

## STATUTORY AUDIT SERVICES MARKET INVESTIGATION

### ERNST & YOUNG LLP - RESPONSE TO COMPETITION COMMISSION WORKING PAPERS

#### 1. Introduction

1.1 Rather than respond to each of the Working Papers in turn, this response sets out EY's general observations on what EY considers to be the key themes and issues arising out of the Working Papers listed in Footnote 1 below<sup>1</sup>, taken together. This response should be read in conjunction with the transcript of the hearing of 26 September 2012.

#### 2. Audit is not a low-risk business

2.1 The CC concludes its Working Paper *Liability, insurance and settlements* with the statement "*the low level of claims settled by firms in the last ten years and the low value of these claims (relative to the size of the firms), combined with the ability of the firms to enter into effective insurance arrangements, suggests that the risks faced by audit firms in relation to professional negligence may be regarded as low*" (emphasis added).<sup>2</sup>

2.2 EY disagrees with this statement. The risk of negligence claims being made arising from EY's audit practice continues to be regarded by the firm as a significant business risk, in respect of which EY continuously seeks to minimise its incidence through a combination of training and other quality control and risk management measures and to protect against the consequences of claims through insurance. The fact that the level of claims over £1 million settled by audit firms has, according to the CC<sup>3</sup>, been relatively low in the last few years, and that insurance has been available to audit firms, does not justify a conclusion that the risk faced by audit firms in respect of professional negligence is low. Rather, it demonstrates that audit firms have been successful in taking steps to manage that risk as far as possible.

2.3 In assessing the level of risk, the CC needs to take into account the cyclical nature of these sorts of risks. Claims against audit practices tend to increase in difficult economic times. Although the last eight years have been marked by relatively low levels of settlements, EY is starting to see an increase in the volume of claims and indeed the size of claims. The real risk cannot be assessed without looking over fairly long periods: the

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- (a) Audit market investigation: Overview.
- (b) Firms' stated competitive strategies and the accompanying Appendix – The strategies of individual firms.
- (c) Nature and strength of competition within the market.
- (d) Evidence on switching costs (and implications for barriers to entry).
- (e) Evidence relating to the selection process: tendering, annual renegotiations and switching.
- (f) Liability, insurance and settlements.
- (g) Barriers to entry: International networks.
- (h) Barriers to entry: Reputation and experience.
- (i) Descriptive statistics.
- (j) Tacit co-ordination.
- (k) Survey results.

<sup>2</sup> Working Paper *Liability, insurance and settlements*, paragraph 53.

<sup>3</sup> Working Paper *Liability, insurance and settlements*, paragraph 44.

commercial market for example (to which we refer further below) considers the risk over a ten to fifteen year cycle. Consequently there is no guarantee that settlements will remain at their present level in the future. Indeed it appears from the comments made by the CC<sup>4</sup> that the value of claims has fluctuated widely even over the last 10 years.

- 2.4 EY operates a number of training programmes, such as the Professional Development programmes and internal training programmes (the details of which are set out in EY's response to Q26 of the MFQ). EY also operates an Audit Quality Review programme (the details of which are set out in EY's response to Q101 of the MFQ). These are designed in part to minimise the incidence of negligence by its auditors. The fact that these measures have been successful in maintaining a relatively low level of claims in recent years (with a consequent impact on professional indemnity insurance premium levels) does not mean that the intrinsic risk of audit work is low. As EY has explained to the CC in earlier submissions, and at the hearing, where a company encounters financial difficulties, the (perceived) deep pockets of its auditor means that the auditor remains an attractive target for litigants who believe that they have suffered loss, irrespective of whether negligence by the auditor is apparent or not. The incidence of such claims is likely to increase in the next few years as the phase of the economic cycle moves on.
- 2.5 Further, it is also not appropriate to consider the risk associated with claims and potential claims in the UK without properly considering the basis on which insurance cover is obtained, and the difficulties the firms have historically faced in buying cover in the commercial market. It is not possible to purchase insurance that would cover the severity of the potential claims that might be brought against audit firms. The commercial market still believes the Big 4 to be high risk; and it is unlikely EY in the UK could purchase commercially reasonably priced cover. EY and, we understand, certain other audit firms therefore obtain their insurance cover through a captive insurer (which partially reinsures in the commercial market) that allows for pooling of risk and the purchase of cover on a more efficient and effective basis. However, we suggest care needs to be taken when considering whether EY's insurance arrangements are "effective". If "effective" is meant to convey that the arrangements are sufficient then we disagree with the CC's conclusion that EY's insurance arrangements are effective. EY is able to maintain a level of insurance that it hopes will be enough to satisfy litigants, but the reality is the firm's capital is always at risk.
- 2.6 [redacted]
- 2.7 Whatever training, quality control and risk management measures the firm puts in place to minimise that risk there will always remain some residual risk of a claim which could threaten the entire firm's viability. That will always remain a significant risk for any audit firm.
- 2.8 In the absence of the ability to secure in practice effective limitation of liability agreements with clients, the use of a Limited Liability Partnership structure provides a degree of protection for partners' personal assets but does not protect the business against a catastrophic claim which may exhaust the firm's insurance cover.
- 2.9 The potential for the exceptional, catastrophic claim coupled with the continual need to try to manage and reduce the incidence of other professional negligence claims continues to be a priority for EY and (it is assumed) all other audit firms.
- 2.10 It should also be noted that the risks faced by audit firms are not limited to the risks associated with negligence claims. Audit firms are also exposed to the potentially significant consequences of reputational harm and adverse findings being made against

