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The Auditing profession - independence, quality and reforming the regulations as proposed by the European Commission

Distinguished guests, ladies and gentlemen

I am delighted to be with you again, and to be speaking to you on some of the recent and significant developments for the audit profession coming out of the European Union and the International Audit and Assurance Board.

While some of these developments on the future of audit and audit reporting are taking place in other continents, the proposals have implications for auditors everywhere, including here in Antigua.

One of the most significant influencers at the moment is the European Commission.

The Commission believes that the 2008 global financial crisis highlighted considerable shortcomings in the European audit system following some large financial institutions being given “clean” audit reports, despite serious intrinsic weaknesses in the financial health of those institutions, coupled with criticism of the quality of audits by national supervisors.

The proposals from the European Commission, set out to clarify the role of the auditors and introduce more stringent rules for the audit sector, with the particular aim of strengthening the independence of auditors as well as introducing greater

diversity into the current highly-concentrated, Big Four dominated, audit market.

The proposals are far reaching in terms of their impact on the European profession and the wider global profession, and include the following:

Audit firms having to rotate after a maximum engagement period of six years - extended to nine years where more than one audit firm is carrying out the audit. Once an engagement has come to an end, audit firms would not be allowed to be engaged by the same client for four years.

Public-interest entities must have an open and transparent tender procedure when selecting a new auditor, with the audit committee being closely involved in the selection .

Audit firms will be prohibited from providing non-audit services to their audit clients. In addition, large audit firms will be obliged to separate audit activities from non-audit activities in order to avoid all risks of conflict of interest.

Given the global context of audit, the Commission believes it is important that coordination of and cooperation on the oversight of audit networks is ensured both at EU level as well as internationally. It has therefore proposed the coordination of the auditor supervision activities is ensured within the framework of the European Markets and Securities Authority (ESMA).

A single market for audit will be created with the introduction of a European passport for the audit profession, allowing audit firms to provide services across the EU.

It will also require all statutory auditors and audit firms to comply with international auditing standards when carrying out statutory audits, but allows for what it refers to as a proportionate application of the standards in the case of small and medium-sized companies, a sentiment that was expressed at roundtable events hosted by ACCA Caribbean in both Jamaica and Trinidad in April of this year.

Taken together, the Commission believes that all these measures should enhance the quality of statutory audits and restore confidence in audited financial statements, in particular those of financial institutions and large listed companies.

That's a brief overview of the key elements of the proposals – so what does ACCA think of them?

We welcome the Commission's involvement in this issue and believe that its proposals contain many helpful suggestions for improving the effectiveness of audit and the level of understanding of audit among non-auditors.

Their proposals have certainly ignited a heated debate, not just in Europe, but around the world, including here in the Caribbean. The round tables I referred to a moment ago had a general consensus that change is necessary - the status quo is not an option. Participants also agreed that the independence of auditors and strong ethical guidelines are essential for the maintenance of the value of assurance services provided by the auditors.

Following the crisis of 2008 it was appropriate that national and transnational authorities undertook a thorough analysis of the role of audit in the corporate

reporting process and consider whether aspects of audit practice and regulation might need to be reformed so as to make auditing more effective and relevant in the 21st century.

ACCA has undertaken its own wide-ranging and international review of stakeholders' views about the future of the audit and the results of this initiative have informed our current thinking on the issue.

Our conclusion, based on that global research, is that while current audit practice is not fundamentally flawed, audit could be made more effective by expanding its scope and improving the effectiveness of the relations between auditors and internal auditors, audit committees, shareholders and regulators.

We welcome the proposals for introducing greater flexibility for statutory auditors and audit firms to operate on a cross-border basis.

We see this as a single market issue which has the potential to bring greater flexibility to the operations of international audit networks. For these proposals to have any real effect, however, it will be necessary to ensure that additional restrictions are not imposed at the individual member state level.

But we are concerned about some of the proposals – which we believe are ill-conceived.

For reform to be effective, we believe that it must always be based on a correct assessment of the problem that is intended to be resolved.

If this is not done, the risk is that the solutions brought forward will either not address the real problem or else will introduce unreasonable and disproportionate regulatory burdens.

We are concerned that, in its explanatory text, to the draft legislation, the Commission made categorical statements such as ‘the financial crisis has highlighted weaknesses in statutory audit’ and ‘self regulation is not adequate’, without explaining the basis on which these conclusions have been reached.

Unless we make the right distinction between things which have actually gone wrong with audit, and things that on reflection could be done better in future, we risk introducing the wrong solutions.

Specifically, in trying to learn the lessons of the recent past, it is essential for everyone involved to understand that the responsibilities of auditors are laid down by a combination of law and professional standards. If auditors have not done all that many observers presumed that they should have, that may not be because they have failed in their duties, but rather because they complied with their duties as framed by law and standard.

ACCA would also stress that audit is only part of a wider corporate reporting process. The role of the auditor, as currently defined, is essentially to give an opinion on whether a set of financial statements is properly prepared in accordance with the applicable accounting framework and that it gives a true and fair view.

