

Enhancing the value of the audit committee report



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Using examples drawn from current practice, this paper explores how a small sample of FTSE 100 company audit committees address the external audit aspects of the reporting responsibilities assigned to them by the UK Corporate Governance Code.

1. Introduction and background

The UK Corporate Governance (CG) Code (FRC 2012) addresses the relationship between a company's corporate governance committee and the independent external auditor. It does this in two main ways – by setting out, firstly, the issues relating to the external auditor and the external audit process that the committee should consider and, secondly, the issues concerning the external audit that the committee should report on externally to the members. As the examples cited in this exploratory report demonstrate, UK listed companies are making lengthy disclosures along the lines required by the UK CG Code.

A recent report by the FRC's Financial Reporting Lab (see Box 1) has, however, found that investors are demanding more – they want audit committee reporting to be bespoke (rather than boiler-plated) and company specific, and for the most significant financial statement issues to be disclosed annually.

Using examples drawn from current practice, this paper explores how a small sample of FTSE 100 company audit committees address the external audit aspects of the reporting responsibilities assigned to them by the UK CG Code (FRC 2012).

At the time of writing (February 2014) it appears likely that the provisions of the 2012 Code will be updated to include the proposals of the Competition Commission issued in October 2013. Both the existing FRC requirement and the new proposals are summarised in Chapters 1 and 2 below.

The 'real world' disclosures selected to illustrate current good practice were drawn from a number of FTSE 100 companies shortlisted for one or more categories in the 2013 PwC Building Public Trust Awards. The examples are not necessarily 'best practice' but should be seen as illustrative of the way in which audit committees are trying to fulfil their responsibilities under the 2012 edition of the UK CG Code. The first section of the analysis also shows that some of the companies studied are

responding well to the challenge of ensuring investor engagement (as highlighted in Crump 2013, reproduced in Box 1).

A follow-up paper will be published later this year examining whether audit committee reports issued in the first half of 2014 are tackling the new challenges posed by the proposals from the Competition Commission and, if they are, how they do so.

Box 1: Investors call for bespoke audit committee reports

by Richard Crump, 25 October 2013

Investors would engage more with audit committee reports if they provided 'hooks' to form a discussion around, the UK's reporting watchdog has been told.

From the views of 19 companies and 25 investor analyst groups, the FRC's Financial Reporting Lab found that information on audit committee judgements related to financial statement issues had the most scope for improvement and could help them in developing views on valuation.

'It's not useful to have four pages on immaterial issues – far better to be shorter and focus on real issues,' one respondent suggested.

There were also specific recommendations that the audit committee chair be more accountable by personalising the report; describe in detail actions taken rather than just the functions they serve and depict their specific activities during the year and their purpose, using active, descriptive language.

Audit chairs were also advised to disclose judgements made for the year, and the sources of assurance and other evidence used to satisfy themselves of the appropriateness of the conclusion and consider their audience in describing issues and their context.

'Investors have told us that they will pay more attention to audit committee reports if they provided more meaningful information,' said Sue Harding, director of the Financial Reporting Lab. 'Audit committee reports should form part of the conversation between companies and investors, building confidence in this important area of governance and showing how it contributes to good financial reporting.'

Source: Crump (2013).

2. The requirements of the UK Corporate Governance Code 2012

The UK CG Code sets out the minimum requirements for those issues relating to the external auditor that the audit committee should consider. These are:

- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor¹ and to approve the remuneration and terms of engagement of the external auditor
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken.

The UK CG Code also prescribes the minimum content for a section within the annual report and accounts describing how the audit committee has carried through the responsibilities set out above. These minimum reporting requirements are:

- the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed
- an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted, and
- if the external auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded.²

With regard to the financial accounts themselves, the audit committee must also consider:

- the quality and acceptability of accounting policies and practices
- the clarity of the disclosures and compliance with financial reporting standards and relevant financial and governance reporting requirements
- material areas in which significant judgements have been applied or there has been discussion with the external auditor, and
- whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's performance, business model and strategy

The audit committee's judgements on these last four points do need to be communicated to the board, although many published audit committee reports also make an attempt to address them.

1. FTSE 350 companies should put the external audit contract out to tender at least every 10 years. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

2. Disclosure requirements relating to the disclosure of audit fees and fees paid to the auditor for non-audit services are dealt with separately under the Companies Acts.

3. The recommendations of the Competition Commission – October 2013

The proposals issued by the Competition Commission in October 2013 are likely to become 'mandatory' and will in due course be absorbed into the UK CG Code. The key recommendations regarding corporate audit committees and external auditors are set out below.

FTSE 350 companies must put their statutory audit engagement out to tender at least every ten years. This differs from guidance introduced by the Financial Reporting Council (FRC) in 2012, which encouraged companies to go to tender on a 'comply or explain' basis. No company will be able to delay beyond ten years, and the Competition Commission believes that many companies would benefit from going out to tender more frequently at every five years. If companies choose not to go out to tender this frequently, the audit committee will be required to report in which financial year it plans to put the audit engagement out to tender and why this is in the best interests of shareholders.

The FRC's Audit Quality Review (AQR) team should review every audit engagement in the FTSE 350 on average every five years. The audit committee should report to shareholders on the findings of any AQR report concluded on the company's audit engagement during the reporting period.

There will be a prohibition of 'Big-Four-only' clauses in loan agreements (ie clauses that limit a company's choice of auditor to a preselected list or category), although it will be possible to specify that any auditor should satisfy objective criteria.

There must be a shareholders' vote at the AGM on whether audit committee reports in company annual reports are satisfactory.

Measures will be introduced to strengthen the accountability of the external auditor to the audit committee and reduce the influence of management, including a stipulation that only the audit committee is permitted to negotiate audit fees and influence the scope of audit work, initiate tender processes, make recommendations for appointment of auditors and authorise the external audit firm to carry out non-audit services.

4. Examples of current reporting practice

(1) The significant issues that the committee considered in relation to the financial statements, and how these issues were addressed.

SOURCES

All the examples of current reporting practice in this section are quotes from the following sources:

- Anglo American plc (2012: 102–7)
- British Land Company plc (2013: 86–9)
- National Grid plc 2013: 63–5)
- Vodafone Group plc (2013: 61–2)
- WPP plc (2013: 118–20).

COMMENTARY

Disclosures in this area usually fall within a description of the work undertaken by the committee at its various meetings during the year. These descriptions are almost invariably lengthy and detailed. Thus, with the exception of Vodafone, only brief extracts have been reproduced below. The Vodafone extracts give a good 'window' into the way in which the audit committee should go about addressing significant accounting issues.

