



KPMG Response to CC's Working Paper "Evidence of trends in audit fees"

1 Introduction and summary

- 1.1 This note sets out KPMG's response to the Competition Commission's (CC's) working paper "Evidence on trends in audit fees" (the "Working Paper"). We submit that the CC's Working Paper clearly shows that, as noted in our Response to the Provisional Findings¹, we, and other audit firms, have been successful in reducing our costs and have passed these reductions onto our clients. This, using the CC's own test, clearly demonstrates that the audit market is competitive.
- 1.2 The CC states that evidence of falling costs, combined with stable or falling gross margins, shows that cost reductions have been passed on to consumers. The CC states that this is what it would expect to observe in a competitive market².
- 1.3 The evidence in this Working Paper shows that average costs and fees per hour have fallen in real terms between 2006 and 2011³ (the time period for which the CC has full information available) while gross margins have remained stable. In addition, total engagement hours have fallen over the same period. This evidence appears consistent across the market and suppliers.
- 1.4 This finding, by the CC's own test, is a 'powerful indicator'⁴ of a competitive and well-functioning market.
- 1.5 This evidence directly contradicts the CC's provisional finding that "*the market is not working well in delivering competitive prices*"⁵ and we fail to see how on a balanced assessment of the evidence this finding can stand. This therefore fundamentally undermines the existence of an adverse effect on competition ("AEC") in the reference market certainly under the first theory of harm that the CC espoused. The CC's Provisional Findings on the AEC simply cannot be confirmed in the light of this

¹ Paragraph 2.4.3.2 of our response to the CC's Provisional Findings.

² Paragraph 4 of the Working Paper.

³ The CC states that in real terms audit fees increased between 2001 and 2010³, but this increase is based on the public dataset, where fees also include audit-related services and global audit fees. When the CC analyses total fees using the engagement dataset, for the period 2006 to 2011 (the same data and time period that is used to analyse hourly costs, fees and total engagement hours) it is apparent that total fees have also declined in real terms since 2006.

⁴ Paragraph 5 of the Working Paper.

⁵ Paragraph 7.94 of the Provisional findings report

evidence and they need to be amended. Similarly this evidence has significant implications for the arguments justifying remedies and we will return to that matter in our reply to the CC's Provisional Decision on Remedies. We are concerned that this evidence has been considered and published at such a late stage in the course of the CC's market investigation. We have not been given an opportunity to review and comment on this evidence until now and our ability to respond as comprehensively as possible to those two publications has been undermined.

2 A framework for testing whether the market is competitive

2.1 The CC sets up its framework for analysing these trends in the introduction of the Working Paper. It states first that:

*"in a competitive market we expect reductions in marginal costs to be passed on to customers ... We therefore want to consider whether any reduction in fees was associated with a constant or falling gross margin"*⁶.

2.2 The CC goes on to state that:

*"We consider that cost reductions driven by firms' efforts to lower costs ... which have passed on to customers are a more powerful indicator of a competitive market. Such cost reductions might be driven by a reduction in the cost per hour (e.g. seniority of staff) and/ or a reduction in total hours (volume of work)."*⁷

2.3 The CC therefore considers that evidence of cost reductions, whether that is reductions in cost per hour or total hours worked, which have been passed on to customers is evidence that the market is competitive. The Working Paper clearly shows that this has been the case in the audit market, as we set out in more detail in the next section.

3 Costs have fallen and margins have been stable over time

3.1 In this Working Paper, the CC presents analysis of the trends in various measures of fees, costs and engagement hours over time. There are two elements to an analysis of

⁶ Paragraph 4 of the Working Paper.

⁷ Paragraph 5 of the Working Paper.

costs over time, first what variable to use and second how to compare its value of time (whether and how to deflate costs). We discuss in this section first the appropriate way to analyse costs over time and second which measure of costs we think is most informative.

Costs per hour decline over time

- 3.2 The CC finds that, across FTSE350 audit engagements, “*in nominal terms the fee per hour remained roughly stable from 2006 to 2011*”⁸. Similarly, a measure of weighted staff costs per hour remained constant in nominal terms between 2006 and 2011. As a result, the gross margin remained stable over the same period⁹.
- 3.3 In other words, in real terms hourly costs and fees have fallen since 2006. This is the case whichever index is used to deflate hourly fees and costs.
- 3.4 The CC suggests that the consumer price index (“CPI”) might not be the most suitable deflator for hourly fees¹⁰, although it is not clear which other indices might be suitable to deflate fees and costs. We have therefore considered a range of other indices with which to deflate hourly fees and costs. Specifically, CPI, labour costs for the sector including professional, scientific and technical activities¹¹, unit labour costs (“ULC”, or wage inflation across the whole economy), services producer price index (“SPPI”), SPPI for banks only and the GDP deflator. As shown by Figure 1 at the end of this paper, using any of these indices real hourly costs and fees have fallen very substantially over time.

⁸ Paragraph 8c) of the Working Paper.

⁹ Paragraph 8c) of the Working Paper. It is important to note that while a pattern of stable gross margins in the face of cost reductions over time is strong evidence of a competitive market, the CC can make no conclusion about the level of margins from this, or any other parts of its analysis without conducting a thorough analysis and engaging with the evidence put forward by interested parties. The CC has failed to put itself in a position to draw any conclusions about the level of margins or profits, having not engaged with our analysis of profitability.

¹⁰ Paragraph 48e) of the Working Paper.

¹¹ This sector includes “legal and accounting activities” and “accounting, book keeping and auditing activities”.

