STATUTORY AUDIT SERVICES MARKET INVESTIGATION

RESPONSE OF ERNST & YOUNG LLP TO PROVISIONAL FINDINGS REPORT AND NOTICE OF POSSIBLE REMEDIES

This letter and its enclosures are the response of Ernst & Young LLP ("EY") to the CC's Statutory Audit Services for Large Companies Market Inquiry - Provisional Findings Report (the "Provisional Findings") and Notice of Possible Remedies (the "Remedies Notice").\(^1\)

In an interview on 22 February 2013\(^2\), the Inquiry Chair commented that the Provisional Findings did not concern alleged "wrong doing" on the part of audit firms. EY welcomes that finding and sentiment.

The issues that the CC has identified are, in the words of the Inquiry Chair, concerned with "the functioning of the market and in effect... the system's architecture"\(^3\), which EY understands to be a reference to the UK corporate governance regime, which is an extensive framework of finely balanced rules and principles. The regulatory regime applicable to audits is only one element of a wider corporate governance regime. That regime (which consists of legislation, regulation and, in the UK, the Corporate Governance Code (the "Code")) has developed over many years. It continues to evolve at the national, European and international level. EY regularly engages with those bodies charged with reviewing, developing and updating this complex framework, and welcomes the opportunity to engage constructively with the CC on these issues.

Those parts of the regime that relate to audit are the result of extensive reflection and consultation on the part of expert regulators and stakeholders. The CC must exercise caution when recommending changes to the corporate governance regime. The risk of unintended consequences is acute.

We have a pervasive concern that the CC has not established clearly that its concerns about the prevailing architecture, audit quality or any of the other features it has observed, have led, in practice, to adverse effects. Given the recognised importance of audit quality, we are also concerned that the CC has not considered the potential impact of the proposed remedies on audit quality. The CC should be cautious about recommending far reaching changes without stronger evidence of current adverse effects, and without having conducted a detailed examination of the potential impact of the proposed remedies on audit quality. We comment later on areas where strong evidence is lacking.

Annex 1 sets out EY's response to the Provisional Findings.

1. There is no reasonable basis for the CC's conclusion that "there are significant, persistent and widespread concerns regarding the quality of audits delivered to FTSE 350".\(^4\) Such a conclusion represents a misrepresentation or misunderstanding of AQRT reports and a selective approach to the evidence. Moreover, it significantly overstates the conclusions reached by the AQRT in relation to some aspects of some audits.

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\(^1\) Unless stated otherwise, this response adopts the abbreviations and definitions contained in the Glossary to the Provisional Findings.

\(^2\) Interview given by Laura Carstensen to the Radio 4 Today programme, 22 February 2013.

\(^3\) Ibid.

\(^4\) Provisional Findings, paragraph 7.121.
2. The Provisional Findings do not contain adequate evidence to support a conclusion that prices are too high. In particular: (i) the fact that price reductions can be experienced immediately following a switch does not provide cogent evidence that prices prior to the switch were too high or that subsequent increases are simply a reflection of incumbent power over prices; (ii) given the admitted limitations of the CC’s analysis, the conclusion that the “risk reward balance offered to audit partners is attractive” in this market is flawed; and (iii) the provisional conclusion that firms enjoy persistently higher profits than average in relation to certain companies is not reliable.

3. The conclusion that “innovation is not at levels we would expect to see in a well-functioning market” is not supported by the CC’s analysis and is not backed by adequate evidence. Furthermore, although EY agrees that there is unmet demand from shareholders for information, unless there is a consensus view from the shareholders on what additional reporting they require, an auditor cannot be criticised for failing to innovate to meet that unmet demand.

4. The provisional finding that auditors are “insufficiently sceptical in carrying out audits” over-generalises comments made by regulators. The constant vigilance of expert regulators in this regard, and the instances where it has been found that an auditor could have exercised more challenge on some aspects of some audits, provides an insufficient basis for reaching that general conclusion. The Provisional Findings ignore the substance of the findings of regulators, and demonstrate a lack of understanding as to the concept of professional scepticism in auditing and the function of regulators.

5. The conclusion that the UK corporate governance regime, and in particular ACs, have failed to “remedy any detriment arising from a misalignment of auditor incentives with those of shareholders” indicates a misunderstanding of the UK corporate governance regime, and discredits the integrity and role of executive management, ACs, ACCs and auditors. The Provisional Findings do not reflect the extent to which the Code addresses the relationship between boards and shareholders, and ignores (for example) the roles of Chairman, non-executive directors and the Senior Independent Director, and the overarching role of the unitary board.

Annex 2 sets out EY’s initial response to the proposed remedies given in the Remedies Notice:

1. In the light of the recent FRC-led changes to the Code introducing mandatory tendering every ten years, there is no case for making further changes at this stage. Increasing the frequency of mandatory tendering is likely to result in firms more frequently deciding not to respond to bids, or submitting less detailed bids, and would reduce the recurring competitive pressures currently experienced outside the tender process. However, EY welcomes the CC’s provisional decision to adopt proposals for tenders to be conducted on an open book basis.

2. EY considers that the proposal to introduce mandatory rotation would harm shareholder interests and undermine corporate governance. It would also constitute an unwarranted restriction on the ability of companies and shareholders to appoint the audit firm that best meets their needs. There is no evidence that the many recognised negative effects of
mandatory firm rotation would be outweighed by any improvements in audit quality, lower audit fees or enhanced innovation.

3. Although EY recognises the positive role played by AQRT reviews, the potential benefits of significantly increasing the number of FTSE 350 audits reviewed each year by the AQRT must be balanced against the increased expense and other potential costs. EY notes the initial comments of the FRC express caution in this regard.

4. EY has long supported the removal of clauses in loan documents which limit auditor choice to the Big 4 firms, and is therefore fully supportive of this proposal.

5. EY supports any practical recommendations to strengthen the role of the AC. However, EY considers that the assessment contained in the Provisional Findings undervalues the power and influence of ACs, and ACCs in particular, to secure audit quality and auditor independence in the interests of shareholders. EY is also concerned that drawing the ACC into a more extensive management role would lose the benefits of the ACC's current supervisory role.

