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EY News and views provides a snapshot of recent developments in corporate governance, tax, reporting and audit of interest to investors and boards, and summarizes EY’s views.
Corporate governance in focus

In September 2015, the G20 Finance Ministers and Central Bank Governors endorsed the revised G20/OECD Principles of Corporate Governance. Since the Principles were first adopted in 1999, they have been recognized as the benchmark for corporate governance frameworks globally. This is the first update of the Principles since 2004, and the first time that the G20 has formally endorsed them. The revised Principles reflect significant changes in the global economic landscape and in corporate governance practices, such as the expansion of board committees, including the role of the audit committee, and the introduction of independent audit regulation.

Country-specific developments include Japan’s issuance of its first-ever corporate governance code in June 2015. The code is the latest in a series of corporate governance reforms introduced by the Japanese Government as part of its economic growth program (so-called “Abenomics”). The Code operates on a “comply or explain” basis and, among other things, includes requirements for boards to have a minimum of two independent directors and for companies to disclose their policy with respect to “cross-shareholdings.” A recent report by The Nikkei newspaper found that 49% of Japanese companies surveyed have so far appointed at least two independent directors.4

Nigeria also is planning to introduce a corporate governance code, while other countries, including the Philippines, Mauritius and South Africa, expect to update their existing codes to reflect recent corporate governance developments.

1 No English translation is available.

OECD publishes its final recommendations on tackling Base Erosion and Profit Shifting

Policymakers around the world are scrutinizing the global tax profiles of multinational companies (MNCs), questioning MNCs’ local tax positions and seeking greater transparency into their entire tax footprint. A key initiative has been the OECD project to address Base Erosion and Profit Shifting (BEPS). On 5 October, the OECD published its final recommendations for the design of countries’ domestic laws, as well as proposed changes to tax treaties. The BEPS recommendations focus on transparency, coherence and substance and are intended to address government concerns about the potential for MNCs to erode tax bases and shift profits to jurisdictions where they are subject to more favorable tax treatment. Among other things, the recommendations include changes to:

• Limit interest deductions
• Eliminate the benefits of hybrid financing arrangements
• Lower the permanent establishment standards for taxable presence in a country
• Place new restrictions on access to benefits of tax treaties
• Create new transfer pricing rules for intangible property
• Recharacterize taxpayers’ transactions through new approaches to transfer pricing
• Require more robust transfer pricing documentation
• Require new country-by-country reporting to tax administrations

Global coordination on tax reform remains relatively limited, despite the OECD’s recommendations. More than 50 countries have taken unilateral action in advance of the final BEPS output. Tax competition also is likely to remain attractive to countries as they compete for tax revenue from MNCs. Therefore, the amount and pace of change for MNCs is likely to increase. More information on the OECD’s recommendations, and EY’s analysis, is available here.

Our view

We share the concern of many that elements of the systems for taxing MNCs are outdated. We welcome the final recommendations of the OECD’s BEPS project. Consistent adoption of the recommendations will remain a challenge, however, and will depend on countries remaining coordinated. We anticipate that MNCs will continue to face different and competing tax regimes in many countries.

We had hoped that more progress would have been made on dispute resolution, which will be increasingly important since the reforms, when implemented by the countries, are expected to give rise to a large increase in tax controversy.

Growing interest in Audit Quality Indicators

There are several initiatives under way to develop Audit Quality Indicators (AQIs), with the purpose of helping audit committees and others identify factors that warrant consideration in the context of audit quality:

• In the U.S., the Public Company Accounting Oversight Board (PCAOB) recently sought input on 28 possible AQIs. These are not intended to provide scores or grades for audits; rather, they are put forth as possible accompaniments to other contextual information in informing discussions among those concerned with the financial reporting and auditing process, for example among audit committees and audit firms.
• In the US, the Center for Audit Quality (CAQ) published its approach to AQIs in 2014, which focuses on enhancing auditor-audit committee communications using engagement-specific metrics. The CAQ divides AQIs into four categories: firm leadership and tone at the top; engagement team knowledge, experience and workload; monitoring; and auditor reporting. The CAQ worked with EY and other audit networks to pilot its approach and is expected to publish its observations before the end of 2015.
• Starting in January 2016, the Singapore Accounting and Corporate Regulatory Authority (ACRA) will implement an AQI reporting framework for audit firms. The framework comprises eight AQIs which are to be disclosed at the engagement and/or firm level: audit hours; experience; training; inspections; quality control; staff oversight; attrition rate; and independence.

Our view

We believe that, with the appropriate context, AQIs could increase understanding of the audit process and enhance discussions between auditors and audit committees. We also believe that AQIs can provide benefits to other stakeholders, such as investors, regulators, academics and others, either directly or indirectly.

Important issues to consider include the need to differentiate between engagement-specific AQIs, which are more appropriate for discussions between auditors and audit committees, and broader firm-level AQIs or other metrics that might be appropriate for public disclosure. EY’s response to the PCAOB consultation can be found here.
US initiatives to increase transparency of the audit process

The U.S. Securities and Exchange Commission (SEC) and PCAOB recently sought input on three initiatives to enhance transparency of the audit process. The SEC and PCAOB are now considering the comments received and their next steps.

The US initiatives are:

1. **SEC concept release on Possible Revisions to Audit Committee Disclosures.** The release explored whether audit committees should provide more qualitative disclosures about how they execute their existing responsibilities to oversee the external auditor. Most commenters did not support additional prescriptive requirements although there was wide support for continued voluntary enhancements to audit committee reporting. EY’s response to the SEC can be found here.

