Financial Reporting Council
Developments in Audit
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Introduction and Welcome

Stephen Haddrill

CEO, Financial Reporting Council

I. Welcome

Good afternoon, ladies and gentleman. My name is Stephen Haddrill, which is up on the screen in case I forget it. Welcome to this event. This is an auspicious moment for us at the FRC. The government, through legislation back in June, appointed the FRC as the Competent Authority in the UK for audit. We thought we would mark that occasion with a bit of exposition on what we think the issues in audit are at the moment, and how we are going to go about our job.

II. Introductions

You are not going to hear a great deal from me, for which I am sure you will be very grateful, but I am very glad to say you will first hear from Melanie McLaren, who is the FRC's executive director for audit. She has just taken over that a few months ago. She is going to talk about the regulatory landscape and developments in audit from her perspective of heading up audit work for the FRC.

Secondly, Robert Hodgkinson, who is the executive director for technical strategy at the Institute of Chartered Accountants in England and Wales (ICAEW), and under the new arrangements the FRC will be handling public interest entity matters in relation to the audit, and delegating other responsibilities to the ICAEW, and the other relevant professional bodies.

I am very pleased that Jeannette Andrews, who is LGIM's corporate governance manager, has joined us to give us an investor perspective, which is always very valuable. Jeannette has done that over a number of years with great success, as far as we are concerned.

Finally, I am very pleased to introduce Ralf Bose, who is chief executive of the Audit Oversight Body in Germany, which has just re-established itself, under the German legislation. He is also, since July, the chairman of a body called the CEAOB, which is the oversight body which brings together all the competent audit regulatory bodies from the European Union, including ourselves, (at the moment).

III. Background

Before they speak, I would just like to say one or two things about the FRC's perspective. When the government designated us as the UK Competent Authority, we determined that our focus would very much be on promoting high quality audit in the public interest, to underpin investor confidence in the capital markets and British business. The FRC is going to be working closely with the professional bodies in doing that, and promoting the quality of audit, and as I said, where possible we will delegate regulatory functions to them. Our goal, which Melanie will talk about in a moment, is first and foremost to increase confidence in audit. We all know, following the financial crisis, that confidence in audit was somewhat reduced. However, in the intervening years, we have done a great deal, I believe, and the profession itself has responded to rectify that situation, but we are not at the end of that journey as yet.

The FRC set out in its last strategy document that we want, by 2019, to see 90% of the audits that we review in the FTSE 350 being assessed as either good or requiring only the most limited improvement. This would be a rise from around 70% that we see meeting that threshold at the moment. We do not regard around 30% of audits in the FTSE 350 not achieving that level as anything like satisfactory, and we will be taking a close look at firms and working with firms to get up to that much higher level.

Some people may think it is an ambitious target; I do not believe it is. However, it will require a great deal of work, by both the regulator and the regulated. I believe we need to achieve it in order to achieve trust and confidence and establish it on a permanent basis.

How are we going to go about our role? The answer is that we are focusing in promoting the practice and sound root cause analysis, by ensuring continuous dialogue between us and the audit firms, and also that we work together to achieve this outcome. An effectiveness review into our corporate reporting work, and our audit quality work, has helped us to realise this, to make this happen.

I talked about working in cooperation with the firms; I must stress that we have quite separate roles. As regulators we are totally independent of the firms, and it is our job to set the standards with which they must comply, and to make sure that in our inspection work, etc, we reinforce those standards and that we drive forward an improvement from where we are at the moment.

Just a week after the Audit Regulation Directive was implemented in the UK and the FRC was nominated as the relevant regulatory body, the UK voted to leave the EU. We have heard from the Prime Minister, Theresa May, that she intends to trigger Article 50 at the end of March, and that will of course begin the formal process of negotiation for Brexit. We need to look ahead, though, to what that means for the financial world, and in particular for audit and the sector in future. We will remain highly committed to ensuring high standards, the kinds of standards we have strived for whilst being members of the EU. We will want to maintain and reinforce them after we have left the EU. We do not regard this as an opportunity for a reduction in standards in this area, or the achievements of the audit sector – quite the opposite – nor do we regard it as an opportunity for any reduction in the quality of reporting that auditors are looking at.

That is something that we can perhaps discuss a bit more in detail as we move forwards. Now, let me ask Melanie to say something.

Developments in Audit, Regulatory Landscape and Underlining FRC's Credentials as the Competent Authority

Melanie McLaren

Executive Director for Audit, Financial Reporting Council

I. Introduction

Stephen, you said that some of the targets are not ambitious, but they will be hard work. You are right, and we are going to have to be persistent. In fact, this is my third attempt to launch the FRC's role as the Competent Authority for audit. As Stephen has said, we were all set to do something on what for us was called Super Friday, on 17 June, but decided that it might be politic to wait and see what the result of the referendum was before we did anything very substantial. That was a very good call. We were less far sighted when we launched our developments in audit report in the middle of July, choosing the day on which the new Prime Minister appointed her new cabinet, and therefore that somewhat detracted from the messages we were trying to give out.

