

### About Overview

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# UK House of Lords Economic Affairs Committee issues its final report

## *Auditors: market concentration and their role*

### Introduction

On 30 March 2011, the UK House of Lords Economic Affairs Committee issued a report ("the Report") that concludes an inquiry it launched in July 2010 to examine the perceived dominance of the Big 4 in the UK audit market and whether the audit profession could have helped prevent the banking crisis. The Report makes recommendations to the UK Government that it is not required to implement but that it will consider carefully.

The Report comes at a time when there is general interest in audit and the audit market among policymakers, including the European Commission, as evidenced by its Green Paper on Audit Policy ("the Green Paper"). As a result, the Report could affect policymaking by the UK Government, the Commission and potentially other legislators and regulators across the world who are watching events in Europe closely.

The Report sets out a variety of recommendations but singles out three as being the most important. These focus on measures to (i) address market concentration in the large listed company audit market; (ii) reassert prudence as the guiding principle of the audit; and (iii) enhance bank audits and their contribution to financial stability, primarily through a regular two-way dialogue with auditors and supervisors about the financial health of banks. Other areas of focus include mandatory re-tendering, audit committees, an enhanced role for audit, non-audit services, IFRS, risk committees, going concern judgment for banks and "living wills" for audit organizations.

In evidence to the Committee, the UK Government did not support regulatory intervention to address concentration in the audit market. However, it favored bolstering the role of the audit committee to improve transparency in the audit process and to increase tendering activity with a view to companies changing audit firms more frequently. Enhancing transparency in audit committee reporting and decision-making is in line with Ernst & Young's position, expressed both to the Committee itself and in our response to the Green Paper.

### Report summary

In the Report, the Committee says that audit is valuable and fundamental to the capital markets, but that it is concerned about the "oligopoly" of the Big 4 and the risk of Big 4 failure. It also suggests that banking auditors failed to raise red flags in the run-up to the financial crisis and were complacent when making going concern judgments. The Committee said it considers the lack of dialogue between regulators and auditors during that time to have been a "dereliction of duty" by both parties. It also believes the implementation of IFRS has led to reduced audit quality and a box-ticking approach, because the Committee believes IFRS is more rules-based than UK GAAP.

## Further Resources

House of Lords Economic Affairs  
Committee report on audit market  
EY's media statement on the report

The Committee singles out the following three recommendations as being the most important:

**1. There should be a detailed investigation of the large listed company audit market by the UK competition authorities.**

The Committee believes market-based solutions to address competition and choice issues have failed. In particular, it proposes the UK competition authorities should look at:

- ▶ Big 4-only clauses in loan agreements
- ▶ Auditor liability and whether unlimited liability is a barrier to entry for non-Big 4 audit firms
- ▶ Ownership restrictions
- ▶ How a changing role for auditors might increase choice
- ▶ Non-audit services and whether further bans are appropriate

The Committee observed the international dimension of the concentration issue and called on the UK authorities to take a lead and seek to influence their international counterparts on these matters.

As we expressed in our response to the Green Paper, we share the view that there is concentration in the upper end of the global public company audit market and support measures to increase choice of auditor, provided that such measures would not impair audit quality or erode the audit committees' responsibility to appoint the auditor and oversee the audit process.

**2. Prudence should be reasserted as the guiding principle of audit.**

This recommendation is less clear and seeks to impose a requirement on auditors to be more prudent in their audits. It appears that the Committee is confusing the concept of prudence as applied to accounting and the need for auditors to exercise professional skepticism. The recommendation does not seem to take account of the fact that financial statements are prepared by companies, the accounting judgments are the responsibility of management and the directors, and auditors are responsible for reviewing these judgments as part of assuring that the financial statements are fairly presented.

**3. Bank audits should do more to contribute to financial stability, in particular through a two-way dialogue between auditors and supervisors about the financial health of banks.**

The Committee believes that the recently agreed-upon UK FSA/Bank of England Code of Practice (the "Code"), intended to promote a regular dialogue between auditors and supervisors, does not go far enough because it is essentially voluntary. The Committee recommends that a statutory requirement be imposed.

Consistent with our evidence to the Committee and our response to the Green Paper, we support the two-way dialogue between auditors and financial supervisors. External auditors and supervisory authorities share a common objective in safeguarding public confidence in financial institutions and financial reporting. Increased levels of cooperation between auditors and supervisory authorities can only benefit the financial markets as a whole. This is why the Code is an important development.

### Other recommendations

#### *Audit tenders*

The Committee recommends that FTSE 350 companies be required to re-tender their audit every five years, and that each tender process should invite a non-Big 4 to participate. In evidence to the Committee, we said that other measures are likely to be more successful in promoting the capability of audit firms outside the Big 4. Audit committees need to conduct periodic evaluations of audit quality, determine whether to re-tender the audit, and explain why

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they have not re-tendered after more than a set period of years. We also believe that independent audit oversight bodies should evaluate the reporting of their inspection results to improve visibility of the quality of audit work.

