

# Comments on the KPMG submission 'Assessing the profitability of KPMG's audit function'

## Note prepared for BDO and Grant Thornton

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Non-confidential

### 1 Introduction

1.1 This note comments on KPMG's paper 'Assessing the profitability of KPMG's audit function', published on December 13th 2012.<sup>1</sup> Whereas the CC has expressed an initial view that calculating economic profitability to a reasonable standard is not feasible,<sup>2</sup> KPMG claims that 'it is possible to demonstrate that the economic profitability of KPMG's Audit Function is consistent with a competitive market'<sup>3</sup> and presents results suggesting that the profits of audit are in line with, or below, the relevant cost of capital. This note therefore comments briefly on two points:

- is it correct that economic profitability of audit can be calculated to a reasonable standard, and, if so, does this imply that the CC should have performed this analysis?
- given that KPMG has carried out a profitability analysis, could the CC rely on this in reaching conclusions as to the existence, or absence, of excess returns in the reference market?

<sup>1</sup> Available at: [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/profitability\\_parts\\_1\\_and%202\\_kpmg.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/profitability_parts_1_and%202_kpmg.pdf).

<sup>2</sup> Competition Commission (2012), 'Statutory Audit Services Market Investigation. Profitability – part 1', available at: [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/profitability\\_part\\_one.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/profitability_part_one.pdf), para 8.

<sup>3</sup> KPMG (2012), 'Assessing the profitability of KPMG's audit function', December 13th, para 1.4.

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## 2 The feasibility of economic profitability analysis

- 2.1 Oxera has discussed with the CC on three occasions the feasibility of profitability analysis in the reference market.<sup>4</sup> The view expressed by Oxera at these meetings has been that profitability analysis is difficult in the context of partner-owned firms, but that conducting an analysis in the framework of a return on capital method, and other methods, would be informative to the CC's inquiry.
- 2.2 The Oxera view has therefore, in general, been contrary to the CC's initial finding that it is not possible to undertake a reliable or meaningful assessment of economic profitability in this market. However, in the absence of seeing the data held by the CC, our view on the feasibility of profitability analysis has been expressed with caution.
- 2.3 The major hurdles to a standard profitability assessment (ie, using an IRR/ROCE measure and comparing it to a WACC benchmark) have been:
  - a) the need for an assumption on partner salary;
  - b) the difficulty in isolating the activity of audit firms in the FTSE 350 reference market;
  - c) the requirement to assess the economic capital base of audit firms, including placing a value on intangible assets; and
  - d) the challenge of estimating a cost of capital for partner-owned firms with a lack of close comparators among listed companies.
- 2.4 The striking result from KPMG's paper is that all these hurdles appear to have been overcome, except for (b), the isolation of activity in the reference market. See comments below in section 3 regarding this issue.
- 2.5 It is notable that KPMG has followed a similar approach to the CC with respect to point (a), the measurement of notional partner salary. It would appear that the different approaches to benchmarking partner salary are converging (indeed, KPMG's estimate is lower than that of the CC),<sup>5</sup> and, although KPMG does not use the data, it is apparent that KPMG has useful information on the salaries that are paid to partners who are temporarily classed as directors after returning from overseas assignments.<sup>6</sup> This lends weight to the idea that an approximate measure of partner salary is achievable in the context of the CC's inquiry.
- 2.6 It should be noted, however, that KPMG has measured profits for the whole audit function, not only for the FTSE 350 (which comprises about 20% of the audit function). The same is true of PwC's profitability assessment.<sup>7</sup> Until a profitability assessment is made of the FTSE 350 reference market, it is not appropriate to claim, as KPMG does, that 'Partner

<sup>4</sup> Oxera (2012), 'Methodologies for audit market investigation: lessons from Oxera's 2006 and 2007 studies', prepared for Competition Commission, January 17th, available at: [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/oxera\\_presentation\\_17\\_january\\_2012.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/oxera_presentation_17_january_2012.pdf); Oxera (2012), 'Ideas on profitability assessment: statutory audit services market investigation', presentation to the Competition Commission, May 29th, available at: [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/oxera\\_presentation\\_ideas\\_on\\_profitability\\_assessment.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/oxera_presentation_ideas_on_profitability_assessment.pdf); Oxera (2012), 'Audit profitability: comments on working papers, meeting with the Competition Commission, December 6th, available at: [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/audit\\_profitability\\_meeting\\_oxera.ppt](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/audit_profitability_meeting_oxera.ppt).