It must therefore be understood that audit cannot be considered in isolation from the whole accounting framework, and if there are weaknesses in the amount and quality of information which is to be required to be communicated, that cannot be rectified by the audit process.

The effectiveness of auditors' work, however, can be improved by making changes to the framework in which they operate, most especially by reinforcing the role of the audit committee.

In the course of trying to standardise conduct requirements, the Commission has chosen effectively to enshrine in legislation much of what is currently contained in professional standards and guidance statements. It is clearly justifiable, in appropriate cases, to give added force to expectations by setting them out in law rather than guidance. But the Commission's approach gives rise to two criticisms.

Firstly, despite the draft legislation providing that audits are to be conducted in accordance with International Standards in Audit – or ISAs, as developed by the International Auditing and Assurance Standards Board, it proceeds in some cases to lay down requirements which are in fact already covered by ISAs. This is duplication and unnecessary.

Secondly, the Commission has to a great extent adopted, sometimes word for word, the text used in standards or guidance. The problem with this is that language which is appropriate in standards or guidance can lack the precision which is appropriate in legislation, especially in a Regulation.

We suggest that it would be appropriate and simpler for the legislation to make more use of simple cross-referencing to ISAs and the parallel IAASB quality control standards.

A further criticism we would make of the approach taken is that, in some instances, potentially onerous requirements are imposed on auditors which allow no account

to be taken by the auditor of materiality. We believe that this would amount to a disproportionate burden.

The proposals in the draft Regulation concerning the independence of the auditor would have the effect of imposing rigid legal restrictions on the length of service that audit firms can remain with the same client and on their ability to provide non-audit services to their clients. Again, this was a view shared by those taking part in ACCA Caribbean's roundtables on audit.

We agree absolutely with the Commission that independence and objectivity are key to the performance of a quality audit, and are prepared to support measures in relation to these issues that offer the prospect of achieving enhancements to audit quality.

But we do not agree that the Commission's regulatory solution would necessarily improve quality, and are not aware of evidence to support the claim made in the text that 'stricter rules for the appointment of auditors and mandatory firm rotation would contribute to higher quality audits.'

We believe the imposition of rigid rules on length of service and range of services that could be offered by an auditor would mean that shareholders, who are the primary stakeholders in the audit process, would have less influence in that process. But we do accept that the perception of an auditor's independence may be impaired by long service, and that some strengthening of controls on independence would be appropriate.

Because of that, we propose that scope should be left in the legislation for a company's audit committee, or even the regulatory authority, to be required routinely to assess the independence of an auditor or prospective auditor and to make appropriate recommendations and declarations, disclosing how they have satisfied themselves over the independence of their favoured choice of firm.

We would also prefer to see companies having to change their auditor after a set period - say ten years - unless the audit committee, or regulatory authority, is able to satisfy the company's shareholders that the auditor remains sufficiently 'independent'.

We agree that more competition should be encouraged in the listed company audit market and that artificial barriers to competition should be removed.

We believe that another important issue which should be addressed is that of **auditor liability**. In arguing for greater competition, though, it is important to remember that audit firms will only consider involvement in high risk audit work if they have the resources, experience and insurance cover to do so, and this must always be a decision for each individual firm to take.

ACCA also welcomes the Commission's thinking on expanding the content of the audit report.

Our own research found that stakeholders regarded the current standard audit report as uninformative, and wanted to see more information from auditors about exactly what they have done and what material issues they have considered in coming to their audit opinion.

We also found that many stakeholders wanted to see some assurance from the

auditor with regard to the company's management of risk, but this has not been included in the list of specific disclosure items set out in the draft Regulation.

We believe that international standards on auditing should be the required basis standards throughout the EU, irrespective of the size of the entity being audited. I understand that here in the Caribbean, some concerns were expressed about how this would affect the small business sector, and similar concerns have been expressed in EU.

While we agree with the Commission that the work required to be carried out in the course of auditing SMEs should reflect the scale and complexity of the entities concerned, we have an issue with part of the draft Directive which calls on individual member states to ensure that auditors apply auditing standards to the audit of SMEs in a way which 'is proportionate to the scale and complexity of the business of those undertakings'.

The potential consequence of the Commission's proposal is that different standards are applied to the audit of SMEs in each member state: this outcome could result in 27 different solutions which would only add to the widespread confusion about what an audit means, and should be avoided.

In our view, the standard of assurance provided by an audit should be the same - irrespective of the size of the entity being audited, and we recognise that some rationalisation should be sought in respect of the guidance to which auditors at this level are subject.

But believe it is essential, that those expectations are the same for auditors in all

member states.

So where are we in the debate - we understand Members of the European Parliament will prepare an audit "working document" before October, which will explain the main issues for debate, with a draft report by the end of **2012**.

We currently understand that the key issues for debate at the European Parliament and with member states include auditor rotation, mandatory public tendering of audit mandates, non-audit services and on the definition of "going concern" – when an auditor vouches that a company looks able to stay in business for the following year.

These developments are having a global impact, as I mentioned earlier. The PCAOB in the United States is preparing their response to the debate, which will also be issued later this year.

The next development will, however, be the Invitation to comment on Auditor Reporting from the International Auditing and Assurance Standards Board, or IAASB, based in New York, which will issue in the next few days.