In this context it is interesting to note the recent conclusions of the UK FRC's Financial Reporting Lab (see page 3) which recommend that 'information on audit committee judgments related to financial statement issues had the most scope for improvement and could help them in developing views on valuation'.

EXTRACTS

Vodafone

'The primary role of the Committee in relation to financial reporting is to review with both management and the external auditor the appropriateness of the half-year and annual financial statements concentrating on, amongst other matters:

- the quality and acceptability of accounting policies and practices;
- the clarity of the disclosures and compliance with financial reporting standards and relevant financial and governance reporting requirements;
- material areas in which significant judgements have been applied or there has been discussion with the external auditor;

- whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the Company's performance, business model and strategy; and
- any correspondence from regulators in relation to our financial reporting.

'To aid our review, the committee considers reports from the Group Financial Controller and the Group Financial Reporting Director and also reports from the external auditor on the outcomes of their half-year review and annual audit. As a Committee we support Deloitte LLP in displaying the necessary professional scepticism their role requires.

'The primary areas of judgement considered by the Committee in relation to the 2013 accounts, and how these were addressed, were:

- Goodwill impairment testing: The judgements in relation to asset impairment largely relate to the assumptions underlying the calculation of the value in use of the business being tested for impairment, primarily the achievability of the long-term business plan and macroeconomic assumptions underlying the valuation process.
- Taxation: Provisioning for potential current tax liabilities and the level of deferred tax asset recognition in relation to accumulated tax losses are underpinned by a range of judgements
- Liability provisioning: The level of provisioning for contingent and other liabilities is an issue where management and legal judgements are important. These are addressed through the Committee discussing with management the key

judgements made, including relevant legal advice that may have been received.'

Anglo American

'Role and responsibilities: Monitoring the integrity of the annual and interim financial statements, the accompanying reports to shareholders and corporate governance statements...At the December 2012 meeting the Committee reviewed the significant audit and accounting items for the 2012 year end. This included the process for reviewing the valuation of the Minas-Rio project, the accounting implications of the Platinum structure review and the accounting treatment for De Beers.'

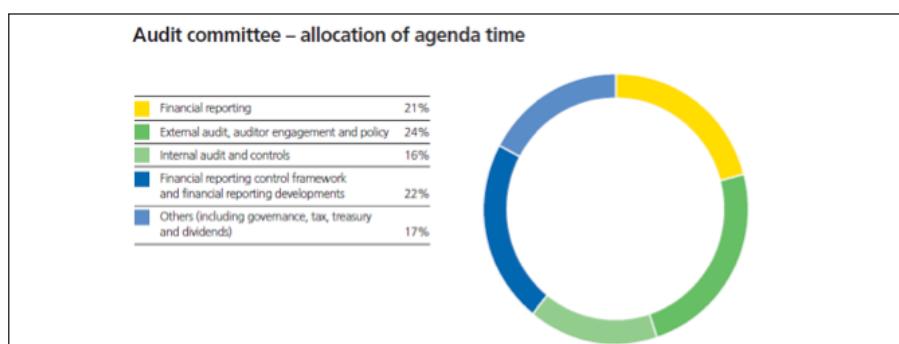
Some companies sought to make disclosures in this area more accessible by using diagrams and tables.

British Land

PRINCIPAL RESPONSIBILITIES OF THE AUDIT COMMITTEE	
FINANCIAL REPORTING AND EXTERNAL AUDIT	<p>• Monitoring the integrity of the Company's financial statements and any formal announcements relating to the Company's financial performance; reviewing significant financial reporting judgements contained within them.</p> <p>• Making recommendations to the Board regarding the appointment of the External Auditor and approving the External Auditor's remuneration and terms of engagement.</p> <p>• Monitoring and reviewing the External Auditor's independence, objectivity and effectiveness.</p> <p>• Developing and implementing policy on the engagement of the External Auditor to supply non-audit services, taking into account relevant ethical guidance.</p>

KEY AREAS FORMALLY DISCUSSED AND REVIEWED BY THE COMMITTEE DURING 2012/13 INCLUDE:	
<ul style="list-style-type: none"> • Results, commentary and announcements. • Key accounting policy judgements, including valuations. Impact of future financial reporting standards. • Going concern. • External Auditor effectiveness. • Half-yearly External Auditor reports on planning, conclusions and final opinion. • External Auditor management letter containing observations arising from the annual audit leading to recommendations for control or financial reporting improvement. 	

Aviva



National Grid

'Financial reporting: The committee monitors the integrity of the Company's financial information and other formal documents relating to its financial performance and makes appropriate recommendations to the Board before publication.

'A key factor in the integrity of financial statements is ensuring that suitable and compliant accounting policies are adopted and applied consistently on a year-on-year basis and across the Company. In this respect, the committee also considered the estimates and judgements made by management when accounting for

non-standard transactions, the treatment of exceptional items and in provision calculations.

'Summarised below are some of the significant issues the National Grid Audit Committee considered in relation to the financial statements during the year (extracts only provided):

- US financial controls programme: An important milestone of the programme took place when we implemented a new enterprise resource planning system, which went live during November and December 2012.
- Environmental provision: At the half year and year end we reviewed the Company's environmental provision to ensure that it remained appropriate.
- Pensions: Movements in the market value of plan assets and changes in economic assumptions, principally the discount rate, were noted along with their consequential impact on net pension and other post-retirement liabilities.
- Recoverability and disclosure of storm costs: The committee discussed the disclosures around the financial impact of Superstorm Sandy in our half-year results statement, and the impact of storm costs on cash flows and working capital.'

(2) An explanation of how the audit committee has assessed the effectiveness of the external audit process.

COMMENTARY

The UK GC Code requires that audit committees report on how they have assessed auditor effectiveness, not just on whether they have or not. There are many 'auditor effectiveness assessment tools' available. EY summarise the key parts of the process as follows.

Auditor assessment: Frequent areas of audit committee focus:

- technical competence
- knowledge of company strategy and risks
- quality-control processes
- independence
- professional scepticism
- partner temperament
- communication and reporting
- global capabilities.

The most detailed statement of how effectiveness was assessed was provided by Vodafone – although the strong emphasis attributed to risk assessment by Vodafone suggests that reporting requirement '(1) Significant issues considered in relation to the financial statements', has been combined with reporting requirement '(2) How the effectiveness of the external audit process is assessed'.

