

## STATUTORY AUDIT SERVICES MARKET INVESTIGATION

### ERNST & YOUNG LLP - RESPONSE TO VIEWS OF INVESTORS AND OTHER STAKEHOLDERS WORKING PAPER

1. This submission is in response to the CC's working paper *Views of Investors and Other Stakeholders* (the "Working Paper"), and the CC's email of 16 November 2012, in which the CC asked EY to consider (within the context of the CC's second theory of harm) whether *"investor views show that there is an unmet demand relevant to the audit product, and if so, whether any inability of or constraint on either firms or companies is producing such unmet demand, and so could amount to one or more features of the market leading to an adverse effect on competition"*.
2. As to EY's general views on the CC's second theory of harm, we refer the CC to EY's previous submissions on this issue, including its response to the CC's working paper Framework for the Commission's Assessment and Revised Theories of Harm, and submissions made at the hearing of 26 September 2012.
3. EY makes the following preliminary comment. The Working Paper states that the CC considers *"the purpose of audit is to provide assurance to shareholders regarding the financial reports produced by the management of the companies in which they hold shares. However, other stakeholders such as lenders, suppliers and customers, as well as other ratings agencies, also benefit from the assurance audit firms provide"*. To be clear, a statutory audit is the provision of an independent view to shareholders on whether the company's financial statements present a "true and fair view" of that company's financial position (section 495 of the Companies Act 2006). Although other stakeholders might refer to and use audited financial statements, that is not the purpose of a statutory audit.
4. On the issue of whether there is an "unmet demand", EY considers that caution should be exercised by the CC in this regard. In particular:
  - (a) There is not a commonality of interest within any single category of stakeholder, let alone across the range of different categories of stakeholder. Although some (but not all) institutional investors would like more to be included in the audit report, there is no consensus among institutional investors on what should be included, and therefore there is no clear consistent "unmet demand".
  - (b) Considerable regulatory attention has been focussed on what, if anything, additional features should be included in audit reports, with all interested parties having the opportunity to contribute their views. Significant proposals (which EY generally supports) are under consideration by appropriate regulators.
5. In the absence of any clear evidence of consistent views on "unmet demand", it would be inappropriate for the CC to draw any conclusions about the existence of *"features of the market leading to an adverse effect on competition"*.

### No Commonality of Interest

6. As EY noted in its response to the *Framework for the Commission's Assessment and Revised Theory of Harm* paper, in considering this issue the CC needs to be mindful of the fact that there is not necessarily any commonality of interest within any single category of stakeholder, let alone across the range of different categories of stakeholder.
7. The views reflected in the Working Paper reinforce this lack of commonality of interest. The range of views is unlikely to be fully represented in the Working Paper: CC has limited its assessment to the views of a small number of stakeholders. In particular, although clearly important, the views and interests of institutional investors are not necessarily aligned with (for example) individual shareholders.
8. As stated, what is clear from the views described in the Working Paper is that the stakeholders whose views have been sought hold a variety of views on the issue of whether more information could be provided in the audit report. As the Working Paper recognises, some do not think that further information is necessary, whilst others expressed views as to what additional information should be included. This raises the question of whose "demand" should be considered – institutional investors, individual shareholders, or each and every investor, potential investor, shareholder or other stakeholder?
9. Of course, the audit report could be designed to address all of the issues that all of the shareholders in a particular company, and other interested stakeholders, would like it to include (to the extent that these issues can be determined), provided it meets statutory and regulatory requirements. However, any such additional reporting will inevitably drive up the audit fee. As the Working Paper states "*investors who wanted more information were willing to pay more for this (as long as the price was reasonable)*". EY has some preliminary observations in this regard:
  - (a) Whilst each shareholder or investor might be willing to pay for the additional reporting that they wish to see, they will be less willing to pay for the cost of an audit report that covers all of the areas and issues that all shareholders and stakeholders might wish to see included.
  - (b) The demand for any additional reporting or expanded audit scope will depend on the cost. As a result, in considering whether there is truly an "unmet" demand, it is necessary to consider whether there would be demand for additional reporting given the likely cost of that additional reporting.
  - (c) The only stakeholders who pay (albeit indirectly) for audit services are shareholders, and it is for shareholders' benefit that audits are conducted and audit reports produced. Although other stakeholders (including potential investors) might find additional reporting useful, they do not pay for the audit.
10. Given this clear lack of any commonality of interest, it is not clear that there is a consistent "unmet demand" for the market to respond to.