<sup>5</sup> Although the data is redacted, the impression given by KPMG (2012) is that the salary measures employed by the CC, by KPMG, and by PwC in various submissions, are reasonably similar in magnitude. It is apparent from para 3.2.5 that KPMG obtains a lower estimate than the CC.

<sup>6</sup> KPMG (2012), op. cit., para 3.2.5.

<sup>7</sup> PricewaterhouseCoopers (2012), 'The market investigation into the supply of audit services to large companies. Observations on the assessment of audit profitability: PricewaterhouseCoopers LLP', August 7th, available at: [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/pwc\\_observations\\_on\\_the\\_assessment\\_of\\_profitability.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/pwc_observations_on_the_assessment_of_profitability.pdf).

employment cost estimates based on external benchmarks such as the FTSE 350 Finance Directors (FDs) would be considerably higher.<sup>8</sup> Note that notional partner salary for the mid-tier companies, which provide audit services almost entirely outside the reference market but, therefore, in the market covered by 80% of the Big Four's audit output, is assumed by the CC to be half that of the Big Four.<sup>9</sup> There appears to be no clear justification for the 100% difference in notional average salaries, when the majority of Big Four output being measured is outside the FTSE 350.

- 2.7 This point can be illustrated by looking at Figure 4 in KPMG (2012), entitled, 'Remuneration of Senior Finance Professionals'.<sup>10</sup> This chart compares the cumulative distribution of KPMG audit partner remuneration with that of FTSE 350 finance directors. The comparison is clearly misleading, since presumably around 80% of the KPMG audit partners illustrated in the chart do not work on FTSE 350 audits. The relevant comparison would be to use the cumulative distribution of remuneration for only those audit partners working on FTSE 350 audits, or to use as a benchmark finance director remuneration for all companies audited by KPMG, which would produce a considerably lower figure.<sup>11</sup>
- 2.8 Regarding point (c), KPMG does not report any great difficulty in calculating the costs invested in building intangible assets, and remarks that its results on the ROCE are not particularly sensitive to the assumptions used for intangible assets.<sup>12</sup> This suggests that the CC's previous concerns have been misplaced, and that the CC would be in a position to calculate the value of intangible assets if it obtained the relevant data from the other audit firms (presumably the CC now has the relevant data for KPMG, and could assess the intangible asset value for KPMG).<sup>13</sup> It would appear, given KPMG's comment that ROCE results are insensitive to the assumptions on intangibles, that the intangible asset value may be relatively small. If true, this indicates that the CC's initial view on the scale of intangible assets may be incorrect:
- Because the intangible asset base could have substantial value, and be long-lived, in contrast to the relatively small tangible asset base, this leaves us in a position of being unable to reliably measure the appropriate capital employed.<sup>14</sup>
- 2.9 The emerging picture, although difficult to assess given the level of redaction in KPMG's document, seems to be that the large audit firms have relatively small asset bases (tangible plus intangible assets). A full view of this would require full disclosure of all on and off balance sheet liabilities, and for the CC to complete for the other audit firms the (apparently straightforward) exercise carried out by KPMG of calculating the costs invested in intangible assets.
- 2.10 As to point (d), both KPMG and PwC have now put forward estimates of the cost of capital for their activities. It is true that these estimates are imprecise—in particular, the approach to

<sup>8</sup> KPMG (2012), op. cit., para 1.17.

<sup>9</sup> As a working assumption, the CC assumes £473,000 average salary for Big Four partners, and £264,000 for mid-tier partners. Competition Commission (2012), 'Statutory Audit Services Market Investigation. Profitability – part 1', para 43.

<sup>10</sup> Figure 4 can be found above para 3.2.10. The KPMG document does not have page numbers.

<sup>11</sup> For example, the website [www.payscale.com](http://www.payscale.com) reports that median UK finance director total pay is £72,400. Accountancy Age reports similar results (average finance director salary £72,000). See [http://www.payscale.com/research/UK/Job=Finance\\_Director/Salary](http://www.payscale.com/research/UK/Job=Finance_Director/Salary); <http://salary.accountancyagejobs.com/salary/Finance-Director-salary>.

<sup>12</sup> KPMG (2012), op. cit., para 5.2.7.