EY by regulators. The collapse of Arthur Andersen demonstrates the scale of the audit firms' exposure in this regard, and how easily reputational damage can cause irreparable harm, even in the absence of a negligence claim.

### 3. The "Virtuous Circle"

3.1 In paragraph 22 of the Overview paper, the CC states:

*"[T]here is a virtuous circle that benefits Big 4 firms, in that in tendering for engagements they can point to an established client base, an extensive international network and numerous candidate audit engagement partners with directly relevant experience. This increases their chances of success, and success in a tender reinforces each of those factors. ... the circle operates in reverse for Mid Tier firms"* (see paragraph 22 of the Overview paper).

3.2 This view fails adequately to take into account that:

- (a) the reputation and experience gained by EY reflects strategic decisions taken and costs incurred by EY over a number of years;
- (b) EY's current reputation and market position reflect the outcome of a process of intense competition;
- (c) the possibility of others breaking the virtuous circle, either by using their existing FTSE 350 clients as a basis on which to develop their reputation and experience, or through developing innovative strategies; and
- (d) the ease with which reputation can be lost.

3.3 EY's current market position and reputation has been hard won in fierce competition against other audit firms. It is the result of strategic decisions taken by EY's management about the kind of firm it would like to be, the kind of clients it wished to secure and the reputation it wished to have. To secure those objectives, EY has taken steps to adapt itself, including its products, its approach to service quality and its global business model, in order to enable it to compete to win and retain business including audit business from FTSE 350 companies. This has taken both time and money to achieve – and continues to require effort and costs to enable EY to continue to compete effectively, particularly for these larger audit clients.

3.4 EY's current reputation and market position reflect a process of intense competition. In pursuing its strategic objectives, EY faces rivalry from other firms who are also competing for the audit business of those larger corporates. This competition drove, and continues to drive, EY: (i) to invest in its people its training and its quality control procedures; (ii) to innovate; and (iii) to seek to find ways to differentiate itself from its competitors.

3.5 However, the possibility of others breaking the virtuous circle through innovative "market disruptive" strategies, that the largest firms would not be able to replicate given their existing business models, must not ruled out. As EY indicated at the recent hearing before the CC, the possibility of other audit firms developing novel competitive strategies to gain both broader experience of working with FTSE 350 companies, enhancing their reputation with those companies and ultimately securing more audit work from them could, and should, have been market tested by the smaller firms if they are committed to gaining a larger presence in the FTSE 350 audit sector. Market disruptive strategies by non-incumbents which have been successful in securing market share have been seen in other industries.

3.6 The possibility of similar developments in the audit sector cannot be ruled out, particularly in the light of the FRC's reforms introducing a "comply or explain" tendering regime.<sup>5</sup>

#### 4. **Competitive Pressures**

##### ***Introduction – bases for competition***

4.1 The view expressed by the CC that "*prior to the tendering of an audit engagement there appear to be limited direct competitive interactions between the audit firms in relation to a particular engagement*"<sup>6</sup> does not reflect EY's experience.

4.2 Although competitive interaction is more visible and intense during a tender process, competitive pressures have a significant impact on the competitive behaviour of audit firms before a tender process is initiated, and (if appointed) during the annual reappointment process. Those pressures arise from the competitive actions of other audit firms, and the negotiating strength and position of companies. The Working Papers do not reflect the full extent of these competitive pressures, or how those pressures impact on the competitive conduct of audit firms.