It was with great trepidation this morning that I awoke to the *Today* programme, to listen to the preliminary reports of Theresa May's Conservative Party conference speech today. As Stephen has indicated, she has said some things about corporate governance, but I am pleased to see that she has not diverted the people who matter in this room from our mission around promoting high-quality audit in the public interest. Thank you. I have finally got an opportunity to set out our stall, and I am very grateful for that.

II. High-Quality Audit

As Stephen has said, we want to make a great success of our role as the competent authority for audit, because audit underpins confidence in investment in the UK, and therefore audit is a public interest activity. We often use the words 'high quality audit', and I will say something about what we mean by those words. It is certainly something for us, and for our stakeholders, that goes much beyond complying with regulation and with standards. It is because of that that we felt we should set out what our vision for audit is, rather than having a mandate that says we will simply ensure compliance with relevant requirements that are set for the Competent Authority.

When we talk to users, particularly investors, which is why we are very grateful to Jeannette for being here, they give us great insight into what they want from audit. They want something that gives both assurance and insight, and something they can engage with and understand, so they can get a clear and unambiguous view of where the areas of judgment are and what is being done about them. We intend to take that input forward in carrying out our work.

III. The Audit Context

We cannot operate in a vacuum, so we need to understand the context in which we are currently operating. Therefore, we have, over the past four years, commissioned two YouGov surveys in connection with confidence in audit. The last survey, carried out in the summer of this year, was encouraging. It said there was an increased confidence in audit in the UK, and it highlighted key influences: first and foremost, that audit firms are increasingly seen as being independent and competing for audit engagements on the grounds of quality. That is, of course, encouraging, when we look at the measures that the FRC, through the Corporate Governance Code, have put in in connection with retendering, and we are now seeing mandatory rotation. The fact of the introduction of mandatory rotation and the tightening up of some of the requirements and provisions on audit services were also seen as contributing to that increased level of confidence. We also have some evidence that the quality of the audits themselves is improving, which is coming both from our own monitoring work, and from the work of the recognised supervisory bodies. Robert will say a little bit more about that in a moment.

IV. Vision for audit

As Stephen said, when we embarked on this journey of implementation, 70% of FTSE 350 audits required no more than limited improvement. In the 2015/16 cycle, that has risen to 77%. However, I am conscious that one year does not necessarily mean we are on a path to reach the target. Therefore, we will be working with the firms and with audit committees in companies to do everything we can to ensure that this is continuous improvement, and that we are actually looking at root cause and root cause analysis as to what promotes a good high quality audit, and not just what are the root qualities of a poor quality audit. We want to do much more about promoting good practice, but we will be very clear and hold people to account when we see quality that falls below the required bar.

There is still much more to do, and looking at our vision for audit, if we do a stocktake as to where we are on each of the points [on the screen], we have made progress in ensuring that auditors are trustworthy and that they act with integrity. There is still more work to be done on professional scepticism, and that is quite a common finding. The role in the public interest is also something that we have been developing through things like the Audit Firm Governance Code, which requires independent non-executive directors to look at those public interest aspects. There is a general debate in the UK, at the moment, about the needs of broader society and broader stakeholders in connection with trust, and therefore assurance, in business. Therefore, there will be an ongoing debate we need to have to take that forward. We will play our part in communication and in doing things like thematic reviews, and in looking at more innovative ways of narrowing the continuing expectation gap. We are giving some thought, for example, to an audit lab where we might be able to bring investors, as the primary users of audited accounts, and auditors together to try and bridge some of that understanding gap.

We have set a target in our vision for audit to have appropriate oversight, with a clear regulatory regime, and we will be doing everything we can to communicate the nature of the new regime. This took some working out between all of the stakeholders, but we now feel that we have a solid base to move forward from.

In the survey of confidence, we were told that one of the most transformative things we have done to promote confidence in audit is to re-establish where the relationship lies between the audited entity and the auditor. In other words, we have moved that relationship, underpinned by the ARD, to sit with the audit committee and not, say, the finance director or elsewhere in management. We now need to continue to work forward, particularly with audit committees, to ensure we are giving them the necessary support that they need to make a success of retendering requirements, but also ongoing independence requirements. However, under the Corporate Governance Code, they have an overall responsibility for reporting on how they have ensured the effectiveness of the audit.

We intend to do much more communication with audit committees, and particularly audit committee chairs, and so those of you who are audit committee chairs of public interest entities will shortly be receiving a request to have contact details logged with the FRC, so that we can engage with you in our regulatory functions and assist the promotion of high quality audit.

