

STATUTORY AUDIT SERVICES MARKET INQUIRY

Summary of hearing with Ernst & Young LLP held on 26 September 2012

Profitability

1. Ernst & Young LLP (EY) said that the method it used to measure profitability per audit was kept under constant review. The current metric used was recovery rate per audit, but a new measure, based on gross margins, was being implemented across all its operations.
2. EY offered a number of professional services in addition to audit. As its business had grown and diversified, it believed the gross margin model would afford a more consistent appraisal of performance levels across its portfolio of services. It recognized that some of the shortfalls in the recovery model would exist in the gross margin model.
3. EY believed that the most efficient way to cost an audit was to discuss with the client the actual costs of delivering the audit in accordance with auditing standards and the cost drivers that might affect this. Cost drivers were numerous and comprised a number of factors, for example: a company's complexity; whether the company was a regulated business; and a company's IT and control systems. Factors such as these could impact on the cost of an audit and it was only when these were presented to the client that EY believed it could have a meaningful conversation with regard to fees.
4. Fees might not always directly correlate with costs, and a number of non-cost factors needed to be considered before the fee was agreed. [REDACTED].
5. EY reported on its performance to the client over the course of the audit cycle and these contacts ensured that the client had input into the question of fees. In the current economic climate, clients were reluctant to accept any increase in audit fee and so EY would discuss with clients what could be done, where more work needed to be done than previously to ensure that the audit was conducted in an effective and cost efficient manner.
6. EY expected to achieve a [REDACTED] per cent recovery rate on the standard costs of an audit. If there was a risk that a fair return would not be achieved, there were internal escalation processes that would see the involvement of the Chief Financial Officer (CFO) or the service line leader of its business.
7. The viability of an audit engagement would be reconsidered if the recovery rate was less than [REDACTED] per cent, but factors other than profitability, such as risk and strategy, were also taken into account before a client relationship was ended. Strategically, the ability to audit a prominent client and use its name as a credential added value to the EY brand and could offset a lower recovery rate. Likewise, where a client had indicated that it wished to expand its business, a lower recovery rate might be endured in the hope that the audit engagement would become more profitable in the future.
8. EY believed that while audit was a repeatable business, other services offered by EY, such as some of its taxation services, had similar characteristics. It was also keen to stress that although the Competition Commission (CC) had identified audit as repeat business, there was a rigorous discussion and negotiation process each year with the client.

Differentiation

9. Across EY's service lines, it had invested in a number of areas that set itself apart from its competitors. It had invested in developing its capabilities and strategies and its marketing materials emphasized its global reach, its entrepreneurial spirit and the quality of its staff. Global reach was an important differentiator for EY. Its authority and ability to influence events across its international network was highly valued by clients and was valued more highly among clients than the actual size of the network.

Switching, tendering, marketing

10. EY did not believe that certain types of company were predisposed to engage in a long relationship with an auditor and there were a number of factors that could affect a relationship. For example, EY was aware that some Audit Committee Chairs (ACCs), when they joined a new organization, always told their new CFO that a tender would be a good way to reduce the audit fee, whether that resulted in the retention of the incumbent or a change of auditor.
11. With respect to the Financial Reporting Council's (FRC) recent review of audit committee guidance (so that companies must tender their audit every ten years or explain why not), EY was unsure what effect the review would have on the tender process. If the requirement to tender proposals were confirmed, there would be an expectation that audit committees and boards would have to make a strong case for the reappointment of an auditor following a tender. Other boards might believe it would be easier to change auditors.
12. When attempting to win new audits, it was difficult to measure the degree to which EY's investment in time and relationship building would be recovered during an audit engagement. It had developed tools to identify these costs when it prepared large-scale bids, but it was not an exact science. The preferred approach when it sought to gain new clients was to do whatever it cost to win the tender.
13. If the FRC proposals were enacted in full, EY would need a different model with regard to winning tenders. The current infrequency of tenders meant that the best way to compete competitively was to make every effort to win, since if EY won the tender it would be likely to lead to a long engagement. EY believed that the infrequency of tenders strengthened the arguments for pursuing bids at all costs, even if there was a low chance of winning. For future tenders, EY might adopt a more selective approach.
14. The team responsible for the bid was led by a partner and comprised senior staff. The team would emphasize its global presence and demonstrate that it understood the business and could work with the company and its people. Partners were allocated to business development in a manner that utilized the skills of each individual. Some partners were very good at handling long-term relationships while others demonstrated a flair for building new relationships.
15. The effort put into a tender was to a degree regulated by the client. There would be a schedule of meetings and visits to undertake and it would be very difficult to turn any of these down. There were occasions when EY would like more access to the process, but a balance had to be struck with the desire to win a contract and not upsetting the client.