EXTRACTS

Vodafone

'The effectiveness of the external audit process is dependent on appropriate audit risk identification and at the start of the audit cycle we receive from Deloitte LLP a detailed audit plan, identifying their assessment of these key risks. For 2012 the primary risks identified were in relation to goodwill impairment, provisioning for current tax liabilities and deferred tax asset recognition due to the inherent management judgement required in these areas. These risks are tracked through the year whenever we receive reporting from Deloitte LLP. We hold private meetings with the external auditor at each Committee meeting to provide additional opportunity for open dialogue and feedback from the Committee and the auditor without management being present. Matters typically discussed include the auditor's assessment of business risks and management activity thereon, the transparency and openness of interactions with management, confirmation that there has been no restriction in scope placed on them by management, independence of their audit and how they have exercised professional scepticism. I also met with the external audit partner outside the formal committee process throughout the year.'

Anglo American's audit committee report is more focused on audit process effectiveness.

Anglo American

'The effectiveness assessment involves a review, with the senior finance managers in each of the business units and relevant corporate functions, of the audit process, including the planning, execution and reporting activities along with an assessment of the quality, quantity and leadership of each of the external audit teams involved in the audit. Any improvement opportunities identified are discussed with the external auditors....'

In contrast to Vodafone and Anglo American, the audit committee reports of National Grid, British Land and WPP are far less detailed and focused – indeed the word 'effectiveness' is hardly used – two of the companies preferring to use the word 'performance' instead.

National Grid

'The annual review includes consideration of: the external audit process globally; the auditors' performance; the expertise of the firm and our relationship with them; and the results of questionnaires completed by National Grid employees engaged with the audit and members of the Audit Committee'

British Land

'In accordance with its normal practice, the Audit Committee considered the following: the performance of the External Auditor, including: value for money; and quality and effectiveness in the Audit Committee's own assessment and, where available, according to external regulatory review'

WPP

'In line with the committee's responsibility to review and appoint the external auditors and approve their remuneration and terms of engagement, in 2012 we monitored Deloitte's independence, objectivity and performance with reference to frequent reports from Deloitte during the year covering the overall audit strategy and the progress and results of the audit. The committee concluded that it continues to be satisfied with the performance of Deloitte and that Deloitte continues to be objective and independent'.

Finally, Aviva produced a good example of a 'comply or explain' statement.

Aviva

'Given the resignation of Ernst & Young LLP as external auditor in early 2012 and that PwC has only just completed its first full-year audit, no external auditor effectiveness review was carried out in 2012. A review will be conducted in 2013.'

(3) Information on the approach taken to the appointment or reappointment of the external auditor.

COMMENTARY

The UK GC Code requires audit committees to report publicly on the approach that they have taken to the appointment or reappointment of the external auditor. Disclosures in this area frequently merged with those required on audit tendering and assessment of objectivity and independence, National Grid and British Land being examples of this.

EXTRACTS

National Grid

'An annual review is conducted by the committee of the level and constitution of the external audit and non-audit fees and the effectiveness, independence and objectivity of the external auditors. Following this year's annual review, the committee is satisfied with the effectiveness, independence and objectivity of the external auditors, and recommend to the Board their reappointment for a further year. A resolution to reappoint PwC and giving authority to the Directors to determine their remuneration will be submitted to shareholders at the 2013 AGM'.

British Land

'Following best practice and in accordance with its Terms of Reference, the Audit Committee annually reviews the audit requirements of the Group, both for the business and in the context of the external environment, and considers whether to undertake a formal tender. There are no contractual obligations which would restrict the selection of a different auditor. In accordance with its normal practice, the Audit Committee considered the following:

- 'The performance of the External Auditor, including:
 - value for money, and
 - quality and effectiveness in the Audit Committee's own assessment and, where available, according to external regulatory review.
- 'The External Auditor's:
 - independence
 - compliance with relevant statutory, regulatory and ethical standards, and
 - objectivity, as assessed by the Committee.'

Vodafone addresses the issue slightly differently, providing one piece of discretionary information that is found in only one of the other reports reviewed – lead audit partner rotation.

Vodafone

'The Committee considers the reappointment of the external auditor, including the rotation of the audit partner, each year and also assesses their independence on an ongoing basis. The external auditor is required to rotate the audit partner responsible for the Group audit every five years. The current lead audit partner has been in place for three years...In accordance with section 489 of the Companies Act 2006, a resolution proposing the reappointment of Deloitte LLP as our auditor will be put to the shareholders at the 2012 AGM. There are no contractual obligations restricting the Committee's choice of external auditor and we do not indemnify our external auditor'.

Anglo American and WPP provide fairly straightforward narratives to support this reporting requirement.

Anglo American

'The appointment of Deloitte LLP as the Group's external auditors...is kept under annual review and, if satisfactory, the Committee will recommend the re-appointment of the audit firm.'

WPP

'In line with the committee's responsibility to review and appoint the external auditors and approve their remuneration and terms of engagement, in 2012 we monitored Deloitte's independence, objectivity and performance with reference to frequent reports from Deloitte during the year covering the overall audit strategy and the progress and results of the audit.'

Aviva makes perhaps the least informative disclosure in this area although, like Vodafone, it makes reference to the lack of restrictions on whom it can appoint as auditor.

Aviva

'The Committee led the tender and selection process through which PwC was appointed and has recommended to the Board that PwC be re-appointed by shareholders at the 2013 AGM. There are no contractual obligations that restrict the Committee's choice of external auditor'

(4) Information on the length of tenure of the current audit firm.

COMMENTARY

Disclosures under this heading are generally kept brief and to the point.

EXTRACTS

Anglo American

'The appointment of Deloitte LLP as the Group's external auditors (incumbents since the listing of Anglo American in 1999) is kept under annual review and, if satisfactory, the Committee will recommend the re-appointment of the audit firm.'

National Grid

'PwC have been the Company's external auditors since the merger with Lattice Group plc in 2002, having been the incumbent external auditors of both the merging parties.'

Vodafone

'Deloitte LLP have been the Company's external auditor since its stock market listing in 1988'.

WPP

'Deloitte has been WPP's auditor since 2002. The lead partner rotates every five years and the last rotation was in 2010.'

Aviva

'PwC was appointed by the Board as the Company's external auditor on 22 March 2012 for the 2012 reporting period and was re-appointed by shareholders at the 2012 AGM.'

Unsurprisingly perhaps, these disclosures tend to get tagged onto other disclosures such as those required under heading '(5) Information on when a tender was last conducted', and heading '(3) Information on the approach taken to the appointment or reappointment of the external auditor'.

(5) Information on when a tender was last conducted.

COMMENTARY

This disclosure requirement needs to be read alongside the fuller recommendations of the 2012 UK CG Code, which say that 'FTSE 350 companies should put the external audit contract out to tender at least every ten years. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.'