4.3 The purpose of this section is therefore to outline the way in which, in EY's experience, competitive pressures operate at each of the following stages of the relationship between an audit firm and a FTSE 350 company:

- (a) Prior to a tender, when audit firms seek to establish and maintain relationships with non-audit clients.
- (b) During the tender process, which represents the most intense (and visible) period of competition.
- (c) Following appointment as an auditor, including the annual reappointment process.

4.4 In addition, the following key issues are briefly addressed:

- (a) the bases for competition and the role of innovation as a basis for competition; and
- (b) the behaviour and bargaining position of companies.

##### ***Bases for competition***

4.5 The evidence available to the CC demonstrates that competition between audit firms takes place on a number of bases, in particular:

- (a) the experience and knowledge of the AEP and the audit team;
- (b) the working relationships between the audit team and the senior management and ACC of the company;
- (c) reputation;
- (d) where relevant, the strength of the international network (and particularly the ability of firms' ability to influence the performance of the network members, and address issues arising, in the context of individual audits); and
- (e) the audit fee.<sup>7</sup>

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<sup>5</sup> See <http://www.frc.org.uk/News-and-Events/FRC-Press/Press/2012/September/FRC-publishes-updates-to-UK-Corporate-Governance-C.aspx>

<sup>6</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 7.

- 4.6 The factors identified at (a), (b) and (d) in particular go to a key basis for competition: the ability to deliver a quality audit. This is reflected in the earned reputation of an audit firm. As the CC's survey demonstrates, one of the key reasons given for deciding to switch auditor is concern about the quality of the audit.<sup>8</sup> In EY's view, the Working Papers do not fully capture the role of quality as a basis for competition between audit firms.
- 4.7 Throughout the Working Papers<sup>9</sup> the CC also considers the role of innovation as a basis for competition between audit firms, and notes that "*tender proposals very rarely mention innovation*", implying that audit firms do not compete on this basis. In EY's experience, audit firms do compete on the basis of innovation, although it might not be explicitly labelled as such in tender proposals:
- (a) As the CC has identified, although there is limited scope for innovation in relation to the audit product<sup>10</sup> audit firms have identified areas where innovation is possible, and have innovated in those areas.<sup>11</sup>
  - (b) This innovation is reflected in tender proposals and reappointment negotiations, and that innovation will be recognised as such. For example, tender proposals submitted by EY include references to the analytics modules that EY has developed and uses when conducting audits.
  - (c) As mentioned at the hearing before the CC, other ways in which EY has innovated include globalising its international network to better serve its multinational clients (from whom consistency and responsiveness across the global network has become an important service issue), and innovating the current audit product being delivered by leveraging a client's investment in areas such as IT to deliver a more efficient or insightful audit.

### ***The behaviour and bargaining position of companies***

- 4.8 Although EY agrees that the bargaining position of companies is particularly evident during the tender process, EY disagrees with the CC's initial view that the bargaining position of companies outside of a tender process "*is weakened by the limited effectiveness of benchmarking, the costs to a company of tendering and switching auditor, and the costs and risks to the individuals involved*".<sup>12</sup> In EY's experience, companies maintain a strong bargaining position throughout their relationship with an audit firm.
- (a) Contrary to the CC's initial conclusions, benchmarking is not of limited effectiveness outside of the tender process. The benchmarking and market testing exercises conducted by companies is a more sophisticated process than the CC acknowledges.
  - (b) FDs/CFOs and ACCs are "*highly qualified and experienced*", "*sophisticated*" and "*experienced and knowledgeable purchasers of audit services*".<sup>13</sup> Many have experience of auditors from their roles in different companies. These individuals are capable of conducting benchmarking exercises, even though such exercises are not necessarily straightforward.

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<sup>7</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 67.

<sup>8</sup> IFF Survey, Slide 63.

<sup>9</sup> See, for example, Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 39 and 84.

<sup>10</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 25 *et seq.*

<sup>11</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraphs 30-32 and 34-38, and Annex 2 ("*Firm-specific examples of innovation*").

<sup>12</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraphs 141.

<sup>13</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraphs 74-76.

- (c) A majority of companies do not consider choice to be limited. It is possible for companies to expand the range of firms whom they can appoint as auditor through their selection of firms for non-audit roles. Even if there are only a limited number of potential alternative firms, the fact that strong alternatives are available, and given the competitive activities of those companies, means that the competitive threat and bargaining position of companies is maintained.

