

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

ERNST & YOUNG LLP - RESPONSE TO THE FRAMEWORK FOR THE COMMISSION'S ASSESSMENT AND REVISED THEORIES OF HARM

1. Ernst & Young LLP ("EY") has already expressed its views on the Commission's original theories of harm. The Commission's apparent move away from some of its earlier areas of concern is welcomed. In particular, the Commission's recognition (according to the paper on Restrictions on Entry or Expansion) of the absence of any material evidence that barriers to entry are being created by bundling or tying entirely accords with EY's own experience and expectations.
2. It would be premature to comment in detail at this stage on the various hypotheses that the Commission has now indicated that it is exploring, particularly in relation to the first of the Commission's revised theories of harm. EY awaits with interest the Commission's exposition of the evidence it has obtained and its preliminary conclusions on the validity and relative importance of the various issues it is investigating in its subsequent working papers.
3. There are however a number of issues raised by the second revised theory of harm which merit further comment at this stage.
4. The Paper provides an interesting analysis of the economic role of the audit and highlights a number of important issues, in particular:
 - (i) the number and variety of parties with an interest in the audit and the consequent multiplicity of potential principal-agent issues;
 - (ii) the wider public good served by audits;
 - (iii) the very different levels of engagement between the various stakeholders and the auditors;
 - (iv) the information asymmetries between the different stakeholders in relation to the audit and auditor;
 - (v) the multifaceted regulatory framework in which audits are provided and auditors supervised;
 - (vi) the fact that the audit is only one element in an extensive regulatory framework designed to minimise the risk of market failures.
5. However, there are a number of aspects of the Commission's analytical framework that merit further comment.

Focussing on shareholders v management is an oversimplification

6. On the range of interested parties, although the Commission acknowledges the importance of the audit for a wide range of stakeholders including potential investors, creditors, customers, suppliers and employees, in subsequent sections it tends to focus on the

difference between the position of the Finance Director, Audit Committee and Audit Committee Chair on the one hand and the shareholders on the other. Polarising the analysis on the potentially different interests of the shareholders on the one hand and management on the other, fails to address the positions of other interested stakeholders and risks oversimplifying the issues.

It cannot be assumed that stakeholders have the same interests

7. The Commission has posited the existence of a “*disconnect between the demand from shareholders and other stakeholders and supply (in terms of the product delivered by auditors)*” and raised the possibility that auditors may be more focussed on the demands of / variables used by Finance Directors and Audit Committee Chairs rather than those of other stakeholders (particularly shareholders).
8. In considering this possibility the Commission needs to be mindful that there is not necessarily any commonality of interest within any single category of stakeholders—let alone across the range of different groups of stakeholder.
9. In places the Paper appears to assume that the interests of all shareholders (and indeed other groups of stakeholders) are aligned. That is not the case, particularly in relation to companies within the FTSE350. Indeed as the Commission acknowledges in paragraph 87 they may conflict. The conflict in interests between different shareholders is patently apparent at many AGMs. Indeed as the Blackrock case study indicates a single shareholder may adopt very different approaches and so have different interests in relation to different investments
10. Consequently, even if the Commission were to conclude that this is an area of concern from a competition perspective any remedy would need to address whether it is feasible –or indeed desirable-- to attempt to first identify, reconcile and then address other stakeholders' interests.

Practical aspects of greater engagement with other stakeholders and their interests

11. The Paper does not articulate what the Commission has in mind when it refers in paragraph 84(b) to “*certain demands of the company's shareholders and other investors*”.
12. From the comments submitted to the Commission there are indications that some shareholders would like greater direct engagement with the auditors—although views appear to vary on this point. However, there are clearly practical and legal constraints on how far such desires could be met - not least confidentiality and potential insider information issues - as well as the additional costs entailed. In this context, we note that principles F1 and F3 of the Audit Firm Governance Code (issued in January 2010) commit audit firms and shareholders to have dialogue with each other. EY has followed those principles through regular meetings with a number of institutional investor groups to discuss matters of mutual interest that are consistent with our confidentiality obligations to clients and the spirit of these principles.
13. Any proposals that place obligations on auditors to address and engage with a wider range of stakeholders or which seek to reduce the information asymmetries must address not only what demands auditors should be expected to respond to and from which stakeholders but also how these practical issues are to be addressed.

