A Conversation with a Regulator:

Meeting with Paul Boyle, Chief Executive of the Financial Reporting Council

Paper prepared for the Audit Committee Chair Forum
by Dr Ruth Bender, Cranfield School of Management

The Audit Committee Chair Forum (ACCF) is convened by the CBI and Ernst & Young and is facilitated by Cranfield University.

The Forum comprises a select group of audit committee chairs from the UK's leading companies. Our aim is twofold, namely:

- to influence the direction of regulation as it impacts audit committees, and
- to act as a vehicle to develop points of view and best practice.

The Forum provides an opportunity to contribute to the debate, influence its direction and improve the performance of audit committees.

The Forum is currently chaired jointly by Richard Wilson, Senior Partner at Ernst & Young, and Martin Broughton, President of the CBI.

This is the tenth paper produced by the ACCF. Previous papers include:

- The role and function of the Audit Committee
- The drivers of audit quality
- What is an effective audit and how can you tell?
- Audit Committee regulation: 'Financial literacy' – what does it mean?
- Audit Committee communication: What is said, why, how and to whom?
- The role of the Audit Committee in risk management
- The role of the Audit Committee regarding non-audited information
- The Audit Committee and the credit crunch
- Risk management in a cost-cutting environment

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Executive summary

- **Confidence in corporate reporting**

  It is important that confidence in the quality of corporate reporting is maintained, to avoid the current financial crisis turning into an accounting and auditing crisis as well.

  A major obstacle is the complexity of corporate reports, brought about in part due to the multiple stakeholders they now address.

- **Corporate governance and the Walker review**

  The banking crisis and the commissioning of the Walker review brought forward the timescale for a review of the Combined Code.

- **Effectiveness of audit and auditors**

  The AIU has made public its high-level reports for the first time. There was some uncertainty from the audit committee chairs as to how these should be received.

  A duty of the audit committee is to review the effectiveness of the auditors. This is an essential task, but not an easy one.

  Were one of the Big Four audit firms to leave auditing, there would be significant problems for companies and regulators. However, it is difficult for audit committee chairs to know how to address this.

- **Increased liaison with auditors**

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- **Corporate governance and boards**

  Governance is about board behaviour; mere adherence to codes and standards is not sufficient on its own.

  Governance might be improved if Board members were to undertake more structured professional development.

- **Going concern**

  The recent publications of the FRC on going concern were considered to have been very helpful, both to audit committees and to auditors.

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Introduction

This paper reflects the discussions at a meeting of the Audit Committee Chair Forum (ACCF) held on 19th March 2009, which was addressed by Mr Paul Boyle, Chief Executive of the Financial Reporting Council.

The meeting was attended by 13 chairs of the audit committees of leading companies, and three audit partners and one director from Ernst & Young and two CBI representatives.

The Financial Reporting Council

> *"Some people think that regulators decide on the train on the way to work: Who are we going to annoy today? That's not the way we do it at the FRC!"*
> *[Paul Boyle]*

The evening opened with a talk by Paul Boyle, addressing a wide-ranging review of the FRC's activities. (Appendix 1 sets out an overview of the FRC organisational structure.) In this, he explained the regulatory approach adopted by the FRC, whose mission it is to provide confidence in corporate reporting and governance. He pointed out that the current economic crisis was a financial crisis, and differed from the collapse of confidence after Enron and WorldCom; the FRC's intent was that it should not turn into an accounting or auditing crisis as well.

The FRC understands the need for an adequate supply of skilled and experienced people willing to serve on corporate boards, and tries to ensure that it does not discourage that.

Mr Boyle went on to discuss the FRC Draft Plan for 2009/10, in which it sets out what it sees as the most significant risks to confidence in corporate reporting and governance.[1] Paraphrasing from that Plan, he outlined these risks as follows:

- **The current financial crisis**

  Threats to the way goverance is implemented (although the Combined Code itself is sound).

  May be a tendency by companies to push the boundaries in financial reporting and in goverance.

