

Response of Ernst & Young LLP (UK) to the FRC Discussion Paper “Choice in the UK Audit Market”

Introduction

1. This is the response of the UK firm of Ernst & Young to the Financial Reporting Council’s discussion paper “Choice in the UK Audit Market”. Ernst & Young recognises that concentration of auditor choice is an important matter facing the profession and our markets. Ideally, there should be more choice in the market for the audit of large UK public companies. However, we believe that the current state of the market is not causing significant problems for most large public companies and there appears to be ample choice in the market for other companies.
2. We are in favour of promoting the capabilities of mid-tier and smaller firms. Nevertheless, it will be difficult in the short to medium term for the mid-tier and smaller firms to compete effectively with the Big 4 firms in the audit market for large public companies. This being the case, we think that one of the salient questions in this debate, as recognised in the FRC discussion paper, is how to avoid the collapse of a large firm. Undoubtedly there would be problems on choice if the four large accounting networks were to reduce to three. Indeed, if this were to happen there is a real risk that this would put the entire profession at risk because it is unlikely that firms would be able to retain enough talented people to consistently deliver a quality audit product.

Basis of Ernst & Young’s response

3. The FRC discussion paper identified seven points for commentary. We believe that the degree of choice in the market for audit services to large public companies should be a primary focus of the debate. The remaining six points in the discussion paper in general seek input on how choice can be increased, how the risk of a firm leaving the market can be reduced, and how the costs of uncertainty and disruption arising in the event of a firm leaving the market can be reduced.
4. Realistically, there would be significant uncertainty and disruption, with costs consequences for companies and investors, were a large firm to leave the market, and it would be very difficult to identify steps to avoid this uncertainty and disruption. We therefore believe that the focus of this element of the debate should be on preventing a firm leaving the market, whether voluntarily or involuntarily.
5. In the light of the above considerations, Ernst & Young has approached this debate on the basis of two summary questions:
 - How can the risk of a firm, in particular an existing Big 4 firm, leaving the market, voluntarily or involuntarily, be reduced?
 - How can increased choice be achieved, such that there will be more audit firms participating in the UK audit market for large public companies?
6. These two questions were identified at the stakeholder meeting on 26 April 2006, and are reflected in the bullet points in paragraph 18 of the FRC discussion paper.
7. In framing this response we have tried to consider whether the solutions proposed are realistic and likely to be effective. We have sought to consider whether they will be good for our clients and the market as a whole and, consistent with our values, we have avoided a consideration simply from the perspective of whether the proposed solutions will be good for Ernst & Young.

How can the risk of a firm, in particular an existing Big 4 firm, leaving the market, voluntarily or involuntarily, be reduced?

8. In response to this question, we discuss each of the following five potential and complementary solutions:
 - a) Continued substantial investment by the Big 4 recognising that we, of all stakeholders, have the greatest responsibility towards our people, our clients and the capital markets to provide and maintain quality, and to avoid the collapse of our individual organisations.
 - b) Fair and equitable reform on an international basis of unlimited liability regimes to reduce the risk of collapse of one or more of the Big 4 or other firms.
 - c) Elimination of the present and current threat to survival due to reputational collapse caused by disproportionate criminal or regulatory prosecution.
 - d) Substantial ongoing efforts to clarify the role of the auditor.
 - e) Explicit recognition by all regulators and stakeholders that the best quality audits can only be realised if audit is an attractive and innovative profession.
- a) ***Continued substantial investment by the Big 4 recognising that we, of all stakeholders, have the greatest responsibility towards our people, our clients and the capital markets to provide and maintain quality, and to avoid the collapse of our individual organisations.***
9. We recognise the significant responsibility to our clients and the capital markets to maintain the orderly operation of our international network. We also have a responsibility to our people to ensure that Ernst & Young is protected from threats to its existence. In recognition of these responsibilities, quality is our first priority. We have made significant investment in and devoted enormous resources to achieving quality. However, even the highest possible standards of quality do not prevent claims or other threats. Therefore, like any commercially responsible organisation, we also make significant investment in managing risk and avoiding failure. The drive for quality goes hand in hand with protecting against threats and both are continuously challenged, top priorities. As our delivery of quality is audited by the FRC in the UK and analysed in some depth separately, we expand below on some examples of our efforts to protect against threats.
10. Ernst & Young operates globally as independently owned and licensed country entities, operating in line with country specific laws and regulations. However, through our global organisation we are closely integrated. Membership in our global organisation means that member practices agree to implement operating procedures designed to drive consistent, high quality service delivery to our clients while providing for the continued survival of the network in the event of an isolated failure. Member firms are required to comply with rigorous global quality, independence and risk management policies, including global methodologies for services delivered (audit, tax, etc).
11. Significant resources are devoted to implementing these and monitoring compliance with them. We have large teams dedicated to independence, regulatory compliance, legal risk management, and specific technical excellence and practice protection. Enormous energy is devoted to training and to developing and progressing global and member firm risk management. As ever our drive for quality is behind these initiatives.
12. In recent years, we have developed operating structures that will, as far as possible, contain legal liabilities within jurisdictional boundaries and seek to prevent liabilities spreading

