November 2012

Point of view

Our perspective on issues of concern

About this *Point of view*

Welcome to Ernst & Young's *Point of view* series. These documents express our view on current public policy and regulatory matters of importance to our stakeholders, our profession and the capital markets.

Enhancing transparency of the audit committee auditor oversight process

Our point of view

To promote investor confidence in auditor independence and objectivity, Ernst & Young believes there should be greater transparency of the audit committee's auditor oversight process so that shareholders have the information they need to properly evaluate an audit committee's decision to retain or change the auditor. To this end, we believe that shareholders should receive a report from the audit committee on a periodic basis detailing its oversight of the auditor and the audit process.

Context

In recent years, there have been an increasing number of calls from regulators, investors and other stakeholders for reforms to enhance auditor independence. Some policy makers and other stakeholders have expressed concerns about the perception of "coziness" between audit firms and the companies they audit. This is especially the case in instances of apparent very longstanding relationships between companies and external auditors.

In response to these concerns, some policy makers have put forth proposals for mandatory firm rotation or mandatory tendering. Both of these options paint with a sweeping brush. Their advocates take the position that after a certain number of years the auditor is de facto no longer independent and either the auditor must be switched or the audit put out to tender.

We believe a better and more meaningful approach would be to strengthen the audit committee oversight process and make it transparent to shareholders, to provide shareholders with a clearer picture of how the audit committee actually carries out its important responsibility to ensure that the auditor is both independent and effective. Over the past year, Ernst & Young has considered and reviewed the experiences of our member firms' partners regarding audit committee requirements and practices in 43 countries around the world. The findings support our belief that, while there are many effective audit committees in place, there is an opportunity to enhance audit committee oversight and reporting to shareholders. This *Point of view* explains our proposal for an auditor's independence and effectiveness assessment and report to shareholders that would be responsive to those findings.

In addition to enhancing audit committee transparency to shareholders, we also believe auditors should be more transparent by increasing the usefulness and informational value of the auditor's report. For more information on our views, please see our *Point of view* on auditor reporting (November 2012), available here.

Ernst & Young
Quality In Everything We Do

Ernst & Young's proposal: an auditor independence and effectiveness assessment and report

Starting nearly ten years ago, many countries implemented reforms that elevate the role of the audit committee in overseeing auditors on behalf of shareholders. To bolster this existing foundation, Ernst & Young believes shareholders should, on a periodic basis, receive a report from the audit committee setting forth the steps it has taken to assure itself, and the reasons it believes, that the auditor is right for the company, i.e., that the auditor is both independent and effective.

While the details could vary and be adapted to different jurisdictions and markets, our proposal for an auditor independence and effectiveness assessment and report envisions a separate role for the audit committee, shareholders, the auditor and regulators, and comprises the following elements:

Role for the audit committee: Audit committees should on a periodic basis conduct a robust assessment of the auditor's independence and objectivity. The proposed assessment would include the audit committee's consideration of the:

- Effectiveness of the external auditor, including whether the external auditor selected is in the best interest of the company and its shareholders and why.
- Independence of the external auditor, including any breaches that have occurred since the prior review and how they have been mitigated.
- Type and extent of non-audit services being provided by the external auditor and why the audit committee concluded these were appropriate to obtain from the auditor.
- Fees paid to the external auditor for audit, audit-related, and non-audit services and whether they are appropriate.
- The length of continuous tenure of the audit firm, the date of the last tender, and whether the audit should be put out for tender.
- The audit committee's involvement in the selection of the auditor's lead engagement partner and any other information about how they manage audit partner rotation.

Role for shareholders: Shareholders would receive and review the audit committee's report, which would include the details of the assessment. This would give shareholders the information they need to make their own decision about the auditor so that they can vote knowledgeably at shareholders' meetings. In some markets, it may be appropriate to give shareholders an advisory vote on the assessment report at the annual shareholders' meeting.