### **Competition prior to tender**

- 4.9 The CC recognises that EY, and other large audit firms, "*actively target companies that are currently audit clients of rival firms, for example approaching the company specifically to discuss their proposed approach to the audit engagement together with an alternative fee schedule*".<sup>14</sup> The CC's survey evidence and case studies support this conclusion – those results show that 88 per cent of FDs and 55 per cent of ACCs have been formally or informally approached by one of the four largest audit firms.<sup>15</sup>
- 4.10 The CC's survey results also demonstrate that the AEP and working relationships are key factors in a company's choice of auditor. Relationships therefore play a key role in ensuring that EY is invited to participate in a tender process. EY therefore seeks to establish and maintain relationships with non-audit clients, with a view to: (i) ensuring that it is invited to participate in the tender process; and (ii) putting itself in a better position than it otherwise would have been when a tender process is initiated. Such relationships may also, on occasion, put EY in a position where it can encourage a company to initiate a tender process.<sup>16</sup>
- 4.11 There are many ways in which EY seeks to establish and maintain relationships with potential audit clients: how this is achieved in practice depends on the company and the individuals concerned. Such activity benefits EY in relation to all of its service lines, not just in relation to its audit function. In addition to the investments highlighted by the CC<sup>17</sup>, the key means by which relationships are established and maintained include:
- (a) Competing fiercely for non-audit work (for example, tax and transactional support), in order to raise EY's profile within the company.
  - (b) Where appropriate, using existing non-audit relationships with the company as a means of introducing key EY contacts and EY's audit credentials.<sup>18</sup>
  - (c) Assisting non-audit clients in benchmarking the audit fees paid by them to competitor firms.
  - (d) Using industry events, including events sponsored or hosted by EY, to establish personal relationships.
  - (e) Maintaining personal contacts and client relationships through (for example) providing regular updates, meetings and targeted events.<sup>19</sup>
- 4.12 Not only does this competitive activity put EY in a better position than it otherwise would have been, in the event that a tender process is initiated, it also applies competitive pressure on the incumbent auditor. For example:

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<sup>14</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraphs 154 and 155.

<sup>15</sup> See Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraphs 156-157.

<sup>16</sup> The CC recognises this at Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 7. See also Working Paper *Firms' stated competitive strategies*, paragraph 25 *et seq.*

<sup>17</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 155. See also Working Paper *Firms' stated competitive strategies*, paragraph 18 *et seq.*

<sup>18</sup> Working Paper *Firms' stated competitive strategies*, paragraph 22 *et seq.*

<sup>19</sup> Working Paper *Firms' stated competitive strategies*, paragraph 31 *et seq.*

- (a) The knowledge that an audit client has close relationships with other audit firms makes the threat of losing that client more acute, which has an impact on the competitive behaviour of the incumbent firm.
- (b) Assistance in benchmarking, or the provision of alternative free schedules, applies significant competitive pressure in relation to audit fees.

4.13 The impact of the competitive conduct of audit firms prior to a tender process on the incumbent audit firm is set out more fully below.

#### ***The decision to initiate a tender***

4.14 A decision by a company to initiate a tender process can be driven by a number of factors. As the CC acknowledges, the threat of a tender process also has an impact on the competitive conduct of the incumbent auditor. This section therefore considers:

- (a) The factors that can prompt a company to initiate, or threaten to initiate, a tender process.
- (b) The competitive activity on the part of the incumbent auditor to avoid a tender process.
- (c) The costs and benefits of tendering or switching, and how (in EY's experience) companies approach the decision of whether or not to initiate a tender process.

#### **Factors prompting a company to initiate, or threaten to initiate, a tender process**

4.15 A wide variety of factors can prompt a company to initiate, or threaten to initiate, a tender process. Common factors include:

- (a) A perception that conducting a tender process at regular intervals represents good corporate governance practice.
- (b) Dissatisfaction with the performance of the incumbent auditor – including dissatisfaction encouraged by competing audit firms. For example:
  - (i) perceived weaknesses in the prior year audit (for example, perceived late surprises);
  - (ii) a difficult prior year audit (for example, where the management of the company is not happy with some of the audit judgements taken by the auditor);
  - (iii) perceived audit quality issues;
  - (iv) discontent in relation to an overseas audit team.
- (c) Competitor activity, including a rival audit firm targeting the company in order to induce switching.
- (d) Company cost pressures triggering demands for fee reductions, or disputes between the company and the incumbent auditor surrounding the audit fee.
- (e) Changes to key individuals within the company (for example the Chief Executive Officer, Finance Director, Financial Controller, Internal Audit Head or Audit Committee Chair), where the appointee has preferences for particular auditors gained from past experience, or where the personal chemistry does not work effectively with the incumbent auditor.