None of the companies reviewed for the purposes of this paper appeared to use the 'comply or explain' option offered by the Code. The more restrictive October 2013 recommendations of the Competition Commission (see Appendix 2 on page 22,) were published too late to affect any of the audit committee reports reviewed for the purposes of this paper.

EXTRACTS

The National Grid

'The new [UK GC] Code requires FTSE 350 companies to put the audit services contract out to tender at least once every ten years, to enable the committee to compare the quality and effectiveness of the services provided by the incumbent auditors with those of other audit firms. Transitional arrangements provided by the Financial Reporting Council indicate [that] the Company should tender the audit, at the latest, at the time of the next audit partner rotation[,] currently scheduled for 31 March 2015. We may, however, put the audit out to tender at any time before this date.'

Vodafone

'As part of the Committee's review of the objectivity and effectiveness of the audit process an assessment was undertaken in 2011 as to whether the Group should consider putting the audit engagement out to tender. This process included the re-proposal by Deloitte LLP of their audit approach. After extensive discussion, the Committee felt a tender was not necessary at present and provided the Board with its recommendation to the shareholders on the reappointment of Deloitte LLP as external auditor for the year ended 31 March 2012. This position will be kept under annual review.'

Aviva

'The Committee led the tender and selection process through which PwC was appointed and has recommended to the Board that PwC be re-appointed by shareholders at the 2013 AGM.'

WPP

'The committee will recommend a course of action to the Board during 2013 to respond to the new requirement in the Code that the external audit contract is put out to tender at least every 10 years.'

British Land

'In addition, the Committee will oversee the tender of the External Audit within the next year, with the successful firm performing the External Audit for the year ending 31 March 2015.'

(6) ...and if the external auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded.

COMMENTARY

The provision of so-called 'non-audit services' has been a source of fierce debate since at least the early 1980s. The debate is regularly re-fuelled by the occurrence of individual corporate failures or by the more systemic collective financial market collapses such as that which gave birth to the US Sarbanes–Oxley Act. Participants in this debate occupy a spectrum starting from an 'audit only and nothing else' position. The 'audit only' space/position is then gradually expanded to include a range of permissible non-audit services, the permissibility of which depends largely upon the extent to which it can be successfully argued that the service provided does not compromise the independence and objectivity of the external auditor, and that it does not place the auditors in a position where they could be accused of becoming part of management itself. Both in Europe and the US it seems to be the case that the final decision on what constitute the acceptable boundaries remains a high-level, political judgement.

EXTRACTS

In the companies reviewed, the disclosures varied from the short and snappy (Anglo American and WPP) to the long and detailed (National Grid, British Land and Aviva).

Anglo American:

'The independence and objectivity assessment is conducted by a review of compliance with the policies in place in the Group and within the external auditors to maintain independence and objectivity'.

WPP

'The committee has established a policy regarding non-audit services that may be provided by the external auditors, which prohibits certain categories of work[,] in line with relevant guidance on independence, such as ethical standards issued by the Auditing Practices Board and SOX. Other categories of work may be provided by the auditors if appropriate and if pre-approved by the committee, either as individual assignments or as aggregate amounts for specified categories of services. All fees are summarised periodically for the committee to assess the aggregate value of non-audit fees against audit fees. The level of fees for 2012 is shown in note 3 on page 189.'

National Grid

'Auditor independence and objectivity is safeguarded by limiting the nature and value of non-audit services performed by the external auditors, ensuring that employees of the external auditors who have worked on the audit in the past two years are not appointed to senior financial positions within the Company, and the rotation of the lead engagement partner at least every five years. The current lead engagement partner has held the position for three years. Non-audit services provided by the external auditors require approval by the committee. Approval is given on the basis [that] the service will not compromise independence and is a natural extension of the audit or...[that] there are overriding business or efficiency reasons making the external auditors most suited to provide the service. Certain services are prohibited from being performed by the external auditors, as required under the SOX Act.'

'Total non-audit services provided by PwC during the year ended 31 March 2013 were £2.3 million (2012: £3.8 million)[,] which comprised 23% (2012: 44%) of total audit and audit related fees. Total audit and audit related fees include the statutory fee and fees paid to PwC for other services which the external auditors are required to perform, for example regulatory audits and SOX Act attestation. Non-audit fees represent all other services provided by PwC not included in the above.'

'Significant non-audit services provided by PwC in the year included quality assurance provided on the US financial controls improvement programme (£0.7 million) and tax compliance services in territories other than the US (£0.5 million). PwC were engaged on the US financial controls improvement programme, as they were best placed to provide valuable insight on the programme, given their in depth knowledge of our control environment and relevant utilities experience. They were appointed in an advisory capacity only and were not involved in designing or implementing new controls and processes, thereby helping to safeguard independence and objectivity.'

'The committee considered that tax compliance services were most efficiently provided by the external auditors as much of the information used in preparing computations and returns is derived from audited financial information. In order to maintain the external auditors' independence and objectivity, management reviewed and considered PwC's findings and PwC did not make any decisions on behalf of management.'

(7) Additional discretionary disclosures made by companies reviewed

COMMENTARY

Some reporters make what might be termed 'discretionary disclosures' – meaning that the disclosure is not mandated or highlighted by the UK CG Code. Examples of these discretionary (or voluntary) disclosures include those shown in the examples below.

EXTRACTS

Outsourcing of internal auditor

British Land

'During the year the Company's Internal Audit function was fully outsourced to KPMG. The firm had worked closely with the previous internal Head of Internal Audit for two years prior to this, building experience and knowledge of the Group and its practices. The Head of Internal Audit and Internal Audit Partner review the Group's processes and controls in line with the Internal Audit programme and Internal Audit Charter, attending Audit Committee meetings by invitation at least three times a year to report to the Committee.'

Lead partner rotation

National Grid

'The current lead engagement partner has held the position for three years.'

Contractual obligations restricting appointment ability and indemnification of auditors

Aviva

'There are no contractual obligations that restrict the Committee's choice of external auditor.'

National Grid

'There are no contractual obligations restricting our choice of external auditors and no auditor liability agreement has been entered into.'

Vodafone

'There are no contractual obligations restricting the Committee's choice of external auditor and we do not indemnify our external auditor.'

5. Current UK practice compared with global guidance and practice

The 2012 UK CG Code enhancements, supplemented by the 2013 proposals from the UK Competition Commission, appear to place the UK in the vanguard of audit committee reporting developments.

