Public policy developments affecting the accounting profession and our business:
July 2013

Our global public policy environment remains highly fluid and challenging. This Point of view summarizes the current status of key policy reforms under consideration in several jurisdictions that would affect the accounting profession and our business, and reiterates EY’s views on these important issues.

Status of key policy debates

European Union: consideration of audit policy legislation continues; outcome and timing remain uncertain

EU consideration of the European Commission’s audit reform proposals continues. Those proposals, which were originally issued in November 2011, included mandatory firm rotation, the complete prohibition of non-audit services by auditors to the companies they audit, incentives for joint audits and the creation of audit-only firms.

Mandatory firm rotation is the measure that seems likeliest to survive the EU deliberations in some form, although everything is still in flux and much could happen before the legislative process concludes. In April, a key committee in the European Parliament rejected proposals for audit-only firms and adopted prohibitions on non-audit services that generally align with the International Ethics Standards Board for Accountants (IESBA) Code. However, the committee supported mandatory firm rotation on a 14 year basis for all Public Interest Entities, although Member States could extend this to 25 years in certain circumstances. (The term “Public Interest Entities” generally includes listed companies as well as banks and insurance companies.)

The committee’s vote was just one milestone in the legislative process. While it did signal a direction from the Parliament, the European process requires the Parliament, the European Commission and the EU Council of Ministers, representing the now 28 EU Member States, to agree on a common legislative package if it is to become law. The Council continues to be very divided. While a majority of Member States seem to support the principle of mandatory firm rotation, they have not yet been able to agree on a specific proposal, disagreeing about both the duration of the auditor tenure and the scope of entities to which rotation would apply. Other provisions, including additional restrictions on non-audit services, are
still under debate as well. Much debate will take place in the coming months and there is some possibility that no agreement will be reached before the end of this year.

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**Our view**

EY believes the focus of the audit policy reform debate should be on improving the quality and relevance of financial reporting and audit. We therefore support measures to enhance audit quality, promote auditor independence, and strengthen the audit market. We also support efforts to strengthen boards and audit committees, because strong governance contributes to audit quality. We oppose mandatory firm rotation because it takes away from the audit committee's authority over the audit relationship, which, over time, weakens audit committees and is harmful to audit quality.

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**UK Competition Commission issues provisional decision on remedies in its audit market structure review**

At the request of a UK Parliamentary committee, the UK Competition Commission (UK CC) has been conducting an examination into UK audit market competition since late 2011. Most recently, on 22 July, as part of its consultative process, the UK CC issued a summary of its provisional decision on remedies. Notably, the UKCC did not recommend either mandatory firm rotation, any further constraints on the provision of non-audit services to audit clients, or joint audits. The UK CC did, however, include mandatory tendering every five years - aligned to the period of partner rotation in the UK - as part of its package of remedies, but made very clear that the incumbent audit firm could be retained following the tender. The UK CC also is including in its remedies package additional measures designed to strengthen auditor accountability to the audit committee and reduce the influence of management. These include giving the audit committee the exclusive authority to negotiate the audit fees and authorize non-audit services, and to report to shareholders on the “findings” from inspections by the UK Financial Reporting Council (FRC). Other provisional remedies include banning restrictive “big four only” clauses in loan agreements, requiring the UK FRC to inspect every FTSE 350 audit roughly every 5 years, and to have as its secondary objective “due regard to competition.”

This description of the UK CC provisional remedies is necessarily high-level as it is based only on the short summary the UK CC has issued. The UK CC will release its full package of provisional remedies shortly, and comments are due by 13 August. The UK CC will issue its final package of remedies by October 2013 and perhaps before then.