6. EY is supportive of measures to give shareholders a greater involvement in auditor selection through the right to vote on holding a tender process, and the requirement for an enhanced level of support if an auditor is to remain in place after a tender. EY notes that the FRC is currently consulting on proposed additional reporting requirements, which addresses many of the issues raised by the CC. EY will provide a copy of its response to that consultation to the CC in due course.
ANNEX 1

EY’s Response to the Provisional Findings Report

1. Introduction

1.1 In this Annex, EY sets out its comments on the Provisional Findings. However, as the Provisional Findings is a lengthy document (running to over 1,500 pages), EY does not seek to address every point of difference between itself and the CC in this response.

1.2 Given that limitation, the focus of this response will be on those findings that appear to underpin the CC’s analysis, and which EY considers to be flawed. Specifically:

(a) AEC – Weakened bargaining position and restricted choice

The CC provisionally concludes that, for the reasons set out at paragraphs 13.3 to 13.5 of the Provisional Findings, the bargaining position of companies is weakened outside of the tender process, and that this constitutes an adverse effect on competition (“AEC”). EY disagrees with this conclusion. In EY’s experience, companies maintain a strong bargaining position throughout their relationship with an audit firm. In particular, as set out in EY’s response to the Working Papers, although competitive interaction is more visible and intense during the tender process, significant competitive pressures exist outside of the tender process. EY refers the CC to its previous submissions on this issue. This response therefore focuses on the unsubstantiated allegations that “as a result of the AEC… companies are offered higher prices, lower quality and less innovation and differentiation in offerings than would be the case in a market without the features”.

(b) AEC – Audit firms compete to satisfy management rather than shareholder demand

The Provisional Findings conclude that the “[m]isaligned incentives between auditors, shareholders, and company management are a feature of the market that produces and AEC… [t]his results in shareholder detriment as auditors are not sufficiently independent from executive management and therefore insufficiently sceptical in carrying out audits. The activity of the AC (and other factors) is not sufficient to mitigate this detrimental effect”. EY disagrees with this analysis. This response therefore focuses on the CC’s allegations that (i) auditors are not sufficiently independent and do not exercise sufficient professional scepticism, and (ii) the corporate governance regime is ineffective in protecting the interests of shareholders.

2. Allegation: Prices are too high

2.1 The Provisional Findings state that "the market is not working well in delivering competitive prices". It is also stated that "companies are offered higher prices... than would be the case in a market without the features". However, the Provisional Findings

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1. See paragraphs 4.1 to 4.43 of EY’s response to the CC’s Working Papers.
2. Provisional Findings, paragraph 13.6.
3. Provisional Findings, paragraph 13.7(a).
4. Provisional Findings, paragraph 7.94.
5. See, for example, Provisional Findings paragraphs 9.264 and 13.6.
The conclusion that audit fees are higher than would be the case in absence of the alleged AECs provisionally identified appears to have been inferred from the following:

(a) "Companies that switch firm enjoy a significant, if transient price cut". The CC’s position appears to be that, because a switch tends to lead to an immediate price reduction, that provides prima facie evidence that the company was paying an audit fee that was uncompetitive prior to the switch. The CC further infers that the temporary nature of the price reduction reflects the fact that companies become less able to identify the "competitive price" as time passes after an audit tender.

EY disagrees with this analysis.

The fact that price reductions can be experienced immediately following a switch does not provide cogent evidence that prices prior to the switch were too high. The lower prices offered in a tender process will often reflect the difficulty that non-incumbent firms have in establishing the adequacy of the human and system resources and the controls (“the control environment”) already in place (which is why EY strongly supports the proposal that tender processes should be “open book”). Audit fee proposals are therefore often based on an incomplete understanding of the control environment – leading to a need to increase the fee in subsequent years once the reality of the control environment becomes apparent to the new auditor in order to avoid audit quality being compromised.

Equally, the fact that audit fees increase in the years following a switch does not provide evidence that “incumbent auditors have power over price”. As the CC recognises, the data on which it bases its findings do “not control for other observable factors which determined the audit fee, for example, scope and complexity of the audit”. Changes in the scope and complexity of any audit may account for significant changes to the audit fee – this is compounded in the early years of a relationship between and auditor and a company as the auditor becomes more familiar with limitations of the control environment in place.

(b) “The risk reward balance offered to audit partners is attractive” and “audit is a relatively attractive service line whose risks are not unusually high”.

The Provisional Findings explain at some length the considerable limitations of the CC’s analysis on this issue. We do not intend to rehearse those limitations,
which the CC recognises and which EY has commented on previous submissions, in this response.

However, given those recognised limitations, it is surprising that the CC feels able to conclude, without qualification, that:

(i) the risk reward balance is "attractive", particularly as the CC has stated that it is "not able to conclude... that Big 4 firms are earning profits above the competitive level";\(^\text{15}\)

(ii) the risks faced by audit firms are not "unusually high" – in this regard, EY refers the CC to the submissions it made in its response to the Working Papers.\(^\text{16}\) Briefly put, the potential for the exceptional catastrophic claim, coupled with the continued need to try to reduce the incidence of other professional negligence claims, continues to be a priority for EY and (it is assumed) all other audit firms;

(iii) the apparent attractiveness of the risk reward balance is an indicator that prices are not at competitive levels – particularly bearing in mind that: (1) the CC's analysis necessarily focuses on the entire audit service line where the range of competing firms is more extensive, not just the audits of FTSE 350 companies; and (2) there is "no systematic difference in remuneration per partner for audit and non-audit partners".\(^\text{17}\)

As a consequence, the CC's provisional conclusion on this issue is flawed and cannot reasonably be drawn from the evidence available to the CC.

(c) "There appear to be significant numbers of companies from which the firms enjoy persistently higher profits than average".\(^\text{18}\)

In the absence of any details as to the companies that the CC consider fall in to the category of companies where "firms enjoy persistently higher profits than average", it is not possible to comment in detail on this allegation. However, EY notes that, as the CC admits, there are limitations to the CC's analysis.\(^\text{19}\) In particular, by basing its analysis on average staff costs within grade bands, the CC's analysis significantly understates the costs of conducting complex audits - the CC accepts this.\(^\text{20}\) The CC also accepts that the audits identified by the CC as having "higher engagement profitability" are in relation to engagements that are "more likely to be the more complex audits".\(^\text{21}\) The CC therefore recognises that its analysis is especially unreliable in relation to the very companies it has identified.

