

STATUTORY AUDIT SERVICES MARKET INVESTIGATION

ERNST & YOUNG LLP - RESPONSE TO THE DEVELOPMENT OF THE STATUTORY FINANCIAL AUDIT

We set out below the response of Ernst & Young LLP ("EY") to the Competition Commission's working paper *Development of the Statutory Financial Audit* (the "Paper"), the stated purpose of which is to consider "*the development of the statutory financial audit of companies from their origins in Victorian legislation to the present day*".

EY has the following overarching comments:

- Although corporate governance, corporate law, accounting standards and auditing standards have developed in a variety of jurisdictions around the world (particularly the US), those developments have been on a different (albeit parallel) tracks to developments in the UK. As currently drafted, the Paper implies that the tracks are fungible, but they are not. We consider that it is inappropriate to make extensive reference to non-UK developments in the course of an inquiry that is limited in scope to the UK, and that the Paper should deal exclusively with developments in the UK.
- The FRC and its discharge of its various statutory powers has had a seminal influence on the development of the statutory financial audit. However, as currently drafted the Paper does not contain any material references to that influence (details of which are set out at paragraph 7 below), which is continuing. We also note that the Paper omits any reference to the current FRC proposals on mandatory tendering, for which a consultation process has been completed, and in relation to which we expect a final pronouncement to be issued in the next couple of months. These proposals will have a significant impact, and we therefore suggest that the proposals be included in the Paper, and form part of the Commission's analysis going forward.
- The Paper appears in various places to move from a description of the development of the statutory audit to the development of audit firms. If the latter is considered relevant, we would suggest that it should be dealt with separately (see, in particular, the below comments in relation to paragraphs 41 and 42 of the Paper).
- There are occasions where the paper contains technical inaccuracies or observations that are not substantiated, or statements that we consider to be inappropriate in the context of what purports to be an objective description (see, in particular, the below comments in relation to paragraphs 2, 4(a), 42 and 59 of the Paper).

In addition to the above, EY also has the following comments on the substance of the Paper:

1. Paragraph 2 of the Paper refers to the "*growth in power*" of audit firms. The reference to the "power" of audit firms is an unsupported, subjective assessment which is inappropriate in the context of what should be an objective description. We therefore suggest deleting the words "*in power*". Also whilst the development of audit firms has been influenced by the statutory developments the reverse is not true, which the Paper seems to suggest as currently drafted.
2. In relation paragraph 4 of the Paper:

- (i) It is stated that "*audit firms were given a monopoly of auditing*". That is incorrect, as not all auditors are members of firms. We would therefore suggest replacing this with "*appropriately qualified accountants were given a monopoly of auditing*".
 - (ii) A reference to the establishment of the FRC in 1990 would be appropriate in this context, given its substantial impact on the development of the statutory audit in the UK.
 - (iii) The chronology should also include key developments in the oversight of auditors (by the ICAEW and other bodies) prior to the creation of the FRC, and audit standard setting
3. At paragraph 11, it seems to be overstating the objectives of the relevant legislation to suggest that it was expected to safeguard against mismanagement. At best the legislation was seeking to ensure that the financial results properly reflected management actions.
4. In relation to paragraphs 41 and 42:
 - (i) The extensive, colourful and prejudicial quote from Austin Mitchell, who clearly had particular, subjective views on these matters, is in our view wholly inappropriate in a document that should be giving an objective historical account. A full review of Parliamentary proceedings on the Limited Liability Partnership Act places Mr. Mitchell's particular views in a balanced context. It is unclear what purpose reference to this unrepresentative quote serves, and we note that use of this quote alone and in isolation could expose the Commission to a risk of a charge of bias. We would therefore suggest either removing the quote, or including other quotes to provide a more balanced record of the Parliamentary proceedings.
 - (ii) These paragraphs are not directly relevant to the development of the statutory audit in the UK, but rather to the development of audit firms. If the Paper is to cover audit firms, and in particular their transparency requirements, then we would suggest that reference needs to be made to the current obligations of the audit firms to produce transparency reports.
5. As the Paper is concerned with the statutory audit in the UK, the relevance of paragraphs 43 to 49 needs to be clearly articulated. At present it is not clear why the Commission considers the contents of paragraphs 43 to 49 to be relevant to the development of statutory audit in the UK.
6. Paragraph 50, as currently drafted, suggests that prior to 2004 there were no proper standard setting or disciplinary processes. That is incorrect. We therefore propose that the first two lines are amended to read "*In the UK the Companies (Audit, Investigations and Community Enterprise) Act 2004, introduced a number of provisions designed to strengthen the mechanisms for audit standard setting and disciplinary mechanisms applicable to auditors. It placed new requirements on the five recognized supervisory bodies of auditors*".
7. Paragraph 51 massively understates the significance of the very extensive regulatory mechanisms introduced under the oversight of the FRC. The powers given to the FRC were a major milestone in the development of the statutory financial audit. Examples that we consider should be referred to in this context include:
 - (i) Annual inspections of the large audit firms test whether the firms have established an appropriate control environment fit to deliver high quality audits.

- (ii) These inspections also test individual listed company audits for effectiveness in the companies' application of accounting standards and whether audit evidence has been gathered and documented in accordance with Auditing Standards.
 - (iii) The inspections lead to both public reports on each firm's perceived quality performance and letters to the Audit Committee of each audit inspected.
 - (iv) Publication annually by each large firm of a Transparency Report describing a range of matters that are seen as relevant to the public interest.
 - (v) The appointment of Independent Non Executives ("INEs") whose remit covers all the business activities of the firm by reference to certain prescribed aspects. INEs have a regular, private dialogue with the FRC.
8. The comment at paragraph 59 that "*[t]he banking crisis in 2008 highlighted that considerable shortcomings remained in the audit system*" is emotive and unsubstantiated, and therefore should be corrected and clarified. The banking crisis highlighted that statutory audits were not designed to provide a guarantee of the future financial health of businesses, and prompted widespread reexamination in a number of jurisdictions of the function and regulatory framework within which auditors operate. We are not aware that any competent authority in the UK has concluded that the banking crisis in 2008 highlighted that "*considerable shortcomings remained in the audit system*" and refer you in particular to the public reports issued by the AIU on the audit firms that conducted the relevant audits. Furthermore, we note that this was not the conclusion of the House of Lords, the FRC or the FSA.