throughout the international network. This is in our clients' and the markets' interests, as well as our own.

13. Nevertheless, we recognise that the threat of damage remains real and our governance model provides for rapid and appropriate response in the event of a contingency. However, across the profession it is fair to say that in the event of a collapse of one of the US firms, it is very difficult to see any response that would enable the network as a whole to survive. This fact emphasises the key importance of both liability reform on an international basis, and protection against the spread of reputational damage and loss in confidence in the markets, as discussed below.

b) *Fair and equitable reform on an international basis of unlimited liability regimes to reduce the risk of collapse of one or more of the Big 4 or other firms.*

14. Catastrophic audit claims continue to present a real risk to the survival of the Big 4 and other firms and liability reform is a necessary step to protect against such life-threatening claims. Equitable Life is a recent and powerful example. In the UK, the compelling public policy arguments in favour of liability reform have been recognised, including the protection this ultimately affords the markets. It is recognised that unlimited liability is not a driver of audit quality and objectivity, so liability reform does not threaten or dilute quality or objectivity. There are far more effective mechanisms to ensure high quality and objectivity, including high standards of professionalism, each firm's own quality control procedures, continued efforts to protect individual firm reputation, brand strength and market attraction, independent oversight and regulation, as well as the robust disciplinary regimes that exist.
15. We obviously welcome the provisions of the Companies Bill in the UK, although it remains to be seen how the "fair and reasonable" test will be applied by the Courts. Ultimately, we would welcome legislation which permits an absolute cap (subject to the provisions of the Unfair Contract Terms Act 1977 or equivalent), so as to bring the position into line with that for the provision of non-audit services.
16. However, liability reform in the UK alone will not be enough. A disastrous claim in another jurisdiction, most obviously the US, has the potential to undermine an entire international network. That is why it is vital for suitable liability reform to be implemented, in particular, in the US and EU. The EU's recent recognition of public policy arguments in favour of reform is particularly promising. The implications of failure and the remedies afforded through liability reform warrant global consideration by other key policymakers.

c) *Elimination of the present and current threat to survival due to reputational collapse caused by disproportionate criminal or regulatory prosecution.*

17. Although much attention is rightly focused on protection against catastrophic claims, we would say that the threat of reputational damage through criminal or regulatory prosecution still poses as great a threat. There is also the reputational impact of catastrophic claims, but we hope this will be managed in the majority of cases by liability reform.
18. Although the climate has undoubtedly changed since the collapse of Andersen, an "Andersen scenario" could still happen. Maintaining a credible and trusted reputation is key to maintaining business (and staff) in this market. Of course, if there has been criminal activity it must be punished appropriately, but we firmly believe that there remains a real and potent risk to a firm and an entire network if there is disproportionate criminal prosecution or other serious regulatory sanction, especially if this occurs in one of the key jurisdictions.
19. There have been recent examples of regulatory intervention against Big 4 firms. Fortunately, the largely responsible reaction of the various stakeholders and influencers have in the main protected the networks involved from disproportionate damage. Unfortunately, we have no

guarantee that all stakeholders and influencers will react responsibly to the next serious challenge and it is undesirable to leave things to chance.