2.3 On a related point, we note that the CC's analysis has not demonstrated that excess profits are generated in the provision of audit services; notwithstanding the weaknesses we have identified to the CC in some of its analysis in this regard (most notably but not exclusively in relation to the appropriate definition of mean capital employed). We agree with the CC and,

\(^\text{15}\) Provisional Findings, paragraph 7.74.
\(^\text{16}\) EY's Response to the CC's Working Papers, section 2.
\(^\text{17}\) Provisional Findings, paragraph 7.71.
\(^\text{18}\) Provisional Findings, paragraph 7.92(d).
\(^\text{19}\) Provisional Findings, paragraph 7.89, and Appendix 14, Annex 2.
\(^\text{20}\) Provisional Findings, paragraph 7.89.
\(^\text{21}\) Provisional Findings, paragraph 7.90.
indeed, have shown that, with more appropriate calculations, excess profits are demonstrably not earned.

2.4 The Provisional Findings do not advance any reliable evidence to support a conclusion that prices are too high. Instead the CC infers its provisional findings from various observations, which themselves are based on inferences and assumptions. Such a tower of inferences is insufficient for such a significant finding. The CC has no reasonable basis on which to conclude that prices are too high.

3. **Allegation: Audit quality is too low**

3.1 The Provisional Findings contain the preliminary conclusion that "there are significant, persistent and widespread concerns regarding the quality of audits delivered to FTSE 350 companies as identified by the AQRT". The Provisional Findings further states "reports produced by the AQRT identified a range of issues (of varying degrees of gravity) regarding quality and a lack of auditor scepticism across a large proportion of the relevant market" (emphasis added). Those conclusions either misrepresent, or misunderstand, the level of concern about quality found by the AQRT in its reports. They are also inconsistent with the CC’s finding that "most of the time audits were performed diligently and with appropriate challenge", and that the FRC and AQRT have raised concerns that auditors have only "on occasion failed to demonstrate appropriate levels of professional scepticism" (emphasis added).

3.2 It is accepted that there is always room for improvement, and that it is the role of the FRC and other bodies to press firms to continue to improve the quality of audit work. This is reflected in the highest band into which the AQRT categorises inspected audits in its public reports – ie, good with limited improvement required. A push towards constant improvement is a sign of a well-functioning regulatory regime and a competitive environment, and the reports of the AQRT should be considered in that context.

3.3 Furthermore:

(a) The conclusions reached by the AQRT reflect concerns about some aspects of some audits. Those concerns fall well short of being "significant, persistent and widespread concerns" about audit quality "across a large proportion of the market", and it is wholly unreasonable of the CC to reach that sensationalist conclusion.

(b) The CC has taken a selective approach to gathering and analysing the available evidence, in order to dismiss evidence that audit quality is high. In particular:

(i) The CC has explicitly not asked companies and shareholders for their views, on the spurious basis that they would not be critical of audit quality. That is particularly surprising given the CC’s conclusion that "evidence shows that FDs and ACCs for FTSE 350 companies are

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22 Provisional Findings, paragraph 7.121.
23 Provisional Findings, Summary, paragraph 11.
24 Provisional Findings, Summary, paragraph 28.
25 Provisional Findings, paragraph 11.104.
26 Note that in confidential AQRT reports, this category is divided between "good" and "acceptable with limited improvements required".
27 Provisional Findings, paragraph 7.97.
typically well-qualified and experienced individuals\textsuperscript{28}, who would be well placed to comment on audit quality.

(ii) Although the CC concedes that "the low levels of claims, settlements and insurance premiums" could be explained by the high quality of audits\textsuperscript{29}, it nevertheless dismisses this explanation without any substantive reasoning.

3.4 There is no reasonable basis for the CC's conclusion that "there are significant, persistent and widespread concerns regarding the quality of audits delivered to FTSE 350 companies". The CC's conclusion appears to be based on a conflation of two issues:

- concerns expressed by the AQRT about the quality of some aspects of some audits; and
- the desires expressed by a range of shareholders about the content of audit reports – an issue which does not reflect concerns about audit quality.

The CC's conclusion represents an unwarranted attack on audit quality which could itself undermine the confidence of stakeholders in published accounts.

4. Allegation: Insufficient innovation

4.1 The conclusion contained in the Provisional Findings that "[i]n our provisional view innovation is not at levels we would expect to see in a well-functioning market"\textsuperscript{30} is not supported by the preceding paragraphs of the Provisional Findings, which acknowledge: numerous areas in which firms have demonstrated innovation despite the extensive constraints which exist on innovation due to the statutory and regulatory regime in which audits are prepared. The basis for the CC's view that they would have expected to see more innovation in a well-functioning market is not supported by any evidence. EY would welcome discussing with the CC the type of innovation that the CC would have expected to see.

4.2 The CC's provisional conclusions on innovation link this issue to that of unmet demand. However the CC's views on unmet demand fail to address the basic issue that shareholders' views on what information they want and in what form they want it differs not merely between shareholders in different companies, but between different shareholders in the same company. The CC's comment that "[w]e note that the evidence indicates that different shareholders may demand different information, but we think that this is to be expected: suppliers in markets often face varying demands from their customer base"\textsuperscript{31} completely disregards the basic fact that an auditor produces a single report for each company and therefore cannot adapt its output to meet the varying demands of shareholders within that company.

4.3 Whilst EY accepts that there is unmet demand from shareholders for information in relation to the output of the audit (ie, the audit report), unless there is a consensus view from the shareholders of a single company on what additional reporting they require, an auditor cannot be criticised for failing to innovate to meet that unmet demand.

\textsuperscript{28} Provisional Findings, paragraph 9.66.
\textsuperscript{29} Provisional Findings, paragraph 7.120.
\textsuperscript{30} Provisional Findings, paragraph 7.179.
\textsuperscript{31} Provisional Findings, paragraph 7.204.
4.4 Whilst innovation is generally viewed as a good thing in most markets, in the context of audits there is a risk that certain types of innovation may undermine some of the benefits of audits. As the CC recognises:

"Auditing financial statements in accordance with certain principles and standards gives substance to the obligation to undertake an audit and makes the assurance provided more valuable as financial statements of different companies are easier to compare"\(^{32}\) (emphasis added).

