

## Audit – a long-term investor position paper on proposed EU reforms

2 November 2012

### Context

The signatories to this paper are large institutional investors and individual investor associations. The institutions manage approximately EUR 1.4 trillion on behalf of their members / investors. We are all long term investors who take our ownership responsibilities seriously, investing significant resources and time in securing, monitoring and voting our assets. Financial reports provide vital information for us to be able to monitor executives' use of our capital, and the audit of annual statements offers an essential assurance that information in company accounts is 'true and fair' (as required by the 4<sup>th</sup> and 7<sup>th</sup> Accounting Directives of the EC). The quality of the audit is, therefore, of utmost importance.

We believe there are a number of worrying features of the audit market. At a very fundamental level, we are concerned about auditor independence and professional scepticism. Potential conflicts of interest have always been present in the system of auditing, so the challenge is how these are managed. We believe the current system is not delivering, as evidenced by:

- **The failure of auditors to provide adequate warnings** prior to the collapse of a number of banks and insurers in the financial crisis. In the EU alone, between September 2008 and the end of 2010, 182 banks received liquidity aid and/or debt guarantees, and 114 banks received either capital injections or asset relief aid<sup>1</sup>. None of these banks received a qualified audit report prior to the crisis.
- **Too few large auditors** providing audit services to the largest listed companies. The average market share of the Big Four audit firms in EU member states is over 90%, and in certain sectors this rises to virtually 100%<sup>2</sup>.
- **The lack of rotation**. In the UK, audit firms retain a FTSE 100 client on average for 48 years, and it is not uncommon for this to rise above 100 years with some clients<sup>3</sup>.
- The **high levels of non-audit work** conducted by the auditor for the same company. For many EU countries, non-audit work represents a worryingly high percentage of total fees. In the UK, Portugal, Spain, Slovakia and Finland, non-audit fees represent around 30% of total fees<sup>4</sup>.
- The apparently heavy **dependence of the regulators and standard setters** on the large audit firms for professional and financial support.

Given the above context, we set out our thoughts and specific proposals below in response to the proposed EC Directive and Regulation on audit<sup>5</sup>.

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<sup>1</sup> Recent data on aid to the financial sector in Europe can be found in "The effects of temporary state aid rules adopted in the context of the financial and economic crisis", EC Staff Working Paper, Oct 2011 ([http://ec.europa.eu/competition/publications/reports/temporary\\_stateaid\\_rules\\_en.html](http://ec.europa.eu/competition/publications/reports/temporary_stateaid_rules_en.html))

<sup>2</sup> ESCP Europe, "Final Report – study on the effects of the implementation of the acquis on statutory audits of annual and consolidated accounts including the consequences on the audit market". Paris, November 2011.

<sup>3</sup> House of Lords Select Committee on Economic Affairs, "Auditors: Market concentration and their role", Vol. 1: Report, 30 March 2011. Lords data based on study: Oxera, 2006, "Competition and choice in the UK audit market" in which average auditor switching rates calculated for FTSE 100 and FTSE250 for 1998-2004 were calculated as 2.1% and 2.8%, respectively.

<sup>4</sup> See ESCP Europe (2011), Table 68.

<sup>5</sup> These proposals represent a minimum set of requirements / standards to tackle the mentioned audit failures. For several signatories, stricter standards would be desirable. Please refer to individual submissions for further information.

### **Mandatory rotation**

**EU proposal:** To prevent the same firm being reappointed, firms are to be required to rotate after 6 years. The period before which rotation is obligatory can be extended to 9 years if joint audits are performed. Joint audits are not obligatory but are thus encouraged. There is to be a cooling off period of 4 years before the audit firm can be engaged again by the same client (Article 33 of the Regulation).

### **Comments:**

- Independence and scepticism is vital for audit quality. Firm rotation is ultimately necessary to ensure a “fresh pair of eyes” and to avoid:
  - Too close a relationship between management and auditors developing; and
  - Auditors becoming ‘captured’ by their own historical judgments. There is a real risk of incumbent auditors being unwilling to challenge their own past judgments, where such an act would be likely to inflict reputational damage and – where restatements result – potential legal liabilities.
- Moreover, where an audit firm knows it will be replaced, it will be incentivised to maintain scepticism as its judgments will be reviewed in detail by the incoming auditor.
- Empirical evidence is inconclusive on rotation’s impact for audit quality and costs. There are very few countries that have implemented auditor rotation for long enough to offer robust conclusions. The fact that many countries introduced mandatory rotation, to later abandon it either before it was implemented, or in the early years of implementation does not in our view provide evidence that it does not work.
- It is also worth highlighting that existing guidance/rules for the tenure of independent directors in member states ranges from 9-12 years. It is widely believed that after this period directors lose their independence.
- Rotation might also support increased competition, in that it provides the opportunity for entry by non-Big 4 firms, as well as greater competition among Big 4 firms.
- Partner rotation does not provide a sufficient guarantee of a ‘fresh pair of eyes’. The chances that a new partner will challenge opinions of their predecessor (and the team that stays on) and potentially open the company up to legal challenge are very low. Moreover, action needs to be taken to prevent the auditor’s engagement partner becoming the audited entity’s CEO / Senior Executive / Chairman. Where the audit partner has interests in eventually getting a job with his client, this would introduce clear disincentive to robustly challenge management. There should be a minimum ‘clear water’ period of, say, 5 years.
- We are cognisant that rotation will be associated with a learning curve as new auditors develop their understanding of the business, and this is especially true for large and/or complex groups. While we wish to encourage a ‘fresh pair of eyes’ and, indeed, welcome the associated process of starting from scratch to check through all existing assumptions and approaches taken, audit tenure must not be so short that it undermines incentives to take on more complex clients.