As some of you may be aware I was recently appointed to the board of the

IAASB, having been nominated by ACCA. I come here from Edinburgh following a long and rigorous week where the board debated, amongst other things, Auditor reporting and the direction it should take in to the future.

This will be a very significant piece of the discussion which will also set the direction globally as it will inform developments with the European commission, PCAOB and many other regional and national regulators and standard setters.

The IAASB issued a consultation paper in May 2011 on Enhancing the value of auditor reporting to explore what the options for change might be if the audit report of the future is to deal with the challenges which have been identified by stakeholders, following the financial crisis.

The clear message that came from stakeholders across the spectrum is that if the Audit Report is to meet the needs of users of audited financial statements there must be greater transparency about significant matters in the financial statements as well as the conduct of the individual audit.

They stakeholders were also of the view that this requires meaningful change and not just incremental update over time in order to meet the information needs of users of audited financial statements.

The IAASB recognises that it will be necessary for audit reports vary across different jurisdictions to reflect the differing requirements of national laws and regulations. It is however important in a global marketplace, with global stakeholders, that Audit Reports share a degree of commonality that will enable investors around the world to clearly recognise and compare them.

In reviewing the responses received to that consultation paper it became clear to the IAASB that urgent and decisive action was required to deal with the calls for change in this area and therefore the work program of the IAASB was altered to facilitate a revised standard, ISA 700, by June 2014. I can tell you from personal experience that this timeline is hugely ambitious and demanding for the Board and staff.

The Board has taken the unusual step of looking for further contributions on the direction it is following before it moves into standard setting mode on this issue, which it will do in December of this year.

The invitation to comment, or ITC as it is known, sets out the boards thinking on the direction of auditor reporting and is looking for comment from all stakeholder, be they auditors, regulators, users or the public interest groupings.

The finalised ITC will be available on the IAASB website next week, while the board papers for the recent meeting are available now.

So what are the proposals for this new state of the art audit report:

Its going to be longer!

The current standard requires maybe two pages while the new one is likely to run to between four and five pages. With a lot more entity specific information to assist users in understanding of the financial statements.

A bit more Feng shui!

not an IAASB term. The ordering of the content may change with more

prominence given to the Opinion. This will put greater emphasis on the “Pass/Fail” nature of the audit report, something which regulators are supportive of. This will then be followed by directly relevant entity specific information which will then be followed by the generic and “boiler plate” information.

Going Concern gets a permanent place!

The financial crises has put a greater focus on the assessment of going concern and liquidity risk issues, to be reported on a timely basis. Much of the debate on this point has centred around what additional contribution the Auditor can make. The direction which the IAASB is currently taking this is to have the audit report include:

A conclusion regarding the appropriateness of managements use of the going concern assumption ; and

A statement indicating if material uncertainties relating to events or conditions that may cast significant doubt on the entity’s ability to continue as a going cocern.

It is intended that these disclosure will give more timely and relevant information to users but could be challenging for the auditor given that it may be difficult to do this without doisclosing information that management is not required to disclose in the financial statements, but should be management’s responsibility to disclose.

Another new element will “shine a light” on importand things.

Auditor commentary is in response to the call for Auditor reporting,,particularly from investors and analysts of listed companies, to enhance the informational value of the Auditor’s report to assist in decision making.

The type of disclosures which the IAASB is considering fall into the following categories:

Pointers to disclosures in the financial statements with additional context on the matter.

Commentary to give users a better understanding of complex financial statements

Matters of Audit significance

Matters leading to increased transparency about the audit

It is recognised that guidance will have to be given on the balance to be struck by Auditors in providing Auditor commentary between relevance, understandability, and value while not resulting in the Auditor being the original provider of information about the company.

The board recognises that this type of disclosure may not always be appropriate and that a decision will need to be made as to whether Auditor commentary should be provided for all entities, or just certain entities. This is a key point on which the Board is looking for feedback.

The Board's current position is that it believes that it is important auditors of all entities should have the ability to use Auditor Commentary in their reports, while recognising that the demands for this have come primarily from institutional investors.

The IAASB has initially concluded that this type of information should at minimum be required for listed entities and that there is strong merit in extending the mandatory requirement to Public Interest entities as defined by the International Ethics Standards Board.

To date there has been no feedback to indicate that there is a demand for Auditor commentary amongst SME'S.

There are a couple of other less significant proposed changes which are:

1. Expanded disclosures on the role of Management, those charged with governance and the auditors.
2. Disclosure of the name of the engagement partner
3. The role of other auditors, without altering the responsibility of the group auditor.

The comment period for the ITC closes on October 8 so I urge you please contribute to the debate. Let the IAASB hear your voice, be it as an individual, a professional body or other stakeholder. The IAASB needs to get your view on this.....you need the IAASB to get your views on this. Obtaining diverse views in order to achieve the right balance between global consistency and national flexibility is an important part of what is to be achieved.

For ACCA's part we will continue to monitor the situation... and of course will be working to put across ACCA's thinking on the various issues that I have spoken about in the coming weeks and months.

Thankyou. I am happy to take any questions.