**Audit committees**

In addition to recommending mandatory re-tendering, the Committee also recommended that audit committees should:

- ▶ Discuss auditor choice with principal shareholders every five years
- ▶ Report in detail to shareholders on their choice of auditor. This would include why the tender decision was made.
- ▶ Report significant financial reporting issues raised during the course of the audit

This is generally consistent with our evidence to the Committee and our response to the Green Paper.

**Enhanced role for auditors**

To address the expectation gap, the Committee recommends that the audit should provide broader, more up-to-date assurance on such matters as risk management, business model and narrative reporting.

In our response to the Green Paper, we recognized the importance of distinguishing between a company's responsibility to report its results to the market and the responsibility of the auditor to provide assurance on that information. To that end, we supported considering whether the auditor should be required to provide some level of assurance or attestation on – or have other involvement with – certain information outside the financial statements, including, for example, a company's narrative reporting (e.g., MD&A) and disclosures made in an audit committee report. If this were to move forward, we noted that consistent standards would need to be developed.

**Non-audit services**

The Committee explicitly states that it does not advocate a total ban on auditors carrying out non-audit services for audit clients. However, unexpectedly, it recommends that external auditors should be banned from providing internal audit, tax advisory services and advice to risk committees.

Importantly, the UK Auditing Practices Board (the UK independence standard setter) has reviewed the rules on non-audit services extensively since the crisis. It undertook a very thorough analysis of the evidence and received extensive input from a wide range of stakeholders. It concluded that major changes concerning non-audit services, including tax, were unnecessary and made relatively small adjustments. Those changes just took effect in 2011.

**IFRS**

The Committee supports the concept of a single set of high-quality global accounting standards. However, it considers that IFRS has left less scope for auditors to exercise judgment, because it is more rules-based than UK GAAP. The Committee wants to see prudence reinforced particularly in relation to bank audits. As a result of its concerns, the Committee believes that the use of IFRS in the UK should not be extended beyond its current application and that UK GAAP should continue to be available as an alternative. The Committee also recommends that the UK Government take a lead in promoting an expected loss model for valuations of financial instruments under IFRS.

We have long believed in the importance of having a single set of global, high-quality accounting standards. We are pleased that the Committee shares our view and that it recognizes the international nature of these issues. However, we do not agree with the suggestion that IFRS should be linked as a cause of the financial crisis, and specifically with bank failures. Not all jurisdictions that use IFRS have experienced problems in their banking sectors. By the same token, some countries that do not use IFRS have experienced problems.

This does not mean that IFRS cannot be improved, and indeed standard setters are seeking to develop improved, principles-based standards, especially for financial instruments, that respond to the criticisms made following the crisis. We also welcome the considerable progress made by banks in the quality of their disclosures on the financial instruments they hold and the risks they are exposed to.

#### ***Risk committees***

The Committee recommends that:

- ▶ Risk committees be mandated for banks and other financial institutions
- ▶ Auditors ensure that every bank has a properly constituted and effective risk committee of the board. If this requirement is not met, the Committee further recommends that the auditor disclose this fact in the audit report
- ▶ External advice to the risk committee not be provided by the auditor

The establishment of risk committees has become an accepted leading practice for most large financial institutions, and we do not believe it is necessary to mandate such committees by law.

#### ***Going concern for banks***

The Committee is concerned about the inability of auditors to signal problems in the financial health of banks for fear of causing a collapse of confidence. However, it admits that this problem cannot be avoided but that a closer relationship with the prudential regulator will help minimize the issue.

#### ***Living wills for auditors***

The Committee believes that any move from the Big 4 to a Big 3 is unacceptable. It recommends that the Government and regulators should promote the introduction of “living wills” for Big 4 networks.

In our response to the Green Paper, we gave our support to contingency planning by audit firms, their networks and regulators to potentially reduce the threat of a large audit firm or network exiting the market, or to mitigate its impact so as to ensure continuity of audit services. In contrast, we did not support the concept of a “living will,” as currently applied to banks. Such a living will does not seem appropriate for global audit networks, which do not hold financial assets and do not trade with each other and for which government bailouts have never been considered.

#### **What's next?**

The UK Government will have up to two months to respond to the Report, and sometime after that there will be a debate on the floor of the House of Lords.

It is possible that the Office of Fair Trading (the UK competition authority) will take up the Committee's invitation to carry out a detailed investigation of the large listed company audit market. However, the OFT has suggested that it would prefer to see the outcome of the Green Paper before making a final decision. To be effective, the OFT also suggested that international coordination of competition authorities would be needed.

If you have any questions regarding the information in this EY Overview, please contact either your Area Regulatory and Public Policy leader; Beth Brooke or Felice Friedman in Global Public Policy, or in the UK: Robin Heath or Andrew Hobbs.

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