- (f) Changes to the audit team, and in particular a change to the lead audit engagement partner (whether as a result of mandatory rotation or otherwise).
  - (g) A breakdown in the relationships within the company, leaving the auditor as "piggy in the middle".
  - (h) A merger where the merging entities have different auditors.
- 4.16 The statement that "*companies do not make this threat [to initiate a tender process] often*"<sup>20</sup> is an over-simplistic conclusion that does not accord with EY's experience. That threat is implicit in all reappointment discussions and arises in the context of each "trigger point". These "trigger points" can occur at any stage of an audit relationship. By way of example:
- (a) An increased focus on costs by an EY audit client, together with a change in AEP and new CFO, prompted the company to request a substantial reduction in the audit fee. A joint plan was developed and, working closely with the company over a two year period, cost savings were identified as a result of which the audit fee could be reduced.
  - (b) In relation to another EY audit client, following a change of CFO, the new CFO requested a fee reduction. An extensive fee benchmarking exercise was performed and targets were set for refined service delivery and reduced audit fees. This approach was sufficient to avert a possible audit tender and the client's expectations have subsequently been met.
- 4.17 In EY's experience, "trigger points", and implicit threats, arise frequently. Although the threat of a tender process being initiated differs in intensity, EY's expects to experience:
- (a) at least one serious threat every 5 years in relation to almost all clients;
  - (b) less critical threats on a more frequent basis.
- 4.18 The threat of tender is real and often acted upon. The CC's survey shows that companies have initiated tenders – 84 per cent of companies who have had the same auditor for over 5 years have initiated tenders.<sup>21</sup> EY therefore considers that threats of switching, particularly in the circumstances described above, are credible threats which EY takes seriously.

#### Avoiding a tender process

- 4.19 The threat of a tender process, however that threat is manifested, prompts a competitive reaction from the incumbent auditor (assuming the incumbent auditor is given an opportunity to react, which is not always the case). Indeed, an incumbent audit firm is only too aware that any negotiations surrounding their reappointment could, if those negotiations fail, lead to the initiation of a tender process.
- 4.20 Pro-competitive responses on the part of the incumbent auditor in response to "trigger points", where the threat of a tender process is the most acute, could include:
- (a) A commitment to change the way in which the audit is conducted (within the confines of applicable rules and regulations), or a commitment to change service delivery, in order to address dissatisfaction with performance.

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<sup>20</sup> Working Paper *Evidence relating to the selection process: tendering, annual renegotiations and switching*, paragraph 101.

<sup>21</sup> IFF Survey, Slide 20.



- (b) Changes to the members of the audit team, including changes to the audit engagement partner.
- (c) Arrangements in relation to the audit fee, where that is warranted. This may involve changes in the scope of the audit work, resulting in lower fees. However, it will not always lead to an audit fee reduction, but could include, for example, an agreement that a proposed increase in the fee will be limited, the provision of increased audit scope within a given fee, or an arrangement whereby overruns are not recovered.
- (d) Increased investment in the relationship, for example more frequent meetings with the ACC, periodic additional briefings to the Board or Audit Committee on topical issues and developments, introducing an additional senior partner to act in an advisory role to the board, and extending core audit work on processes and controls to deliver greater insight in areas of particular concern.

#### Deciding to tender – Switching costs

- 4.21 Those companies that have decided to initiate a tender process are in a better position than EY to describe the way in which companies analyse the costs and benefits of tendering / switching, and how the decision of whether or not to initiate a tender process is approached in practice.
- 4.22 Of course, when deciding whether or not to initiate a tender process, a company must take in to account a wide range of factors, and in particular the costs and benefits of switching auditor. The CC has identified what it considers to be the switching costs that individual companies may incur when deciding to switch.<sup>22</sup>
- 4.23 However, as the CC has identified "*[t]hose [companies] that have switched have not found the process particularly burdensome or the costs particularly high. Firms go to considerable efforts to ease the process and to manage the risks involved*".<sup>23</sup> Whilst audit firms do not necessarily absorb all of the costs of switching, competition is such that audit firms do go to "*considerable efforts*" to ameliorate the costs of switching. As the CC recognises, in the context of a tender process, evidence demonstrates that "*[t]ransition plans to minimize costs and disruption when changing auditor tended to be present where applicable, and quite detailed*".<sup>24</sup> This is a competitive outcome.

