

Point of view

Our perspective on issues of concern

About this *Point of view*

Welcome to Ernst & Young's *Point of view* series. These documents express our view on current public policy and regulatory matters of importance to our stakeholders, our profession and the capital markets.

Ernst & Young views on current public policy proposals affecting the audit profession

The current public policy environment is marked by heightened expectations and accountability for all market participants, including the audit profession. As policy-makers move forward post-crisis, many have proposed reforms to corporate governance, financial reporting and the role of audits and the audit profession.

Most recently, the European Commission (EC) has developed a set of draft proposals in response to its Green Paper on Audit Policy, a consultation it initiated in October 2010 to focus on the role of the auditor, auditor independence and the structure of the audit market in Europe. While the EC's proposals are not yet official, many people have seen drafts and they have been widely reported in the press. In the US, the Public Company Accounting Oversight Board (PCAOB) is seeking comment on its concept release on measures to enhance auditor independence, objectivity and professional skepticism, including the possibility of mandatory audit firm rotation. In other countries, including Australia, Brazil, Chile and Singapore, there is a range of proposals that would affect corporate governance and audits.

In light of this widespread regulatory activity, the following document sets forth our views on current policy debates for use in engaging with clients, audit committees¹ and other stakeholders. It is important to remember that most of these proposals are still in the early stages and are likely to evolve significantly. Moreover, some of the measures we support may already be in place in some jurisdictions. It also is important to note that we do not oppose all policy proposals or reforms. We support those measures that would enhance audit quality, encourage greater choice in the audit market and contribute to the long-term sustainability of the private-sector market for audit services.

Independence

Auditors serve the public interest, and confidence in our independence is critical to investor confidence in financial reporting and the audit. We support the following measures to promote auditor independence in fact and appearance:

- ▶ **Require each member of the audit committee to be fully independent of management so as to be able to carry out his or her responsibilities to oversee the company's financial reporting process and the independence of the auditor** (to enhance independence of the audit committee)

¹ The term "audit committee" as applied in this document is intended to refer broadly to those entities charged with responsibility for a company's governance or a subcommittee thereof.

- ▶ **Prohibit auditors from providing non-audit services that would be considered to impair an auditor's independence based on the International Ethics Standards Board for Accountants (IESBA) Code of Ethics** (to promote a consistent set of rules on non-audit services globally)
- ▶ **Prohibit audit firms from compensating members of the audit engagement team for the sale of any non-assurance services provided to that audit client consistent with the IESBA Code** (to prevent an auditor from compromising its views in exchange for obtaining additional business from the client)
- ▶ **Require pre-approval by the audit committee for all significant permitted non-audit services received from the auditor** (to ensure that the independent audit committee makes a deliberate and considered decision about which, if any, non-audit services it believes are best provided by the auditor)
- ▶ **Limit the maximum level of fees that an audit firm can receive from any one audit client as compared to the audit firm's total fees, consistent with the IESBA Code of Ethics** (to prevent an audit firm from becoming excessively dependent upon one client)
- ▶ **Independent audit regulators should actively monitor and inspect auditors' systems and compliance with independence requirements as part of their regular oversight activities** (to further promote vigilance in auditor independence)

We oppose the following measures that have been proposed to address independence concerns:

- ▶ **Mandatory firm rotation** (would remove the decision of when or whether to replace an audit firm from the purview of the audit committee, without any link between independence and tenure having been demonstrated)
- ▶ **Audit-only firms** (would be detrimental to audit quality; multi-disciplinary firms help attract and retain the best talent and foster the provision of high-quality service to clients across the world)
- ▶ **Excessive bans on non-audit services to audit clients** (delivering the most complete range of permissible services increases a firm's knowledge of the company, its risks and processes, all of which contribute to audit quality)

The structure of the audit market

We support appropriate efforts to remove any barriers, real or perceived, that might exist for the selection of smaller firms and to promote greater choice in the selection of auditors. We support the following:

- ▶ **Encourage audit committees to conduct periodic evaluations of audit quality in determining whether there is a need to retender the audit, and to be transparent about their decision-making process** (to encourage audit committees to consider their audit needs on a regular basis, determine the optimal timing for any change in auditors and disclose their reasoning for their decision)