The fourth item is about audit being a sustainable business with adequate activity, and having sufficient levels of investment competition and choice, and when we talk to the stakeholders – including audit committees and investors, and the auditors themselves – this is often seen as being one of the most challenging. We have moved competition to be competition on quality, however we have not really broadened the pool from which auditors of PIEs in particular are selected. We are also receiving feedback that a tighter regulatory regime may be making the audit profession less attractive to professionals, so how are we going to ensure some of the capacity is maintained and developed in the future. We do not pretend to have any easy or ready answers around that, but we want to keep engaged with stakeholders as to how that might be addressed.

V. Evolution & Innovation

We think it is important, and I hope this is clear from all we have said, that audit needs to continue to evolve and innovate. In the UK, with the support of the firms, we have been innovative in implementing the extended auditor reporting, which is now being taken up internationally. We are described as having taken an ‘international pathfinder’ role, and investors tell us that they value this extended reporting, because it does provide them with some of the insight that was previously lacking. It helps them engage on some of the key risks to the financial statements. We have some track record of innovation, but we need to keep moving forward, and the development and use of technology is something we see as being quite key to promoting increased quality and also efficiency of audit. That ought to help, and we need to make sure that we, as a regulator, support such efforts, and certainly do not act as an obstacle.

VI. Global Audit

We recognise that audit in the UK, and particularly in public interest entities, is actually a global activity. These are global businesses, with global footprints, and therefore it is important that component audits are carried out by auditors who are meeting appropriate standards, and the sort of quality bar we have in mind. To facilitate that, the FRC will continue to be engaged in international fora such as that which Ralf is chairing, in order to promote and learn from good practice internationally. We will do likewise in the world of standard setting. In the UK, we choose to adopt the international standards for audit, and then we add to them specific UK requirements. We will continue to do that, but we need to continue to influence the standards themselves, so that they too stay agile to the developing needs of the users of audit, and to developments in technology. Therefore, we will continue to promote that forward.

VII. Conclusion

You will see there is actually quite a lot to do in this role as Competent Authority for audit, particularly if we are determined to do it with a mindset that keeps an eye on the future and the overall effectiveness of the regime. I look forward to your support in delivering that. Thank you.

RSBs/Professional Bodies' Perspectives on the New World of Audit

Robert Hodgkinson

Executive Director – Technical Strategy, ICAEW

I. Introduction

In the middle of Melanie's comments, she said, 'as Robert will discuss later'. I would not want that to set too much of a tone for the relationship between us in this new regulatory world, but I was given some questions to answer, and I am going to answer them whether you like it or not, because otherwise we might find we are undermining the arrangement. If this seems a little bit strange, I will tell you what the questions are, and that might help you.

II. The New Regulatory Regime

The first thing was how does ICAEW see working under the new audit regulation and direction regime? And then it says pointedly, 'i.e. with the FRC as the competent authority.' Apart from having my Zhou Enlai comment about the French revolution that 'it is a bit early to tell' how we see it, I would make four comments.

First of all, for us as a professional body, our role in the UK is actually very important, but we see this as a European-wide initiative. It is a good thing that Alain Deckers is still here, because we invited Alain to an event we are holding today in Athens, with seven professional and oversight bodies from central and eastern Europe, to talk about these issues in a quality assurance roundtable group that we convene regularly. There is a broader view, and we have members operating throughout the European Union, and their experience is being sought. That is relevant, because actually, although there is a new regime, we should not overstate the extent to which there is a lot of difference. There are important differences, but we have a long and good track record in the professional bodies in the UK of doing this work, and it is good to have a clarified structure which is consistent across Europe. However, it is not like there is a complete revolution.

The final comment I would make about the working is that we will need to adapt. There has been a lot of thinking ahead of time and planning, as we are good at doing, as to how things will work out. However, we are going to have to see how it goes, and adapt and change. There are already signs that there will be new sorts of guidance being sought, clarification, Q&As which might be helpful to make sure that there is an alignment between what we are all saying, to make sure there is efficient regulation, and that the regulated know where they stand. Independent standards are a case in point there.

Although it is important to see how things work in the context of how we in our world of auditing think, the ultimate test – going back to what Melanie said about why we are doing all of this – is a public test, and it is a broader public test beyond even the investors as the primary users of audit, because ultimately it is a matter of public confidence, and there is no point us saying our arrangements are working fantastically if we are not getting a good press in the broadest sense. We have set up a new regime, but there is a lot of learning to go.

III. High-Quality Audit

The next question I was set was: how does ICAEW define a high quality audit, and what are your targets and in what specific areas is there more work to be done? It is nice to see that this meeting is already serving as a context for the oversight function of our delegated activities, and it is very important we do them well otherwise the FRC can claw them back. I was told that the first question about how does the ICAEW audit quality, the politic answer is in exactly the same way as the FRC. We are focusing on key audit judgments and evidence, rather than just looking for standard violations. That is not to diminish those, they are very important, but at the end of the day, we are trying to make sure that the judgments and the evidence supporting them are right.