<sup>13</sup> This is consistent with Oxera's previous recommendation that the CC ask the audit firms for data regarding expenditure on costs to be capitalised as intangible assets. See, for example, Oxera (2012), 'Response to working paper on Profitability—parts 1 and 2', note prepared by Oxera on behalf of Grant Thornton and BDO, November 5th, available at: [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/profitability\\_parts\\_1\\_and%202\\_oxera\\_on\\_behalf\\_of\\_bdo\\_and\\_grant\\_thornton.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/profitability_parts_1_and%202_oxera_on_behalf_of_bdo_and_grant_thornton.pdf), section 3.4.

<sup>14</sup> Competition Commission (2012), 'Statutory Audit Services Market Investigation. Profitability – part 1', para 58.

dealing with the uplift that may be required for non-diversification of ownership interests. However, if the CC had its own estimates of audit profit (ie, a return on capital measure), the further challenge of computing a cost of capital estimate would not, in light of the work by KPMG and PwC, seem insurmountable.

2.11 In summary, KPMG's paper seems to add weight to Oxera's previous view that:

Overall, the [CC's] apparent conclusion—that profitability analysis will not have any evidential value—would seem to be misplaced. The relevant question to consider is not whether the profitability analysis gives a 'perfect' answer (which it hardly ever will), but whether the results of the analysis (combined with the other quantitative and qualitative evidence available) are sufficiently robust to provide an indication of the workings of the market. Notwithstanding the difficulties involved, analytical techniques exist which are likely to deliver results that are useful, in that they allow the CC to measure some of the competition effects that are discussed in the various other working papers it has issued recently.<sup>15</sup>

2.12 It seems readily apparent, following KPMG's paper, that the CC could have had more success with profitability assessment (albeit still not obtaining the 'perfect' answer) had it obtained more data from the audit firms.

### 3 The reliability of KPMG's profitability assessment

3.1 KPMG's paper cannot be used to reach conclusions on the reference market for the simple reason that it *does not measure returns in the reference market*. As KPMG remarks, activity in the reference market constitutes only around 20% of total audit fees used in its profitability assessment.<sup>16</sup> Oxera has previously explained that a robust profitability analysis must obtain results that pertain to the reference market, since finding that audit profits are normal in aggregate (ie, across the 80% of fees derived outside the FTSE 350 and the 20% within the FTSE 350) is not inconsistent with there being excessive profits in the market of interest.<sup>17</sup> As stated previously, the challenges of isolating FTSE 350 activity in this market do not appear to be substantively different from the challenges faced by the CC in other inquiries, since businesses rarely report financial results according to the precise delineation of a relevant market.<sup>18</sup>

3.2 It is noted that the CC's results on engagement level profitability appear, at first glance, to have established a similar level of gross margins between FTSE 350 and non-FTSE 350 audits. This might suggest that there is no need to isolate activity in the reference market. However, it appears that 'non-FTSE 350' audit engagement profits as measured by the CC are, as Deloitte points out, measured only in relation to audits of companies that 'were in the FTSE 350 at some point between 2006 and 2011, but in the year in question were not FTSE 350 constituents (or were private companies)'.<sup>19</sup> This is clearly inappropriate, since a counterfactual to FTSE 350 audits cannot properly be determined by looking at audits of

<sup>15</sup> Oxera (2012), 'Response to working paper on Profitability—parts 1 and 2', note prepared by Oxera on behalf of Grant Thornton and BDO, November 5th, p. 2.

<sup>16</sup> KPMG (2012), op. cit., p. 1, footnote 3.

<sup>17</sup> Oxera (2012), 'Comments on PwC document: "Observations on the assessment of audit profitability"', note prepared for the Competition Commission, August 30th, available at: [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/profitability\\_analysis\\_oxera\\_comments\\_on\\_pwc\\_paper.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/profitability_analysis_oxera_comments_on_pwc_paper.pdf), para 2.4.

<sup>18</sup> Oxera (2012), 'Response to working paper on Profitability—parts 1 and 2', note prepared by Oxera on behalf of Grant Thornton and BDO, November 5th, section 3.2, p. 3.

<sup>19</sup> Deloitte (2012), 'Competition Commission Audit Services Market Inquiry', December 3rd, available at: [http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/engagement\\_level\\_profitability\\_analysis\\_deloitte.pdf](http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/engagement_level_profitability_analysis_deloitte.pdf), para 2.2.

companies that have previously been, or are very close to being, FTSE 350 constituents. It cannot be the case that the 80% of audit activity outside the FTSE 350 is being performed by the Big Four for companies that have, at some point, been members of the FTSE 350—indeed, it is likely that most audit activity is for smaller companies that are omitted from the CC's dataset for engagement profitability. Indeed, because the CC's dataset appears to contain only FTSE 350 and TopTrack 100 companies, the CC has no ability to compare engagement profitability between the reference market and a more competitive comparator market.