<http://www.ons.gov.uk/ons/publications/re-reference-tables.html?edition=tcm%3A77-300574#tab-all-tables>

- 3.5 On any of these measures, across the FTSE350 engagements, audit staff costs (the largest component of direct cost) have declined by between 10 and 16 per cent. In particular, deflating by using the index for wages of professional, scientific and technical jobs imply that staff costs on FTSE350 audit engagements have fallen by 15 per cent between 2006 and 2011. The stability of gross margins shows that these substantial efficiencies have been passed on to customers.
- 3.6 The CC states that *"the decreasing fee per hour in 2005 prices was almost completely driven by deflating the numbers"*¹². Similarly, in paragraph 8e) the CC states that *"there is no strong evidence for a reduction in the nominal cost per hour, or the pass through of such an efficiency."*¹³ It is not clear to us why the CC appears to be seeking evidence of a reduction in *nominal* cost per hour.
- 3.7 We are concerned that these statements suggest that the CC will put more weight on nominal rather than real changes in costs per hour. This would be incorrect and a departure from CC's practice in other inquiries.¹⁴ Costs and fees need to be deflated over time in order for any meaningful comparison over time to be made. The decline of our hourly costs in real terms for all of the different indices we considered (as set out in paragraphs 3.4 and 3.5 above) shows that in spite of inflation across the economy as a whole, including in relation to wages for professionals, we have not increased our direct costs. In fact, comparing current costs to their equivalent value in 2006 these have declined substantially. This is an important indicator of the competitive pressure we face, which has led us to seek and continue to seek efficiencies.
- 3.8 These reductions in costs per hour have been driven by ongoing pressure from our clients to obtain ever better terms from their audit firm, and we have achieved them through a number of means. We have kept tight control on pay rises across our business over the period analysed by the CC. Further, we have used more off-shore staff to

¹² Paragraph 48e) of the Working Paper.

¹³ Paragraph 8e) of the Working Paper.

¹⁴ In the CC's market investigation into the supply of local bus services, the CC has analysed costs over time for the main parties in the context of its "Econometric analysis of bus operator costs". In this context the CC has rightly deflated the cost measures (using the CPI). It is also worth noting that in the Bus industry, similarly to the Audit industry, labour costs make up the vast majority of direct costs.

deliver parts of our audit engagements, where this does not compromise audit quality –
[redacted]

Other measures of audit engagement costs

- 3.9 In relation to costs the CC examines the trend since 2006 in (weighted average) hourly audit engagement costs and the average number of total hours per engagement. We discussed costs per hour above. The CC also finds that the average number of total hours per engagement for FTSE250 engagements fell between 2006 and 2011¹⁵.
- 3.10 In general, analysis of average total hours per engagement is in our view less informative of patterns in costs than that of costs per hour. This is because, as we have set out in previous submissions to the CC¹⁶, total engagement hours are more likely to be affected by changes in the scope of engagements, which is not controlled for in any of the CC's analysis. Indeed, the CC recognises the limitation in drawing conclusions from its analysis because of not being able to control for audit scope, stating that "*we do not know to what extent the change in hours is caused by changes in audit scope, realised efficiencies, or other factors*"¹⁷.
- 3.11 We welcome the CC's acknowledgment of this inherent limitation in analyses that fail to control for audit scope. We expect that the CC will adopt a consistent approach across the various analyses where this issue is relevant. Specifically, the CC has not recognised that the conclusions it can draw from other pieces of its analysis, in particular in the Provisional Findings and in the working paper on "Review of evidence on the price effects of switching", are similarly limited because of a failure to control for audit scope. The CC must address this in its Final Report.
- 3.12 In our experience, patterns of average engagement hours over time are likely to be driven by a number of factors, including audit scope, innovation and efficiencies. A reduction in deal activity across the FTSE250, as considered by the CC, is likely to have

¹⁵ Paragraph 8d) of the Working Paper.

¹⁶ For example, see paragraph 2.3.2.10 of our response to the CC's Provisional Findings and paragraph 1.3 of our response to the CC's working paper "Review of evidence on the price effects of switching".

¹⁷ Paragraph 24 of the Working Paper.

had some impact on audit scope and therefore on the average number of hours per engagement.

3.13 In addition, while we can't comment on the drivers of changes in total audit fees at other audit firms, the period between 2006 and 2011 was also characterised by changes in the efficiency of KPMG's audit offering. In particular, prior to 2006, KPMG developed its global audit methodology, which allowed us to realise efficiency savings and reduce, all else being equal, the number of hours per engagement. In 2010 – 2011 we rolled out our e-Audit tool across our audit engagements. [redacted]

3.14 To summarise, this Working Paper shows that there have been real falls in hourly staff costs and fees, and stable gross margins.

4 Conclusions from the evidence

4.1 This Working Paper shows that real hourly costs and total engagement hours have declined over the time period analysed, while gross margins have remained stable. Using the CC's own tests for a competitive market, as set out in section 2, the evidence in this Working Paper is therefore a "*powerful indicator*"¹⁸ of a competitive market.

4.2 Although the CC recognises that "*any efficiency gains leading to a reduction in the average number of hours per engagement may have benefitted companies*"¹⁹, the CC appears in general not to draw the clear conclusion that the analysis in this Working Paper is a strong indicator of a competitive market.

4.3 After having considered the evidence outlined in this working paper we strongly recommend that the CC revisit its Provisional Findings on the AEC it considers exists in the reference market. This evidence will also have a significant impact on the validity of the CC's remedies package as outlined in its Provisional Decision on Remedies; if the CC's understanding of the AEC is modified as a result of this additional evidence, as we submit it must be, the CC's assessment of the proportionality and effectiveness of the remedies it proposes will likely be affected.

¹⁸ Paragraph 5 of the Working Paper.

¹⁹ Paragraph 8e) of the Working Paper.



*KPMG LLP
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in audit fees"*

Figure 1: Costs and fees per hour (using the measure of costs used by the CC in the Working Paper), deflated by different indices