In terms of targets, it is worth saying for those who are not focused on this 'rest of the market issue', we are talking about give or take 3,000 firms, about 700 of which are inspected in a year. The overall statistics do not work in quite the same way, although I could point you at our 2016 report, which says that looking at a high-level measure, we went from something over 50% of audits requiring significant improvements, to about 25%. That might be sampling difference. We do report those statistics around the results of our reviews in just the same way that you would expect of the FRC.

Our focus, because we cannot get around all of the population every year, is also to have a constant level of engagement with firms that are staying in the audit business. We are full of admiration and encouragement for firms staying in the audit business and make sure we have a series of touchpoints. It is not that you are inspected this year and it will be a few years before they are back. They will be in contact, and it is very important that, in building public confidence, we do that. If we look at specific areas requiring attention at the moment, I will just point you at the reality of what it means in this market. FRS 102 might not be a top-of-the-mind issue for the investors and sophisticates in the audience, but it is important if you are auditing in the SME market and you are thinking about explaining to the directors of a company how and why directors' loans, which they thought they were making interest free, are going to be reduced to a present value and a market rate of interest imputed to them. High quality audit is about making sure that what can seem to them as ivory tower accounting is telling you something significant. If you are making funds available to this business, that tells an economic story, and do you understand how profitable you really are? Some of the issues are actually really vital to the economy, and people understanding how small businesses perform, and that is what auditors are involved in doing. They cannot and would not just say, 'There is some mad standard come from ivory tower people from the FRC and the ICAEW.' Engagement with the FRC is really valued, but there are some different issues, but do not think they are not of great importance for the economy and the quality of reporting.

I would just say, at the end of my second question about views on audit quality, we have very conventional views on audit quality, which is about the reality of doing good audits as we understand them, but we also are always looking to think a little bit beyond the present. You will find in the work we have done working with the FRC and others in the Audit Quality Forum over the years, we are looking to address the real expectation gap issues. A high quality audit on its own is actually not that great, if people do not believe they are getting high quality and reliable corporate reporting, and we need to think about the system as a whole. It is not great to just have high quality financial reporting if people think that business is not doing the right thing. The latest iteration of the Audit Quality Forum is – and we see number of steering group members here, including not only Melanie and Janine [van Diggelden] but a number of others – saying, 'Actually, if things go wrong in business, people are always going to ask "What were the auditors doing about it?" or, "What could they have done about it? What issues could they have drawn attention to?"' Audit quality has a very broad sense, and do not worry if you are an audit firm, that does not mean you are going to be inspected on those grounds, but as an audit profession we need to make sure we are aware of the issues that affect the reputation of business.

IV. Challenges and Opportunities in Audit

The third question was, 'What are current challenges and opportunities for the future of the audit profession?' It is obvious to talk about technology. At a certain level, you can talk about how technology affects the audit and how we square that with standards, which is an obvious first question. However, I think we would want to think about those in a more fundamental way, firstly by thinking about the real impacts on businesses, and that is, fundamental to the risk assessment that underpins the audit, and whether we are sure – which plays to one of Melanie's themes – that unless we have people who are doing auditing who have a real appetite and understanding of business, they are never in this rapidly changing world going to be able to do good audits, and the power of technology to undermine or transform business models is very important. We are also aware that this is very important, in terms of how people do audits, and we have put out a recent publication on data analytics in auditing, which has been widely admired and commented upon. We went to talk to people in all the firms about what the firms are actually doing. The interesting reflection we had, was that if we had the technology that we have now, we would not have the audit that we have now, that was developed when we were writing the standards. That is a challenge for anyone in a regulated industry. We have just about sorted out how to regulate it and society, business and technology change the basis of doing it.

A lot of that traditional story we have had about not being able to look at everything, to lower expectations, however people are managing to look at everything, so what does that mean for the basic response that you cannot look at everything, and how do we do economic audits? This led us to think about setting high materiality levels, doing as much control testing as we can so that we have to do as little substantive testing as we can justify, and then using sampling to minimise the work so it is economically viable. That technological model which underpins audit is being threatened, and we need to be alive to that issue, and recognise that we might be able to meet some of the expectation gap issues we have always said were impossible to address.

A final area where we are really in our Audit Futures initiative thinking quite seriously about is the changes we face in the very structure of how audit firms work. Again, we have a very long-established model which has been around for 40 years as to what an audit firm looks like in terms of its structure. It is well-known; but actually how does technology change that? These are deep issues that ultimately, in fact, the regulator serves.

