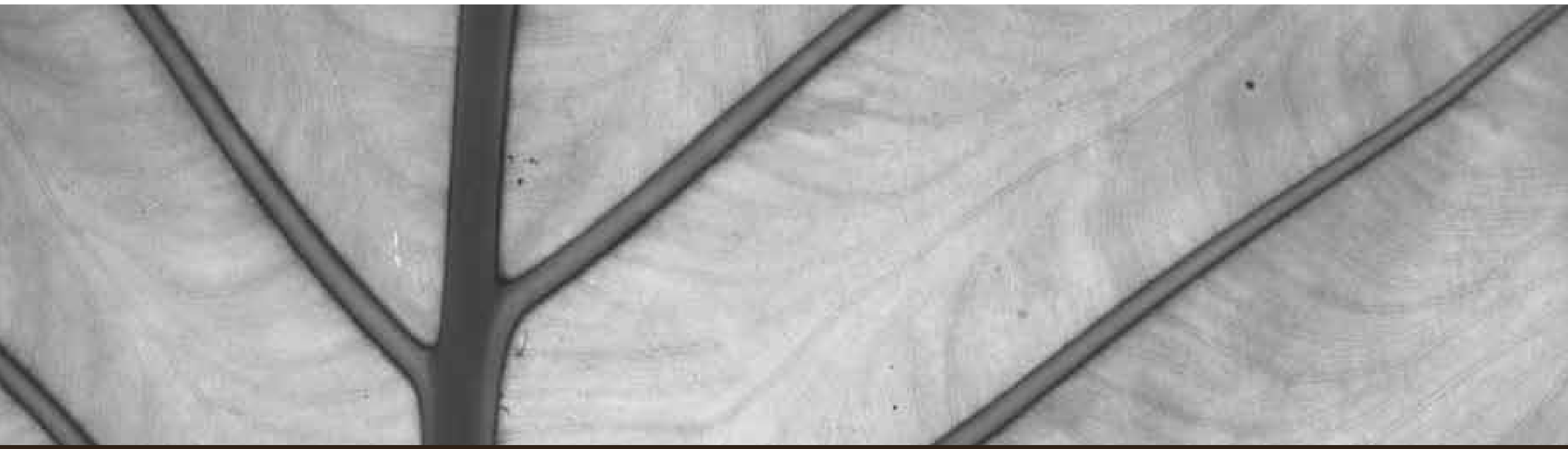

ACCOUNTANTS FOR BUSINESS

Investor round table: EC audit proposals

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With work progressing in Europe on the development of legislation to strengthen statutory audit requirements for public interest entities, ACCA and Grant Thornton held a round-table event in London on 14 May to enable investors to express their views.

This report captures key points raised during the round-table discussion.

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Introduction

With work progressing in Europe on the development of legislation to strengthen statutory audit requirements for public interest entities, ACCA and Grant Thornton held a round-table event in London on May 14 to enable investors to express their views. Sajjad Karim MEP, rapporteur for the European Parliament's Legal Affairs (JURI) Committee, also attended, giving him an opportunity to hear investor opinions in person.

The event was the latest in a series of events organised by ACCA and Grant Thornton with a view to ensuring investor needs and priorities sit at the heart of legislative developments. Given the specific subject matter, it was agreed that ACCA would chair this meeting.

- Investors see merit in some of the European Commission's audit proposals, but have concerns and questions about other aspects. This report captures key points raised during the round-table discussion. In particular it considers:
  - mandatory auditor rotation
  - shared or joint audits
  - provision of non-audit services by auditors
  - transparency: the need for clear reporting from audit committees and auditors
  - other issues raised by investors.

CONCLUSIONS

While the EC's proposals were the direct focus of the round table, participants also gave views more generally on the role of audit. The main conclusions, based on the views expressed at the round table, are as follows.

- Investors feel strongly that the market structure has failed in relation to the provision of audit services and that some regulatory intervention is needed.
- Auditor reporting also needs to be enhanced with more information given on audit judgements.
- The role of audit committees in representing shareholder interests in the audit process is crucial. Some committee chairs need to be more aware of this and 'open up' more to investors.
- While there should be an upper limit on length of an auditor's tenure, audit committees should be given considerable flexibility to justify the retention of auditors to that limit.
- Investors would be willing to pay higher costs for shared audits if this improved audit quality.
- Investors have concerns that non-audit services can impair audit objectivity, but feel the EC's intended measures go too far.

Mandatory auditor rotation

Investors generally feel there is a need for action to address the problem of audit firms retaining long tenure, as this can pose a threat to objectivity, independence and audit quality.

One commented: 'When we talk about independence it's not just independence from management, but it's also independence from the baggage of the audit firm's own historical judgments.' Fresh assumptions can be needed.

There is also a counter-argument, however, that the link between long auditor tenure and reduced audit quality has not been proven. The UK Financial Reporting Council, for example, does not appear to have made this association in its audit inspection reports.

In terms of the EC's proposals, investors have some concerns that imposing mandatory rotation after just six years (or nine years for joint audits) could be costly, disruptive and have negative repercussions for audit quality and the role of the audit committee.