Tendering

16. While EY had won audits where it had no prior relationship with the company, this was generally very difficult. It was possible to overstate the importance of a relationship, but EY saw it as an important component when it assessed the likelihood of winning a tender. Where a relationship did not exist, EY was not inclined to bid unless there were a number of favourable countervailing factors.
17. EY had won a significant tender where it did not have previous audit-based relationship with a client ([X]). The decision to bid was taken due to a combination of factors and the key was the availability of its most experienced audit partner in the sector, who had just rotated off a very dominant client. It knew that this partner would be favourably viewed by the client and EY was also in a position to assemble a strong team to run the bid.
18. The availability of the audit partner was crucial in both winning tenders and a company's decision to tender. In the CC's survey, both CFOs and ACCs cited the experience and the relationship and the experience of the Audit Engagement Partner (AEP) as being key. EY felt that the better this key relationship, the more chance one had to win a tender.
19. EY viewed the tender process in two stages. The initial phase was to meet with the individual decision-makers and the second phase was the formal pitch. The initial meetings allowed EY to demonstrate its experience of working with similar organizations and highlight initiatives that might appeal to the client. EY believed that if the tender was not won in the initial meetings, it was very difficult to secure the tender via the pitch.
20. It was also not always obvious why a company had gone out to tender. The driver was usually good governance, but as EY engaged with the client and gained its confidence, concerns and shortfalls with its current auditor sometimes emerged. These types of insights enabled EY to build and present a relevant and exciting audit proposition.
21. Of all EY's service lines, the audit entailed the most complicated tender process. It was possible to generate high revenues, for example from tax consulting, which would involve a much simpler tender process of talking to one or two client staff compared with an audit tender which typically involved talking to a large number of client staff.
22. Having a prominent client in a certain sector could be an important indicator of an audit firm's reputation and help win new clients. Industry knowledge and insights were also clear advantages. It was important to demonstrate experience of a certain sector and show the practical consequences and benefit to the client of the experience gained.
23. As EY identified what was valuable to the client, the commercial strategy was tailored to the client's needs and the fee was developed. As a rule, the larger the fee, the more people it would expect to have involved in approving the audit fee. When it determined a base fee, EY worked from the data supplied by the client. Some clients expected a certain level of service and if EY was unsure how price sensitive the client was, it would prepare a number of fees that contained different options and service levels. This was another way to identify what clients wanted and what they were willing to pay.

