

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

Summary of response hearing with Ernst & Young LLP held on 19 April 2013

Introduction

1. Ernst & Young LLP (EY) expressed its reservations about the evidential base of the Competition Commission's (CC's) provisional findings. It was concerned that there had been a selective approach to the evidence and that all of the relevant evidence had not been sought. It also considered that the evidence that had been relied on had not been fully tested and that it, in any event, did not support the conclusions in the provisional findings.
2. In relation to the CC's proposed remedies, EY considered there was considerable overlap between these and changes that the Financial Reporting Council (FRC) had recently implemented. EY was happy to embrace any change that regulators deemed appropriate provided they did not damage audit quality and did not trigger unintended consequences.

Provisional findings

3. In its provisional findings, the CC had found that a tender and switch of auditor typically led to a short-term price reduction that eroded over two to three years. EY said that it would have a good understanding of the requirements for a company's audit where it already had an existing business relationship with the company, where it had, for example, been working on improving aspects of the control environment or working on a company's accounting systems. However, if this was not the case, or if it was only providing tax-based advice, then in terms of understanding what was required for a company's audit, it would be reliant on representations made by a company's management to it about the state of the company's control environment and the state of its accounting. For such clients, there was a significant risk that EY would underestimate the cost of what was required to perform the audit. Accordingly, once it understood the full extent of any additional work required, its prices would rise.
4. This was not peculiar to audit and happened in other services that were complicated and non-commoditized. The reason it happened was because it took a while to understand the full scope of an audit, even if EY had many conversations with management.
5. EY considered that a way of improving its ability to price more accurately in a tender would be to split the tender into a two-part process, where the first part would focus entirely on audit quality, based around an open-book process, with no debate about price. Only those parties that got over the hurdle on quality would then be involved in part two, namely a debate on price.
6. EY did not put any premia into its bids to take account of any unknowns around scope. It would be aware of the current audit fees and so would have an idea of what it was expected to bid. It would also put qualifications into its bid and price on the basis that the information it had seen was fair and accurate. If that then turned out not to be the case, it would go back to the company to renegotiate the price.

7. EY's view was that because of the relatively low volume of tenders in the audit market, people were not very experienced of how to run them. Current tender processes tended to provide extensive access to management with a lot of opportunity to ask questions, but a non-incumbent firm would not have any direct evidence.
8. If EY felt that it could not manage the risk of insufficient information to understand the necessary scope and so price accurately by including qualifications in its contracts, then it might not make a bid. EY encouraged clients and potential clients to be as open and transparent as possible. However, the issue of not having enough information to bid accurately was not a massive problem.
9. If the volume of tenders increased then companies might change their approach in terms of providing access to management and bidders might not be able to obtain sufficient information to bid accurately. Audit tenders at the moment were very labour intensive. Everyone from the audit committee, Chief Executive, Chairman and financial controllers in the major divisions were involved. In contrast, EY could sell, say, £1 million of tax services after talking to three individuals. If the number of tenders a year increased, even if individual companies were only tendering infrequently, once every ten or seven years for example, EY expected tender processes to become more streamlined.
10. This would concern EY if it led to the audit being treated more as a commoditized product because this might have an effect on the quality of audits. EY believed the FRC and shareholders would have similar concerns.
11. EY considered that the CC had failed to understand that audit committees were sub-committees of the company board and had obligations to keep the board informed about their proceedings. Secondly, the chair and senior independent non-executive directors had obligations under the governance code for engagement with shareholders. EY would expect companies to be engaged with shareholders anyway. In EY's view this stream of information led to engagement with the audit committee and this context in which the audit committee played a role had been missed.
12. In the context of the CCs conclusions around principal-agent issues, the CC had failed to examine what company chairs did, what senior independent directors did and what streams of information were exchanged in this context with shareholders.
13. Since the audit product was defined by regulatory obligations, EY could not envisage a way of providing the product to meet the varying demands of shareholders within a single company. Whilst it could go above and beyond what was required by the obligations, there was a risk that meeting the demands of one set of shareholders might conflict with what other shareholders wanted.
14. The FRC had made proposals to amend ISA 700 which introduced new content into the audit report, which EY thought shareholders might find quite surprising. This included a description of how 'materiality' was used, which was a response to a demand. EY felt more comfortable with the FRC, given its role and responsibility, seeking to introduce changes to articulate a response to any demand, rather than an individual audit firm responding. EY thought that would be dangerous, in the context of audit as part of a global market. At the moment, there was a broad understanding of what 'true and fair' meant. Any departure from that which was not coordinated through regulatory bodies, could damage that general understanding. Making changes through regulatory bodies to meet changing demands for audit reports through an orderly and independent process was the right mechanism to meet differing shareholder demands for information.