### Regulatory Attention

11. There has recently been considerable regulatory attention on the issue of what, if any, additional features should be included in audit reports to enhance their value, and various proposed changes are currently under review. EY generally supports the proposals, and has been actively engaged in with regulators on these issues to ensure that the proposals

are implemented effectively. Stakeholders, including institutional investors, have been consulted on the proposed changes.

12. By way of example:

(a) In June 2012 the International Auditing and Assurance Standards Board (IAASB) published an Invitation to Comment "*Improving the Auditor's Report*" (Annex 1).<sup>1</sup> The Invitation to Comment follows the IAASB's Consultation Paper "*Enhancing the Value of Audit Reporting: Exploring Options for Change*", which was published in May 2011, and to which a wide variety of stakeholders (including institutional investors) responded. The Invitation to Comment, which takes account of the views of other stakeholders, recommends a number of improvements to audit reporting, including:

- "• *Additional information in the auditor's report to highlight matters that are, in the auditor's judgment, likely to be most important to users' understanding of the audited financial statements or the audit, referred to as "Auditor Commentary." This information would be required for public interest entities (PIEs) – which includes, at a minimum, listed entities – and could be provided at the discretion of the auditor for other entities.*
- *Auditor conclusion on the appropriateness of management's use of the going concern assumption in preparing the financial statements and an explicit statement as to whether material uncertainties in relation to going concern have been identified.*
- *Auditor statement as to whether any material inconsistencies between the audited financial statements and other information have been identified based on the auditor's reading of other information, and specific identification of the information read by the auditor.*
- *Prominent placement of the auditor's opinion and other entity-specific information in the auditor's report.*
- *Further suggestions to provide transparency about the audit performed and clarify the respective responsibilities of the auditor, management, and [those charged with governance] in an ISA audit".<sup>2</sup>*

EY generally supports the proposals set out in the Invitation to Comment, and is engaging with the IAASB on practical issues to ensure an increase in the usefulness and informational value of audit reports. EY's response to the Invitation to Comment is contained at Annex 2, and copies of EY's public statements on the issues raised are contained at Annexes 3 and 4.

<sup>1</sup> See [http://www.ifac.org/sites/default/files/publications/files/Auditor\\_Reporting\\_Invitation\\_to\\_Comment-final\\_0.pdf](http://www.ifac.org/sites/default/files/publications/files/Auditor_Reporting_Invitation_to_Comment-final_0.pdf).

<sup>2</sup> *Ibid*, page 6.

- (b) In April 2012, the FRC issued a Consultation Paper "*Proposed revisions to International Standards on Auditing (UK and Ireland) to give effect to the FRC Effective Company Stewardship Proposals*" (Annex 5).<sup>3</sup>

The Consultation Paper, to which all stakeholders had an opportunity to respond, proposed a number of changes aimed at enhancing auditor communications with audit committees, enhancing board reporting and extending auditor reporting (including a requirement on auditors to report whether the review undertaken by the auditor of the annual report reveals information which is incorrect or inconsistent with the information contained in the financial statements).

EY is again generally supportive of the proposals, and considers that the proposals will, if properly implemented, contribute to greater transparency in corporate reporting and as such enhance stakeholder confidence. A copy of EY's response to the Consultation Document is contained at Annex 6.

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<sup>3</sup>

See [http://www.frc.org.uk/getattachment/cf1f2c07-b64e-40bb-bcbb-51f639760978/Consultation-Paper-Proposed-Revisions-to-International-Standards-on-Auditing-\(UK-and-Ireland\).aspx](http://www.frc.org.uk/getattachment/cf1f2c07-b64e-40bb-bcbb-51f639760978/Consultation-Paper-Proposed-Revisions-to-International-Standards-on-Auditing-(UK-and-Ireland).aspx).