



KPMG response to the Competition Commission working paper “Engagement level profitability analysis”

1 Summary

1.1 This paper sets out our response to the Competition Commission’s (“CC”) working paper “Engagement level profitability analysis” (the “Working Paper”). We welcome the opportunity to comment on the Working Paper at this stage of the CC’s analysis.

1.2 The Working Paper seeks to analyse engagement profitability according to different types of engagement (the index designation of the company, the identity of the audit firm, the length of tenure of the audit firm, etc). The analysis is based purely on descriptive statistics and as a result can establish only correlations between engagement characteristics and engagement profitability, rather than causal drivers of engagement profitability. As a result, we would urge the CC to be cautious in its interpretation of the descriptive statistics it presents in the Working Paper.

1.3 However, in our view the analysis in the Working Paper is useful in that it shows some trends about engagement profitability consistent with our own experience:

- There is in our view little difference between the engagement margins that are earned overall on FTSE100, FTSE250 and other engagements. This is further evidence against any hypothesis that the largest four audit firms (who have a higher market share among FTSE100 and FTSE250 companies) are able to extract higher margins from their clients than other audit firms or that the level of concentration in the supply of statutory audit services produces any adverse effects on competition.
- Engagement margins do not show any pattern in relation to the audit firm’s size. Again, this is further evidence against any hypothesis that the largest four audit firms are able to extract higher margins from their clients or that the level of concentration in the supply of statutory audit services produces any adverse effects on competition.
- Profitability increases due to improvements in efficiency as audit firms learn about their client’s business throughout the life of an engagement leading to reductions in cost.

1.4 Finally, we note that the CC’s method of calculating margins in this Working Paper is to assume that the costs of partner time are twice the costs of director time. In our view, this underestimates the cost of partner time. We set out in our response to the CC’s working papers “Profitability – part 1” and “Profitability – part 2” what we believe

instead to be a conservative¹ but nevertheless more appropriate estimate of the labour costs for partners, based on the median salary of the twenty per cent highest paid directors (rather than the average salary of all directors, as the CC has used).

1.5 To the extent that any of the groups of engagements analysed by the CC are more or less likely to include a higher proportion of partner hours, under-estimating partner costs may impact comparisons of margins. We discuss this issue further in relation to our specific comments on the CC’s analysis in the rest of this response.

1.6 The rest of this response provides our detailed comments on the CC’s analysis and conclusion in relation to:

- profitability of engagements by market segment;
- profitability of engagements by firm;
- profitability of engagements by industry;
- profitability of engagements by tenure and the effect of switching auditors; and
- effect of month end on engagement profitability.

1.7 Finally, in Appendix 1 we set out a short list of queries in relation to the CC’s analysis and the underlying data it has used.

2 Profitability of engagements by market segment

2.1 The CC finds that FTSE100 audits are on average more profitable than FTSE250 audits by between two and six percentage points, and that non-FTSE350 audits are on average more profitable than FTSE250 audits but less profitable than FTSE100 engagements². However margins earned on any particular client will depend very much on the individual facts and circumstances, in particular the complexity of the audit in question, and may well deviate from the average.

2.2 In our view, the evidence available on the relationship between index designation and the margin earned does not support any hypothesis that there is an adverse effect on

¹ Indeed, this estimate was slightly below the estimate that corresponds to the CC’s estimate of partner employment costs based on the PwC benchmarking submission, which the CC itself recognised as reasonable in its working paper “Profitability – part 1”.

² Paragraph 7 of the Working Paper.

competition arising in the supply of audit services to FTSE350 companies resulting from the existing level of concentration, or that the largest four audit firms enjoy any significant market power and are able to extract higher margins from their clients.