2. **PCAOB Supplemental Request for Comment on Rules to Require Disclosure of Certain Audit Participants.** The PCAOB asked for feedback on possible disclosures about the auditors that participate in an audit and, in particular, whether the PCAOB should require audit firms to disclose the names of the engagement partner and other accounting firm participants in the audit in a new regulatory form, Form AP. The stated goals of this disclosure are transparency and an increased sense of accountability. Previously, the PCAOB had sought comment on whether these disclosures should be made in the auditor’s report, as they are in many other countries. In the US context, however, this raised concerns from a range of stakeholders about potential liability implications. EY believes disclosure in a new PCAOB form, instead of the auditor’s report, could represent a reasonable compromise. EY’s response to the PCAOB can be found here.

3. **PCAOB Concept Release on AQIs, discussed in the previous section.**

**Our view**

EY supports enhanced transparency of the audit process and the audit committee’s oversight activities. Such transparency can contribute to investor confidence, which is the foundation of strong, well-functioning capital markets.

European Union audit legislation: Member States focused on implementation

European Union (EU) Member States are continuing the process of implementing last year’s EU audit legislation into their national laws. The legislation comprises a Regulation and a Directive. The Regulation will have immediate legal effect from 17 June 2016 and will apply to all EU Public Interest Entities (PIEs), including EU PIE subsidiaries of companies headquartered outside the EU. The separate Directive, which requires implementation into Member States’ domestic legislation by the same date, will apply to every statutory audit in the EU. More information on the legislation can be found here.

Together, the Regulation and Directive include a large number of options for Member States, including, for example, to vary the length of the initial auditor engagement period and to choose whether or not to permit any extension of that period. Companies with one or more EU PIEs in their group structure therefore should pay close attention to how Member States implement the legislation.

As we had anticipated, due to the large number of options the legislation included, Member State implementation varies significantly, creating a patchwork of different approaches:

- While most Member States will opt for the 10-year initial auditor engagement period recommended in the EU legislation, a few are likely to opt for a shorter period. For example, Italy is likely to keep its existing nine-year mandatory audit firm rotation regime.
- There is likely to be a range of different approaches regarding the potential extension of the initial auditor engagement period:
  - Some Member States, like the UK, may allow an extension where there is a competitive audit tender. Others, like Spain, will not.
  - Some Member States, like France, may allow an extension where there is a joint audit.
  - Some Member States may not allow any extension at all, like the Netherlands.
- A few Member States, including the Netherlands, are considering extending the list of non-audit services that an EU PIE cannot obtain from its auditor.

**Our view**

The legislation is already beginning to have an impact on the audit market in the EU, including an increase in the number of audit tenders in some countries. This is driving some positive developments, including more robust conversations about assurance, innovation and audit quality. We also are seeing a positive impact from expanded auditor reporting in some countries. Early evidence would suggest, however, that the legislation is not so far leading to less concentration in the audit market. EY also has concerns about the challenges for MNCs and their investors from the regulatory patchwork that is emerging due to the large number of options available to Member States in implementing the legislation. We also remain concerned about the longer term impact of the legislation on our people and teams, including mobility challenges.
Audit firm governance in the spotlight

While the background and specifics are different, policy makers in the UK and Netherlands continue to focus on the governance of audit firms.

In the UK, the Financial Reporting Council (FRC) recently sought views on the operation of the UK Audit Firm Governance Code, which was introduced in 2010 and applies to audit firms auditing 20 or more listed companies. Among other things, the FRC sought views on: the role of Independent Non-Executives (INEs) in audit firms; decision making within an audit firm that is part of an international network; and the culture and business model of audit firms and how these contribute to audit quality. The FRC is now considering the responses to its consultation and its next steps. EY’s response to the FRC can be found here.

In the Netherlands, the Government has proposed legislation that would significantly affect the governance of audit firms that are licensed to audit PIEs. The wide-ranging proposals include:

• A requirement for audit firms to create a Supervisory Board comprising a majority of independent members and a maximum of one executive member. This mirrors the governance structure for most public companies in the Netherlands. The Supervisory Board members would need to be pre-approved by the Dutch audit regulator.

• The Supervisory Board is proposed to have the power to appoint and set compensation for the Management Board and provide input into the process for determining partner compensation (including the role of quality in determining compensation).

• Further, a working committee of the Dutch Association of Auditors has proposed a partner profit deferral and potential “clawback” provision, under which an element of profit entitlements is delayed for six years and can be recovered in the event of deliberate or willful acts of fraud in connection with an audit.

Our view

As auditors of public companies, EY recognizes the importance of investing in and being transparent about governance. We have concerns, however, about a proliferation of different governance requirements at a national level. EY has enhanced our own governance in recent years, including adding four independent non-executives to our Global Governance Council (GGC), which carries out certain key oversight functions, including identifying risks and providing strategic guidance for the long-term success of EY. We have included INEs on our GGC because we believe they are in this way best positioned to contribute their outside perspective and experiences to strategic oversight, important appointments and all public interest aspects of our decision making. Our Global INEs also sit on a subcommittee dedicated to public interest matters.

For more information

For more information on any of these issues and our views, please speak to a member of the EY public policy team or your usual EY contact.

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For information on other public policy developments and EY’s views, visit ey.com/publicpolicy.