V. The Implications of Brexit

The final thing, with virtually no time to talk about it – thank goodness – is the implications of Brexit on the profession. First of all, there is a big risk, and we can think about it as a professional body that there is a potential loss of automatic recognition of our members across member states. That is vital to us, and there is no reason in substance why that should go whether it is hard Brexit, soft Brexit or anything else; because the substance is the reputation and regulation of the profession in the UK means that that equivalence should apply whether or not we are in the single market. However, as well as talking about that short-term, we also need to bear in mind that actually if you cannot get mobility of auditors, that might really affect audit quality. Let us not forget that. It might be far more difficult to do European audits, and it might be that we also, in worrying about the implications to the profession, forget the fact that this is a huge period of business uncertainty and change and when that happens things happen which mean people ask, 'Where were the auditors?' Therefore, we should not lose track, in all this, of how we maintain the quality of audit, because of the ability of audit firms to manage themselves to deliver effectively to deliver quality, and what are the audit risks that are coming out of this period of uncertainty?

How Audit needs to Support Investor Needs now and in the Future

Jeannette Andrews

Corporate Governance Manager, LGIM

I. Introduction

Thank you for inviting us to speak at this event this afternoon. We certainly feel that auditors have a unique role in the governance of the companies in which we invest. Auditors are appointed by shareholders, they work for shareholders, and yet they are embedded within the organisation looking at the gritty details of the business. It is for this reason that it is so important that the auditor is independent, has appropriate professional scepticism of the details at which they are looking, and is both willing and able to challenge where appropriate. If these elements are in place, shareholders place considerable weight on the assurance provided by such an independent and high-quality external audit. We consider this to be essential for well-functioning public markets.

Since 2011, we have worked with other investors, the FRC and various stakeholders, including many in the room today, to improve the quality and trust in the audited financial statements. The FRC's July report on the developments in audit, which we are talking about today, has clearly demonstrated the result of some of the regulatory changes that we have been pushing for. Audit firms are perceived as more independent and competing for engagements on quality grounds, as Melanie has discussed. We think that is crucial for improving the assurance you are providing investors and for the functioning of the markets in which we invest. We were extremely supportive of the EU statutory audit directive, and despite some initial scepticism from the market at the time, we are pleased to see that most companies and all the audit firms we have spoken to have really embraced the challenges laid out in this directive.

In particular I am going to talk today about the audit tendering process, the non-audit fees, and the extended auditor reporting, which has really revolutionised the way in which we look at the auditor's report.

II. Audit Tendering

In terms of the audit tendering process, we really feel that the way it is conducted at the start can set the tone of the relationship between the auditor, the board, the audit committee, the management committee, and, of course, shareholders for the whole length of this relationship; which can be up to two decades under the regulations. That definitely is not a short period of time. It is something that we support, with regular retendering, but shows the importance of getting the audit tendering right from the beginning.

We have seen quite a large disparity between the quality of the audit tendering currently being conducted in the UK market. We have recently published a very short, three-page document, of which I have a few copies here with me today, on what we consider to be some of the better practices we have seen from the companies we have been speaking to. The report is also available on the LGIM website.

For us, most importantly, it is for the audit committee to have responsibility and ownership for the audit tendering process and be able to demonstrate this to investors. For that, we would like to see improved transparency regarding the process itself, both before and after the tendering. Prior to the tendering process, we would like to see in the audit committee's report, plans on how the tendering will be conducted, confirmation that the audit committee as a whole will be leading this process, a timetable and who will be invited to participate, but most importantly, we would like to see an acknowledgement that conflicts do exist.

Conflicts exist everywhere, but the perception of conflicts in the audit profession, between the auditors and the companies, can be really damaging to investors' trust in the audit process. Perceived or actual, we want to understand how these conflicts are being identified and then if appropriate, managed and possibly mitigated. We see many conflicts when we look at audit tendering. For example, audit committee members, are often already qualified auditors. The board or executive team may have previously worked for some of the audit companies which are being invited to tender. Or, does the company receive great advice from an audit firm, that they do not want to lose if that firm has a successful bid for the audit? Also, there may be conflicts within the auditors and the audit teams. Most companies are pretty good at looking at whether or not there may be relationships of perceived conflicts internally, but are not necessarily so proactive in identifying whether the teams that are coming in to undertake the tender may have conflicts.

Post the completion of the audit tender, shareholders would like to know why the successful firm was selected. Some companies are doing this brilliantly, but many companies are still just saying, 'We did an audit tender and X has been appointed from year X.' Actually, we would like an explanation of how that firm met the requirements for audit quality, and where they excelled. We think it is in the interest of the audit profession to remind the audit committee and the corporate reporting team that shareholders are interested in this information and it can create the foundation of trust and independence in the audit going forward.

III. Extended Auditor Reports

Additional disclosure by the audit committee, and by the auditors in the extended audit report, has also gone a long way in restoring and building trust in the independence, integrity and objectivity of the audit process. We foresee that more information on the tender process itself will add to the work you are already doing in communicating with your end-clients, who are essentially ourselves.