The variety of stakeholders with potentially different interests is addressed by a multifaceted and evolving regulatory regime

14. As the Commission recognises audits and the regulatory regime applicable to audits are only one element of a much more extensive regulatory framework aimed at minimising the risks of market failure. The potential principal-agent relationships and issues are very numerous and, irrespective of whether they raise competition issues or not, it is recognised that at least some of these issues merit being addressed. As a result an extensive framework of legislation and regulation has been developed over the years to address some of these concerns. This framework includes corporate law, specific rules applicable to publicly listed companies, and insider dealing rules. This framework is extensive and has developed over many years and is continuing to evolve at both a national, European and, in some areas, international level.
15. The rules specific to audit form only a small part of this matrix. However there are (as the Paper acknowledges to some extent) already structures in place to address some of the potential concerns raised by the Commission. For example:
 - (i) the detailed statutory and standards based controls over the content and conduct of the audit;
 - (ii) the extensive ex post review of audit quality carried out by the AIU is designed in part to address the difficulty that management, shareholders and others have in assessing audit quality;
 - (iii) the role of professional bodies in disciplining auditors;
 - (iv) the detailed standards established for the conduct of audits.
16. In addition, but critically, the importance of maintaining their reputation for professional integrity is a powerful factor in ensuring that auditors do not become unduly focussed on the priorities of management. The Commission should not lightly dismiss the efficacy of the measures already in place.
17. The need to keep the risks and regulatory solution under regular review is acknowledged. By way of illustration a number of the issues under consideration specifically related to audits are currently subject to review and proposals for change by specialist regulators. For example:
 - (i) the FRC's current proposals in relation to audit tendering;
 - (ii) the FRC proposals on changes to the International Standards on Auditing (UK and Ireland);
 - (iii) the PCAOB's consideration of audit firm rotation;
 - (iv) the AADB's consideration of the sanctions regime for accountants and auditors;
 - (v) the FRC's consultation on proposed further changes to the Corporate Governance Code in relation to audit committees and audit retendering.

18. Whilst these regulatory issues are complex, they do not in any clear sense relate to or derive from the level of competition in the market. In seeking to address perceived principal-agent issues the Commission needs to consider carefully to what extent these issues are already addressed through other regulatory mechanisms – or could more satisfactorily be so addressed.

The role of the UK Corporate Governance Code in addressing shareholder-management principal-agent issues

19. One important aspect of the existing regulatory landscape which appears to have been overlooked or at least undervalued in the Commission's analysis is the UK Corporate Governance Code promulgated by the FRC. The relationship between the board and shareholders is addressed throughout the Code and effective communication between a Board and the shareholders was a focus of the revisions made in 2010
20. Section E of the Code is entitled *Relations with shareholders* and the introductory paragraph emphasises the need for the board as a whole to ensure that a satisfactory dialogue with shareholders takes place. The Code also contains 'Engagement Principles for Institutional Shareholders'.
21. Section C of the Code addresses *Accountability* and contains provisions on the board's responsibilities to "*present a balanced and understandable assessment of the company's position and prospects*". Section C also contains extensive provisions dealing with the composition and function of the Audit Committee.
22. The Code also requires the appointment of a senior independent director with a specific responsibility to be available to shareholders.
23. In considering potential principal-agent issues the Commission needs to examine the extent to which these issues are already, or could be further, addressed through the Code.

The role of the non-executives on the Audit Committee and Board should not be disregarded

24. In assessing the extent of principal-agent issues the Commission needs to have regard to the involvement of non-executives on Audit Committees and Boards and the role they have in ensuring that external stakeholders' interests are considered.
25. The Commission's paper focuses on the Chair of the Audit Committee. However, the other members of the Audit Committee must include at least two or three (depending on the size of the company) non-executive directors. The role of these non-executives in overseeing the selection and review of the external auditor is a key part of the mechanisms already in place to address some of the potential principal-agent issues raised by the Commission. The suggestion that the Audit Committee creates a further problem rather than being the solution to a problem seems to be an unduly cynical view.

Conclusion

26. Whilst not disputing the potential for principal-agent issues to arise in this context, care must be taken to ensure that further changes to an already complex and evolving matrix of regulations do not lead to unintended consequences.