There is a danger that if innovation results in varying approaches to the content of audit reports, rather than illuminating shareholders, it may lead to confusion with the potential to distort the capital markets. For that reason, it is preferable for audit reports to follow a standard format – prescribed by a regulator so that the same approach is adopted for all companies.

5. **Allegation: Insufficient professional scepticism**

5.1 The conclusion contained in the Provisional Findings that auditors are "insufficiently sceptical in carrying out audits"\(^{33}\) and that "..reports produced by the AQRT identified a range of issues (of varying degrees of gravity) regarding quality and a lack of auditor scepticism across a large proportion of the market"\(^{34}\) (emphasis added) is unsupported by the evidence available to the CC.

5.2 The CC's analysis appears to proceed on the basis that a pervasive lack of professional scepticism can be deduced from:

- (a) the constant vigilance of expert regulators in this regard; and
- (b) limited instances where it has been found that an auditor could have exercised more challenge on some aspects of some audits.

5.3 That is an insufficient basis for reaching a general conclusion that auditors are "insufficiently sceptical in carrying out audits". Not only does it ignore the substance of the findings of the regulators and impugn the professional integrity of the audit profession, it demonstrates a lack of understanding as to the concept of professional scepticism and the function of the regulators.

**Professional scepticism is not a “black and white” issue**

5.4 As the Auditing Practices Board made clear in a recent publication\(^ {35}\), there is a balance to be struck between too little and too much professional scepticism. It is not a "black or white" issue. The fact that (for example) the AQRT have identified instances where an auditor could and should have exercised a higher degree of challenge is not indicative of a pervasive lack of scepticism.

5.5 The constant vigilance of expert regulators in this regard, including (for example) publications such as the Auditing Practices Board's *Auditor Scepticism: Raising the Bar* discussion paper, does not provide evidence of a pervasive lack of professional...

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\(^{32}\) Provisional Findings, paragraph 5.19(c).

\(^{33}\) Provisional Findings, paragraph 13.7(a).

\(^{34}\) Remedies Notice, paragraph 11.

\(^{35}\) Audit Practices Board, *Auditor Scepticism: Raising the Bar*, August 2010 – referred to at Provisional Findings, Appendix 17, paragraph 50.
scepticism. It is important that audit firms and regulators continually strive to challenge and improve standards. Initiatives such as the discussion paper (and indeed AQRT reports – see below) are important contributions in that context.

No evidence of a pervasive lack of professional scepticism

5.6 In the context of auditing, “professional scepticism” is used in a specific sense as laid out in ISA 200. It may be that the CC has chosen to use the term in a different way and, if so, the CC should explain what meaning it has employed, in order to avoid confusion in the minds of companies and shareholders. Based on the meaning prescribed by auditing standards, the conclusion that auditors are “insufficiently sceptical in carrying out audits” is a misrepresentation, or misunderstanding, of the evidence. In particular:

(a) “Recent examples”

The Provisional Findings set out six examples that the CC consider are “suggestive of the potential for the auditors to have demonstrated a higher degree of scepticism, whether or not the threshold was reached for a successful claim to be mounted against the firm”.36 The examples referred to have been redacted from the published version of the Provisional Findings. However, it is clear that the CC has adopted an unreasonable and prejudicial approach to the evidence on this issue:

(i) That the examples referred to do not concern a lack of professional scepticism is clear from the CC’s admission that “[t]he FRC does not use the word ‘scepticism’ in its reports”.37 That reflects the view of the expert regulator following detailed investigations. No explanation has been given as to why the CC departs from that view.

(ii) The CC, without itself having conducted an investigation and without the necessary expertise, nevertheless feels able to conclude that having analysed the outcomes of those investigations “[w]e consider that we are correct in interpreting this as a lack of scepticism”.38 This represents an unjustifiable and prejudicial distortion of the evidence.

(iii) [Redacted]

As a result, it is extremely surprising that the CC considers that it can conclude that the outcome of the AADB’s investigation provides evidence of a lack of professional scepticism in relation to the conduct of statutory audits (unless the CC disagrees with the meaning of professional scepticism determined by expert regulators, in which case the CC is asked to explain what it considers to be the meaning of professional scepticism).

(b) AQRT Reports

The Provisional Findings refer to various AQRT reports and findings as evidence that auditors are “insufficiently sceptical in carrying out audits”. However, the AQRT reports do not, contrary to the inferences contained in the Provisional Findings, Appendix 17, paragraph 55.

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36 Provisional Findings, paragraph 7.139 and Appendix 17, paragraphs 55 to 87.
37 Provisional Findings, Appendix 17, paragraph 55.
38 Ibid.
Findings\textsuperscript{39}, provide evidence of a lack of professional scepticism "across a large proportion of the market".

A number of AQRT reports do identify instances where, in the opinion of the AQRT, in isolated cases and in relation to a specific issue, audit teams "did not apply sufficient professional scepticism".\textsuperscript{40} However, such limited findings cannot, on any reasonable basis, provide support for a general finding that there is a pervasive lack of scepticism.

Findings by the AQRT that, on balance, a greater degree of professional scepticism should have been applied in a limited number of cases should be taken in their context. In particular, AQRT reports identify areas for improvement, which are taken seriously and acted upon by the audit firms in question. That is not the same as a finding that an audit was conducted in breach of professional rules. If the AQRT had identified a serious failure to apply professional scepticism, that would have been referred to the AADB and would have been the subject of further investigations and disciplinary sanction, with the possibility that the audit report would have been withdrawn. It would be instructive for the CC to ask the FRC to provide details of AADB cases that have led to disciplinary sanction, and for which a lack of professional scepticism has been a key factor.

6. **Allegation: Ineffective corporate governance regime**

6.1 The Provisional Findings conclude that certain features of the UK corporate governance regime, and in particular the introduction of ACs, have failed to "remedy any detriment arising from a misalignment of auditor incentives with those of shareholders".\textsuperscript{41}

6.2 In EY's view, not only does this unjustifiably discredit the integrity and role of executive management, ACs, ACCs and auditors, it also represents a misunderstanding of the entire UK corporate governance regime.

