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Overview

Our overview of topical issues

About Overview

Welcome to Ernst & Young's *Overview* series. These documents provide a concise overview of relevant topical or fast-moving global public policy and regulatory issues and are designed to give you current information on emerging developments.

Update on public policy developments affecting the audit profession

This *Overview* provides an update on recent key public policy developments affecting the audit profession and audit committees.

Introduction

Over the past year, the European Commission (EC) has issued a series of Green Papers - early consultation documents - that discuss issues of immediate relevance to the audit profession and audit committees. Most recently, the EC issued a Green Paper on the corporate governance framework in listed companies. Last October, the EC issued a Green Paper on audit policy, which raises a wide range of questions about the role of audit and the audit profession, and earlier last year, the EC completed a consultation focused specifically on corporate governance in financial institutions.

The EC activity comes at a time when there is heightened interest in audit and the audit market among policymakers. In the UK, for example, the House of Lords Economic Affairs Committee recently concluded an inquiry into the perceived dominance of the Big 4 in the UK audit market and made a series of recommendations designed to address market concentration in the large, listed company audit market.

The UK Office of Fair Trading (OFT) responded to the House of Lords recommendations by announcing that it had provisionally concluded that there are competition concerns in the UK audit market and that it would consider whether to make a referral to the UK Competition Commission. To that end, the OFT will hold a series of stakeholder discussions later this year. However, competition concerns are not the top priority for all audit regulators. In the US, Jim Doty, the new Chair of the Public Company Accounting Oversight Board (PCAOB), has been making a series of speeches raising significant challenges to the audit profession, including our business model and the incentives and constraints of the environment in which we operate.

The developments in the UK and EC clearly have the potential to influence one another, and also the potential to affect policymaking outside of Europe, particularly as there is an increasing amount of cross-border regulatory communication and cooperation, both on a bilateral basis and in regulatory groups such as the International Organization of Securities Commissions (IOSCO) and the International Forum of Independent Audit Regulators (IFIAR). The EC also has made it clear that it is seeking to lead the international community in its consideration of these issues.

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Status of the EC Green Papers

Corporate governance

The EC issued its Green Paper on the corporate governance framework on 5 April 2011; comments are due on 22 July. In the Paper, the EC raises questions about how to improve the functioning of boards, including questions about board composition and diversity, risk management, remuneration, and the time devoted to board roles. The EC also asks questions about how to improve shareholder engagement and encourage a longer-term perspective. Finally, the EC focuses on how to improve the monitoring and enforcement of corporate governance codes through the comply or explain process.

Audit policy

The EC Green Paper on audit policy was issued on 13 October 2010, and the comment period is complete. The EC will now consider the nearly 700 comments it received along with a report from the European Parliament, which is likely to be approved in June. Draft legislation is anticipated at the end of the year.

The European Parliament's report will be a product of politics and trade-offs. Indications are that it will reject some of the more interventionist measures that the EC has raised and contain some positive proposals, including:

- ▶ Calling for the EC to treat audit as part of the broader corporate governance debate, and recognizing the importance and value of audit, as well as the need for an expanded and strengthened role for audit committees;
- ▶ Recognizing the benefits of providing non-audit services, but calling on the EC to identify the conditions under which non-audit services should not be provided by the auditor;
- ▶ Supporting audit partner over audit firm rotation, although it is anticipated that the European Parliament will call on the EC to assess the costs and benefits of mandatory firm rotation, as well as of joint audits and a cap on non-audit services; and
- ▶ Calling on the EC competition authorities to conduct a full investigation into the audit market.

It is still too early to predict how the EC will respond to the European Parliament's report. While the EC will need to weigh the Parliament's views, it continues to state that the status quo is not an option.

We appreciate the significance of the issues that the EC raises in the Green Papers, both for companies and investors in the EU and around the world, as well as for the audit profession. The debate around the role of audit is an important one, and should be considered along with the roles of others in the governance framework, including management, boards, audit committees, investors, and regulatory authorities. As these discussions move forward, the need to maintain high audit quality should be a guiding principle.

The need to support effective board committees

In both its corporate governance and audit policy Green Papers, the EC is silent on the importance of board committees in effective governance and specifically of the audit committee's essential contribution to audit quality. Indeed, some of the measures that the EC had proposed in the audit policy Green Paper would disempower audit committees and undermine their effectiveness.

We believe that the EC should focus on strengthening boards and audit committees, articulating their specific responsibilities, thereby reinforcing their ability to oversee management and protect the company and its shareholders. Indeed, some audit committee chairs have expressed their concern directly to the EC over its seeming failure to appreciate the benefits that well-functioning, independent committees of the board can provide, particularly with regard to many of the issues the EC raises in its corporate governance Green Paper.

Summary of relevant UK developments

House of Lords report on UK audit market

On 30 March 2011, the Economic Affairs Committee of the UK House of Lords issued a report, *Auditors: market concentration and their role* (the Report), in which it makes recommendations that the UK government will consider carefully, although it is not required to implement them. The Report recognizes that audit is essential to the capital markets, but expresses concerns about the "oligopoly" of the large audit firms and that one will fail. The Report suggests that banking auditors failed to raise red flags in the run-up to the financial crisis and were complacent when making going concern judgments. Among other recommendations, the Report suggests that the UK competition authorities should undertake a detailed investigation of the large listed company audit market.