15. If it was not coordinated by a regulatory body and left to individual firms to respond, auditors might disclose more information about some companies relative to others. This might lead to misinterpretations by shareholders and possible adverse consequences. If it was left to companies to decide whether more information about them should be disclosed then required by regulation, then it was unlikely that they would collectively move beyond the minimum requirement.
16. With respect to whether the FRC should have competition duties, EY considered that there was a tension between regulation and competition and trying to combine the two could create a conflict of interest. One of the FRC's six strategic objectives was about raising the productivity of the UK and so at that level it might be said to have an objective to make the UK more competitive.

Mandatory tendering

17. When bidding in a tender, EY would expect, if it won the tender, for the engagement to continue longer than one year and, as it would want the relationship to last a reasonably long time, it would put significant effort into the bid (and subsequently to provide a high-quality service) so that it did not lose the relationship. However, EY did not start from the position that the relationship would definitely last 10, 20 or 40 years.
18. If companies had to tender every ten years, EY would consider carefully whether to bid or not. This would be because one of the most important criteria that companies considered was the quality of the lead engagement partner. EY had a limited number of these and it would be very expensive to recruit more. It took EY approximately 14 years to develop such a partner. In a scenario where companies were required to bid every ten years, EY would have to take into account, at the time of tender, if it had the right quality of lead engagement partner available to compete for the engagement. If EY had the right resources, then it would bid as now. It would not change its bidding behaviour because even in the current framework, it assumed there were a number of points, shorter than ten years, where a tender might happen, such as at the five-year partner rotation point, or with the appointment of a new FD at a company. So, having a mandatory tender requirement at ten years would not make a difference to the way it bid.
19. In deciding whether to bid or not, EY would consider: the nature of the company; the nature of its pre-existing relationship; why the company was going out to tender; if it already acted for any of its close competitors; and the nature of the tender process. It would then form a view on what would be required to win the audit and make its decision whether to bid or not.
20. EY was concerned that a world of more frequent tendering for audits would lead to a shortage of high-quality audit partners. It did not think the market for such talent would adjust and it did not expect to see a dynamic movement of partners between firms, if certain firms were more successful than others in tenders.
21. EY supported open-book tendering where all bidders were given enough information to understand the problem areas in a company's audit (to the extent there were any). It also preferred a two-stage audit process. With a ten-year tender requirement, EY did not think that all firms would be in a position to tender for all big audit tenders. The information in an open-book process should include: how many hours were spent on the engagement; the hierarchy of the team; and if the hours were influenced by particular issues. This would be enough information for EY to have an informed conversation with management.

22. The information in an open-book process would not have to be as detailed as the information that currently passed between a new and old auditor on a change of firm. EY did not see the need for any proprietary information belonging to the audit firm to be shared in an open-book process. All firms had to demonstrate to the FRC that their audit methodologies complied with the ISAs. It was unlikely that any firms' methodology went beyond these standards to any groundbreaking extent.
23. EY did not think that tenders were currently over-specified. It was unclear if specifications from firms would change in response to an increasing overall number of tenders. From EY's perspective, where it decided to bid for a tender, it would give 110 per cent. There would be many more instances of firms opting not to bid because the staff required would already be utilized in other audits. This already happened to some extent. For example, EY had recently declined to tender for the [X] audit [X].
24. EY supported a ten-year frequency for mandatory tendering. It did not have any better data to suggest that any other period was better. If such data were to come to light then it said the frequency could be changed.
25. EY favoured a 'comply or explain' requirement over a 'mandatory' requirement. Comply or explain was at the heart of the UK Corporate Governance Code and applied to everything within the Code. The principle behind it was that boards were accountable for operating the business in accordance with the requirements of the code. However, there would be events and occasions when it would not be appropriate to follow the Code and more appropriate to explain to shareholders why that was the case. EY saw no reason why similar arrangement would not work for audit tendering.
26. EY saw no need for a limit on the number of explanations a company could provide. Shareholders were likely to intervene if they were not satisfied with the explanations that companies were providing.
27. There was a risk that more frequent tendering might reduce the recurring competition faced by the incumbent. Companies might tolerate behaviour or a sub-standard service that they might not do at the moment, in the knowledge that they were required to tender in the near future. This was only likely to be a risk at the margin, not where companies were very dissatisfied.
28. EY could not think of any circumstances in which conducting a tender would, in all cases, not be in the interests of shareholders. However, tendering every year would clearly be inefficient and on certain occasions, such as in the middle of a major acquisition, conducting a tender would not be in the interests of shareholders.
29. There was a possibility that EY might not bid for some non-audit services if there was a risk that that conflicted it out of bidding for the company's audit which it was aware would be tendered in the near future.