**Our proposal:** Audit Committees are required to set a maximum tenure period for auditors to suit their company’s complexity and size, and outline their reasoning to shareholders. An upper bound of 15 years should be set to safeguard shareholders long term interests. It is expected that Audit

Committees will undertake at least one competitive tender including the incumbent, and then again at the end of the full term, excluding the incumbent<sup>6</sup>. There should be a ‘clear water’ period of at least 5 years before an auditor can be re-appointed.

### *Appointment & tendering*

**EU proposal:** Public Interest Entities (PIEs) to have an open and transparent tender procedure when selecting a new auditor. The audit committee (of the audited entity) should be closely involved in the selection procedure. Any appointment of the auditor to a meeting of shareholders, other than a renewal, to include at least two choices excluding the incumbent (Article 32 of the Regulation). To promote choice, one of the firms to be a smaller firm. Auditors appointed for a two year minimum term which for a PIE could only be renewed once (Article 33 of the Regulation).

#### **Comments:**

- Currently management has too much control over appointment through its proposals to the Board / Audit Committee.
- Shareholders in the UK have the ability to approve the auditor every year through a vote at the AGM. This is an important mechanism for holding the auditor to account. It has, however, been rarely employed.
- Shareholders receive very little information about the quality of the auditor, past interactions with the Board/Audit Committee, criteria used in auditor selection, etc., so find it difficult to assess performance.

**Our proposal:** We would like to see a system of mandatory tendering every 5-7 years, combined with mandatory rotation after no more than 15 years (see above). The tender should involve at least two candidates (other than the incumbent) to ensure genuine competition and to open the market to new entrants. We do not feel the EC should go as far as requiring that a smaller auditor is involved in the process. The selection and appointment process needs to be transparent for shareholders.

**Additional note:** We have concerns that the two year minimum appointment would potentially undermine an important shareholder right in the UK: namely, the right to re-appoint the auditor annually.

### *Non-audit services*

**EU proposal:** Audit firms prohibited from providing non-audit services to their audit clients (Article 10.3 of the Regulation). Fees for related financial audit services limited to 10 per cent of the audit fees (Article 9 of the Regulation). In addition, large audit firms obliged to separate audit activities from all other activities in order to avoid risks of conflict of interest (Article 10.5 of the Regulation).

#### **Comment:**

- Non-audit work introduces a potential conflict of interest within the audit firm, especially where non-audit work is more profitable than audit work.

**Our proposal:** Auditors should be permitted to undertake audit related work, but we favour restrictions on non-audit work for audit clients. We would like to see a requirement that where the value of non-audit work rises above 50% of the audit work, the Audit Committee must bring down the ratio below 50% within the next 12 months, or select a new audit firm at the next tender.

<sup>6</sup> A term of 6-7 years would be in line with the EU’s 8<sup>th</sup> Directive on Statutory Audit.

Whichever action is taken must be disclosed in the next annual report.

### *Audit reports*

**EU proposal:** Two pages of disclosures are proposed for the audit report within four pages or 10,000 characters (Article 22 of the Regulation).

#### **Comment:**

- Setting a numerical target for the report is too prescriptive.

**Our proposal:** We would like to see a fuller audit report that draws attention to key areas of judgment, estimates, any weaknesses in the financial system, assumptions underlying fair value estimates, any disagreements with management, etc. We would support more formal adoption of the “Audit Committee Reports – Global Disclosure Guidelines” published by the Enhanced Disclosure project<sup>7</sup>.

### *Audit committees*

**EU proposal:** Every PIE to have an audit committee. Audit committees strengthened with a majority of members independent and at least one member with competence in audit and one other in accounting and audit (Article 31 of the Regulation).

**Our proposal:** We support having two members with some auditing/accounting expertise on Audit Committees at large cap firms.

### *EU-wide International Standards on Auditing (ISAs)*

**EU proposal:** Audits throughout the EU carried out in accordance with ISAs, enhancing audit quality and supporting the provision of EU-wide audit services (Article 20 of the Regulation).

#### **Comments:**

- We have concerns that ISA’s will lead to more compliance driven audits tied to International Financial Reporting Standards (IFRS), and reduce auditors’ duty to apply professional and prudent judgement in determining whether accounts present a ‘true and fair’ view of the company’s underlying economic position (as required in the 4<sup>th</sup> and 7<sup>th</sup> Accounting Directives of the EC)<sup>8</sup>.
- We also have concerns over the independence of the standards setter, IAASB, given its strong dependence on the professional bodies and Big 4 for its funding and support.

**Our proposal:** Rather than extending the coverage of ISAs, the EC should investigate as a matter of some urgency whether IFRS is delivering accounts that provide a “true and fair” view as required under 4<sup>th</sup> and 7<sup>th</sup> Accounting Directives, and therefore can ensure prudent long term stewardship by management and shareholders.

<sup>7</sup> See <http://www.enhanceddisclosure.org/>

<sup>8</sup> See Richards, I. “Undermining the Statutory Audit: the damaging effects of adopting IFAC-IAASB standards on auditing (ISAs)”. June, 2005.

**Signatories**



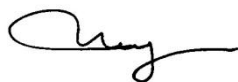
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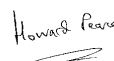
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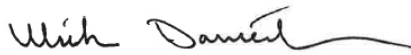
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