#### **The tender process**

- 4.24 The CC has outlined the tender process that is generally followed by FTSE 350 companies<sup>25</sup>, and recognises that tenders are "*structured and thorough processes*"<sup>26</sup> and that "*the tender process is further evidence that FDs and ACCs are sophisticated purchasers of audit services*".<sup>27</sup> Also, as the CC recognises, audit firms "*compete aggressively for these opportunities when they arise*"<sup>28</sup>, and that "*competition in tenders for FTSE 350 engagements is strong in relation to the factors on which selection is based,*

<sup>22</sup> Working Paper *Evidence on switching costs (and implications for barriers to entry)*, paragraph 7 et seq. See also Working Paper *Evidence relating to the selection process: tendering, annual renegotiations and switching*, paragraph 105.

<sup>23</sup> Working Paper *Evidence on switching costs (and implications for barriers to entry)*, paragraph 72(e).

<sup>24</sup> Working Paper *Evidence relating to the selection process: tendering, annual renegotiations and switching*, paragraph 77.

<sup>25</sup> Working Paper *Evidence relating to the selection process: tendering, annual renegotiations and switching*, paragraph 30 et seq.

<sup>26</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 83.

<sup>27</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 76.

<sup>28</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 162.

*namely the capabilities and experience of the firms and the audit team, the reputation of the firm and the audit fee".<sup>29</sup>*

- 4.25 Subject to the comments below, EY considers that the description given by the CC is a fair representation of the tender processes followed, and the intensity of the competition. As the CC recognises, responding to invitations to submit tenders is an intensive process, and requires the devotion of considerable time, resources and effort.<sup>30</sup> This reflects the vigorous competition between audit firms.
- 4.26 Current tender processes are not perfect, and EY has made a number of recommendations to the FRC as to how the tender process can be improved (including, for example, the introduction of "open book" tender processes, to ensure that 'challenging' audit firms can submit more informed, and therefore more informative and accurate, proposals). However, EY is concerned that the Working Papers do not fully reflect the nature and scope of the interactions that take place during the tender process, or the way in which the tender process assists companies in assessing, and comparing the ability of, competing audit firms to provide a high quality audit. The Working Papers also do not take in to account the impact that the changes recently announced by the FRC (in particular, the introduction of the "comply or explain" requirements) are likely have once they have been fully implemented.

#### Nature and scope of interactions

- 4.27 The Working Papers state that the audit tender process, once the invitation to tender letters have been sent, is characterised by "*a minimum of four steps*", those steps being: preliminary meetings or exchange of information with company management, with a view to the audit firm better understanding the business and its requirements; the submission of detailed written proposals; an oral presentation; and the contract negotiation phase.<sup>31</sup>
- 4.28 However, this does not capture the full nature and scope of the multiplicity of interactions that take place during the tender process. For example:
- (a) Throughout the process, there are on going contacts and interactions between the audit firms and key individuals within the company, including numerous meetings and calls, both before and after the written proposal is submitted.
  - (b) Companies frequently test the technical expertise of audit firms, including by setting detailed "exam questions" or otherwise posing difficult technical issues. In a number of cases, EY has actively sought such questions.
  - (c) Although the detail of proposals submitted by audit firms may vary (depending on the instructions or expectations of the company), they are generally detailed documents which reflect the level of interaction between the company and the audit firm concerned.

#### Assessment of quality

- 4.29 As set out in EY's response to the Working Paper *Restrictions on entry or expansion*, EY considers its reputation to be important. EY's reputation has been earned over time through, for example, building up its national and global network (and establishing effective working relationships across the network) and through developing its expertise. The extent of the investments that EY has made, and must continue to make, to maintain that reputation is a direct result of the competition that exists between firms. In EY's view,

<sup>29</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 165.

<sup>30</sup> Working Paper *Evidence relating to the selection process: tendering, annual renegotiations and switching*, paragraph 99 *et seq.*

<sup>31</sup> Working Paper *Evidence relating to the selection process: tendering, annual renegotiations and switching*, paragraph 54.

performing high quality audits on a consistent basis is the only way in which EY can maintain its reputation.