6.3 As stated above, and in EY's response to the CC's Revised Theories of Harm document, the UK corporate governance regime is an extensive regime of finely balanced rules and principles, and the regulatory regime applicable to audits is only one element of a much more extensive corporate governance framework. The CC has focused on only limited aspects of that corporate governance regime, and largely ignores (for example) the roles of Chairman, non-executive directors and the Senior Independent Director, and the overarching role of the unitary board. As a result, the Provisional Findings do not reflect (for example) the extent to which the Code addresses the relationship between boards and shareholders.

6.4 Instead, the Provisional Findings level criticism, without any evidential basis, against:

(a) FDs, who are characterised as self-interested individuals who seek to influence auditor appointment and auditor conduct to meet their own requirements and, and act in such a way as to undermine the independence of auditors\textsuperscript{42};

\textsuperscript{39} Provisional Findings, Summary, paragraph 11.
\textsuperscript{40} See, for example, AIU Public Report on the 2011/12 inspection of Ernst & Young LLP, 15 June 2012 at page 7, where the AIU reported that it had found that in the case of three audits, the audit team did not apply sufficient professional scepticism in reaching a conclusion on the impairment of goodwill and other assets.
\textsuperscript{41} Provisional Findings, paragraph 11.102.
\textsuperscript{42} Provisional Findings, paragraphs 11.102(a)-(c).
(b) ACs which, despite being "an important and, by and large, powerful force in directing audit firms towards satisfying the demands of shareholders"43, are found by the CC not to have remedied "any detriment arising from a misalignment of auditor incentives with those of shareholders"44; and

(c) The regulatory regime, which has the apparent failing of not reviewing in detail every FTSE 350 audit.45

6.5 In reaching these conclusions, the CC states that its provisional findings in this regard are "consistent with"46:

(a) "[C]oncerns raised by the FRC and AQRT... that auditors have in recent years on occasion failed to demonstrate appropriate levels of professional scepticism" - for the reasons set out above, this materially overstates the extent of failure to demonstrate professional scepticism; and

(b) "[T]he failure of auditors to identify the impending financial collapse of some large companies" - the Provisional Findings contain no evidence whatsoever of this apparent "failure". This is a highly prejudicial statement, unsupported by fact or analysis. It has no place in the Provisional Findings at all, and certainly should not be used as evidence to support the CC's findings.

6.6 EY engages regularly with those bodies charged with reviewing, developing and updating the complex framework supporting corporate governance on a continuous and constructive basis. EY welcomes any moves towards further strengthening that framework, and is willing to engage constructively with the CC and on these issues. However, the unsubstantiated criticisms made in the Provisional Findings and directed at executive management, ACs, ACCs and auditors are: (i) unwarranted, and unsupported by the evidence; (ii) are based on an incomplete and prejudicial analysis of the corporate governance regime; and, moreover (iii) are not constructive additions to important, ongoing debate on these issues which is being conducted under the auspices of regulators in other fora.

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43 Provisional Findings, paragraph 11.98.
44 Provisional Findings, paragraph 11.102.
45 Provisional Findings, paragraph 11.102(d).
46 Provisional Findings, paragraph 11.104.
ANNEX 2

EY’s Response to the Remedies Notice

1. Introduction

1.1 In its first submission to the CC, EY stated that:

"Although strong competition for audits among the existing players is alive and well, we would support measures that both safeguard existing sources of audit supply as well as encouraging the emergence of other audit providers so that audit committees of large companies have a wider range of audit firms from which to choose when seeking a high quality audit."\(^1\)

1.2 That remains EY’s position, and it is in that spirit that EY welcomes engagement with the CC on the proposed remedies. However, EY remains of the view that, as set out in that first submission, the CC should "look carefully at audit quality, and use it as an important benchmark against which it assesses any potential remedies."\(^2\)

1.3 In assessing the effectiveness and proportionality of any possible remedies, the CC needs to give full consideration to:

(a) the practical operation of the proposed remedies;

(b) the clear adverse and distortive effects of some of the proposed remedies; and

(c) what net benefits (if any) would flow as a result of the imposition of the proposed remedies.

2. Proposed Remedy 1: Mandatory Tendering

2.1 As the CC highlights\(^3\), under recent FRC-led revisions to the Code "FTSE 350 companies should put the external audit contract out to tender at least every ten years".\(^4\) Those changes to the Code followed from the FRC’s discussion paper ‘Effective Company Stewardship – Enhancing Corporate Reporting and Audit’ published in January 2011\(^5\), and subsequent extensive consultations.\(^6\)

2.2 The FRC-led changes to the Code have only been in place for a few months, and the practical impact of those changes has yet to be observed. It is not clear on what basis the CC has concluded that those changes are inadequate. In EY’s view, there is no case for making further changes at this stage. The recent changes, operated in a “comply or explain” environment, are more than adequate to achieve the aims set out by the CC at paragraph 23 of the Remedies Notice. EY agrees with the FRC’s view that the tendering period should re-assessed in the light of experience of the new tendering regime. Such a re-assessment should consider not only the level of switching that has taken place, but also the experience of ACs and any impact on audit quality.

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\(^1\) Letter from Robin Heath to Roger Witcomb, 11 November 2011.

\(^2\) Ibid.

\(^3\) Remedies Notice, paragraph 19.

\(^4\) UK Corporate Governance Code, C.3.7.

\(^5\) http://www.frc.org.uk/FRC-Documents/FRC/Effective-Company-Stewardship-Enhancing-Corporate.aspx

2.3 The existing, rigorous partner rotation rules, when coupled with the recent changes to the Code and the wider regulatory regime, provide an effective safeguard against audit relationships becoming "too cosy".

2.4 No analysis or evidence is offered by the CC to explain why it considers that: (i) mandatory tendering every five or seven years would be appropriate, or strikes the right balance between "the costs of the tender process and the benefits to be obtained from increased frequency of tendering"; or (ii) tendering every ten years, a time period determined by the FRC following detailed review and consultation, is insufficient to address the AEC identified by the CC (particularly when combined with mandatory partner rotation).

2.5 More frequent mandatory tendering is likely to have consequences that cannot be reliably predicted, but might be expected to include:

(a) More audit firms deciding not to respond to invitations to bid, or submitting less detailed bids, which would compromise the effectiveness of tendering as a means for companies to assess the relative abilities of audit firms;

(b) Reducing the (currently considerable) recurring competitive pressures experienced by incumbent auditors.