24. There was little negotiation before determining the fee, but if the client did not like the fee, it would speak with EY. The goal for EY was to understand the client's business and for the client to like the team and the offer. Where there was a long-standing relationship with a client, it was possible to discuss the fee on an informal basis. EY was a little surprised at the conclusions reached in the case studies with regard to price versus quality, as EY's perception of working with clients was that price was something that was actively debated. Pre-tender engagement with a client was important, in order to develop a sense of a company's style, which would feed in to the audit product and fee. Where a company had undertaken the tender to drive down costs, EY's tender proposal would be different from that where a company reacted positively to EY proposals and initiatives.
25. EY's fee was not driven by competitors' offers as it did not usually know the price offered by its rivals during the tender process. Flexing of its fee was driven by what mattered to the client, rather than expectations of what others might be bidding.
26. EY had submitted to the FRC that tenders should be done on an open-book basis. This, it believed, would enable an understanding of what was needed to deliver the audit safely. EY had also suggested that the tender process should be run in two parts, as was very common in large consulting assignments. First, there would be a tender process based on quality, to sift out those who had put forward the best-quality presentation. The second part would involve a further discussion on price with those who come through the first round.
27. An open-book approach would enable a client's Audit Committee to work with the incumbent auditor and develop a document that set out the principal audit risks, the staff deployed to respond to these risks and the hours needed to deliver a safe audit. EY believed that this approach would enable a much more coherent and grounded tender response. The structure of audit tenders carried an inherent level of uncertainty when compared with, for example, the outsourcing of a large finance function where the level of detail would be known to the smallest degree. In an audit tender, it was relatively rare to get an understanding of the bespoke elements of a client's control and accounting environments.

Choice

28. It was not unusual for a company to tender to reduce its audit fee, which might lead to a fee reduction of 10 to 20 per cent on some occasions. The question of why there were not more tenders was a valid question, but was best directed at those who made the decision to tender. EY's own belief was that tenders occurred when there was some degree of dissatisfaction with the audit product, but dissatisfaction was not an automatic trigger to tender. The desire to achieve a fee reduction could be weighed against other competing items on the corporate agenda. It was also the case that when issues arose, the incumbent auditor was likely to be proactive and to resolve these. When a company did go out to tender in an attempt to reduce the audit fee, it was not a surprise to see a reduced audit fee, but sometimes that did not happen.
29. When a client wanted a reduced audit fee, there was a negotiation around the scope of services offered, while still retaining the required level of assurance. EY had worked hard to remove redundant costs from the audit process and to innovate in the delivery of an audit; its off-shoring facility was an example of this. The current trend in its audit offering had witnessed a decrease in revenue per hour and gross margin.
30. To decrease costs, while maintaining the required level of assurance, EY had worked with companies' internal audit departments. Another tactic was to ensure that it

adopted its approach to utilize investments clients had made in IT. Clients had identified in tenders examples of the incumbent not moving its audit approach forward to reflect and leverage off some of the investments it had made. EY believed that opportunities did exist for audit firms to work in a more efficient and collaborative way.

31. Independence and conflicts of interest did on occasion limit tenders for which EY could bid, but at the top end of the FTSE, companies planned their working arrangements with the Big 4 firms to ensure that there were no conflicts.

Annual renegotiations

32. EY periodically undertook a benchmarking exercise across its fees and costs. It undertook such an exercise not to justify a fee, but to enable a meaningful discussion with a client around audit costs and fee levels. EY had the resources to undertake such an exercise and, as it worked across a number of organizations, it had insights that provided it with more granular data points than the publicly available information.
33. Benchmarking was not necessarily a means to an end in determining an audit fee, but it did enable a fuller explanation of an audit cost. EY had clients who had eight subsidiaries and others that had 95 and these drove very different cost bases. Similarly, some clients had a different IT system in each subsidiary and another that used the same IT system globally and this would lead to very different cost drivers. EY would also look at comparisons with companies in similar sectors or similar types of FTSE clients when benchmarking.
34. The fee negotiation would usually take place with the group controller and CFO. If there were any disagreements around the fee, the Audit Committee Chair might become involved. The fee negotiation was a two-way process. EY would undertake a lot of research and produce an analysis of the fee. With the CFO or equivalent, it would go through a detailed breakdown of the cost, what were its components and how it compared with other companies. The breakdown would go forward to the Finance Director and board and then to the Audit Committee. The client, usually because of the backgrounds and experience of its staff, would have a good idea of how the audit was made up and of the costs. Non-executive directors would have experience from other companies.