- 4.30 The Working Papers refer on a number of occasions to the reputation or size of an audit firm acting as a proxy of quality.<sup>32</sup> In EY's experience, this ignores the extent to which companies are able to assess the quality of audits. Contrary to the inferences contained in the Working Papers, companies do not simply rely on reputation as a proxy for quality. The tender process in particular enables companies to assess and test the quality of the auditors submitting tenders, using information obtained during the tender process and information more widely available:
- (a) The interactions between the company and the auditor during the tender process provide the company with extensive opportunities to appraise the technical skills of the audit firm, including through the submission of "exam questions".
  - (b) As the CC recognises elsewhere, "*the tender process generally provides FS/CFOs and ACCs with detailed information on the capabilities of the audit firm and the team that will carry out the audit... companies may use information on the capabilities of the firm and audit team as an indicator of the quality they can expect*".<sup>33</sup>
  - (c) As the CC recognises<sup>34</sup>, the tender process is conducted by individuals within the company who are highly qualified and experienced, and who use their knowledge and experience.<sup>35</sup> Most will have experience of numerous different audit firms throughout their careers. Those individuals have the experience and ability to assess quality without recourse to proxies.
  - (d) The tender process (particularly where tests of technical expertise are set) allows the company to conduct a direct comparison of the skills and competences of the tendering firms.
  - (e) ACCs, Non-Executive Directors and Finance Directors generally each have peer networks which are used to provide valuable insights into audit partners who are incumbents and those who are tendering. This source of information helps these individuals to gain informed views on questions such as whether particular partners are typically challenging of management, whether they show professional scepticism, whether they demonstrate an independent mindset, and whether they are effective in resolving disagreement. Whilst an audit is a bespoke offering, the qualities mentioned here are not bespoke and necessary components of auditor effectiveness.
  - (f) Companies also use other publicly available information (including, for example, the findings of the AIU, FRRP and PCAOB) when assessing the quality of the audit firms.

### ***Post-tender and reappointment***

- 4.31 Contrary to the suggestion contained in the Working Papers, competitive pressures do not dissipate the moment that an auditor has been appointed. Incumbent auditors face, and react to, significant competitive pressures – as the CC states "*competing firms may persuade companies to challenge the incumbent auditor on the ground of fees (with the*

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<sup>32</sup> See, for example, Working Paper *Evidence relating to the selection process: tendering, annual renegotiations and switching*, paragraph 9.

<sup>33</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 82.

<sup>34</sup> Working Paper *Evidence relating to the selection process: tendering, annual renegotiations and switching*, paragraph 72.

<sup>35</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 82.

*hope of triggering a tender), scope and efficiencies of the audit", and "incumbent auditors face indirect competitive pressure from competitors trying to win new clients".<sup>36</sup>*

- 4.32 The competitive conduct that audit firms engage in where they are not the incumbent auditor is analysed above. That conduct, which takes place before and after a tender process, places significant pressure on the incumbent auditor, particularly during the reappointment process.
- 4.33 It is also important to note that the terms of engagement agreed following a competitive tender process (including quality, price and service offering) will reflect that competitive process. All subsequent renegotiations, which are subject to the competitive pressures described, will be from that competitive base: it therefore should be assumed that the offerings of incumbent audit firms continue to be competitive.

#### The reappointment process

- 4.34 As the CC recognises, audit firms are reappointed each year, and as a result there is "*no security on long-term tenure*"<sup>37</sup> and reappointment negotiations take place annually at a senior level<sup>38</sup>, prior to formal reappointment by shareholders.
- 4.35 The CC has outlined the reappointment process that is generally followed by FTSE 350 companies.<sup>39</sup> Subject to the comments below, EY considers that the description given by the CC is a fair representation of the reappointment process. However, EY does not agree with the CC's initial view that the bargaining position of a company vis-à-vis its current auditor "*is weakened by the limited effectiveness of benchmarking, the costs to a company of tendering and switching auditor, and the costs and risks to the individuals involved*".<sup>40</sup>

#### Review of auditor performance

- 4.36 It is stated in the Working Papers that, although firms compete on experience and quality when trying to win new clients "*when renegotiating existing engagements, discussions are rather on fees and the scope of the engagement*".<sup>41</sup> That does not reflect EY's experience: issues of quality are routinely raised during annual renegotiations. The performance of an incumbent auditor is under constant review. Incumbent auditors receive, and expect to receive, on going feedback from the companies they audit.
- 4.37 As the CC acknowledges, in most cases, a more formal review of performance is conducted prior to reappointment.<sup>42</sup> That review encompasses all aspects of the relationship between the company and the auditor, including:
- (a) Technical issues. For example, how the auditors dealt with particular accounting issues arising during the previous audit, the quality of engagement with management, the quality of the audit of overseas operations (and, increasingly, the ability of firms to influence that network, and address issues arising, in the context of individual audits), timely agreement of accounting treatment, timely communication of issues and potential problems, no subsequent changes in accounting opinions, and the extent of debate.