- **Auditing and reporting**

  The current economic situation makes reporting more challenging, in particular as regards valuations, accounting estimates, and going concern issues.

  High level of concentration in the audit market, and the potential problems were one of the Big Four accounting firms to fail.

  The quality and complexity of global financial reporting standards were discussed, and there were concerns around the convergence agenda.

- **Actuarial standards**

  Serious threats to the ability of people who use actuarial information to actually understand what is being communicated.

He went on to discuss the review of the Combined Code, announced the previous day, which was being conducted as a response to the current reviews of banking regulation. [2]

Following these brief comments, the debate broadened as ACCF members responded to his remarks and introduced other topic for discussion. These are summarised in the rest of this document.

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1 *See text of FRC Draft Plan 2009/10 at http://www.frc.org.uk/documents/pagemanager/frc/Draft_plan_200910_December_2008/Draft%20One%20Year%20 Plan%20-%20Long.pdf*
2 *The call for evidence for the review of the effectiveness of the Combined Code is at http://www.frc.org.uk/corporate/reviewCombined.cfm*

Confidence in corporate reporting

> *"Who are we reporting to? And for what?"* [3]

> *"I know for a fact that analysts don't read [these notes to the accounts]. Who does?"*

The first issue raised was that of the complexity of corporate reporting, and the feeling amongst many that the financial statements are losing relevance for many investors and analysts. It was argued that finance directors issue results according to the financial reporting standards, and then feel obliged to explain separately what the company 'really' did. This is unsatisfactory.

One of the problems is seen to be the multiple audiences for financial reporting, all of whom appear to have slightly different requirements for information, which leads to annual reports becoming thicker and thicker, to little advantage.

Mr Boyle agreed with the basic premise of the discussion, and pointed out that the FRC was taking steps to address it. He highlighted the ongoing project to review the complexity and relevance of corporate reporting (see Box 1) and said that a report from that group is due to be issued very shortly. However, in an elegant analogy he argued that a car manual designed for the average motorist contains very different information to one designed for the garage mechanic, but both are useful. There is a need for financial reports to address multiple audiences, and the days when individual shareholders were seen as the only users of financial reports are long gone.

Box 1 – Project to Review the Complexity and Relevance in Corporate Reporting

The FRC Plan & Budget 2008/09 includes a project to review the complexity and relevance of current corporate reporting requirements ("the complexity project"). The complexity project will consider whether corporate reporting requirements are disproportionate to their intended benefits and whether there are opportunities for improvement. It will address the risk that these requirements, and related influential guidance, are contributing to the increasing complexity of corporate reports without making them more useful or understandable."

http://www.frc.org.uk/about/complexity_panel/index.cfm

Further discussion on the topic led to general agreement that the route taken by the IASB had led to additional complexity, and that the convergence agenda was probably unnecessary. It was argued that over the last decade the depth of liquidity in European capital markets has increased, and the financial world not solely dependent on liquidity in the US capital markets. Furthermore, both IFRS and US GAAP exist in both of these markets, albeit in rather different proportions.

The EU does not require a reconciliation to IFRS for US GAAP accounts for those US companies listed on EU markets, and the US no longer demands a reconciliation to US GAAP for IFRS accounts. Given this, Mr Boyle commented that there was no need for full convergence, and that the focus of the IASB should be to make IFRS as good as they could be, rather than changing to converge with US GAAP. In that way, IFRS could have continued in with its more principles-based style leaving the US to join IFRS if and when it was ready.

3 Unless otherwise stated, all quotes are from audit committee chairs

Corporate Governance

The Walker review

> *"To the extent that there are banking issues, [we should] address those in banking regulation and not use them to ratchet up general goverance."*
> *[Paul Boyle]*

In the light of events in the banking and financial services industries, Sir David Walker's review of corporate governance in the UK banking industry commenced in February 2009, with the aim of producing a consultation document in the summer, with conclusions in autumn 2009. Its terms of reference are set out in Box 2.