Role for the auditor: Auditors would have to sign off on the completeness and reasonableness of the assessment report.

Role for regulators: The audit regulator, either by itself or working with other appropriate authorities in its jurisdiction, would have oversight of the assessment process, as an extension of its responsibility for overseeing audit quality. The audit regulator or other appropriate authority would provide guidance for audit committees on how to assess audit quality. In addition, we believe that audit regulators should be able to recommend to the audit committee that the audit be put out for tender (or the auditor changed) in those rare circumstances where it has been demonstrated, through a disciplinary or enforcement process against a firm, that professional skepticism or objectivity was significantly lacking in the firm's audit of that particular company. This would preserve the oversight role of the audit committee while reinforcing the usefulness and seriousness of the assessment process and report.

Our proposal would give the audit committee a detailed framework for assessing the auditor, shareholders the information they need to properly evaluate the audit committee's decision to retain or change the auditor and the regulator additional tools to promote auditor independence. It would achieve these objectives without the downsides of mandatory tendering or mandatory audit firm rotation. In addition to demonstrating the rigor of audit oversight, the assessment combined with disclosure also could help strengthen governance in those jurisdictions with less developed audit committees.

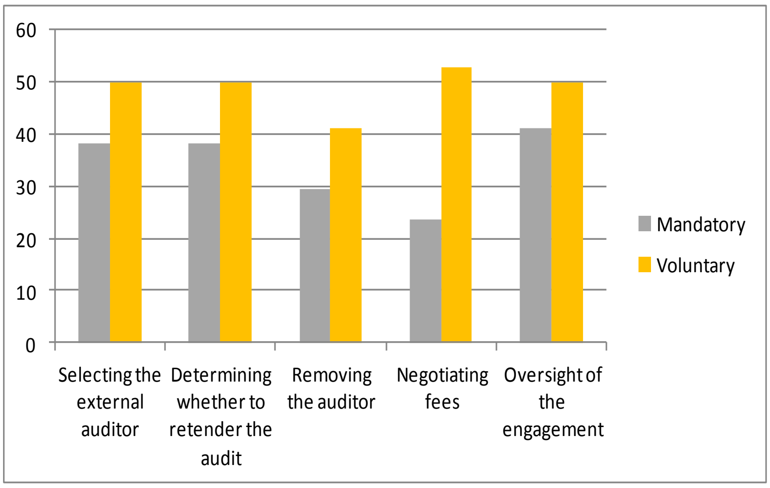
Key points: benefits of our proposal

► **Audit committee oversight of the external auditor is fundamental to auditor independence and effectiveness and should be strengthened where possible.**

Our proposal builds on reforms put in place almost ten years ago following a wave of corporate frauds. Because of these reforms, audit committees in many jurisdictions are well placed to conduct the type of auditor assessment we propose. In some jurisdictions, audit committees already conduct periodic evaluations of the auditor. Where this practice exists, it would be a good basis on which to build the more robust assessment and reporting process that we recommend.

Audit committees in practice have oversight of the audit engagement in almost 90% of the countries we informally surveyed. Their oversight responsibilities are wide-ranging, and may include selecting the external auditor, determining whether to retender the audit and negotiating audit fees. In many cases, however, these responsibilities are not mandatory but are carried out on a voluntary basis only. There is therefore an opportunity to encourage good practice more widely.

Fig. 1: Mandatory and voluntary audit committee responsibilities (% of countries surveyed)



► **There is room for expanding audit committee oversight of non-audit services.**

Audit committees generally have responsibility for the oversight of auditor independence. However, in many countries this does not include oversight or pre-approval of non-audit services provided by the auditor. For example, only one third of the countries we surveyed require audit committee pre-approval of non-audit services. In many countries, however, audit committees do this voluntarily.