Concerns include the following.

- Auditors might have to be replaced at a time their knowledge is particularly useful, for example, after a corporate restructuring.
- New auditors take time to gain understanding of new clients, so audit quality could suffer.
- Auditors might rotate off their better staff toward the end of their allotted audit term.
- Market concentration could actually worsen, with the big four potentially increasing their dominance.
- Mandatory rotation removes the audit committee's ability to use its discretion in determining the timing of any change of auditor.
- Audit committee choice is reduced because one auditor (the incumbent) is removed from the selection pool – this is a particular issue for sectors such as insurance where there may be few audit firms with the appropriate expertise and capability.

There is a view that requiring audit rotation within a set time band could be preferable (for example, in a range between 10 and 15 years' tenure) with the audit committee being able to justify keeping the incumbents on, but that there needs to be a firm upper limit. One investor commented: 'If auditor tenure is longer than 15 years, then the audit committee is not doing its job in terms of protecting auditor independence.' This echoed a recent quote from former International Accounting Standards Board chairman Sir David Tweedie, who said that 'a jolly good reason' was needed to justify a 20-year tenure.

Investors see considerable merit in mandatory audit tendering – or perhaps some combination of mandatory tendering and rotation through the introduction of a cap on the number of years or periods of tenure an audit firm can remain in place.

One said: 'There should be mandatory tendering every six to nine years, so giving the audit committee some flexibility. But after two terms there must be a change of auditor.'

Even with mandatory tendering, however, investors also require transparency about the reasons for audit committee decisions.

'We have to consider the impact of mandatory tendering on the incumbent auditor. If you don't have transparency and the incumbent auditor is coming up for a tender, the auditor is even more incentivised not to challenge management' observed another participant.

The discussion reflected strongly the importance that investors place in the role of the audit committee to represent their interests, given that, as one institutional shareholder pointed out: 'We cannot speak to all the auditors of companies we hold shares in. We have to trust the audit committee – they should be accountable to shareholders and explain why a firm is being kept on._We have to rely on the audit committee to stand in our shoes and to represent our interests in calling the auditors to account and ensuring the auditors are doing their job properly and effectively.'

Shared or joint audits

Investors do not have a problem with shared audits – where a group auditor brings in another firms or firms to conduct some of the audit work – if this is necessary to achieve the desired level of audit quality, even if it results in increased cost. It has been estimated that shared audits could increase audit costs by 20% – but this was not considered by participants to be material. And some of the cost, it was argued, might be justified by the enhanced confidence given by two sets of auditors checking the books, rather than one.

'Some of the cost assigned to shared audit might be value-adding. Duplicating some of the questions that are asked, and people looking at things with multiple pairs of eyes – that might lead to better decisions' said one investor.

Shared audits could also help to open up the audit market.

Another participant argued: 'It [shared audit] does provide an opportunity for other firms to put some of their services in the shop window of the audit committee, and other shareholders as well. Therefore, shared audits, as part of a collection of measures, could provide a means of increasing choice in the audit market.'

Investors would like greater transparency in relation to how work is shared between the different firms in shared audit situations – with a clear lead group auditor - so that investors are reassured that no issues have fallen into a gap between the two.

Turning to joint audits, investors do want to have one auditor with overall responsibility, so are less convinced by the merits of joint audits.

Provision of non-audit services by auditors

Investors are aware that, in the UK, fees earned by auditors from non-audit services appear far higher than in certain other jurisdictions. The UK framework is therefore relatively liberal and permissive.

Investors do have some concerns, particularly in relation to the provision of tax advisory services, due diligence on acquisitions, IT development services (particularly around the finance function) and outsourcing. The EC's long list of potentially banned services is therefore worthy of debate, but a blanket ban would generate less support.

'Investors, as a rule, do think that non-audit services can impair objectivity, particularly if they are generating significant revenues. But what the Commission is proposing in terms of a ban on non-audit services to audit clients and the restriction of related financial audit services to a limit of 10% of the audit fee – I think that is going too far' said one.

Investors feel there are some audit-related services (such as regulatory returns for insurers) that auditors are best placed to provide. Using other firms would be unnecessarily costly.

Investors also highlight the need for clear definitions of what is meant by 'audit' and 'non-audit' services. Some services required by statute, for example, might be considered as part of 'audit and assurance' work in the UK, rather than discretionary or advisory.

'The audit committee should be required to look at it [auditor provision of non-audit services] and ought to be able to explain in detail the policies. It should not only explain the activities it has forbidden the auditors to do, but also the policy – for example, non-audit fees not going above 25% of audit fees. There needs to be a bit of freedom for the board to make decisions, but it should be clear to shareholders about what it has done' argued one participant.

Transparency: the need for clear reporting from audit committees and auditors

Investors see considerable potential for improving the quality of reporting about audit matters so that they can form a view about the quality of the audit undertaken.