Now, Melanie has already mentioned how helpful the extended auditor reports have been to us as investors, and it has been a revelation. All I can say is please, please make sure you keep up the good work. It has become a must-read section within the report and accounts. When I open the report accounts, I will read the Chairman's statement, the board evaluation to see how the Board have been performing, and then I will read the statutory audit report to shareholders. My key message is that the information is useful; we are reading it. My colleagues in the investment teams are also reading it. When I sat for the chartered financial analyst exams, and when I first looked at corporate reports, many years ago now, I was told, 'Do not worry about the audit report, all you need to look at is the last sentence. If it is qualified, then there is a problem, but apart from that do not even bother reading it.' That is what we were told. Now, within such a short period of time, within the second or third reporting cycle, it has changed from a piece of paper in the report that nobody looked at to becoming essential reading. That is not just because of the disclosures about the risks and the judgments, but it is also about educating the markets about what you do and why you are important to the assurance and functioning of the capital markets.

We like to see audit reports with real conclusions, that provide some sort of indication as to the level of agreement or not between the auditor and the audit committee, and where you really are clear about what are the major risks and judgments. It is always nice when you see an auditor's report and it says, 'The most material risks and judgments we have written about first, and then the less important ones are at the back.'

We are seeing a change in not only how investors perceive auditors but also how audit committees perceive auditors. I spend a lot of my time meeting chairmen and non-executive directors of companies. Last year we held over 500 meetings with board directors of public companies. When the Corporate Governance Code first changed in 2012[?] and required companies to think about tendering, one of the first companies I spoke to about their tendering, I asked about materiality thresholds and how that had been assessed in the tendering process. The answer I got back was, 'We did not look at it, because it did not matter. All the auditors use the same materiality threshold. It is the same across every industry, across every sector, so why would we be looking at materiality?' Now, because we have the extended auditor reports, we can see exactly why materiality matters and exactly how it differs between different companies depending on where they are and what issues they are experiencing at the time. Audit committees do not tell me that materiality does not matter now. They know it matters, because you tell us that it matters, so you are already changing the dialogue we are having.

In the auditor's report, we would like to see more and continuing innovations in the use of graphs and colours and graphics, which makes it a lot easier to read, than 15 pages of text. And some of them are now getting very long!

Also, when you are writing your audit reports, please be aware that the readers are not auditors. We are generally not accountants, and I am entirely guilty of this when I talk about governance, use siloed language that nobody else understands. However, the accessibility of the information to the ordinary investor is critical, and it goes back to the original point: breeding trust in the audit, demonstrating your independence and objectivity. An example from one of this year's audit reports talked about a key judgment the company had used in recording an asset as an associate as one of the key risks. I said, 'Fine. What does this mean? Why are you spending three paragraphs talking about holding this as an associate?' It was not clearly explained that because the holding was just under 20% it needed to fulfil certain other criteria, because it would normally be held as an investment. Now, you know that. And I know that I should have gone and looked at it, but if that was explained then I would not have missed it first time around. Hands up: I missed it the first time around! We would like you to consider really carefully the language used, and perhaps to explain some basic accounting rules as to why it is important.

Finally, do not forget, this is the auditor's message to your shareholders, to your clients directly. Therefore, for us it is really important that you decide what goes into the report, and not the company.

IV. Non-audit Fees

Touching quickly on non-audit fees, as that is part of the regulation that will be coming in fairly shortly. Persistently high non-audit fees is something we have had problems with for many years, and we are very supportive of the new rules and the attention it has brought on the issue of non-audit fees. It has really focused the attention of companies. For LGIM's policy, we look at anything over 50% of the audit fee. So if non-audit fee is greater than 50% of the audit fee for two consecutive years we will look at that very, very closely when we take our voting decision. That is because when we look across the pond at our US companies, we see extremely low levels of non-audit fees as being 1 to 3%. High levels of non-audit work is an issue. It is another conflict that does not need to be there. This is about reducing perceived conflicts of interest, and that is why it is important.

V. Cyber-security

Just before I finish, in terms of the future developments in audit, we have spoken a lot about technology. We are doing a lot of work on cyber security at the moment, and looking at the assurance that can be provided on companies' cyber security risks. We have been asking for many years for companies to undertake an independent assurance on their cyber security, and it is a challenge where technology is driving ahead of the regulatory regime.

VI. Management Adjusted Numbers

I also just wanted to raise something that has come up with a number of companies, and that is the difference between the IFRS reporting numbers at the back end of the report and the non-GAAP or adjusted numbers at the front end of the report. It may demonstrate my limited knowledge of accounts and audits, but the use of the management-adjusted numbers is a growing concern for us, particularly if there is a large disparity between the reported number and the management number. The question we ask ourselves is, 'When does ten consecutive years of restructuring charges become no longer exceptional?' We recognise, at the moment, that it depends, but it is an issue we are beginning to look at with increasing interest and as companies use these numbers more and more in their remuneration structures, in reporting, internal capital allocation etc., it is certainly something investors will seek more assurance on.