Restrictions on entry and expansion

35. EY competed strongly in the audit market and always sought to innovate and develop new ways of doing things. As a semi-incumbent, there were limits on how far it could develop its competitive strategies without unbalancing its global business and its business model. What surprised it about its rivals was the lack of innovation in their offerings. There was a perception that there was only one way to compete in the audit market, but it believed there were many alternative ways.
36. Internal audit could be used as an entry point (for instance, for Mid Tier firms) for the external audit. EY believed that internal audit functions in some large, listed companies could be improved. A company could offer a proposition that re-engineered a company's internal audit offering, leading to savings in external audit costs. The credibility that could be garnered might lead to the company being viewed differently when tenders arose. If the proposition came to nothing, it might at least lead to a reconsideration of the audit firm by the Finance Director.

37. Towards the top end of the FTSE 350, when new firms listed, investment bank sponsors tended to prefer one of the larger audit firms. Most of these types of firms were overseas companies, often from emerging markets. Mid Tier firms were active in the mid to bottom end of the FTSE 350.
38. EY stressed that it had got where it was today through its choices, its strategies and investments. Whether it was its reaction to globalization or emerging markets, it had adapted its services, organization and structure to compete and win business in these markets.

Switching costs

39. Following a successful tender, when EY brought a 'fresh pair of eyes', that had been highly valued and acted upon.
40. It did not feel there was any particular point during the life cycle of an audit when there was a greater chance of a mistake occurring. It thought that if it undertook the audit in accordance with auditing standards, mistakes should not happen. Where an auditor took on a big, complex organization, it would take an audit team time to understand the risks and attendant controls of an organization.
41. EY had encountered situations where a company had questioned it on its use of certain accounting practices to see whether it agreed with these practices. It had lost a recent tender where it had disagreed with the incumbent's interpretation of some quite complex accounting.
42. Audit partners did not operate in isolation and their judgements were often checked by others. The big decisions an AEP would make were often subject to review by an independent review partner or a professional oversight panel. When an AEP was rotated, the important consideration for EY was the transition process rather than the judgements and decisions that needed to be taken.

Reputation as a proxy for quality

43. One visible aspect of the quality of EY's audit offering was the quality of the AEP that was put forward. Much pre-tender activity took place during quiet periods of an audit when a partner's time was not expensive to utilize. The pitch team sold the quality of its proposition and stressed its uniqueness. Companies would also ask technical questions of the pitch team during the tender process to assess the strength of the audit proposition.
44. EY believed that audit committees were well positioned to take a view as to the robustness of the audit. The interactions between the audit committee, and certainly the ACC, and audit partner were very thorough. The AEP had to demonstrate a good understanding of the business and the Audit Committee would make a judgement as to whether the team had delivered on quality.
45. As evidenced in the CC's case studies, the level of intervention an ACC chose to make varied. Some ACCs wished to have extensive engagement with the audit planning and work programmes. Other ACCs had less connectivity with those areas. It did not follow that the more engaged someone was, the more likely they were to pick up on things the auditor had missed.

46. In building relationships with clients, EY's emphasis focused on the business side of things rather than 'wining and dining'. A relationship derived from the delivery of something valuable to a client.

Liability

47. EY's claims history was cyclical and it had taken a number of steps to address its exposure as it had unlimited liability. Around 15 years ago, it faced a number of ruinous claims. Following these, it had invested heavily in its quality risk management procedures, carrying out stringent checks, and developed additional procedures, on the risk profile of its clients. In relation to financial services audit work, EY still had high exposure and in times of economic downturn the level of claims increased, and were currently rising.
48. A potentially ruinous claim and significant reputational damage both carried equal weight in posing potentially life-threatening consequences to one of the Big 4. Though reputational damage did not appear to be an overt feature that had affected audit firms following the financial crisis, the risk levels in audit were still very high. As an auditor with unlimited liability, if there was a catastrophe with a large billion dollar organization, the liquidators would pursue EY as it was the financially sensible course of action.
49. There were elements of reputational damage that were not visible. For example, when a large company went into liquidation, an adverse regulatory report could colour perceptions of an audit firm in ways that were difficult to track.
50. EY must have high levels of coverage and pay huge premiums because a high claim could be ruinous to its business. Having such protection also boosted the morale and wellbeing of its partners. Though such incidents could be viewed as unlikely and remote, they could occur at some point.