20. This is one reason why the profession continues its strong opposition to the introduction of the audit opinion criminal offence – contained in the Companies Bill – in its current form. The profession supports punishment of a dishonest auditor but comprehensive provisions in laws that provide for such punishment already exist. However, it is important to recognise that a criminal allegation alone against an auditor could give rise to a reputational threat to a whole firm. We believe it is a key part of the debate on choice in the audit market to foresee the potential serious adverse impact of the introduction of this offence. If it is introduced in its current form it is incumbent on the authorities to apply it responsibly and with the possible wider repercussions in mind.
21. Where rules are breached, firms should clearly be accountable, but it is difficult to imagine a circumstance where it is fair for an entire firm to face collapse. Whatever a group of individuals at Andersen did, it was unjust for the whole network and the people employed in that network to pay the price. There is real merit in promoting a coherent European, and if possible global, regulatory approach involving sensible and proportionate reactions to rule breaches. There is responsibility on regulators not to overreact to particular circumstances. This must inevitably involve increased active dialogue and consistent actions between regulators.
22. There is also a real responsibility on clients, the investment community, the press and other Big 4 firms to respond responsibly to potential reputational and loss in confidence threats to firms. Perhaps if there were less emphasis on the “insurance” component of the Big 4 audit products (ie. the component recognised by Oxera which says that companies will not be criticised for choosing one of the Big 4 as auditor), companies and investors may feel less pressure to switch auditors in a scenario where the reputation of a firm is threatened.

d) Substantial ongoing efforts to clarify the role of the auditor.

23. A related point which we believe is relevant to this debate is to promote greater clarity in the market as to the role of the auditor. Despite years of efforts by the profession to promote understanding, often there is a misunderstanding of the auditor’s responsibilities and role. Clearly, we are responsible and accountable for our audit work, but the standard reaction to pursue the auditors regardless of the circumstances following a corporate collapse continues to represent a threat to our survival. Equitable is a noteworthy and costly example.
24. We believe this often occurs due to a lack of understanding of the legal and professional responsibilities of the auditor. We recognise that we must continue to engage with various stakeholders to promote understanding but think it will be a beneficial output of this debate if greater clarity as to the role of the auditor, including in relation to the detection of fraud, could be achieved.
25. An alternative is to debate the role of auditors with an objective of changing the role to meet the current assumed expectation of key stakeholders. However, it is important to remember that such debate in the past has made clear that additional levels of assurance result in a significantly increased cost to companies and investors, which has been found to be unacceptable. Recent debate around the cost of Sarbanes Oxley 404 reporting highlights the market challenges in expanding the role of auditors.

e) *Explicit recognition by all regulators and stakeholders that the best quality audits can only be realised if audit is an attractive and innovative profession.*

26. The FRC discussion paper raises the possibility of large firms leaving the market voluntarily. It is important to note that this is unlikely to be a proactive decision of a firm but rather a reactive decision due to the erosion of the resources needed to deliver high quality audits in response to actions that make the profession less attractive. Ernst & Young believes that the most serious threat in this regard is through further regulatory intervention adversely changing the role of the auditor or the identity of firms.
27. The depth, breadth and quality of professional experience that an auditor can develop, maintain and bring to bear over his or her professional career by being involved in the wider service offerings available at multidisciplinary firms is already challenged by the current state of rules on independence. In addition, the attractiveness of an auditing career is harmed when the scope for the appropriate exercise of professional judgment is limited. If auditing were to become less attractive, talented people would move away from audit or leave and we may have to reconsider our approach to the market. This is not a hypothetical threat as changes to the audit environment in the last few years have caused some to consider the attractiveness of audit compared to other career options. Any further regulatory intervention must be seen in this context.
28. The motivation of our people is itself a driver of audit quality. If talented people leave then it follows that the quality of the audit product will diminish – itself giving rise to audit failures, more claims, and regulatory and reputational risks. In one respect, the best way to ensure that no large firm leaves the market, voluntarily or involuntarily, is to maintain a climate where our audit teams can be energised, motivated and interested in what they do and in the quality of what they produce, and not feel that they or the firm they work for are vulnerable to unfair litigious or reputational threats.