With respect to non-audit services, the Report recommends that external auditors should be banned from providing internal audit, tax advisory services and advice to risk committees. This recommendation was unexpected, in part because the UK Auditing Practices Board (APB) has recently conducted a thorough review of non-audit services, in which it concluded, following extensive input from a wide range of stakeholders, that major changes concerning non-audit services, including tax, were unnecessary. The APB made only relatively small adjustments that just took effect in 2011. The UK Government's response to the Report is pending, and it will not necessarily take up all of its recommendations, including those relating to non-audit services.

OFT announcement on competition in UK audit market

The UK competition authority, the OFT, has followed up on the Committee's recommendation however, deciding provisionally that there are competition problems in the large listed company audit market. It will now hold stakeholder discussions and consider whether potential remedies exist that could allow the UK Competition Commission to resolve these problems. It also will assess the relative benefits of action at the UK or international level.

The impact of the OFT decision and the OFT's investigation of potential remedies on the deliberations of the European Commission about concentration in the audit market could be significant. Interestingly, the OFT previously has suggested that international coordination of competition authorities would be needed for any remedies to be effective. Similarly, the Report's recommendations relating to non-audit services could have at least as much an impact on the recommendations of the European Commission as they do in the UK.

Challenges to the role and relevance of the auditor

In its audit policy Green Paper, the EC also asks broad questions about the role of the audit profession and whether it should change in a post-financial crisis environment. This debate is taking place outside of the EC as well, as the crisis has prompted questions about whether there should be additional disclosures about what auditors do and how they do it, as well as demands for more insight into the auditor's views and discussions with the audit committee. The debate has also underscored the importance of the independence and objectivity of the auditor and has led to a stocktaking of the measures put in place during the past decade to enhance auditor independence and mitigate potential conflicts. The need for effective audit committees and their importance in overseeing auditor independence have been observed as well.

Auditor communications

Policymakers are focusing attention on potential changes to auditor communications. It is generally recognized that, while the audit has grown increasingly complex and challenging over the past few years, the amount of work that is involved and the judgments that the auditor makes are not well conveyed to the investors through a binary-style audit opinion that has not changed in many years. Both the International Auditing and International Assurance Board (IAASB) and PCAOB are considering potential changes to the auditor's report.

The IAASB has issued a consultation document on *Enhancing the Value of Auditor Reporting*, which seeks to determine whether there are common views among users of audited financial statements and other stakeholders about the usefulness of auditor reporting, describes issues with current reporting and sets out possible options for change. The PCAOB expects to issue a concept release seeking comment on similar issues later this month. Discussions at both standard-setting bodies recognized the desire of investors to maintain the current "pass/ fail" model, supplemented by the provision of enhanced auditor disclosures. Some of the ideas that are being considered include:

- ▶ The German long form report
- ▶ A French-style "justification" of opinion
- ▶ More use of "emphasis of matter" paragraphs

There also seems to be some momentum around greater auditor disclosures about audit estimates and judgments.

Further Resources

Green Paper on EU Corporate Governance Framework - April 2011

Green Paper on Audit Policy: Lessons from the Crisis - October 2010

Recent speeches by PCAOB Chairman

Ernst & Young comment letter on *Green Paper on Audit Policy: Lessons from the Crisis* - December 2010

EY Overview on House of Lords report, *Auditors: market concentration and their role* - April 2011

Enhancing the Value of Auditor Reporting: Exploring Options for Change - May 2011

Effective Company Stewardship: Enhancing Corporate Reporting and Audit - January 2011

It is not clear, however, that changes to the auditor's report will be sufficient to meet the demands of some investors that the audit report go much further – that it be a vehicle for the auditor to convey directly to investors what might in the normal course be discussions between the auditor and the audit committee. Some investors are looking for an “Auditor Discussion & Analysis” (AD&A), in which auditors would disclose directly to investors a significant amount of detailed information regarding, among other things, the scope of the audit (including the auditor's assessment of risks and materiality levels), the auditor's evaluation of significant estimates, judgments, accounting policies and practices, as well as unusual transactions, re-statements and other significant changes.

The demand by some investors for an AD&A suggests a breakdown in the traditional financial reporting value chain, where it is the company's responsibility to provide the information that is then reviewed by an independent auditor. Indeed, some investors, while seeking increased information, are looking instead to an extended audit committee report, which would itself be subject to some level of auditor review. In the UK, for example, the FRC issued a Consultation Paper, *Effective Company Stewardship: Enhancing Corporate Reporting and Audit*. The FRC takes a tri-partite approach to these issues, in which:

- ▶ Directors would have enhanced responsibility for the annual report and improved disclosures including higher quality narrative reporting on matters like business strategy and risk management;
- ▶ Audit committees would issue fuller reports explaining how they have discharged their responsibilities for the integrity of the annual report, oversight of the audit process and appointment of the auditor; and
- ▶ Auditors would report on the completeness and reasonableness of the audit committee report.

The need for safe harbor provisions for both preparers and auditors also has been raised to encourage reporting and avoid boilerplate.

Dialogue with prudential supervisors

As policymakers consider the role and relevance of auditors and the importance of financial stability in this post-financial crisis environment, one proposal that is attracting significant attention is to encourage increased discussions on a regular basis between auditors and prudential supervisors. These discussions could potentially be in the context of a particular regulated financial institution, as well as more general discussions relating to macro prudential supervision, risks, and vulnerabilities. In the UK, the Bank of England has developed a protocol for such a dialogue with the UK profession, which potentially could be mirrored in other countries or regions.

As should be evident from the discussion above, the public policy environment facing our profession is the most challenging we have seen in many years. In the wake of the financial crisis, there are heightened expectations and accountability for all market participants and our profession is no exception. We will continue to engage directly and with our counterparts in the other large networks with regulators and policymakers around the world and will keep you updated on significant developments.

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