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**Our view**

We continue to support any changes in the regulatory framework that are both in the public interest and improve audit quality. With respect to the UK CC's provisional remedies, we support the removal of restrictive clauses in loan agreements, strengthening the audit committee and more shareholder involvement in the selection of the auditor. Other ideas we have proposed, such as a two-stage tender process and strengthening and increasing the transparency of the audit committee's oversight of the external auditor, would be constructive. We are pleased that the UK CC has decided not to recommend mandatory audit firm rotation as we do not believe it is in the public interest or would contribute to a vibrant audit market.

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**US consideration of mandatory firm rotation**

The US Public Company Accounting Oversight Board (PCAOB) has not yet concluded the debate on mandatory firm rotation that it initiated with the issuance of its concept release on auditor independence and audit firm rotation in August 2011. However, the rotation concept
Public policy developments affecting the accounting profession and our business: July 2013

has not gained any public policy traction in the US. In fact, the US House of Representatives recently passed legislation, on a 321 to 62 vote, to block the PCAOB from imposing mandatory firm rotation. The measure was supported by a majority of both Republicans and Democrats. While the prospects for this legislation to become law are uncertain, the lop-sided and bipartisan nature of the vote indicates the extent of US opposition to mandatory firm rotation and could signal an end to the debate in the US.

Our view
We believe a mandatory firm rotation requirement in the US is highly unlikely. While it is still too soon to predict the outcome of either the rule-making or the legislative process, it is doubtful there is sufficient support in the US to advance a mandatory firm rotation requirement. We continue to oppose mandatory firm rotation in the US as elsewhere because we believe that it undermines good governance and harms audit quality.

Increasing attention to tax and tax advice

Policy makers in a number of jurisdictions, including the UK, EU and Australia, are drawing attention to the amount of tax paid by multinational companies and the role played by tax advisers, including those in the accounting profession. At the recent G8 Summit, the leaders called for countries to change rules “that let companies shift their profits across borders to avoid taxes” and added that “multinationals should report to tax authorities what tax they pay where.”

The question often asked is whether companies are paying their “fair share” of taxes. This debate can be highly charged, particularly in the post-financial crisis era where countries are competing for capital, jobs and tax revenues. At the heart of the debate is the fact that tax laws are designed by governments to incentivize corporate behavior. But one country’s gain is another country’s loss. And in many cases tax laws have not kept pace with changes in the global business environment in the last decade. Areas such as the taxation of e-commerce and intellectual property, the definitions and treatment of debt versus equity, transfer pricing and transparency of tax reporting are examples of areas that will be examined and reviewed in the months and years to come.

Our view
The global business environment has changed dramatically over the last decade. We share the concern of many that elements of the systems for taxing multinational corporations are outdated. Countries need to look again at both their laws and the international treaties to which they are signatories, and ensure that the tax rules and the incentives provided are sensible when applied to today’s business models. We are committed to helping governments and international organizations such as the OECD work together to address these problems. The accounting profession also plays an important role in helping companies understand and comply with their fiscal and regulatory obligations relating to tax.

Enhancing the relevance of the auditor’s report

In June 2013, the UK Financial Reporting Council (FRC) issued a revised auditing standard intended to enhance the auditor’s report to provide more information to investors about the audit itself. For example, the new standard will require the auditor’s report to include an overview of the scope of the audit, a description of the assessed risks of material misstatement that had the greatest effect on the audit and how they were addressed, and
materiality considerations. The FRC’s revised auditing standard complements the changes to the UK Corporate Governance Code in October 2012 and therefore is effective for audits of financial statements commencing on or after 1 October 2012.

In addition to the UK FRC changes, other significant auditor reporting initiatives include those of the International Auditing and Assurance Standards Board (IAASB) and the US Public Company Accounting Oversight Board (PCAOB). The IAASB is expected shortly to issue an exposure draft of revised auditor reporting standards, and the PCAOB expects to propose its standard before the end of September. The EU also has proposed changes to the auditor’s report as part of its audit policy legislation.