3.3 As a measure of the general profitability of audit, not specific to the FTSE 350, there are some indications that KPMG has underestimated profitability. Note, in particular, the following.

- At para 3.3.1, KPMG explains that it has capitalised expenditure on 'marketing and business development', 'training' and 'recruitment'. It seems doubtful that all this expenditure would fit the CC's criteria for recognising intangible assets.<sup>20</sup> In particular, it is difficult to see that all the expenditure can be considered entirely additional to those costs necessarily incurred at the time in running the business. As such, the true value of capitalised costs to be recognised as intangible assets seems likely to be lower than that estimated by KPMG.
- At para 3.4.2, KPMG explains that it allocates common costs according to headcount. This may over-allocate common cost to audit, and thereby underestimate audit profitability, if the audit activity employs proportionally greater numbers of junior staff (eg, graduate trainees).<sup>21</sup> The CC can check whether this is the case, but our understanding is that audit 'leverage' is indeed higher than non-audit.
- At para 3.5.5, KPMG reports an estimate of KPMG UK's WACC of 12.2–17.5%. This is not a cost of capital specific to audit. However, the CC's findings elsewhere in this market investigation (for example, the conclusion that 'the risks faced by audit firms in relation to professional negligence may be regarded as low',<sup>22</sup> the extreme stability of audit market shares, and minimal rates of switching) seem to indicate that audit may, in a CAPM framework, attract a lower cost of capital than non-audit services.
- At para 5.2.14, KPMG notes its assumption that the firm is 100% equity-funded in the long term. This means that the estimated WACC must be equal to the cost of equity. Given the present low rates of interest on debt funding, it seems unlikely that 100% equity funding would be an optimal financing structure for an audit firm.<sup>23</sup> In particular, debt finance will not attract the 12.2–17.5% returns that KPMG quotes as being the cost of equity, and, as such, a WACC for an audit firm based on a more efficient capital structure may be lower than that quoted by KPMG.

<sup>20</sup> These criteria being: it must comprise a cost incurred now, primarily to obtain earnings in the future; this cost must be additional to those necessarily incurred at the time in running the business; and it must be identifiable as creating such an asset separate from any that arises from the general running of the business.

<sup>21</sup> Intuitively, this would lead to an over-allocation of common costs to audit, although it is noted that KPMG claims at para 3.4.4 that 'there is normally a strong correlation between different possible cost drivers (for example, headcount and sales) and therefore that using alternative cost drivers as a basis for allocating costs would be likely to result in similar outcomes in terms of our estimates of ROCE.'

<sup>22</sup> Competition Commission (2012), 'Statutory Audit Services Market Investigation: Liability, insurance and settlements', available at: <http://www.competition-commission.org.uk/assets/competitioncommission/docs/2011/statutory-audit-services/liability.pdf>, para 53.

<sup>23</sup> For instance, PwC reports that the comparator set used for PwC's cost of capital calculation has an average debt/equity ratio of 37%. PricewaterhouseCoopers (2012), 'The market investigation into the supply of audit services to large companies. Observations on the assessment of audit profitability: PricewaterhouseCoopers LLP', August 7th, para A7.23.

- At para 5.3.2, KPMG claims that partner employment costs will be significantly higher in the Big Four than in the mid-tier firms, referring to a ‘market rate for the talent required to deal with the larger and more complex audit engagements of the largest four audit firms’. However, given that 80% of the audit activity measured by KPMG occurs outside the FTSE 350, most of the partners relevant to KPMG’s analysis are not dealing with the ‘larger and more complex’ assignments, but are likely to be engaged on smaller assignments which are, perhaps, directly comparable with the work undertaken by the largest mid-tier firms. Presumably for smaller assignments the ‘market rate’ will not differ greatly depending on the identity of the audit firm. This cannot be compatible with the 100% difference in remuneration assumed by the CC.<sup>24</sup>

<sup>24</sup> As a working assumption, the CC assumes £473,000 average salary for Big Four partners, and £264,000 for mid-tier partners. Competition Commission (2012), ‘Statutory Audit Services Market Investigation. Profitability – part 1’, para 43.