Mandatory rotation

30. EY was not overly concerned about the costs to auditors associated with mandatory rotation. The issue that most concerned EY with respect to mandatory rotation was that it introduced the possibility of the quality of the audit being impaired because the incoming auditor might not be suitable to discharge the audit mandate.
31. EY managed audit partner rotation by attempting to ensure that other partners working under the partner rotating off had sufficient credibility with management and the audit committee. Such partners would be familiar with some of the group issues and

participate in dealing with these. EY would introduce the audit committee chair (ACC) to potential candidates up to two years ahead of rotation and might encourage the ACC to speak with the ACC of the candidate's current engagements for a view. EY would try to understand from the current engagement partner the qualities in relation to ways of working that had worked well and use this information to find a suitable replacement candidate. It did not think that any of the processes it went through influenced the new partner's ability to be independent. It was for the ACC to consider the new candidate's ability to be independent and take that into account when deciding if he or she was a suitable candidate. The ACC and the audit committee provided a safeguard to ensure that the efforts of auditors to ensure that a rotating partner was acceptable to the audit committee did not compromise auditor independence.

Expanded remit and/or frequency of Audit Quality and Review

32. The Audit Quality and Review team (AQRT) process looked thoroughly at both the tone at the top in an audit firm and the control environment and processes that drove auditor behaviour. The Public Company Accounting Oversight Board (PCAOB) process looked at both of these also but its public reporting focused primarily on compliance with the Generally Accepted American Standards (GAAS). As a result, it did not have as much impact as a public reporting tool as the AQRT public reporting. These reports were very effective. EY routinely ended up discussing its annual AQR reports with a number of audit committees irrespective of whether it was the company's audit that had been reviewed. EY had no doubt that other Big 4 firms pointed out any weak EY AQR reviews to EY's existing clients.
33. The challenge with the reports was that in 99 per cent of cases, irrespective of the issues that might have been found, the audit opinion was still considered sound. With PCAOB reports, if it found any concerns with the tone at the top for an auditor, it would give the firm two years to resolve the issue before reporting publicly.
34. The AQR would have to recruit a considerable amount of resources if the volume of reviews was to be increased significantly.

Prohibition of Big-4-only clauses in loan documentation

35. EY supported the prohibition on such clauses being made as wide as necessary to avoid impeding the ability of non-Big-4 firms to compete.

Strengthening the accountability of the external auditor to the audit committee

36. EY supported this remedy except the requirement that the ACC should be the first point of contact if any material audit issue arose. This would change the nature of the relationship with, and independence of, the ACC.

Enhanced shareholder auditor engagement

37. Ten to 12 years ago, it was common for audit engagement partners to be asked questions in an AGM, although it was moderated through the chair.
38. EY considered that such questioning might resume again when the changes expected to ISA 700 were implemented. Shareholders would then have much more information around the major risks, how materiality was applied and similar considerations to ask questions about.

39. EY had proposed to the FRC that the auditor effectiveness section of the audit committee's report should be expanded and shareholders be required to vote on it. This might incentivize audit committees to do more to assess the effectiveness of their auditor, especially if their commentary was put to a shareholder vote. This would include a specific vote on whether the company should go out to tender for the audit service contract or not.
40. EY was initiating a further engagement with shareholders [✂].
41. EY also considered that the FRC was better placed to initiate engagement and dialogue between auditors and shareholders.
42. EY was relaxed about whether the hurdle for reappointment of the auditor should be raised from its current level of 50 per cent of those present at an AGM.
43. Part of the problem of little engagement by shareholders at AGMs was that they had other means under the Corporate Governance Code of expressing their happiness or displeasure with how a board of directors was doing.

Extended reporting requirements

44. Extended reporting in both the audit report and the audit committee report were valuable to take forward. Current proposals to amend ISA 700 suggested essentially lifting the risk assessment the auditor did and discussed with the audit committee at the audit planning stage and placing it in the audit report. This would also include the stance taken on materiality under the auditing standards.
45. Anything that was of importance as defined by the relevant audit standard was already lifted into the audit committee report from the management letter.