EUROPEAN
AUDIT COMMITTEE LEADERSHIP NETWORK
ViewPoints

Issue 39: 3 February 2014

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Dialogue with institutional investors about audit policy

On 21 November 2013, several members of the European Audit Committee Leadership Network (EACLN) met with Jeannette Andrews, senior analyst at Universities Superannuation Scheme (USS) Investment Management, and Deborah Gilshan, corporate governance counsel at RPMI Railpen Investments. USS and Railpen are two of the largest pension funds in the United Kingdom and have been at the forefront of investor initiatives on audit policy in the European Union. The meeting was part of an ongoing dialogue between stakeholders and EACLN members about audit-related issues in Europe. For short biographies of Ms Andrews and Ms Gilshan, see Appendix 1, on page 7.

This document summarizes the key themes emerging from the meeting, including the points that investors and members raised, and additional background information and perspectives that guests, members and other experts shared in conversations before and after meetings.[1] For further information about the network, see "About this document," on page 6. For a list of participants, see Appendix 3, on page 9.

Executive summary

Investors and audit chairs viewed their discussion as a fruitful exchange that should continue in additional meetings. In this first meeting, two major themes emerged:

- **Investors are focusing more on audit** *(Page 1)*

  Investors have started taking a greater interest in audit policy and practices. In the fall of 2012, a number of institutional investors drafted a position paper that proposes a maximum tenure of 15 years for audit firms, a cap on fees for non-audit services of 50% of the value of the audit, and more disclosure in the audit report, among other reforms. EACLN members welcomed the growing investor interest in audit, but they reiterated their skepticism about mandatory reforms, arguing for flexibility and judgment exercised by the audit committee and the board.

- **Investors want more transparency from audit committees** *(Page 4)*

  Investors want a better understanding of audit committee activities. They want direct engagement with audit committees, and they want companies to be more willing to respond to investors' requests for dialogue. EACLN members were surprised at how little investors know about the work of the audit committee, and they recognized the need for more engagement. They also acknowledged investors' requests for more informative audit committee reports, though they expressed concerns about excessive disclosures.

Investors are focusing more on audit

Certain institutional investors are paying more attention to the audit of financial reports than they have in the past. Ms Gilshan remarked, *"Post financial crisis, a lot has changed. Shareholders have much greater interest in understanding audit."* Ms Andrews elaborated, referencing some of the issues that are driving their heightened concern: *"During the financial crisis of 2007 to 2010, the audit profession failed to provide adequate warnings prior to the collapse of a number of banks. We are still seeing persistently high non-audit*

[1] *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments are not attributed to individuals or corporations. Italicized quotations reflect comments made in connection with the meeting by network members and other meeting participants.

fees. We do not understand how auditors can be appointed to perpetuity, with some auditors having tenures exceeding one hundred years – it seems very unusual as compared to how other external service providers are treated." Investors are taking an active interest in the audit market reforms currently under consideration or implementation across Europe, such as mandatory audit firm rotation and limits on non-audit services.

Investors are also interested in receiving more and better information about company audits. As Daniel Summerfield of USS explained in a pre-meeting conversation, *"We're concerned about the disenfranchisement of governance from the investor process. We don't want another silo. When there's reporting going on about the audit, it should link to what investors are interested in. It needs to be relevant to investment professionals."*

Investor action on audit policy

Reflecting their growing interest in audit, USS and Railpen drafted a position paper on audit policy in the autumn of 2012 that has been signed by more than 30 other investor groups across Europe. The paper was initially developed in response to the European Commission's proposed directive and regulation on audit policy, which came out in November 2011. The paper was released as the European Parliament and the Council of the European Union were debating their own proposals, which comprised the next steps in the EU legislative process. See Appendix 2 on page 8 for an update on regulatory developments. Additional investors have joined the original signatories, and the signatories in total now represent institutions managing over €2 trillion.[2]

The position paper offered commentary on each of the Commission's major proposals and presented their own preferred alternatives:

- **Mandatory audit firm rotation.** Acknowledging that the empirical evidence supporting rotation is inconclusive, the position paper argues for a maximum tenure of 15 years for the independent auditor.
- **Appointment and tendering.** The paper additionally proposes mandatory tendering every five to seven years, involving at least two candidate firms besides the incumbent.
- **Non-audit services.** The paper argues that when the value of non-audit work exceeds 50% of the value of audit work, the audit committee should scale back non-audit work to below that level within 12 months.
- **The auditor's report.** The paper asks for a fuller audit report discussing judgments, estimates, weaknesses in what it terms the "financial system," assumptions underlying fair value estimates, disagreements with management and other issues.
- **Audit committee composition.** The paper supports having two members with auditing or accounting expertise on any public company audit committee.