Fewer / less useful bids

2.6 Under the revised UK Corporate Governance Code, it is expected that tender processes will be initiated in relation to on average 35 FTSE 350 companies each year. The CC's proposals would increase the number of invitations to tender to 50 or 70 each year on average. As the CC acknowledges, audit firms devote significant effort and resources in responding to invitations to tender. Those resources are finite. As a result, when the CC states that "[w]e envisage that under a more frequent system of tendering, resources expended by firms in mounting bids and companies in assessing bids would be reduced in view of the greater frequency of tendering and by facilitating provision of information", it makes two unsupportable assumptions:

(a) Assumption 1. The provision of additional information will reduce the cost of mounting bids.

EY supports the CC's recommendation in relation to "open book" tender processes. However, the costs of preparing a tender will not automatically decrease if more information is provided to tendering firms. The provision of such information will allow audit firms to submit responses that are more accurately tailored to the needs and expectations of companies. However, that does not mean that such responses will be less expensive or time-consuming to prepare. The time and cost entailed in responding to a tender request is a function of the tender process adopted by each company. The fact that audit firms receive more invitations to tender will not result in individual companies curtailing or simplifying their tender processes. Indeed, as

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7 Remedies Notice, paragraph 20.
8 Provisional Findings, paragraph 9.204 and Appendices 23 and 24.
9 Remedies Notice, paragraph 24.
potential candidates will be expected to demonstrate greater insight and understanding, it is to be expected that the costs of responding to a tender invitation will increase.

(b) Assumption 2. Audit firms will continue to respond to all tender invitations with the same level of detail.

Audit firms will, as a simple matter of practicality, be unable to devote the same effort and resources in responding to an average of 70 tenders each year as they are in responding to 35 tenders. As a result, even in the context of “open book” tender processes, it can be expected that audit firms will either

(i) become more selective when deciding whether to submit a bid (particularly if mandatory rotation is introduced) in order to focus their resources more effectively – this will reduce choice; and/or

(ii) submit less detailed bids which will be less useful to companies as a means of comparing the relative skills and expertise of rival audit companies.

Reduced competition between tenders

2.7 The CC acknowledges that mandatory tendering every five or seven years is likely to lead to "a settled period of auditor appointment". In previous submissions, EY has explained in detail the nature and extend of competition that exists before, during and after a tender process. Steps which have the practical effect (which the CC acknowledges) of giving rise to a "settled period of auditor appointment", of whatever length, will have the inevitable impact of:

(a) reducing the constant competitive pressures experienced by incumbent auditors to satisfy the demands of shareholders;

(b) reducing the benchmarking exercises conducted by companies outside of the tender process.

2.8 A period of 10 years, as currently provided in the Code, provides significant scope for companies to decide to initiate a tender at any time. By contrast, shorter periods – including the proposed 5 or 7 year period proposed – would tend to increase the focus of competition at set intervals, but limit the effectiveness of on-going competition. That would be a perverse outcome.

‘Comply or explain’

2.9 The CC, without explanation, states that it is not in favour of the "comply or explain" approach to corporate governance in the context of mandatory tendering. As the Code makes clear "[t]he “comply or explain” approach is the trademark of corporate governance in the UK. It … is the foundation of the Code’s flexibility. It is strongly supported by both companies and shareholders". Departing from the "comply or explain" approach in the context of audit tenders would remove the flexibility in-built into the Code and could lead to a company being forced to initiate a tender process at a time when it was not in its

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10 Remedies Notice, paragraph 23(c).
11 See, in particular, EY’s response to the CC’s Working Papers.
12 UK Corporate Governance Code, page 4.
interests (or those of its shareholders) to do so. This would be a significant step which should not be taken without clear justification. The CC has not offered any such justification.

The tender process

2.10 EY welcomes the CC’s provisional decision to adopt proposals for tenders to be conducted on an open-book basis. The FRC’s recently published Guidance on Audit Committees provides that, during a tender process, the AC should ensure that "all tendering firms have such access as is necessary to information and individuals during the duration of the tendering process".\(^\text{13}\) Any process by which this is achieved should be regarded as a "valid" tender process.

2.11 In EY’s view, an open-book approach would be key to ensuring that tendering firms have access to necessary information. In order to be effective, an open-book approach would involve ACs working with the incumbent auditor to develop a document that set out, for example:

(a) the principal audit risks and an attendant commentary on whether these reflect risks within the business or in the control environment, or both;
(b) the staffing model deployed to respond to these risks;
(c) a breakdown of audit hours by grade of staff in relation to each audit area; and
(d) a description of any single audit issue that accounted for (for example) more than 5 per cent of audit hours at a parent company or at a subsidiary level.

2.12 This approach will enable audit firms submitting bids to provide a more coherent and focused tender response, which reflects the bespoke elements of a company’s accounting and control environment.

3. Proposed Remedy 2: Mandatory rotation

3.1 No analysis or evidence is offered by the CC to explain why it considers that mandatory rotation would "ensure greater independence... and provide the benefit of a fresh approach".\(^\text{14}\) This remedy appears to be based on no more than an assumption that "switching for switching’s sake" is desirable.

3.2 Length of audit firm tenure, in itself, is not a threat to auditor independence or audit quality. There is no evidence linking audit firm tenure to failings in audit quality.\(^\text{15}\) Although the Provisional Findings point to specific findings of regulators that the CC (but not the expert regulators) has concluded show insufficient professional scepticism, no adverse link has been established between audit tenure and either auditor independence or audit quality.

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\(^{13}\) FRC Guidance on Audit Committees, September 2012, paragraph 4.21.
\(^{14}\) Remedies Notice, paragraph 27.
3.3 Mandatory firm rotation risks harming shareholder interests and undermining corporate governance. A recent case study\textsuperscript{16} highlights the fact that mandatory rotation can have adverse effects. The proposed remedy of mandatory rotation is an unnecessarily blunt instrument with potential negative effects that should be avoided. Specifically:

(a) Companies and their shareholders should be able to appoint the audit firm – and the audit partner – that best meets their needs. The choices available to companies and shareholders should not be circumscribed. Audit firms (and individual partners within audit firms) have different skill sets, industry expertise and geographical reach, all of which contribute to producing a high-quality audit. These are important considerations when selecting an audit firm: as the results of the CC’s survey show, the experience and knowledge of the AEP is the most important issue for companies in selecting an auditor.\textsuperscript{17} Put more directly, companies primarily appoint lead audit partners, not audit firms. Mandatory partner rotation rules already limit the choices available to companies and shareholders. Mandatory firm rotation would automatically disqualify the incumbent audit firm’s partners from the pool of candidates, thereby imposing a further unwarranted restriction on choice.