Box 2 – Walker Review of Corporate Goverance of UK Banking Industry

The Terms of Reference for the review are to examine corporate governance in the UK banking industry and make recommendations, including in the following areas:

- the effectiveness of risk management at board level, including the incentives in remuneration policy to manage risk effectively;
- the balance of skills, experience and independence required on the boards of UK banking institutions;
- the effectiveness of board practices and the performance of audit, risk, remuneration and nomination committees;
- the role of institutional shareholders in engaging effectively with companies and monitoring of boards; and
- whether the UK approach is consistent with international practice and how national and international best practice can be promulgated

http://www.frc.org.uk/about/complexity_panel/index.cfm

Several questions from ACCF members related to the Walker review, and the recently-announced review of the Combined Code.

Mr Boyle pointed out that there were clear overlaps between the terms of reference of the review and those of the FRC. Risk management, board practices and institutional shareholders are all mainstream corporate governance issues. Accordingly, the FRC had the choice of waiting for Walker's conclusions and then reacting to them from a general governance point of view for all listed companies, or working in parallel with that review. It was determined that it would be more appropriate to work in parallel, hence the announcement of a review of the Combined Code (see Box 3), rather earlier than would normally have been the case. This way, in theory, banking solutions could be found for banking problems without affecting the rest of the governance regime.

Box 3 – Review of the effectiveness of the Combined Code: Call for evidence

On 18 March 2009 the Financial Reporting Council announced the latest in its series of regular reviews of the impact of the Combined Code on Corporate Governance. It stated:

"While there is no assumption that the Code is fundamentally flawed or that a different regulatory framework for corporate governance could have alleviated the financial crisis, we are clear that the time is now ripe for testing the Code's content and application against the fresh thinking that the crisis must provoke.

The FRC will liaise closely with Sir David Walker's review of the governance of banks and share relevant research and information."

Views are invited on these questions:

- Which parts of the Code have worked well? Do any of them need further reinforcement?
- Have any parts of the Code inadvertently reduced the effectiveness of the board?
- Are there any aspects of good governance practice not currently addressed by the Code or its related guidance that should be?
- Is the 'comply or explain' mechanism operating effectively and, if not, how might its operation be improved?

http://www.frc.org.uk/corporate/reviewCombined.cfm

Corporate goverance and boards

> *"The focus really needs to be around how people behave on boards."*

> *"It's not about the reporting, it's about where the style of the boardroom does not enable discussion. It's a behavioural issue."*

Discussion of the review of the Code led naturally to a broader discussion of corporate governance of listed companies. Several ACCF members voiced opinions that the focus of the FRC needs to be on directors' behaviour rather than on the rules themselves.

As an example, it was pointed out that the current banking crisis was not caused by failures of reporting or rules, and 'better' reporting would not have made any difference. These were problems created by undertaking major transactions which went wrong.

The discussion on boards and governance covered two further issues. The first reflected the variety of activities in which the board and its committees need to have input and oversight and suggested that this demands boards with a wide range of skills. It was noted that it is difficult to put that specifically into the Code. The second point related to the increased requirements of independent (non executive) directors (IDs), and the need to raise the level of professionalism still further. In this respect, it was thought that current requirements for training and continued professional development could be improved. Some of those present considered that the major accounting bodies should lead the way in providing guidance in this area for their members who are IDs.

> *"If you don't have the technical expertise, you either step back and don't do the job, or you go and get that technical expertise."*

Effectiveness of audit and auditors

"Anyone who says that audit should be done more cheaply is making a mistake." [Paul Boyle]

There was considerable debate about auditor effectiveness and how IDs can evaluate this, as summarised below.

Audit Inspection Unit reports

"Is the onus on the FRC rather than on the individual audit committees to make of it as best they can?"

In December 2008, for the first time, summary reports of the Audit Inspection Unit on the seven largest auditing firms in the UK were made public. [4] Extracts from the forewords to these reports are summarised in Box 4.