- ▶ **Prohibit “Big Four-only” clauses in commercial transactions and the use of criteria that effectively result in the same outcome** (to level the playing field and allow companies to choose the auditor they think best)
- ▶ **Require public reporting of the results of regulatory inspections of audit engagements at individual audit firms, while preserving continued confidential communication with the regulator as required and warranted to facilitate supervision of audit quality improvements** (to allow the market to better judge the quality of audit services that audit firms can provide, thereby reducing bias against non-Big Four firms and encouraging firms to compete on quality)
- ▶ **Allow alternative audit firm ownership structures, provided appropriate controls for independence are in place** (to enable greater access to external capital)
- ▶ **Require audit firms that audit public interest entities to have independent non-executives as part of their relevant firm or network governance structures** (to bring an independent perspective to the governance of audit firms and reduce the risk that may arise from unregulated parts of the business)
- ▶ **Establish a proportionate liability limit in combination with a capping mechanism (based on a multiple of audit fees model) applied at an individual company level** (to eliminate the market bias in favor of a Big Four firm based on its ability to pay large legal claims)
- ▶ **Support increased interaction and two-way dialogue between auditors and prudential supervisors of financial institutions** (to provide more robust information to both auditors and supervisors about key financial institutions as part of an “early warning system” for troubled institutions)
- ▶ **Require contingency planning among audit firms and their regulators** (to reduce the threat of a large firm exiting the market, or mitigate the impact of such an event so as to ensure continuity of audit services)
- ▶ **Within the EU, establish a single EU passport for auditors that would allow them to provide services on an EU-wide basis** (to reduce barriers to service and costs of providing audit services across the EU). *(Facilitated through the adoption of the International Standards on Auditing (ISA) for all statutory audits and the IESBA Code for cross-border services within the EU)*

We oppose the following:

- ▶ **Mandatory audit firm rotation** (would remove the decision of when or whether to replace an auditor from the purview of the audit committee, while at the same time not reducing concentration or enhancing audit quality)
- ▶ **Mandatory retendering** (would be detrimental to audit committee oversight and could threaten audit quality by putting audit firms in perpetual marketing mode; rather than incentivize greater auditor independence, it would work against it)
- ▶ **Joint audits** (would increase costs to shareholders for no discernible increase in audit quality or in ability of smaller firms or networks to serve as the principal auditor for the largest global companies; also would increase risks of gaps in audit process and auditors having to take responsibility for work they do not themselves perform, as well as create opportunities for management to play auditors off against each other)

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Enhancing the relevance of the audit

The financial crisis highlighted the changing information needs of investors, who have expressed dissatisfaction with the increasing complexity of corporate reporting and a desire for more focused information on key risks and performance trends. Within this context, investors and others have called for improvements to the auditor's report. We believe it is important to consider changes to the auditor reporting model in the context of the broader debate aimed at enhancing overall corporate financial reporting and we encourage standard-setters to reconsider the form and substance of the auditor's report. We support the following enhancements to audit reports for public interest entities:

- ▶ **Require the expanded use of emphasis paragraphs in the auditor's report** (to help draw attention to matters in a company's financial statements that are most significant and therefore may warrant a detailed review by users)
- ▶ **Add clarifying language to the auditor's report** (to help investors understand the extent of the auditor's responsibility for financial statement fraud and misstatement, the auditor's responsibility for information outside of the financial statements, auditor independence and the meaning of certain technical terms used in the auditor's report)
- ▶ **Encourage standard-setters and regulators to give further consideration to the benefits, costs and demand for expanded reporting by management or audit committees to shareholders, as well as the possibility of auditor association with or commentary on such reports** (to enhance understanding by shareholders and others of the audit process, especially as it relates to the key audit areas and risks in the financial statements; a separate attestation of the critical accounting estimates section of MD&A would be a helpful first step)
- ▶ **Encourage standard-setters to coordinate their efforts globally** (as users would be better served if the nature and format of information communicated by the auditor were generally consistent, regardless of the jurisdiction)

We oppose the following:

- ▶ **Auditor's Discussion & Analysis (AD&A)** (this auditor's narrative on audit issues and the company's financial statements would have several significant challenges and potentially adverse consequences. Principally, we do not agree that the auditor's subjective views on financial reporting matters, including thoughts on "close calls", can be appropriately conveyed and understood without an effective two-way dialogue. In addition, we question whether an appropriate and practical framework could be developed and consistently followed for such disclosures so as to be meaningful for the reader, whether such disclosures would stifle communication between the auditor and the audit committee and whether the additional focus on reporting as opposed to execution would hinder audit quality)

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