- 2.3 In our view, to the extent that average FTSE100 margins are any higher than those achieved on other clients, this is likely to be driven by, or reflective of, at least in part, the fact that they are on average more complex organisations. For these organisations, greater gross margins may be achieved in order to cover certain investments in the capability of audit firms that are necessary to meet these complex clients' demands (and in particular their demand for specialised resources during critical times). Indeed, that audit firms may recover higher gross margins to cover investments in necessary capabilities is recognised by the CC in paragraph 5 of the Working Paper, which states that *"Firms may be able to achieve a greater gross margin on audit engagements on average than other firms as the result of investment in IT, methodology or training and these costs are not considered."*
- 2.4 In addition, for global engagements, where the group audit is conducted in the UK, partner hours may account for a greater proportion of the total hours worked on the audit compared to engagements with less of a global spread. In particular, for an international client, the group audit work conducted in the UK is likely to be more heavily weighted towards interaction with non-UK member firms and coordination of the group audit, and this work is likely to be more heavily weighted towards partner time, while the staff hours are more likely to be recorded in other member firms and therefore not contained in this dataset. For a client where its operations are exclusively or largely in the UK, by contrast, the audit work conducted in the UK is more likely to include all of the staff and partner hours. Since in our view the cost of partner time is under-estimated in this Working Paper, the engagement profit margins are over-estimated for all clients. However, the degree of that overestimation is greater for global clients (which are likely to include a higher proportion of partner time) than for others. This could further account for any difference between the margins earned on FTSE100 engagements compared to those earned on other engagements, since a greater number of FTSE100 companies are global in nature.

3 Profitability of engagements by firm

3.1 The CC finds that “the profitability of the audit firms does not appear to show any pattern in respect of size of audit firm”³. As in the previous section, this lack of relationship goes against any hypothesis that there is an adverse effect on competition arising in the supply of audit services to FTSE350 companies resulting from the existing level of concentration, or that the largest four audit firms are able to extract higher margins from their clients.

4 Profitability of engagements by industry

4.1 The CC finds that audits of companies in the ‘financials’ industry achieved the highest average engagement profitability and that when margins are calculated on an aggregate basis, audits of companies in the ‘oil and gas’ industry achieved the highest margins⁴.

4.2 These differences provide evidence only on the correlation between engagement margins and companies’ industries, and do not provide any evidence on the causes of any differences in engagement margins.

4.3 To the extent that there are any differences between engagement margins in different sectors, this might again be the result of certain sectors having a higher number of global clients, for which partner time is a higher proportion of total hours. As we set out in paragraph 2.4, since the cost of partner time is underestimated, this might artificially inflate the estimates of engagement margins for global clients. We would caution the CC against placing any weight on these differences.

5 Profitability of engagements by tenure and the effect of switching auditors

5.1 The CC finds that profitability broadly increases over the first five years of an engagement⁵. This is consistent with our experience that a substantial amount of investment and learning by doing occurs throughout an engagement which makes audit firms more efficient. As we set out in our main submission in response to the CC’s

³ Paragraph 8d of the Working Paper.

⁴ Paragraph 10 of the Working Paper.

⁵ Paragraph 11a) of the Working Paper.

Issues Statement (“Main Submission”)⁶ and as recognised by the CC⁷, an audit firm makes relationship-specific investments in learning about each individual clients business (the CC refers to these as ‘familiarisation costs’). These investments over time have a cost, which is absorbed by the audit firm, and have the effect of reducing the cost of an engagement.

5.2 We therefore welcome the CC’s view that this pattern of increasing profitability over the first five years of an engagement is driven by costs rather than revenue⁸.

5.3 Indeed, aside from these investments and learning effects, the CC does not appear to find that there is any relationship between an audit firm’s margin on a particular client and the date at which that client last switched audit firm⁹. This is consistent with the existence of strong competitive pressures throughout the life of an engagement, as we have discussed in several previous submissions¹⁰ and on which we provided extensive further evidence in Annex 2 of our response to the CC’s working paper “Nature and strength of competition in the supply of statutory audits” and in our Main Submission.

5.4 It is important to recognise that the investment and learning process in relation to clients’ businesses is ongoing, since audit firms will have to make sure they fully understand any changes in a client’s structure, accounting practices, operations, etc. We would therefore strongly urge the CC not to dismiss these ongoing learning effects on the basis of broad figures on average engagement profitability. While the pattern of learning is likely to be relatively consistent across engagements in their first five years, when and by how much learning takes place in subsequent years of an engagement will depend on the client’s specific circumstances and may not be picked up in these relatively broad brush descriptive statistics, particularly given the small number of observations¹¹.