Box 4 – Extracts from terms of reference of AIU in public reports

"This is the first year the AIU has reported publicly on individual firms. In the past the AIU issued an annual public report in which the principal findings arising from its inspections of the major audit firms in the UK were dealt with on an anonymous and aggregated basis.

"The AIU exercises judgment in determining those findings which it is appropriate to include in its public report on each inspection, taking into account their relative significance in relation to audit quality, both in the context of the individual inspection and in relation to areas of particular focus in the AIU's overall inspection programme for the relevant year."

"All findings requiring action set out in this report have been discussed with the firm together with the firm's proposed action plan to address them. Appropriate action may have already been taken by the date of this report. The adequacy of the actions taken and planned will be reviewed by the AIU during its next inspection of the firm."

There was no common view in the meeting as to how useful the public information was, or what should be done with it. The audit committee chairs were uncertain as to how the information should or would affect their decisions.

The publication of these reports, which do not include any detail of the individual audit clients, was supplemented by private letters from the AIU to the audit firms, giving the individual reports on those audit clients. The intention of the FRC was that these should be passed by the auditors to the chairs of the relevant audit committees, for discussion. The AIU inspection covers only a sample of companies, and of the ACCF members around the table, one had participated in such discussions, and one knew of another audit committee chair who had seen the report for his company.

4 The Audit Inspection Unit public reports can be found at http://www.frc.org.uk/pob/audit/firmreports.cfm

Assessing the effectiness of the auditors

"If you can't get confidence in the effectiveness of your auditor, you can't have confidence in the accounts."

"There are a couple of dozen companies out there that are so horrendously complex that I doubt if anyone really understand what's going on in them."

The Combined Code requires that audit committees conduct an annual evaluation of the effectiveness of the audit process, as set out in Box 5.

> **Box 5 – Review of auditor effectiveness**
>
> The Combined Code (2008) includes as one of the main roles and responsibilities of the audit committee: *"to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements".*
>
> The Guidance on Audit Committees, issued in October 2008 expands upon this requirement: *"The audit committee should assess annually the qualification, expertise and resources, and independence … of the external auditors and the effectiveness of the audit process. The assessment should cover all aspects of the audit service provided by the audit firm, and include obtaining a report on the audit firm's own internal quality control procedures and consideration of audit firms' annual transparency reports, where available. It might also be appropriate for the audit committee to consider whether there might be any benefit in using firms from more than one audit network."*

Audit effectiveness means different things when viewed through different lenses. [5] There was much discussion as to whether it was possible for a group of independent directors to evaluate the effectiveness of the auditors, given that those IDs are at a remove from the audit process. For some aspects, individuals in the finance department are better-placed to make such judgements, as they have day-to-day contact with the audit team.

Some of those present held the view that the IDs cannot judge effectiveness, as they only see the audit partner and senior manager, and not those who carry out the audit work. However, many at the meeting disputed this, and some argued that if an audit committee felt that it could not do a proper evaluation, then the audit committee contained the wrong mix of skills.

The ACCF held a two meetings during 2006 which addressed the issues of audit quality, and audit effectiveness and evaluation. [6]

5 For example, the ICAEW in its response to the FRC discussion paper Promoting Audit Quality refers to market quality, service quality, operational quality, and compliance quality, each reflecting the needs of a different stakeholder group. http://tinyurl.com/coeyaum

6 Copies of the report of those meetings - What is an Effective Audit, and How Can You Tell? and Drivers of Audit Quality - can be obtained from Andy Davis at adavis1@uk.ey.com

Danger of one of the Big Four firms withdrawing from audit

> *"I know it's a risk ." I know I should think about it. But I don't know what I should do!"*

Ever since the demise of Andersens, regulators have expressed concern about concentration in the audit market, and what might happen if another firm were to fail. The Guidance on Audit Committees (2008) states that the audit committee "should consider the need to include the risk of the withdrawal of their auditor from the market in their risk evaluation and planning".