In April 2013, USS and Railpen announced that they would begin voting against proposals to reappoint the independent auditors at FTSE 350 companies if their tenure at those companies exceeded 15 years, the limit advocated in the position paper.[3] In the press release, Dr Summerfield of USS said, "We believe the current situation is untenable as the lengthy tenure of audit firms in many FTSE 350 companies can put at risk the

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[2] The paper, entitled *Audit – A Long-Term Investor Position Paper on Proposed EU Reforms*, is periodically updated with new signatories, at which time its publication date is also updated. The latest version at the time of the meeting in Rome was dated 5 March 2013.

[3] FTSE 350 companies are the 350 companies with the largest market capitalization whose primary listing is on the London Stock Exchange.

objectivity and independence of the audit process. We're saying to these companies that there can no longer be an assumption that audit firms can stay in place in perpetuity; there needs to be a line drawn in the sand."[4] In July, USS reiterated its position in response to the UK Competition Commission's proposal to forgo rotation in favor of mandatory tendering.[5]

Audit chair efforts to educate investors on policy consequences

In response to the USS/Railpen position paper, and to address investors' increased audit-related concerns, audit chairs have begun making efforts to explain their own position and the possible consequences of current policy initiatives.

Mandatory firm rotation

Previously, in meetings with the European Commission and European Parliament, EACLN members have stated their opposition to mandatory audit firm rotation.[6] Audit chairs have argued that boards and audit committees should set their own policy on auditor tenure, disclosing the policy and the rationale for retaining an incumbent in the annual report. It was noted that audit committees are tasked with different duties in different countries and regions. Members also expressed concern that mandatory rotation would reduce audit quality and might negatively affect the accounting profession: *"Rotation forces down fees, which is great for companies, but lousy for the profession and such imperatives as retaining talent."*

Reflecting on the position paper in pre-meeting conversations, several EACLN members remarked on the need for flexibility as opposed to strictly enforced terms, such as a 15-year maximum tenure.

At the meeting in Rome, a member said of rotation, *"The amount of distraction and disruption is enormous. The process is intense. It takes 18 months to get a new firm on board, and during these 18 months, there is the greatest risk. The new firm has to understand country dynamics, industry dynamics and of course company dynamics."* Another member said, *"Having our own audit tenure policy is our intention, but it is important to keep some flexibility."*

Non-audit services

Several members suggested that limiting the non-audit services provided by the audit firm could affect the quality of those services because it might prevent companies from hiring the provider that has the most relevant knowledge and data about the company. One member said of the audit firms, *"They are best placed to do that work."* Another member added, *"The Big Four are better than [the top consulting firms]."* In previous discussions, members have noted that, although some types of non-audit services should be prohibited, others should be subject to the approval of audit committees, which are careful to avoid overreliance on the incumbent audit firm.[7]

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[4] USS Investment Management and RPMI Railpen, "USS Investment Management & RPMI RAILPEN to Vote against Audit Firm Re-appointments," news release, 26 April 2013.

[5] Adam Jones, "Audit Remedies Fail to Please Big Four's Critics," *Financial Times,* 22 July 2013.

[6] See European Audit Committee Leadership Network, "Audit Committee Perspectives on the European Commission's Green Papers," *ViewPoints,* 28 April 2011, and European Audit Committee Leadership Network, "Audit Committees Discuss Audit Policy with European Parliamentarians," *Summary of Themes,* 27 September 2012.

[7] European Audit Committee Leadership Network, "Audit Committees Discuss Audit Policy with European Parliamentarians."