THE US

The US Securities and Exchange Commission (SEC) requires that every US company listed on an exchange have an audit committee or its equivalent as part of its board of directors. Various SEC rules require certain audit-related and audit committee-related information to be disclosed in the proxy statement, the audit committee report and on company websites (see the Caterpillar example below). A recent survey of US audit committee reports by EY concluded that:

'Our review of audit committee-related disclosures from Fortune 100 US companies shows that many audit committee reports include information that exceeds the minimum disclosure requirements. For example, some shed light on the audit committee's process for evaluating the external auditor, the length of the audit relationship and the level of any non-audit services that the audit firm is providing. Enhanced audit committee reports may also incorporate elements such as a personal statement from the audit committee chair or information on committee members' qualifications and independence. However, these disclosures are made in different formats and through different channels, and the information may sometimes be difficult to locate.'

(EY 2013).³

A *Call to Action* in respect of enhancing the value of the public audit committee report was issued in late 2013 by the Audit Committee Collaboration, an alliance of US bodies committed to enhancing the effectiveness of audit committees. The executive summary of the *Call to Action* states that:

'The annual audit committee report included in the proxy statement is the principal source of public audit committee-related information other than its committee charter. Public disclosures are the primary channel through which audit committees can educate investors and other stakeholders about their critical responsibilities, and demonstrate their effectiveness in executing those responsibilities. Thus, we encourage all public company audit committees to thoughtfully reassess their reporting and communication with stakeholders and, if need be, to strengthen them in the future.'

'We also recognize that additional forces are at work: there are certain external drivers of change, grounded in legislative and regulatory actions that have expanded the responsibilities of the audit committee in recent years. As the scope of audit committees' responsibilities has grown, so too have regulators' and investors' interest in the way in which they are carried out. Importantly, we note a growing trend among a number of leading audit committees that are voluntarily addressing the need for enhanced audit committee reporting in order to strengthen confidence and'

3. A summary of the EY survey results is given in Appendix 3 on page 23.

communication. We give examples of their disclosure language, pulled directly from 2013 proxy statements, which demonstrate emerging practices in key areas.

'While not intending to be prescriptive or suggest a mandate, these leading disclosure examples provide benchmarks that other audit committees can use to evaluate how effectively their own disclosures:

- Clarify the scope of the audit committee's duties
- Clearly define the audit committee's composition
- Provide relevant information about:
 - factors considered when selecting or reappointing an audit firm
 - selection of the lead audit engagement partner
 - factors considered when determining auditor compensation
 - how the committee oversees the external auditor
 - the evaluation of the external auditor.'

(Audit Committee Collaboration 2013).

Example standard disclosure: Caterpillar Inc 2012 proxy statements

The Audit Committee has discussed with the Company's auditors the overall scope and execution of the independent audit and has reviewed and discussed the audited financial statements with management. Management represented to the Audit Committee that the Company's consolidated financial statements were prepared in accordance with generally accepted accounting principles in the United States. Discussions about the Company's audited financial statements included the auditors' judgments about the quality, not just the acceptability, of the accounting principles, the reasonableness of significant judgments and the clarity of disclosures in the financial statements. The Audit Committee also discussed with the auditors other matters required by PCAOB auditing standards. Management, the internal auditors and the auditors also made presentations to the Audit Committee throughout the year on specific topics of interest, including the Company's: (i) enterprise risk assessment process; (ii) information technology systems and controls; (iii) income tax strategy and risks; (iv) derivatives policy and usage; (v) benefit plan fund management; (vi) 2012 integrated audit plan; (vii) updates on completion of the audit plan; (viii) critical accounting policies; (ix) assessment of the impact of new accounting guidance; (x) compliance with the internal controls required under Section 404 of the Sarbanes-Oxley Act; (xi) shared services; (xii) risk management initiatives and controls for various acquisitions and business units; and (xiii) strategy and management of the implementation of new systems.

The auditors provided to the Audit Committee the written communications required by applicable standards of the PCAOB regarding the independent accountant's communications with the Audit Committee concerning independence, and the Audit Committee discussed the auditors' independence with management and the auditors. The Audit Committee concluded that the auditors' independence had not been impaired.

Based on: (i) the Audit Committee's discussions with management and the auditors; (ii) the Audit Committee's review of the representations of management; and (iii) the report of the auditors to the Audit Committee, the Audit Committee recommended to the Board that the audited consolidated financial statements be included in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

Pre-Approval Process

The Audit Committee pre-approves all audit and non-audit services to be performed by the auditors. It has policies and procedures in place designed to ensure that the Company complies with the requirements for pre-approval set forth in the Sarbanes-Oxley Act and the SEC rules regarding auditor independence. These policies and procedures provide a mechanism whereby management can request and secure pre-approval of audit and non-audit services in an orderly manner with minimal disruption to normal business operations. The policies and procedures are detailed as to the particular service and do not delegate the Audit Committee's responsibility to management. These policies and procedures address any service provided by the auditors and any audit or audit-related services to be provided by any other audit service provider. The pre-approval process includes an annual and interim component.

Annual Pre-Approval Process

Annually, not later than the Audit Committee meeting held in February of each year, management and the auditors jointly submit a service matrix of the types of audit and non-audit services that management may wish to have the auditors perform for the year. The service matrix categorizes the types of services by audit, audit-related, tax and all other services. Approval of a service is merely an authorization that this type of service is permitted by the Audit Committee, subject to pre-approval of specific services. Management and the auditors jointly submit an annual pre-approval limits request. The request lists aggregate pre-approval limits by service category. The request also lists known or anticipated services and associated fees. The Audit Committee approves or rejects the pre-approval limits and each of the listed services.

Interim Pre-Approval Process

During the course of the year, the Audit Committee chairman has the authority to pre-approve requests for services that were not approved in the annual pre-approval process. However, all services, regardless of fee amounts, are subject to restrictions on the services allowable under the Sarbanes-Oxley Act and SEC rules regarding auditor independence. In addition, all fees are subject to ongoing monitoring by the Audit Committee.

Independent Registered Public Accounting Firm Fee Information

Fees for professional services provided by our auditors included the following (in millions):

	2012	2011
Audit Fees¹	\$ 31.9	\$ 31.6
Audit-Related Fees²	2.8	1.6
Tax Compliance Fees³	1.7	1.8
Tax Planning and Consulting Fees⁴	1.5	3.9
All Other Fees⁵	0.2	0.9
TOTAL	\$ 38.1	\$ 39.8

¹"Audit Fees" principally includes audit and review of financial statements (including internal control over financial reporting), statutory and subsidiary audits, SEC registration statements, comfort letters and consents.

²"Audit-Related Fees" principally includes agreed upon procedures for securities, attestation services requested by management, accounting consultations, pre- or post-implementation reviews of processes or systems, financial due diligence and audits of employee benefit plan financial statements. Total fees paid directly by the benefit plans, and not by the Company, were \$0.7 in 2012 and \$1.0 in 2011 and are not included in the amounts shown above.