How can increased choice be achieved, such that there will be more audit firms participating in the UK audit market for large public companies?

29. In response to this question, we discuss each of the following:
- a) There has been enormous investment by the large firms to establish global capability. This will be difficult to match in the short to medium term.
 - b) Companies have the ability to give themselves more audit choice.
 - c) Implementation of rules that show activity but result in limited or no benefits to choice issues (often in exchange for an increased cost of audit to organisations) should be avoided.
- a) *There has been enormous investment by the large firms to establish global capability. This will be difficult to match in the short to medium term.***
30. The ability of the large networks to provide audit services of international, often global, reach is recognised as being a significant distinguishing factor. Indeed, the accountancy mergers of the last two decades have largely been driven by our clients' need for such global reach. This capability has not come cheaply or without significant resource investment over a number of years. Each of the Big 4 firms spends millions of pounds annually in developing and sustaining its global audit practice. The total aggregate annual spend of the Big 4 in developing and sustaining their audit practices would significantly impact the profits of the mid-tier firms if they were to undertake a similar exercise. The mid-tier firms are unlikely to be able to match this without significant outside investment, and even then, in our experience, it would take a number of years to translate the investment into an equivalent international network.

31. It has been suggested that were the rules on outside investment to be relaxed, outside investors might find our market attractive. We struggle to see how investors will be persuaded to invest given the number of years that would be required to realise the benefits and without very significant changes to the current risk/reward ratio. Equally, mergers involving mid-tier firms may potentially increase capability somewhat but will not alone provide an international platform – considerable resource and investment would still be required. Also, mergers will not immediately change client perception as to the preferred choice of auditor, which was recognised as a significant factor in the Oxera report.

b) Companies have the ability to give themselves more audit choice.

32. Ultimately, much depends on the actions of companies in determining the degree of choice in the market. Companies have the power to act differently to give themselves more choice. More companies could use the mid-tier firms than currently do so if they thought it was the right decision to do so. The recent statement of the ABI encouraging companies to have a more open mind is noteworthy in the context of this debate.

33. In addition, companies could think differently about how they use the Big 4 firms across the range of services we provide. The barriers to competition in the provision of *non-audit* services are perhaps comparatively less insuperable than in the UK audit market for large public companies. There is less emphasis on international reach and on the ‘insurance’ component and perhaps client perception generally in the provision of non-audit services.

34. For those who choose to use the Big 4 for audit, it may be a sensible strategy to avoid the use of one or two Big 4 firms (in addition to their existing auditor) for those services that would preclude their ability to compete for the audit. This may result in more use of non-Big 4 organisations for those services that would prohibit competing for the audit. This will benefit companies and the markets by providing more auditor choice and potentially strengthen the overall market share of the mid-tier firms relative to the Big 4.

c) Implementation of rules that show activity but result in limited or no benefits to choice issues (often in exchange for an increased cost of audit to organisations) should be avoided.

35. There have been suggestions in the context of this debate that steps such as rotation of audit firms, joint audits and increasing the information made available to successor auditors will have an impact on choice. We think that such changes will have limited impact on choice, for example the Bocconi study in Italy has demonstrated that mandatory rotation actually increases concentration. They will also often adversely affect quality. Mandatory rotation is certainly detrimental to audit quality, and the joint audit may have been a contributory factor in relation to at least one recent high profile case. In general, such changes will increase costs for companies and therefore will have an adverse impact overall. We do not consider that such steps will have a positive impact on this issue.

Closing comments

36. Ernst & Young appreciates the opportunity to provide our views on concentration of auditor choice. We welcome the opportunity to discuss these further and we welcome the suggestions of others that provide realistic and effective solutions to maintain and/or improve choice while ensuring the audit profession remains attractive and innovative thus helping ensure the continued and improving quality of audits performed.