⁶ Section 5.2 and section 7 of our Main Submission.

⁷ Paragraph 13 of the Working Paper.

⁸ Paragraph 17 of the Working Paper.

⁹ Paragraph 11d of the Working Paper.

¹⁰ Summarised in Annex 2 of our response to the CC’s working paper “Nature and strength of competition in the supply of statutory audits”.

¹¹ Paragraph 41 of the Working Paper.

5.5 For this reason, it is not possible to make a definitive statement about the magnitude of ‘familiarisation costs’ faced by any one audit firm, based only on whether it has a ‘steady client base’¹². In competing for new clients, all audit firms will have to make relationship-specific investments to ensure that they are a credible alternative, regardless of the audit firm’s existing client base. In addition, as we set out above, investment and learning occurs throughout the life of an engagement.

5.6 The CC queries whether the need to shoulder ‘familiarisation costs’ could be a barrier to entry for firms that attempt to increase the size of their client base and therefore have a larger proportion of new clients¹³. For the reasons set out in the previous two paragraphs we do not think that having a larger proportion of new clients necessarily increases the burden of ‘familiarisation costs’ significantly. In any case, we would strongly argue that the need to shoulder familiarisation costs cannot be considered a barrier to entry, since, as the CC recognised, there is no evidence that new engagements are not profitable.

5.7 Indeed, we agree with the CC’s conclusion that there is no evidence that audit firms ‘low ball’ to reduce engagement profitability to (or below) zero in the first years of an engagement before increasing fees significantly in subsequent years¹⁴. Due to the intense competitive pressure on audit firms, and the strong bargaining position of our clients¹⁵, clients often secure fixed fees for the first years of an engagement¹⁶ and we are not in a position to tender with a low price to win an engagement with a view to increase profitability over time by increasing fees over and above competitive levels.

6 Effect of reporting month on profitability

6.1 We note that the CC finds in this Working Paper that there is no real evidence that audit firms margins are higher in busier periods (from this analysis)¹⁷. At the same time, in the working paper “Econometric analysis of audit costs”, the CC finds that costs are, if

¹² Paragraph 15 of the Working Paper.

¹³ Paragraph 16 of the Working Paper.

¹⁴ Paragraph 11d of the Working Paper.

¹⁵ Section 7.2.1 of our Main Submission and Annex 2 of our response to the CC’s working paper “Nature and strength of competition in the supply of statutory audits”.

¹⁶ Paragraph 13 of the Working Paper.

¹⁷ Paragraph 20 of the Working Paper.



anything, higher during busier periods¹⁸. Taking these two findings together, this would suggest that audit firms might charge higher prices in busier periods, but only in line with any increases in costs.

¹⁸ Paragraph 76 of the CC’s working paper “Econometric analysis of audit costs”.

Appendix 1: Queries on the CC’s analysis and the underlying data

Table 1: The margins based on cost rates calculated using standard hours are in this table lower than the margins based on cost rates calculated using chargeable hours. For the rates we submitted to the CC, our cost rates based on standard hours are lower than those based on chargeable hours – and so we would expect to see higher margins associated with the former measure (and indeed, this is what the CC has found in table 2). We would therefore request that the CC checks and confirms the accuracy of this table.

Table 2: The average margins for the market segments combined are equal to the average margins of FTSE100 companies (for all the profitability measures used by the CC). Since the margins of all the other market segments are lower than those of the FTSE100 we would expect the combined average margins to also be lower than the average margins for the FTSE100 alone. We therefore request that the CC checks and confirms the accuracy of this table.

Index designation: It is not clear whether the CC has checked that companies’ index designations (in each year) in the Engagement Dataset correspond with the index designations used in the Public Dataset. In our view the latter is likely to be more reliable given the thorough quality assurance process that was undertaken during the preparation of the Public Dataset.