Shareholders

51. EY was surprised at the CC's polarization of the interests of shareholders and management in its analysis of the purpose of an audit. This analytical approach failed to address the positions of other interested stakeholders and risked oversimplifying the issues. EY was concerned at the omission of the Chairman of the Board in the analysis, who had explicit responsibilities under the corporate governance code to engage with shareholders on audit and other issues. The analysis also omitted the role of the senior non-independent executive directors, who also had explicit responsibilities under the code, partly designed to cover an unlikely eventuality in which the Chairman of the Board did not fulfil their own responsibilities.
52. From EY's perspective, audits were conducted in the public interest, under the relevant governance arrangements. It had no issue with shareholder/investor representations. It noted that investor representatives were present on every standard-setting body, whether at the global or UK level. In the design or formulation of accounting standards, investor representatives, usually from large institutional investors, were full members of the decision-making boards.
53. Since the introduction of the audit firm governance code, EY had begun a stakeholder engagement programme and had held two or three meetings with institutional groups. Prior to the new governance code, the success of EY's efforts to engage with stakeholders had been limited.

54. The engagement process was at an early stage of its development, with limited success. As the dialogue matured, it was hoped that a broader discussion would evolve. Following the financial crisis, there was a considerable focus on the future of financial and audit reporting, to which EY contributed at both local and global level. It hoped that those investors it had spoken with were active members of the standards-setting bodies and would raise their concerns on the nature and output of auditing.
55. As the CC's own research had shown, there was a range of different investors. There were the long-term investors whose attitude and approach to corporate oversight was different from those investors at the other end of the spectrum, the day trader whose focus and interest was on immediate profit.
56. EY had encouraged the FRC, as the body responsible for the corporate governance code and for the oversight of firms, to take a role in bringing together the auditor and investor communities.
57. If the purpose of an audit was to give assurance to shareholders and investors, it was reasonable to be surprised that engagement with shareholders and investors was a recent phenomenon and the result of a new code. The roots of this lay in the orientation of UK corporate governance and earlier versions of the governance code that did not wish to constrain the entrepreneurial flair of management in the development of a business by excessive shareholder oversight.
58. EY did not accept that the interests of CFOs and shareholders were misaligned. The concept of the unitary board in UK corporate governance was intended to strike a balance between the short- and long-term interests of shareholders and the strategic opportunities afforded companies.

ACCs

59. The ACC had to be seen to be responsive to shareholders' views. If shareholders expressed concerns about a company's venture into an emerging market, it was to be hoped that an ACC's investigation through the Audit Committee would be more extensive than had shareholders not expressed their concerns.
60. The role of an ACC was an extremely difficult one and involved a huge responsibility. Within the unitary board process, ACCs ensured that the Finance Director, external and internal auditors and others were executing their roles properly and took their roles very seriously.
61. The resources afforded to an ACC would differ from company to company and the work undertaken by an ACC would reflect experience and background. For example, an ACC with a CFO background at a number of listed companies might feel comfortable in the role, while an ACC without this background might want to spend more time with the CFO and group controllers as this was not an environment they were familiar with. Likewise, where an ACC was working with a brand new Finance Director, one would expect the ACC to have a heavier presence than if they were working with a Finance Director of ten years' experience who had a good track record in identifying problems and reporting them. The approaches adopted by different ACCs did not mean that they were not doing their job properly, more they reflected the circumstances the ACC found themselves in.