³"Tax Compliance Fees" includes, among other things, statutory tax return preparation and review and advice on the impact of changes in local tax laws.

⁴"Tax Planning and Consulting Fees" includes, among other things, tax planning and advice and assistance with respect to transfer pricing issues.

⁵"All Other Fees" principally includes subscriptions to knowledge tools, attendance at training classes/seminars and other advisory services.

AUSTRALIA

Australian governance rules are set by the Australian Securities Exchange (the ASX). According to Recommendation 4.3 of the 2010 iteration of the *ASX Corporate Governance Principles and Recommendations* the audit committee should report to the board.

The report should contain all matters relevant to the committee's role and responsibilities, including:

- assessment of whether external reporting is consistent with committee members' information and knowledge and is adequate for shareholder needs
- assessment of the management processes supporting external reporting
- procedures for the selection and appointment of the external auditor and for the rotation of external audit engagement partners
- recommendations for the appointment or, if necessary, the removal of the external auditor
- assessment of the performance and independence of the external auditors; where the external auditor provides non-audit services, the report should state whether the audit committee is satisfied that provision of those services has not compromised the auditor's independence
- assessment of the performance and objectivity of the internal audit function
- the results of the committee's review of risk management and internal control systems.

Principle 4 of the ASX Principles states that the following material should be included in the corporate governance statement in the annual report:

- the names and qualifications of those appointed to the audit committee and their attendance at meetings of the committee, or, where a company does not have an audit committee, how the functions of an audit committee are carried out
- the number of meetings of the audit committee
- explanation of any departures from Recommendations 4.1, 4.2, 4.3 (see above) or 4.4 of the ASX 'Corporate Governance Principles and Recommendations'.

So it appears that, to be compliant with the ASX rules, the main focus of audit committee reporting is on reporting to the board, rather than to the members through the annual report – reporting to the members appears to be mandated only in cases of non-compliance with Recommendation 4.3.

6. A model report checklist

Issues that UK corporate audit committees should or must disclose in respect of the external independent auditor	Relevant issues
The significant issues that the committee considered in relation to the financial statements, and how these issues were addressed	Investors believe that the focus of disclosure and discussion should be on material issues only – lengthy discussion on immaterial topics is not considered valuable
An explanation of how it has assessed the effectiveness of the external audit process	The annual assessment of external auditor effectiveness is a key responsibility of the audit committee – there are many assessment tools available, eg 'Audit Committee Essentials: The Annual Auditor Assessment' (US Centre for Audit Quality 2012)
Information on the approach taken to the appointment or reappointment of the external auditor	The decision to recommend the reappointment of an existing auditor is normally a function the audit committee's conclusions as to the independence, objectivity and performance (effectiveness) of the external auditor
Information on the length of tenure of the current audit firm	Given the increasingly precise nature of the rules on auditor tenure and auditor rotation, audit committees will have to make clear (and concise) statements about past tenure history and future rotation intentions
Information on when a tender was last conducted	
If gap between tenders is greater than five years then report in which financial year it is planned to put the audit engagement out to tender and why this (delay?) is in the best interests of shareholders	This is a new issue introduced by the October 2013 report from the Competition Commission – which is also introducing a maximum length of auditor tenure of 10 years before a formal tender process must be undertaken
If the external auditor provides non-audit services, give an explanation of how auditor objectivity and independence is safeguarded	Clear identification of both the nature and financial value of non-audit services is essential – together with an explanation as to how compliant the auditor/client relationship is with prevailing ethical standards and corporate governance regulations
Additional discretionary disclosures	Discretionary disclosures observed in the research for this paper included: <ul style="list-style-type: none"> ■ outsourcing of internal auditor ■ lead partner rotation ■ contractual obligations restricting appointment ability and ■ indemnification of auditors
Report the findings of any AQR report concluded on the company's audit engagement during the reporting period	This is also a new requirement being introduced by the Competition Commission – none of the reports reviewed for the purposes of this paper covered this issue

7. ACCA commentary

It can certainly be argued that UK requirements for audit committee public disclosures appear to be more advanced and more formalised than almost anywhere else in the world. Also, as the extracts presented in Chapter 4 above show, large listed companies are disclosing a wealth of information about the relationship with the independent external auditor, some 'required' by the UK CG Code and some discretionary.

In the end, however, disclosures (of whatever kind) need to provide positive value to the recipient (see FRC Financial Reporting Lab as reported by Crump (2013)). Two potential tests for whether or not value is provided are:

- testing to see whether any of these disclosures affect an investor's decision to buy, sell or hold a share, and
- testing to see whether, if it later transpired that the accounts were wrong in some material aspect, the disclosures would aid in the determination of the culpable party. For example, if a provision was wrong and the audit committee had said that it had reviewed the provision, it could suggest that the committee was (at least partially) at fault rather than merely ignorant.

In connection with both the 'tests' above, however, ACCA notes the relatively low level of accounting restatements observed in the UK (see Box 2) as compared with the US (see Box 3). It is difficult to interpret this data. One conclusion might be that UK companies produce better financial statements because they have fewer re-statements – so the audit committee and the auditor must be doing a good job. A second conclusion might be that US investors have learned to live with

multiple re-statements – possibly meaning that the audit committees and auditors may be doing a less-than-optimal job but that investors do not see this as a critical issue. As usual, the remedy for such questions is further research.

Another conclusion one might draw is that increasing the rigour of audit committee disclosures is all well and good but it may not increase the utility of financial statements to investors unless accompanied by a more zealous regulatory review process. In the absence of this there is probably a real risk that 'boilerplate' type disclosures may be made.

To mitigate the risk of boilerplating it might be preferable to see additional disclosures that focus upon whether or not the audit committee has looked at:

- external data and events (eg FRC Audit Quality Review Team (AQRT) reports, legal action(s) pending or settled against the incumbent auditor)
- what management assurances had been relied upon as opposed to what conclusions were drawn from audit testing
- what depth of audit testing was employed
- prior period adjustments (eg those suggested by the FRRP) and whether these were tracked and approved
- the external auditors' view of materiality and sensitive areas
- what evaluation the external auditor had carried out in respect of going concern issues.

As the FRC Financial Reporting Lab has also recommended, this 'customising' of the audit committee report could also involve:

- a better focus on discussion of key financial statement issues
- greater accountability of the audit committee chair
- better coverage of judgements made and multiple sources of assurance.

These tentative recommendations go beyond the UK Competition Commission's current proposals and therefore seem unlikely to appear, other than as discretionary disclosures, in the near future.

A ROLE FOR CONFIDENCE ACCOUNTING?