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<sup>36</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 176.

<sup>37</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 169.

<sup>38</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraphs 172-3.

<sup>39</sup> Working Paper *Evidence relating to the selection process: tendering, annual renegotiations and switching*, paragraph 135 *et seq.*

<sup>40</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 141.

<sup>41</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 68.

<sup>42</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 66.

- (b) Service issues. For example, responsiveness and communication issues arising during the audit (including in respect of the audit of overseas locations), the planned rotation of the audit engagement partner, the continuity of the audit team and availability.

4.38 As the CC recognises<sup>43</sup>, the reappointment process is conducted by individuals within the company who are highly qualified and experienced, and who *"can be expected to have the professional knowledge and experience they require to monitor effectively in general terms the performance of the auditor"*.<sup>44</sup> As the CC acknowledges elsewhere, *"ACCs may be able to use this knowledge of other companies to negotiate better terms of engagements"*.<sup>45</sup> Individuals will also use other publicly available information (including, for example, the findings of the Audit Inspection Unit) when considering whether to reappoint an incumbent auditor. Incumbent auditors of FTSE 350 companies therefore expect reviews of their performance to be challenging, and that is EY's experience.

#### Market testing

4.39 The CC concludes that *"firms will be under greater competitive pressure the better informed a client is and the more credible is the risk of a competitive tender"*.<sup>46</sup> EY agrees with that conclusion, but disagrees with the CC's initial view that in the absence of a tender process companies are not informed of the alternatives available to them.

4.40 As the CC's survey results demonstrate, most companies conduct various market testing exercises *"to maintain quality, efficiency and value for money of their audit engagement"*.<sup>47</sup> The CC suggests that the market testing conducted by companies is of little value, and concludes that *"the information provided by benchmarking and other comparable exercises is limited"*<sup>48</sup> and that, in the absence of a tender process, companies *"may not have the information to assess effectively the competitiveness of the audit product and service provided by their existing client"*.<sup>49</sup> EY disagrees with that conclusion:

- (a) Although companies often conduct their own market testing exercises by, for example, comparing publicly available information (including, for example, the findings of the AIU, FRRP and PCAOB), they will also employ their knowledge and experience of other audit firms for this purpose.
- (b) As recognised by the CC, the relevant individuals within companies are highly qualified and experienced<sup>50</sup>, and this informs and strengthens their market testing.
- (c) Companies make use of their non-audit relationships with other audit firms when benchmarking the performance or fees of the incumbent auditor. In EY's experience, such assistance typically includes comparing audit cost drivers such as legal structure, geographical presence, the regulatory environment, information systems, and the nature of the business (including, for example, the existence of long terms contracts or profit sharing arrangements). Companies also frequently ask for assistance from the incumbent auditor in this regard.

#### Fee negotiations

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<sup>43</sup> Working Paper *Evidence relating to the selection process: tendering, annual renegotiations and switching*, paragraph 72.

<sup>44</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 88.

<sup>45</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 88.

<sup>46</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 195.

<sup>47</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 93.

<sup>48</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 97.

<sup>49</sup> Working Paper *Nature and strength of competition in the supply of FTSE 350 audits*, paragraph 194.

<sup>50</sup> Working Paper *Evidence relating to the selection process: tendering, annual renegotiations and switching*, paragraph 72.

- 4.41 With the possible exception of the first three years of an audit relationship, the audit fee is generally negotiated on an annual basis.<sup>51</sup>
- 4.42 The nature and intensity of annual fee negotiations differs depending on the client concerned. However, fee negotiations generally focus on the following:
- (a) Changes in the scope of the audit, which necessitate a change to the fee.
  - (b) Improvements to the efficiency of the audit process, leading to cost reductions.
- 4.43 As to the timing of fee negotiations, whilst those negotiations typically take place after reappointment has been made, they are nonetheless intensive, and the audit firm is all too aware that a failure to offer a competitive price for the audit risks increasing the likelihood of a formal tender process the following year.