Our view
We strongly support meaningful change to increase the usefulness and informational value of the auditor’s report. In particular, we believe auditors should be required to highlight matters that, in the auditor’s judgment, are of most significance in the audit. Moreover, we believe that an expanded auditor’s report should be considered as part of the total information available to users from management, the auditor and those charged with governance (e.g. the audit committee). Different jurisdictions may have different disclosure and reporting requirements, and it is important to strike the right balance as to which information should be disclosed by which party. While recognizing that legal, regulatory and reporting frameworks vary across jurisdictions, however, we continue to believe that comparability helps global investors and global markets. Therefore, although some variation may be inevitable, we continue to encourage global consistency in the auditor’s report.

Enhancing audit committee oversight of the auditor and transparency

Policy makers in a number of countries are considering ways to enhance audit committee oversight of the audit engagement to improve audit quality and promote auditor independence. They also are considering greater transparency about the audit committee’s oversight role as a way of increasing investor confidence.

In Canada, for example, the auditor oversight body together with the accounting profession recently concluded an initiative focused on improving audit quality and enhancing auditor independence. The final report offers recommendations on next steps to improve audit quality for consideration by Canadian standard setters, regulators and other stakeholders. One recommendation is for audit committees to undertake a comprehensive review of the audit firm every five years and disclose publicly both the process used in the review as well as the audit committee’s basis for recommending a specific auditor.

Our view
EY supports strong and independent audit committees as an important complement to auditor independence and objectivity and the promotion of investor confidence in financial reporting. We believe there should be greater transparency of the audit committee’s auditor oversight process so that shareholders have the information they need to properly evaluate an audit committee’s decision to retain or change the auditor. To this end, we believe that shareholders should receive a report from the audit committee on a periodic basis highlighting key points on its oversight of the auditor and the audit process.
IAASB consults on a framework for audit quality

In January 2013, the International Auditing and Assurance Standards Board (IAASB) issued its proposal for a framework for audit quality. The IAASB aims to raise awareness of the key elements of audit quality, encourage stakeholders to explore ways to improve audit quality, and facilitate greater dialogue on the topic. The proposed framework describes the many contributing factors and necessary interactions that contribute to and influence audit quality. The US PCAOB and others are considering the development of audit quality indicators.

Our view
We are committed to audit quality and support the objectives of the IAASB’s proposed framework. We hope it will foster greater dialogue among stakeholders and encourage exploration of ways in which all stakeholders can contribute to improved audit quality. We believe the IAASB should make clear, however, that the framework does not establish new standards or requirements for the performance of audit engagements.

Tensions continue over work papers in China

The impasse between the United States and China regarding the sharing of audit work papers continues. The US Securities and Exchange Commission (SEC) has been investigating potential fraud or other misconduct by a number of Chinese foreign private issuers and requested audit work papers and other documents from several accounting firms in China, including EY’s Chinese practice, EY Hua Ming. However, the Chinese authorities have specifically instructed the China accounting firms not to provide the SEC with the requested documents because doing so would violate Chinese law. The SEC subsequently filed an administrative enforcement action against five of the Chinese member firms of the international networks relating to the work paper issues. The SEC hearing began in early July and will continue in August. An initial decision is expected in October 2013.

Recently, however, there has been some progress. In May, the US PCAOB and the Chinese authorities reached an agreement enabling them to exchange information, including audit work papers, for investigation and enforcement purposes. More recently, the US and Chinese authorities, meeting in the Strategic and Economic Dialogue, announced their commitment to cooperation and information sharing in enforcement investigations, and the Chinese securities regulator announced that it had provided certain requested work papers to the US regulators.

Our view
At the core of these matters are conflicting legal requirements, in particular, regarding the ability of the China firms to meet US requirements and demands to provide work papers to the SEC without violating Chinese law. As we have said repeatedly, EY supports close working relationships between regulators to enable them to cooperate and share information with one another. In a world of cross-border business and cross-border investments, national regulators must be able to develop cross-border relationships to enable them to cooperate and share non-public information with one another.

For more information
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