In 2012, ACCA, the Chartered Institute for Securities & Investment, and Long Finance published a proposal on 'confidence accounting' (ACCA et al. 2012). The proposal set out how accounts might better convey levels of confidence in reported numbers taking into account the uncertainties inherent in many of the values reported on the balance sheet or in the notes to accounts. The feedback to the proposal showed that investors would value the use of the 'confidence accounting' approach by audit committees, when they are considering critical accounting judgements and assumptions as part of the 'fair, balanced and understandable' requirement.

BOX 2: UK FINANCIAL REPORTING REVIEW PANEL REPORT 2012/2013

Summary of activities

In 2012/2013, we reviewed 264 sets of reports and accounts (2011/12: 326; 2010/11: 301). We reviewed fewer reports and wrote to fewer companies than last year. In 2012/13, 8 reviews were prompted by complaints (2011/12: 9; 2010/11: 13).

Outcomes

Virtually all of our enquiries result in companies agreeing to make some change in their next reports and accounts. These range from the less significant, for example, changing the language used to describe an accounting policy or explanation in the business review, to amending figures in the primary statements or correcting other significant data, like earnings per share. The improvements may include commitments to enhance disclosures either by including additional explanation or reducing unnecessary information to focus on what really matters to investors.

Most of our enquiries result in companies giving undertakings to adopt a particular approach in their next report and accounts. Of the 56 listed company cases that were closed in the period following exchange of correspondence, we accepted 140 undertakings to make specific improvements or changes to their future reporting. Since our last annual report, ten companies have included Committee References in their reports and accounts.

BOX 3: RESTATEMENTS FALL OVERALL BUT RISE FOR LARGEST COMPANIES

Frank Byrt, Accounting Web, 13 March 2013.

While the overall number of financial restatements by US public companies has decreased over the last four years, large company restatements have been on the rise, according to research conducted and published by Audit Analytics in the 2012 Financial Restatements: A Twelve Year Comparison report.

Across all public companies, restatements fell from 820 in 2011 to 768 in 2012. Restatements peaked at 1,771 in 2006, fell to 922 in 2008, and dropped again to 803 in 2010.

Last year, 245 large companies had to restate their financials. That's up 21 percent from 202 in 2011, and up 60 percent from 153 in 2009. Large companies, as defined by the Securities and Exchange Commission (SEC), are those with stock values over \$75 million.

While smaller public firms reported 386 restatements last year, they were down 2.5 percent from 2011 and down 55 percent from the 2006 peak of 865, according to the report.

Appendix 1: FRC UK Corporate Governance Code September 2012

C.3: Audit committee and auditors

Main principle

The board should establish formal and transparent arrangements for considering how they should apply the corporate reporting and risk management and internal control principles and for maintaining an appropriate relationship with the company's auditors.

Code provisions

C.3.1. The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience

C.3.2. The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- to monitor and review the effectiveness of the company's internal audit function;
- to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- to develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken; and
- to report to the board on how it has discharged its responsibilities.

C.3.3. The terms of reference of the audit committee, including its role and the authority delegated to it by the board, should be made available.

C.3.4. Where requested by the board, the audit committee should provide advice on whether the annual report and accounts, taken as a whole, is fair, balanced and understandable and provides the information necessary for shareholders to assess the company's performance, business model and strategy.

C.3.5. The audit committee should review arrangements by which staff of the company may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The audit committee's objective should be to ensure that arrangements are in place for the proportionate and independent investigation of such matters and for appropriate follow-up action.

C.3.6. The audit committee should monitor and review the effectiveness of the internal audit activities. Where there is no internal audit function, the audit committee should consider annually whether there is a need for an internal audit function and make a recommendation to the board, and the reasons for the absence of such a function should be explained in the relevant section of the annual report.

C.3.7. The audit committee should have primary responsibility for making a recommendation on the appointment, reappointment and removal of the external auditors. FTSE 350 companies should put the external audit contract out to tender at least every ten years. If the board does not accept the audit committee's recommendation, it should include in the annual report, and in any papers recommending appointment or re-appointment, a statement from the audit committee explaining the recommendation and should set out reasons why the board has taken a different position.

C.3.8. A separate section of the annual report should describe the work of the committee in discharging its responsibilities. The report should include:

- the significant issues that the committee considered in relation to the financial statements, and how these issues were addressed;
- an explanation of how it has assessed the effectiveness of the external audit process and the approach taken to the appointment or reappointment of the external auditor, and information on the length of tenure of the current audit firm and when a tender was last conducted; and
- if the external auditor provides non-audit services, an explanation of how auditor objectivity and independence is safeguarded.

Appendix 2: The October 2013 recommendations of the UK Competition Commission

In a summary of its final report on the supply of statutory audit services to large companies in the UK, the Competition Commission (CC) has confirmed that competition is restricted in the audit market due to factors which inhibit companies from switching auditors and by the incentives that auditors have to focus on satisfying management rather than shareholder needs.

The CC has set out a package of remedies in response to these findings which includes measures to improve the bargaining power of companies and encourage rivalry between audit firms; measures to enhance the influence of the audit committee; and measures to promote audit quality and shareholder engagement in the audit process.

The main measures the CC has proposed are as follows:

- FTSE 350 companies must put their statutory audit engagement out to tender at least every ten years. This differs from guidance introduced by the Financial Reporting Council (FRC) in 2012, which encouraged companies to go to tender on a 'comply or explain' basis. No company will be able to delay beyond ten years, and the CC believes that many companies would benefit from going out to tender more frequently at every five years. If companies choose not to go out to tender this frequently, the audit committee will be required to report in which financial year it plans to put the audit engagement out to tender and why this is in the best interests of shareholders.
- The FRC's Audit Quality Review (AQR) team should review every audit engagement in the FTSE 350 on average every five years. The audit committee should report to shareholders on the findings of any AQR report concluded on the company's audit engagement during the reporting period.
- A prohibition of 'Big-Four-only' clauses in loan agreements (ie clauses that limit a company's choice of auditor to a preselected list or category), although it will be possible to specify that any auditor should satisfy objective criteria.
- There must be a shareholders' vote at the AGM on whether audit committee reports in company annual reports are satisfactory.
- Measures to strengthen the accountability of the external auditor to the audit committee and reduce the influence of management, including a stipulation that only the audit committee is permitted to negotiate audit fees and influence the scope of audit work, initiate tender processes, make recommendations for appointment of auditors and authorize the external audit firm to carry out non-audit services.
- The FRC should amend its articles of association to include an object to have due regard to competition.