Mr Boyle commented that regulators see this not as a competition issue, but in relation to the continued availability of high-quality audits. A lively discussion ensued, covering issues related to the Big Four firms, and the threats to the system if one were to fail.

The FSA published a paper in March 2009, alongside the Turner review in response to the global banking crisis, which considers this and sets out its views on setting up a global supervisory architecture for international audit firms. The background to this is set out in Box 6 below.

> **Box 6 – Reason for considering global oversight of international accounting firms**
>
> *"Reliable financial reporting, especially by companies – including banks – of public interest, is a critical factor in underpinning market confidence. A key element in this is the continued availability of high-quality audit services. In most jurisdictions the 'Big 4'accounting firms have a combined market share of audits of major companies in excess of 90%. Thus, it is important that everything possible is done to mitigate the risk of circumstances arising which might lead to one of the 'Big 4' having to exit the market for audit services."* [7]

Financial Reporting Review Panel

As part of the discussion on auditor effectiveness, the work of the Financial Reporting Review Panel (FRRP) was considered, and members discussed the detail into which that Panel sometimes seemed to delve. A minority view was put forward that this attention to minutiae was unnecessary.

It was noted that the FRRP letters are sent to the company Chairman and copied to the finance director, to ensure that queries are not suppressed. It is intended that the information will flow from the company Chairman to the chairman of the audit committee. The detail of these letters was considered useful.

Mr Boyle explained the philosophy of the Review Panel, pointed out how very few staff it has compared to its USA equivalent. He explained that sometimes it is necessary to address the minutiae of financial statements as this can lead to the unravelling of bigger issues. One ACCF member commented favourably on the reports received from the FRRP and stated how seriously they were taken by companies.

7 A regulatory response to the global banking crisis, Document reference DP09/2 issued by the FSA in March 2009 at http://www.fsa.gov.uk/pages/Library/Corporate/turner/index.shtml The section 'Global oversight of international audit firms' is on pages 111-2. Text quoted is from Box 5.3.

Financial reporting in the current economic climate

"It's jolly nice to get the attention of the board on going concern!"

In the current economic climate, going concern considerations are taking a much higher priority than they have for many years. Mr Boyle asked the ACCF members for their comments on the FRC's alert for directors on the reporting challenges, including going concern, arising from the current economic conditions published in December 2008.[8]

The overall view was that the FRC statement was a very good document, and had proved useful both to audit committees and the auditors. So too had the FRC guidance for audit committees.[9] They had guided good conversations between audit committee chairs and their finance directors. The Ernst & Young partners commented that the robustness of diligence done by companies in this area was higher than previously experienced.

In relation to the financial reports for December year ends, other FRC documentation was also considered to have been of use. The example was given of Review Of Goodwill Impairment Disclosures, issued in October 2008.[10] Having this document highlighted areas which the FRC would consider, which had helped finance directors and audit committees. Paul Boyle confirmed that this reflected the FRC's approach to regulation.

"The philosophy is not to catch people out. It's to alter the incentives so that people get it right first time." [Paul Boyle]

8 FRC alert for directors on reporting challenges http://www.frc.org.uk/press/pub1781.html

9 Challenges for audit committees rising from current economic conditions http://www.frc.co.uk/images/uploaded/documents/Challenges%20for%20audit%20committees%20November%2020081.pdf

10 FRC Review Of Goodwill Impairment Disclosures http://www.frc.org.uk/images/uploaded/documents/Review%20of%20goodwill%20impairment%20disclosures%20(Oct%202008)1.pdf

Questions to ask yourself?

1. What does my audit committee understand by the term 'audit effectiveness', and how do we evaluate it?
2. Does the style and culture of our board and committee meetings encourage discussion and facilitate good governance?
3. Is the balance of skills in our boardroom suitable for the company's needs?
4. What needs to be done by the audit committee in the next reporting period to confirm the company's going concern status?

Appendix 1
Overview of the Financial Reporting Council organisational structure