(b) Mandatory rotation would weaken a key element of the existing corporate governance structure. The fundamental purpose of corporate governance is to make sure companies operate in the interests of shareholders including when appointing auditors. Mandatory firm rotation would limit the ability of the AC to carry out this duty.

(c) As with mandatory tendering (see paragraph 2.7 et seq above), companies are unlikely to initiate a tender process significantly before the end of the set period. If the incumbent audit firm knows that it cannot be reappointed at the end of that period, this will have the inevitable impact of reducing the recurring competitive pressures experienced by incumbent auditors. Increasing the focus of competition at set intervals at the expense of continuing competition would be a perverse outcome.

(d) Longer audit tenures can give rise to significant advantages. It should be for companies and shareholders to decide whether or not they wish to benefit from those advantages. In particular, an audit firm attains significant knowledge and understanding of a company over time, as well as an awareness of the risks it faces. Such knowledge can enhance professional scepticism and audit quality. For example:

(i) experience and knowledge of the personalities and abilities of individuals may prompt increased scepticism;

(ii) a detailed knowledge of historical accounting positions or transactions enables an auditor to assess consistency in approach and better to assess management motivations;

\textsuperscript{16} ICAS What do we know about mandatory audit firm rotation?, Ewelt-Knauer, Gold and Pott (the “ICAS Study”).
\textsuperscript{17} Provisional Findings, Appendix 3, paragraph 35 and Table 12.
(iii) institutional knowledge helps audit firms to identify broader issues and emerging risks, or to "connect the dots" between what might otherwise appear to be isolated issues.

3.4 EY is also concerned that the CC has not fully appreciated the resource challenges posed by mandatory rotation and the long-term negative impact that it could have on audit quality. Forced changes of auditor increases the overall cost of the audit while not necessarily increasing - indeed potentially threatening - audit quality. Although companies and audit firms obviously can and do manage transitions and new audit client risks, this is not without cost or risk. These costs and risks would be multiplied if transition activity is significantly greater than it is currently:

(a) Due to the learning curve that audit firms face with any new audit client, audits can be less efficient at the beginning of an engagement, and present a higher level of audit risk. These factors would increase the cost of the audit process as a whole (for audit firms and companies) if audit firms were regularly being rotated.

(b) Companies would face repeated distraction and disruption due to the need to educate the new audit firm about their business and operations. Even if the incoming auditor accepts a lower audit fee, there will be a significant extra time commitment from senior personnel at the audited company to help explain to the incoming auditor the company’s business, internal control environments, processes and corporate structures.

(c) These audit efficiency and risk issues would be compounded for complex global companies with operations in multiple countries.

3.5 There is no evidence that the many negative effects of mandatory firm rotation would be outweighed by any improvements in audit quality, lower audit fees or enhanced innovation. Indeed, researchers who looked at mandatory firm rotation in South Korea and Italy did not find significant increases in audit quality as a result of mandatory audit firm rotation requirements. Furthermore, experience in Italy and South Korea demonstrates that enforced limitations on audit tenure result can result in greater concentration and increased overall costs, whilst threatening audit quality.

4. Proposed Remedy 3: Expanded remit and/or frequency of AQRT reporting

4.1 As the CC recognises the objective of the AQRT's work is to monitor and promote improvements in the quality of the auditing of listed and other major public interest entities. The methodology which the AQRT currently uses is to form a view on the quality of audits in each firm based on selective sampling. The approach is risk based with a focus on key issues. This approach enables the AQRT to provide information to shareholders of listed companies generally on the quality of audits performed by individual audit firms and to drive improvements in audit quality. EY considers that these reports already provide a valuable indicator to shareholders and management of FTSE

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19 See the ICAS Study for details of relevant academic research.
350 companies of the audit quality of the main audit firms. The potential benefits of significantly increasing the number of FTSE 350 audits reviewed each year by the AQRT need to be balanced against the increased expense and other potential costs of doing so. EY notes that the initial reactions to the CC’s report from the FRC express caution in this regard.\(^{20}\)

4.2 It is always open to the FRC to initiate an investigation of an audit outside of its normal inspection cycle, and this does occur where published market concerns arise. It may be appropriate for the FRC to consider extending this to cover circumstances where information comes to its attention that is from sources other than published market concerns.

5. **Proposed Remedy 4: Prohibition of contractual clauses in template documents limiting choice to the Big 4 firms**

5.1 As previously indicated, EY’s longstanding position is that it is fully supportive of proposals to prohibit clauses in loan documents which limit auditor choice to the Big 4 firms.

5.2 It is not clear from the Remedies Notice whether the CC’s proposal is to prohibit the use of Big 4 clauses in template documents or in all loan documentation.

5.3 For FTSE 350 companies, loan documentation will, in the vast majority of cases, either be based on LMA standard forms (particularly in relation to syndicated loan agreements) or on banks’ own standard forms particularly in the case of bi-lateral agreements. Consequently if the CC intends to focus on standard form documents, consideration needs to be given to whether the prohibition should also extend to standard forms used by banks, although of course these will generally not be publicly available documents, but certainly in terms of influence on market practice they may be as influential as the LMA’s templates.

6. **Proposed Remedy 5: Strengthen accountability of the External Auditor to the AC**

6.1 The CC comments that "[w]e encountered difficulties in evaluating the evidence on AC effectiveness".\(^{21}\) From the analysis contained in the Provisional Findings, EY questions whether the CC has sought out sufficient reliable and relevant evidence to evaluate and test. For example, we see no inquiries being made of the FRC as to what they have observed from reviewing the inter-action of auditors, management and ACCs evidenced on audit files or the FRC’s impressions from their periodic meetings with ACCs to discuss their public inspection reports. EY considers that the CC has undervalued the power and influence of ACs, and in particular ACCs, to secure audit quality and auditor independence in the interests of shareholders.