One said: 'One problem with auditing is that everything is done, in relation to transparency, to the lowest common denominator. Audit reports give very little in terms of 'added added' value, other than assurance about the true and fair view. Audit committee reports are getting better, but it's not very often you get a good meaty dialogue with an audit committee chair. It's difficult to get the assurance we are looking for in terms of how good an audit has been so we can form a qualitative view on that.'

There is disappointment that audit firms do not currently differentiate themselves by including additional information in their audit reports.

Investors would particularly like more information on key audit issues, specifically areas where judgment has been applied. However, consensus is lacking on where this should be given.

One view is that such information should be included in the audit committee report, because the auditor's report would tend to end up rather bland after emerging from internal audit firm review processes. The audit committee report could identify where there had been debates on issues of significance to the audit, together with an explanation of why the audit committee and auditors reached agreement. This would enable shareholders to decide whether they also agree. Taking Enron as an example, what might have been the impact of disclosure of any discussion as to whether certain items should be on or off balance sheet?

However, there is also a strong view that the audit report is the appropriate place for disclosure of issues of judgment relating to the audit. Such information should not be left out of the audit report because it is being included in the audit committee report.

'Accounting judgments ought to sit with the company, but auditing judgments have to be disclosed by the auditor – they're their judgments' argued one participant.

Investors also note the fact that the roles of the audit committee and auditor are different, and the role of the auditor should not be subsumed within that of the audit committee. Auditors have a duty to signal any issues of significance to the shareholders directly.

'The audit committee and the auditor are not interchangeable. The audit committee is an internal body of the board and the directors [on the committee] are aligned with the rest of the board. The auditor has a duty directly to the body of shareholders. I am all for improving the audit committee report, but not as a sop for the auditor giving a clear report to the shareholders about the issues relevant for forming a decision [on whether] to accept the true and fair view' said one investor.

Investors feel that (regardless of information being reported formally) when they have specific questions, they want answers. But they don't necessarily get them.

'The real thing investors want is to be able to talk from time to time to companies and to auditors and get a better answer than the answers in the audit report' observed another.

There are mixed views about the responsiveness of chairmen and auditors. Some investors have found audit committee chairs helpful, while others have found them keen to 'shut down' any questions about the audit directed at auditors. Investors are aware that auditors have to be careful about one-to-one discussions with them, due to insider information concerns. However, they should be able to answer questions asked openly in a company's general meeting.

Investors do want to see a firm statement from auditors on going concern and would be worried about any weakening of reporting in this area.

Other issues

SHOULD AUDITORS BE OBLIGED BY LAW TO REPORT CONCERNS ABOUT THEIR PUBLIC INTEREST CLIENTS TO REGULATORS?

Investors are comfortable with the idea of a two-way dialogue. If auditors have an obligation to report issues to regulators, so regulators should be obliged to raise issues with auditors. If auditors do report issues to regulators, they should also communicate that to shareholders.

PUBLIC INTEREST ENTITY DEFINITION

Investors feel that the EC's proposed definition of public interest entity (PIE) is too widely drawn and includes entities which should not be classified as PIEs, They were keen to know whether there was still scope for further development. This is an issue of interest for the European Parliament's Economic and Monetary Affairs Committee (ECON), whose rapporteur, Kay Swinburne, is interested in how the definition is applied to certain financial structures, so further consideration is being given to whether the PIE definition is set at the right level.

ISAS

Investors have concerns about whether International Standards on Auditing will have to be enforced by member states without scope for adjustment. Investors would prefer 'ISA Pluses' – achieved by both adding elements to improve audit quality, and by removing some burdensome requirements considered unnecessary.

POSITIVE EC PROPOSALS

Investors see some positive elements in the EC's audit proposals, such as requirements for contingency planning, and the prohibition of clauses limiting auditor selection to the Big Four.

AUDITOR LIABILITY

If auditors are to be asked to include more information in their audit reports, consideration may need to be given as to whether legal barriers exist. In some member states, legal frameworks expose auditors to punitive legal liabilities.

RESERVE POWERS

Could the power be reserved to ratchet up requirements and regulations if necessary? This can act as a powerful catalyst for changing behaviour.

INVESTOR COMPETENCE AND ENGAGEMENT

Even if audit reports and audit committee reports are enhanced, that will have little impact on audit quality unless more investors become fully engaged.

Appendix: EC audit proposals: current status and future timetable

Sajjad Karim MEP, the European Parliament's lead negotiator on the draft legislative package on audit proposed by the EC, will be discussing the Commission's proposals with both the Council of Ministers and Financial Services Commissioner Michel Barnier and seeking to reach agreement. Until those meetings are concluded, details about progress must remain confidential.

The schedule for development and agreement of audit reform legislation is subject to change. However, the rapporteur's team may develop a working paper by the summer, moving towards a draft JURI report towards the autumn. The JURI vote on that report could potentially take place in December.

Progress is partly being timed to fit in with work being conducted elsewhere, including by the UK Competition Commission. The timetable is also affected by whether member states see the work as a priority, particularly once the Cypriot presidency begins in July 2012.

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ACCA 29 Lincoln's Inn Fields London WC2A 3EE United Kingdom / +44 (0)20 7059 5000 / www.accaglobal.com