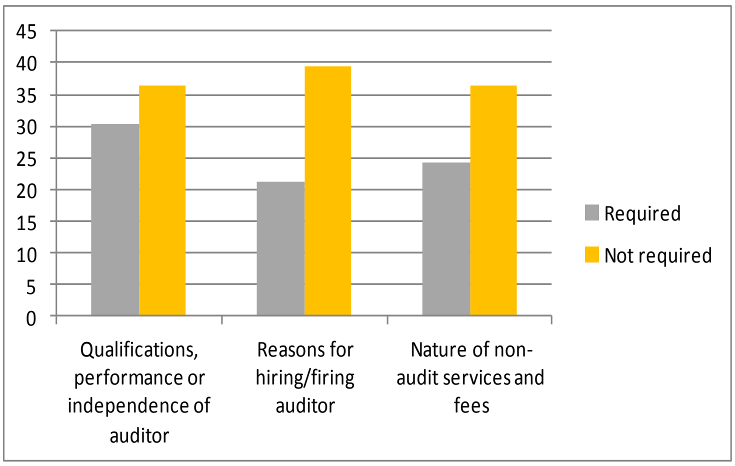
Our proposal would strengthen audit committee oversight of non-audit services. We propose that audit committees make a deliberate and considered decision as to which permissible non-audit services – those services that would not risk compromising the auditor's independence – the company needs and would like to obtain from its auditor. Audit committees should be thoughtful about this decision and transparent with shareholders about what they think and why. They also should disclose fees paid for non-audit services and whether they are appropriate.

Our survey shows that in jurisdictions where there are both clear prohibitions on services that are problematic, along with requirements for audit committee pre-approval for permitted services, audit committees are able to oversee non-audit services effectively.

► **There is substantial opportunity to enhance audit committee reporting to shareholders.**

Our proposal would significantly strengthen audit committee reporting to shareholders, giving shareholders more information about the audit oversight process. This would be responsive to our survey findings, which demonstrate that there is a substantial opportunity for improvement. Our findings indicate that audit committees currently report to shareholders in only one third of the countries surveyed. In a further third of the countries surveyed, the audit committee's report is made available only to the company's board. The content of audit committee reporting on the external auditor's role also varies considerably. For example, we estimate that audit committees report on non-audit services provided by the auditor in only one quarter of countries surveyed.

Fig. 2: Audit committee reporting on oversight of external auditor (% of countries surveyed)



Contacts

Global Public Policy	
Beth Brooke	+1 202 327 8050
Felice Friedman	+1 202 327 6253
Americas	
Les Brorsen	+1 202 327 5968
Asia-Pac	
Tony Smith	+612 6267 3997
EMEIA	
Jeremy Jennings	+32 2 207 1472
Japan	
Makoto Shinohara	+81 3 3503 1100

Points of debate

Are audit committees up to the task of conducting an auditor independence and effectiveness assessment?

Yes, in many jurisdictions, and no in others. The size, expertise and responsibilities of audit committees are not consistent around the world. While there are, of course, a number of very effective audit committees, there is room to strengthen others and promote leading practices. Strong, independent audit committees are best placed to assess the auditor's independence and effectiveness and communicate this to shareholders, even though some audit committees might not welcome the additional transparency we are advocating. The fact that audit committees need to be strengthened is neither a reason to avoid audit committee reforms nor to adopt reforms that could further weaken audit committees. Experience shows that strong and engaged audit committees complement the role of the independent auditor and contribute to audit quality.

How does this proposed assessment compare to mandatory audit firm rotation or mandatory retendering?

Our proposed assessment report would give shareholders the information they need to make an informed assessment of auditor independence, while leaving audit committee oversight intact, if not strengthened. Mandatory audit firm rotation or mandatory retendering would not provide shareholders with any additional insights about the audit committee's relationship with the external auditor. A robust auditor independence and effectiveness assessment, better reporting by audit committees to shareholders and independent regulatory review of the assessment would help increase shareholder involvement and confidence in auditor effectiveness and independence.

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