6.2 The CC has expressed a concern that "the influence in practice of executive management on external auditors is a feature of the market that may prevent, restrict or distort competition by providing incentives for firms to respond to the demands of executive management rather than the different demands of shareholders, and thereby distorting competition by causing firms to compete on the wrong parameters".\(^{22}\) However, EY’s experience is that whilst this risk may exist theoretically, it is not manifest in practice.

\(^{20}\) See Stephen Haddrill’s comments in Accountancy Age, 28 February 2013.
Moreover, the CC has failed to provide compelling evidence that this risk manifests itself in practice.

6.3 In particular, the CC’s claim that "the failure of auditors to identify the impending financial collapse of some large companies" evidences this concern is unjustified. The CC has failed to provide any evidence supporting this claim. Whilst the CC does not identify the companies it may be instructive for the CC to review the companies they have in mind with the FRC in order to determine: (a) whether the audits of these companies were examined by the FRC; (b) if so, whether or not the FRC concluded that there were audit failings; and (c) to the extent there were, what disciplinary action the FRC took.

6.4 Notwithstanding these reservations about the CC’s reasoning and comments, EY has always been supportive of strengthening the role of the ACC and EY will support any practical recommendations in this area. Indeed, the FRC Guidance on Audit Committees already provides that “[t]he audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors”. The FRC guidance also contemplates that the AC will oversee the selection process and imposes a number of specific duties on the AC in respect of the oversight of the external auditor.

6.5 In EY’s experience it would be unusual for an FD of a FTSE 350 company to initiate a tender process, appoint an auditor, request the replacement of an AEP or request the auditor to carry out material non audit work without having discussed the matter with and secured the agreement of the ACC. Consequently imposing a more explicit requirement that certain aspects of the relationship with the audit firm have to be carried out by the ACC rather than the FD should not be difficult to implement and would achieve the CC’s objective of reducing the potential for the FD to exert inappropriate influence over the auditor.

6.6 However, whilst this approach is plausible for clearly defined events such as those indicated above, it is not practical for many issues that arise in the ordinary course of the audit. Frequently such issues have to be addressed through an iterative process, starting at a much lower level in the company being audited. Initially they are addressed to those having executive accountability for the issue that is the subject of the audit enquiry. The issue is only raised with the ACC at a later stage should the audit issue not be resolved to the auditors satisfaction.

6.7 By way of practical example, the auditor may identify an issue relating to increasing debt levels. This could ultimately be a material audit issue, but audit enquiries necessarily commence with those primarily responsible for control of debt levels (which may or may not include the FD), so that the auditor may test relevant controls, assess the reasonableness of information and explanations provided, and conduct such further testing as judged appropriate. Based on the auditor’s provisional conclusions, the auditor’s report to the ACC may take different forms – for example, the increased debt levels are temporary, or they are a consequence of weaknesses in the control environment but the debts should be capable of recovery, or are doubtful as to recovery and management will or will not make further provisions. Under this regime, the

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21 Provisional Findings, paragraph 11.52.
22 Provisional Findings, paragraph 11.103.
23 Provisional Findings, paragraph 11.104.
24 FRC Guidance on Audit Committees, paragraph 4.20.
effectiveness of accountability for sound management of debt levels is assessed and any material weaknesses in that management are identified. The debate with the ACC (and AC) enables them to make an independent and adjudicative assessment as to both the control environment and the recoverability of the debts. A process which makes the ACC “the first point of contact” in this scenario would cause the ACC to move into an executive management role if the purpose of that “first point of contact” comes with an expectation that the ACC will do something to directly contribute to the resolution of the audit issue. That negates the benefit of the ACC being in an independent and adjudicative role, and removes an internal control of benefit to the whole Board and to the external auditor.

6.8 In this context, EY notes that auditing standards already provide that significant qualitative aspects of a company’s accounting practices (including accounting policies, estimates and financial statement disclosures) must be reported to the AC.

6.9 EY would support the AC taking responsibility for negotiating audit fees from the FD.

6.10 EY supports a strengthening of the role of the ACC based on the existing provisions of the FRC guidance on ACs. However, in the absence of evidence of a pervasive problem of audit quality being adversely affected by the relationship between the auditor and management, which EY does not consider the CC to have found, EY is concerned that drawing the ACC into a more extensive management role risks losing the benefits of his current supervisory role.

7. Proposed Remedy 6: Enhanced shareholder-auditor engagement

7.1 EY is supportive of the measures proposed by the CC to give shareholders a greater involvement in auditor selection through the right to vote on holding a tender process and the requirement for an enhanced level of support if an auditor is to remain in place after a tender.

7.2 EY supports the proposal to require the AEP to present to shareholders at the AGM, and notes that this type of engagement is already a requirement in other jurisdictions. However, EY considers that to be effective there would have to be a very clear guidance on the appropriate and required content of such a report if it is to provide any meaningful information to shareholders.

7.3 The FRC is currently consulting on proposed changes to ISA (UK and Ireland) 700 *The auditor’s report on financial statements*. The FRC’s consultation paper states:

“In overview, it is proposed to require the auditor’s report to:

(a) Describe those assessed risks of material misstatement that were identified by the auditor and which had the greatest effect on: the overall audit strategy; the allocation of resources in the audit; and directing the efforts of the engagement team;

(b) Provide an explanation of how the auditor applied the concept of materiality in planning and performing the audit; and

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25 ISA (UK and Ireland) 260 – *Communications with those charged with governance.*
7.4 EY is in the process of finalising its response to this consultation and will forward a copy to the CC in due course.

8. Proposed Remedy 7: Extended reporting requirements—in either the AC’s or auditor’s report

8.1 As indicated above, the FRC is currently consulting on proposed changes to ISA (UK and Ireland) 700. EY is in the process of finalising its response to this consultation and will forward a copy to the CC in due course.

8.2 In the meantime, EY draws the CC’s attention to the proposal, contained in EY’s response to the FRC’s consultation on mandatory tendering, for ACs to conduct and report to shareholders on an expanded “Audit Effectiveness and Independence Assessment”. In EY’s view, this would respect the important governance roles of ACs, while providing relevant information to shareholders and regulators about the audit and the auditor.