European Perspective on Audit Developments

Ralf Bose

CEO, Auditor Oversight Body, Germany

We are unable to publish Ralf Bose's speech due to restrictions on his organisation

Questions & Answers

Stephen Haddrill

We had some carefully crafted questions, but I think you are going to ask much better questions than I am going to. Please start thinking about them. Just to summarise, very briefly, I thought there were some really powerful messages there. The importance of audit quality, the importance of the firms putting in a consistently strong performance. Jeannette's points about disclosure and what you want to know about materiality, but also how was the auditor chosen and how was it conducted. We heard a little bit about the international environment. We are not an island here – well, we are an island, but Robert talked about the internationalisation of the profession and Ralf about the European perspective. It was really interesting to hear what Ralf had to say, both about the importance of looking at the firm as a whole and the challenges that gives to independence. Also, we have heard something about the benefits of technology here, but we need to not be blind to some of its shortcomings.

There is plenty to think on. This is your opportunity to put some questions to the panel, or indeed to me.

Bob Forsyth, Head of Audit Quality, EY

A question to the panel as a whole, but Melanie, the benefit of being expected is not something that should be underplayed, given the progress that has been made. The audit partners now think, generally when they are doing the audit, what the inspectors' view would be. It is a basic benefit and pleasure, that I think we share. I wonder what the view is, perhaps, about sharing that with the audit committee chairs, such that at the moment when an inspection team starts an inspection they will speak to the audit committee chair, but should they be holding that audit committee chair accountable for best practice – as you hold us accountable – in terms of their audit committee report and fulfilling the role you have described in ownership of the audit relationship, tender, etc. Is that something that you think progress can be made on.

Melanie McLaren

We have taken some steps. Of course, there is not a regulatory regime that holds individual audit committees to account, but we have learnt over two and a bit decades in the UK the power of comply or explain, and the use of the corporate governance code, and that depends upon the users of the financial statements, and investors in particular, holding the entity to account for its governance overall. Some of the things that Jeannette has been talking about are just indications that there is an intent, on behalf of investors, in their stewardship activity, to try and further some of that holding of audit committees to account.

We have also got to be realistic about what an audit committee can do. The benefit of an inspection is that we can lift the lid and get inside the audit files. I would not ever think we would get to a stage where we would have an expectation that an audit committee would have that in-depth understanding and quality of evidence about what has happened in an audit. However, I certainly feel that we probably have more that we can do as an organisation, to help support audit committees in better efforts, to support what they now need to do. Particularly, as Ralf has already touched on, in those entities where they have not had the benefit of a corporate governance code approach, so have not had some of these requirements set out for them in quite a structured way that has evolved over time. That, of course, is in the more directly financial services regulated arena, so some of the smaller banks and smaller insurers. We have also got to try and work with the likes of the PRA and the FCA in terms of making sure that journey works through, so we are all working towards effective audit committees.

Jeannette Andrews

I have been nodding through most of what you said, but one point that I would add is that, as investors, we hold the board as a whole accountable for the decisions that are taken in the individual board committees. What do I mean by that? In the UK we have a committee structure for our corporate governance, so each individual committee may look in detail and depth at a particular issue, whether that be remuneration, succession planning, audit and accounting risk, sustainability, but ultimately it is the board that is accountable. Often when we are meeting with companies to talk about governance and what the board has been doing, we will meet with the chairman, and we expect the chairman to be able to talk to us about the actions and decisions of the audit committee and the remuneration committee, even though they themselves might not be a member of those committees. It is a really good example that even though the detail may be discussed in these committees, ultimately we are holding the board as a whole responsible.

Stephen Haddrill

Jeannette, we have cooling off periods for partners joining, does that satisfy you?

Jeannette Andrews

This is a question that, as investors, we have really struggled with, and I myself have struggled with, because on the one hand we are asking boards and committees to be comprised of people who have appropriate skillsets in the area of the business and their responsibilities as directors, and that includes knowledge of accounting and audit regulation and oversight. Particularly if you are on the audit committee, not only does it make sense that you have some sort of accounting and audit knowledge and experience, under the corporate governance code you are also required to have at least one person with that experience. Yet, you have the obvious conflict that if you are an ex-partner of that audit firm and you appoint that auditor.

With rotation of the audit, the competitive nature of the industry has not really been discussed, but in reality there is a limited choice. Therefore if you have two or three ex-audit partners on your audit committee, because you want to ensure you have appropriate skills and expertise, there is likely to be some crossover. We do not think a cooling off period in and of itself can remove the perceived conflict, because if you have worked in the organisation for 20 years, if you have left two or three years ago, it is neither here nor there. Sabbaticals are sometimes longer. That is why we have concluded that actually transparency and discussion of these conflicts early on in the rotation process is the way forward, to at least acknowledge that these conflicts exist, which currently has not really come forward in disclosure to date.