Appendix 3: Ernst & Young 2013 voluntary disclosures in US listed company audit committee reports

2013 findings

Below is a table showing voluntary audit committee-related disclosures by the reviewed Fortune 100 companies in 2012 and 2013 proxy statements. For information on disclosures required under federal statutes and stock exchange listing rules, please see our February publication of *Audit committee reporting to shareholders: going beyond the minimum*.

Category	Disclosure	2012 % of total	2013 % of total
Disclosures in the audit committee report	Statement that the audit committee is independent	56%	54%
	Name of the audit firm is included in the audit committee report	72%	72%
Audit committee composition	Audit committees with one financial expert (FE) ¹²	32%	31%
	Audit committees with two FEs	17%	23%
	Audit committees with three or more FEs	51%	46%
Audit committee responsibilities with respect to the external auditor	Statement that the audit committee is responsible for appointment, compensation and oversight of the external auditor ¹³	37%	50%
	Topics discussed by the audit committee and external auditor ¹⁴	6%	8%
Fees paid to the external auditor	Statement that the audit committee considers non-audit fees and services when assessing the independence of the external auditor	79%	79%
	Statement that the audit committee is responsible for fee negotiations	1%	9%
	Explanation provided for a change in the fees paid to the external auditor	1%	5%
Assessment of the external auditor	Disclosure of the factors used in the audit committee's assessment of the external auditor's qualifications and work quality	18%	21%
	Statement that the audit committee was involved in lead partner selection	1%	17%
	Disclosure of the year the lead audit partner was appointed	3%	3%
	Statement that the choice of external auditor is in best interests of company and/or shareholders	4%	23%
Tenure of the external auditor	Disclosure of the length of the external auditor's tenure	27%	31%
	Statement that the audit committee considers the impact of changing auditors when assessing whether to retain the current external auditor	3%	15%
Accessibility of audit committee charters from proxy statements	Company provides a direct link to the audit committee charter	6%	9%
	Link to the audit committee charter goes to the company's main website	44%	40%
	Link to the audit committee charter goes to the company site for investor relations	26%	28%
	Link to the audit committee charter goes to the company site for corporate governance matters	24%	23%
	Link to the audit committee charter is located in the audit committee report	41%	41%
	Link to the audit committee charter is located elsewhere in the proxy statement	59%	59%

The reviewed companies had an average of 2.7 financial experts on their audit committees both 2012 and 2013.

In 2012 and 2013, a statement that the audit committee is responsible for the appointment, compensation and oversight of the auditor was disclosed by 10% of companies in the audit committee report. Twenty-seven percent and 40% of companies disclosed this information elsewhere in the proxy statement in 2012 and 2013, respectively.

A statement that the audit committee considers non-audit fees and services when assessing the independence of the auditor was disclosed by 47% of companies in the audit committee report, while 32% made it elsewhere in the proxy.

Reviewed companies' audit committees that disclosed information about their assessment of the external auditor stated that the assessments were based on criteria such as the independence and integrity of the external auditor; expertise of the external auditor; performance and qualifications of the auditor; and the quality of the external auditor's personnel and communications.

The average tenure of the external auditor was 27 years in 2012 and 2013 for those reviewed companies that disclosed this information.

Appendix 4 – US accounting restatements

Restatements Fall Overall but Rise for Largest Companies

By Frank Byrt, 13 March 2013.

While the overall number of financial restatements by US public companies has decreased over the last four years, large company restatements have been on the rise, according to research conducted and published by Audit Analytics in the 2012 Financial Restatements: A Twelve Year Comparison report. Across all public companies, restatements fell from 820 in 2011 to 768 in 2012. Restatements peaked at 1,771 in 2006, fell to 922 in 2008, and dropped again to 803 in 2010. Last year, 245 large companies had to restate their financials. That's up 21 percent from 202 in 2011, and up 60 percent from 153 in 2009. Large companies, as defined by the Securities and Exchange Commission (SEC), are those with stock values over \$75 million. While smaller public firms reported 386 restatements last year, they were down 2.5 percent from 2011 and down 55 percent from the 2006 peak of 865, according to the report.

Largest Write-Downs to Net Income

The largest write-downs to net income caused by restatements over the last eleven years of New York Stock Exchange registered companies were:

- 2012: JPMorgan Chase, \$459 million
- 2011: China Unicom (Hong Kong) Ltd., \$1.56 billion
- 2010: Telecom Italia, S.p.A., \$717 million
- 2009: USB AG, \$357 million
- 2008: TMST Inc., \$671 million
- 2007: General Electric, \$341 million
- 2006: Navistar International Corp., \$2.4 billion
- 2005: American International Group Inc., \$5.2 billion
- 2004: Fannie Mae, \$6.3 billion
- 2003: HealthSouth Corp., \$3.5 billion
- 2002: Tyco International Ltd., \$4.5 billion.

Donald Whalen, director of research at Audit Analytics told AccountingWEB there's no clear evidence in the just-finished report indicating why there's been a rise in restatements at the largest companies. 'We're still researching it. It's been frustrating, as we do usually get a sense of why.'

He speculated the increase could be driven by more aggressive activity on the part of the regulators – the SEC and Public Company Accounting Oversight Board (PCAOB).

Whalen said anecdotally, in talking to his firm's clients, which include all the largest accounting firms, 'The PCAOB has reportedly gotten very good at picking certain [companies for] inspections where there's more of a likelihood of a mistake.'

According to the research, in addition to the number of total restatements leveling off in the past few years, the average number of problem issues cited as the cause for a restatement dropped to 1.38 issues per restatement, the lowest during the twelve years under review and a steady decline since 2005. The indicators of how severe the problems were that caused the restatements have dropped steadily as well, 'with some indicators achieving the best value for all the twelve years under review.'

When considering the adverse effects of restatements filed in 2012, Audit Analytics found low indicators of severity with respect to each of the following criteria:

- Negative impact on net income
- Average cumulative impact on net income per restatement
- Percentage of restatements with no impact on income statements
- Average number of days restated
- Average number of issues identified in restatements.

The most common accounting issues that resulted in restatements in 2012 and the rate of their occurrence were:

- Improper measurement of debt, stock warrants, and equity: 15 percent
- Tax expense/benefit/deferral and other (FAS 109) issues: 14.6 percent
- Cash flow statement classification errors: 13.3 percent
- Acquisitions, mergers, and reorganization accounting issues: 12.1 percent
- Revenue recognition issues: 9.5 percent
- Accounts/loans receivable, investments, and cash valuation issues: 8.7 percent
- Liabilities, payables, reserves, and accrual estimate failures: 8.3 percent.

For its report, Audit Analytics used data from more than 12,000 financial restatements and/or non-reliance filings disclosed by over 7,000 SEC public registrants since January 1, 2001.

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