Auditor's report

In pre-meeting conversations, members were also skeptical of the proposal to include more information in the auditor's report. One member said, *"Shareholders must not pretend to manage the company in the place of the board and management. The information at stake is needed by management, but I'm not sure if it's needed by investors."* Another member noted that *"a company is responsible for the transparency of its accounts"* and said that an open-ended discussion by the auditor would just *"open up a can of worms."*

Overall, one member suggested that investors should remember that they are not the only constituency to whom boards are accountable. Members of supervisory boards, in particular, *"traditionally take the view that their constituents are all the stakeholders."* In addition, observers note that the views in the position paper do not represent the views of all investors or their representatives. The Association of British Insurers (ABI), for example, expressed opposition to mandatory rotation in its comments on the European Commission's green paper and the UK Competition Commission's investigation of the audit market.[8] Ms Andrews acknowledged that although not even all investors support mandatory rotation, a significant and growing number of institutional investors have pro-actively called for mandatory rotation.

Investors want more transparency from audit committees

At the meeting in Rome, investors' desire for better communication with audit committees, including more engagement and an enhanced audit committee report, emerged as a major theme.

Investor engagement with audit committees

The investor guests told EACLN members that they would like to improve their understanding of audit committee activities, and they welcomed more dialogue with audit committees. Ms Andrews said, *"We do not see what you are doing. There is limited information available to investors about what you do as a committee. There was a perceived failure to identify issues of going concern at banks by audit committees and auditors [prior to the financial crisis]. This led us to ask whether the relationship wasn't working?"* Ms Gilshan added, *"We spent a lot of our time thinking about remuneration because there's so much information. But there's very little face-to-face engagement with the audit committee, though it has improved in the last reporting season."*

The investors noted that audit-related issues have often been handled by other company representatives. Ms Andrews said, *"The issues were being addressed by finance directors and other management, instead of audit committees, perhaps because we weren't talking to audit committees."*

Ms Andrews said that the position paper was partly an effort to generate more engagement: *"There was no voluntary movement to get discussion and to push for change. So we saw the [position] paper as a catalyst for change. We see it has been successful because we are here talking with you now. It's only a positive to engage with more audit committees."* She noted that companies often fail to respond when investors reach out to them: *"Investors do read the audit committee report. We're not voting mechanically. Whenever we vote against or abstain, we write to the company to explain our position. We explain why we are not supporting the resolution and, if the issue is in relation to audit, we send our position paper. But the response rate from companies has been less than 5%. We are looking for an explanation and we want a*

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[8] Association of British Insurers, *Audit Policy: Lessons from the Crisis: The ABI's Response to the European Commission Green Paper* (London: Association of British Insurers, 2010); Association of British Insurers, *Audit Market Investigation: The ABI's Comments on the Competition Commission's Issues Statement* (London: Association of British Insurers. 2012).

dialogue with audit committees." Ms Gilshan said, *"We are looking for assurance that the people we elect are doing their job."*

Members were surprised by investors' perceptions about the work of the audit committee, and they were disappointed by management's lack of response to investors' desire for dialogue. Reflecting on the discussion the next day, an audit chair remarked, *"Investors did not have a clear view about what audit committees do. They thought audit committees subcontract out their responsibilities. There is a lot we can do to demystify what the audit committee does. In my experience, investors report after they vote against, and their letter is sent to the board secretary. It should encourage us to be slightly more promotional, without selective disclosure. We should find a way to engage with them in advance of voting. Otherwise they may take steps to handicap the audit committee. They will exercise their vote on reappointing the external auditor."*

Improving the audit committee report

The investor guests said they would like to see more informative audit committee reports, echoing comments made by investors at the Audit Committee Leadership Summit in March 2013.[9] Ms Andrews elaborated on what would be of value: *"The report can be quite procedural. We would like to understand what have you done as a committee? It is up to the audit committee to disclose the major issues, materiality, what it has achieved during the year. Reporting should be specific and owned by the audit committee – not written by the external auditor or management. How do you ensure external auditor skepticism? There is a PCAOB[10] publication about auditor–audit committee communications. We want a better flavor of the process versus boilerplate information."*

Ms Gilshan mentioned questions she would like to see addressed: *"Is there a healthy tension and debate? Are people held accountable?"* In a pre-meeting conversation, she said she wanted to learn more about the interactions among the auditor, management and the audit committee: *"How does that triumvirate relationship work?"*

