolved for any reason, its liabilities must be transferred to another NHS body. In these circumstances, Big 6 firms may be unable to charge for their audit services, since it appears that NHS trusts (and their stakeholders) do not benefit in the way that private sector companies do and are, therefore, unwilling to pay the requisite premium.

The lack of an audit premium for trusts is therefore one explanation for the higher observed fees of the matched sample of private sector firms reported in this study. Another possibility is that a less extensive and/or lower quality audit is carried out on trusts (as a consequence of perceived audit risk being lower). For example, unlike the private sector where there is extensive case law (see, for example, Gwilliam, 1991; Jenkins, 1998) relating to the extent of auditor liability (i.e. to whom the duty of care extends), no corresponding legal precedents exist for negligent audits in the NHS.

It could still be argued, however, that private sector auditors (at least) may still be motivated to conduct audits to their usual standard, since audit failure may result in ‘reputational’ loss to the audit firm concerned, together with the loss of both audit and non-audit work from the Government (see, for example, the Barlow Clowes case, Accountancy, November 1993, p. 12). In any event, audits still have to be conducted in accordance with auditing standards and comply with the Audit Commission’s Code of Audit Practice.

In addition, it is possible to surmise different levels of complexity in the accounts of trusts and companies which might make one sector less costly to audit than the other. For example, debtors of trusts are likely to be less extensive, but, in contrast, the fixed assets of trusts are subject to annual revaluations and may therefore be more difficult to audit than for companies. Thus, audit duties and complexities appear at least as onerous in the trust sector and are, therefore, unlikely to explain the observed difference in fee levels.

With regard to setting audit fees, there are significant differences in the appointment of auditors and the determination of remuneration levels in the two sectors. The Audit Commission appoints an auditor for each trust and is also responsible for setting rates for determining the audit fee, for which it issues guidance on fee rates. Consequently, one of the two variables (hourly rates) in the total audit fee is usually fixed, and the other (time spent auditing the trust) is also monitored by the Audit Commission. The presence of a dominant player, the District Auditor, may also have the effect of capping fee levels. Audit firms are unlikely to undertake work at a loss, but it is

equivalent entities in the public sector.

Furthermore, although the variation (standard deviation and coefficient of variation) of the revenue of the trusts and private sector companies exhibit very similar characteristics, the variation in the audit fees of trusts is much less prominent than it is for their counterparts in the private sector—with the coefficient of variation of audit fees for private sector health care firms (0.89) being over twice that (0.44) for trusts. Overall, these results show that trusts pay significantly lower audit fees than corresponding private sector firms, and that the fees charged to trusts exhibit significantly less variance than those incurred by their private sector counterparts.

Discussion and Conclusions
The analysis presented in this article, at first sight, indicates that audit fees charged to trusts contain no Big 6 premium and are substantially lower than those paid by their private sector counterparts. Although it is not possible to be definitive, private sector companies appear willing to pay a Big 6 premium as the market perceives that these auditors provide some form of superior audit service. If this is so, it can be argued that the companies using their services should enjoy a lower cost of capital as investors perceive that there is less risk attached to companies whose financial reports have been subjected to a higher quality audit. Also, Big 6 auditors, by their very size, are substantial undertakings and so are more likely to be able to make financial restitution should their audit transpire to have been at fault, effectively transferring some of the risk from the investor to the auditor, for which an appropriate (increased) fee results.

In contrast, trusts do not need to raise capital in the market and their financial liabilities are backed by the government; there is even specific legislation in the form of the NHS (Residual Liabilities) Act 1996, which ensures that, should a trust be dissolved for any reason, its liabilities must be transferred to another NHS body. In these circumstances, Big 6 firms may be unable to charge a premium for their audit services, since it appears that NHS trusts (and their stakeholders) do not benefit in the way that private sector companies do and are, therefore, unwilling to pay the requisite premium.

Table 3. Matched analysis: NHS trusts versus private sector health care.

<table>
<thead>
<tr>
<th>Variables</th>
<th>NHS trusts (N = 46)</th>
<th>Private sector healthcare (N = 46)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>Standard deviation</td>
</tr>
<tr>
<td>1997 revenue (£000)</td>
<td>20004†</td>
<td>14258</td>
</tr>
<tr>
<td>2997 audit fee (£000)</td>
<td>27.83*</td>
<td>12.27</td>
</tr>
</tbody>
</table>

†Means do not differ significantly: \( t = 0.01; \ p = 0.99 \).
*Means are significantly different: \( t = 2.43; \ p = 0.02 \).
possible that the presence of a regulator in the market, together with the other factors (including market testing) specific to the trust market, has the effect of depressing the overall level of fees.

Private sector auditors may, therefore, be prepared to accept lower fees because other services are more lucrative. In consequence, they may consider it prudent to offer a full range of services (including external audit) and not merely ‘cherry pick’. However, it should be noted that in 1998, two private sector auditors left the Audit Commission’s approved list, largely in consequence of the financial returns being considered insufficient. In the private sector, each company enters the market for audit services and negotiates a fee, possibly after having asked a number of audit firms for a quote. In these circumstances, a market exists with a large number of purchasers and suppliers, although the benefit of a Big 5 audit can, by definition, only be obtained from a limited number of sources.

The findings reported in this paper raise a number of possibilities for further research. A more refined multivariate model could be developed which includes variables to reflect factors which might more fully explain the variation in trust external audit fees, such as audit complexity, risk and audit switching. Alternatively, a more specific corporate governance model could be developed. For example, it might be that due to regulation, together with other associated factors specific to the market, public sector audit fees are in fact appropriate and that the private sector displays higher levels due to some form of market failure. Another possibility is to investigate other benefits which an auditor may derive from carrying out trust audits, such as access to additional consultancy work for the audited trust or other public sector agencies.

In conclusion, changes in the public sector, generally referred to as ‘New Public Management’, have a common theme of making the public sector more like the private sector in terms of management style and organization and the manner of measuring and reporting results. A discernible public sector theme is the creation of units of enterprise which mimic the accountability networks of their private sector counterparts. This article has identified a clear example of a private sector model proving inadequate to explain a superficially similar public sector phenomenon. The possible differences identified between private and public audits suggest that the public sector should enjoy a lower level of fees, and the results do indicate that, prima facie, value for money is being achieved.

Acknowledgement

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