Robert Hodgkinson

Just a point on the excessive use of the phrase conflict of interest. The way that the ethical codes talk about this is there are threats to objectivity, and it is a little bit because naturally they want to advance the interests of their former audit firm, and they also have a duty as a director to do something else, is presented to me as a conflict, whereas it is in fact a potential threat to their objectivity. Actually, risks cause seeing problems in the framing of the issue, which actually miss the point. Because there are people dealing with people, there are always threats to objectivity. We understand from behavioural economics all the threats, all the natural biases there are, and you want auditors that are live to them and that have controls and procedures and a personal awareness to deal with them.

We should not just assume that there is a conflict of interest, because that in a way accepts a very depressing view of humanity, that people have no professional integrity, they are just victims of their interests. Let us not lose sight of the fact that one of the great strengths of the UK audit profession is lots of auditors are good enough at business that people want them on their boards. Auditing professions who have nobody as CFOs of major companies, nobody as chairmen of companies, nobody as chairs of audit committees, I do not think has overall stronger governance, but you could be absolutely delighted at the lack of conflicts of interest. What this is proving, is that the auditors doing the audit probably do not have the capacity to get a job in a corporate environment, and that is not a good thing. Let us make sure we see the bigger picture and I hope people will say that it is actually a great strength of the UK auditing profession that we generate so many people who have apparent conflicts of interest to subsequently manage.

Stephen Haddrill

It is a complex question, but public disclosure, I would say, is probably the message I take from that.

John Aston, Brunel University

A very quick question: do you think mandatory audit rotation and the increasing regulatory framework will push up audit fees?

Melanie McLaren

It is interesting that you pose the question that way around, because actually the risk we are often told about, particularly by the audit firms, is that they are concerned that because of the increased competition, there might be a race to the bottom in terms of audit fees. We are certainly staying alert in our monitoring of how this regime is bedding down. Are audit fees holding up? In the UK, we have set out in our report that generally they are. One of the reasons that has been able to happen in the UK is that investors have consistently said they are prepared to pay for a high-quality audit, and if there is competition on quality then they will pay for it. We will need to wait and see over time as to where audit fees go.

What the firms are increasingly telling us is that we have to be realistic. This change has fundamentally changed the business model of audit. It is no longer an annuity with several hundred years’ tenure. There are 20 years, and therefore you need to think about the investments you are making and therefore the remuneration you are going to get over that 20-year period. We are all learning, currently, that the on-boarding of some quite large, global, complex audits over a short period of time can actually be quite an expensive process, both for the audited entity, and for the auditor. It may well be that we see some increase in audit fees, simply to reflect that the business model has changed and there are some increased costs. We will certainly be monitoring that quite carefully.

Jeannette Andrews

I agree, when tendering is undertaken we would like the company to concentrate on audit quality. That is not writing a blank chequebook. Fees should be looked at before signing on the dotted line. However, we do not see audit as an expense or cost of doing business; we see it as a necessity, and an asset that high-quality audit and assurance over the numbers that are presented and the use of the capital is a benefit to investors. This is a balance, and companies have been struggling with that balance as they undertake their tenders, to ensure that costs are coming in at an appropriate time in their decision.

Devon Brooks, Northern Trust Corporation

There has been a lot of discussion in the industry, at various levels, about auditing culture. That is included in terms of audit firms. I wanted to get some perspective on what parts of culture are considered the most auditable, and fit into the audit quality that I keep hearing about, and does that for external audit firms potentially bring risk if they declare a culture appropriate, ethical or whatever the case may be, and a scandal breaks out a short time later at that firm?

Stephen Haddrill

The FRC has just produced a report on culture, and we did look at the issue of metrics in that. I suppose the conclusion that we draw is that metrics are important, as your starting point for measuring and potentially for auditing, although I think there is a big question over whether this is an issue we expect the auditor to look at. The metrics are important, but metrics have to be company specific. They have to be devised in such a way that they really say to the board something about whether or not the company is really getting the culture that the board has, through its responsibility, interpreted once. Therefore, I think we should wherever possible try and avoid one-size-fits-all separate metrics, and encourage boards to think quite hard about what the values and behaviours of the business are that they want, and on the back of that report to investors against those metrics rather than a standardised set. The value of audit in that? Auditors should be talking to the board about what they see and feel in the company. There are risks there that the auditors should be highlighting, but there is a bigger question about the scope of assurance and perhaps we can address that over drinks in a minute.

I am very grateful to the panel, not just for their contributions now, but for being willing to stay on, and I hope you will be able to ask them about some of these issues future, over a drink, very shortly. Thank you very much to the panel.