Members reflected on how best to respond to these requests. One member said, *"The audit committee report is not sufficient. To say we looked at material accounting standards is not enough ... We should describe how we focused on impairment, revenue recognition, etc."* Others agreed in principle but expressed concerns about excessive disclosures. One member said, *"What you say makes sense, but I disagree with your choice of words. You should rephrase your request that the audit committee report discuss 'the material issues that a company has encountered.' I disagree – that is going too far. Perhaps we could agree to discuss what were the critical audit policies discussed?"* Another member asked, *"Do you want historical debates that were resolved in the report? How politically intelligent would that be?"*

In the United States, many audit committees and corporate governance organizations are considering how to enhance audit committee reporting.[11] A recent review of audit committee reporting to shareholders during the 2013 US proxy season undertaken by EY shows that audit committees are already disclosing more information than is required, and there was an increase in such disclosure during 2012.[12]

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[9] Audit Committee Leadership Summit, "Board-Shareholder Engagement," *ViewPoints,* 2 May 2013.
[10] Public Company Accounting Oversight Board.
[11] See the Audit Committee Collaboration, *Enhancing the Audit Committee Report: A Call to Action* (The Audit Committee Collaboration, 2013).
[12] EY, *Audit committee reporting to shareholders: 2013 proxy season update* (London: Ernst & Young Global Limited, 2013), page 1.

Conclusion

Participants described the discussion in Rome as a fruitful dialogue that should continue. Ms Gilshan said, *"I really enjoyed this dialogue, and I learned a lot from it, speaking directly with audit committee chairs. There should be a wider debate like this – it's very important. Shareholders have a part to play."* Ms Andrews added, *"This dialogue is well overdue. There is an information gap, but we're closing the gap, and as investors we will continue to address the roles and independence of the audit committee and external auditor."* Audit chairs agreed: *"It was a very useful discussion – we need to do more."*

About this document

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is organized and led by Tapestry Networks with the support of EY as part of its continuing commitment to board effectiveness and good governance.

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management and their advisers as they endeavor to fulfill their respective responsibilities to the investing public. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, members of management and advisers who become systematically engaged in this dialogue, the more value will be created for all.

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EYG No. AU2173

Appendix 1: Biographies of Jeannette Andrews and Deborah Gilshan

Jeannette Andrews

Jeannette Andrews is a senior analyst for responsible investment at USS Investment Management (USSIM). Ms Andrews joined the responsible investment team at USS Investment Management in 2008, and undertakes corporate engagement activities and proxy voting. Universities Superannuation Scheme (USS) was established in 1975 as the principal defined-benefit pension scheme for universities and other higher-education institutions in the United Kingdom. It has over 300,000 scheme members across nearly 400 institutions and is one of the largest pension schemes in the United Kingdom, with total fund assets of approximately £39 billion.

Prior to joining USSIM, Ms Andrews worked for five years at Manifest, a corporate governance and proxy-voting agency. She is a member of the GC100 and Investor Group, which published guidance on the new remuneration reporting regulations in September 2012.

She holds the CFA's Investment Management Certificate and recently passed Level III of the CFA program.

Deborah Gilshan

Deborah Gilshan is corporate governance counsel at Railpen Investments. Railpen carries out investment management for the corporate trustee of the pension schemes of the UK railway industry. Ms Gilshan joined Railpen in November 2007 and is responsible for the implementation of their global corporate governance and shareholder engagement policies, with specific responsibility for Railpen's work in the United Kingdom, North America and Australia. The role involves both direct company engagement and market policy work to address corporate governance risk and improve shareholder rights in the markets in which Railpen invests.

Ms Gilshan is a non-executive director of the Railway Benefit Fund, a UK charity, and chairs the investment committee. She is a fellow of the UK's Institute of Chartered Secretaries and Administrators and holds the ICSA's Professional Award in Corporate Governance and the CFA's Investment Management Certificate. In 2009, Ms Gilshan was recognized as a "rising star of corporate governance" by the Millstein Center for Corporate Governance and Performance at Yale. Ms Gilshan started her governance career in December 2000 at the UK's Co-operative Insurance Society and previously worked in corporate tax at EY. She read Mathematics and English at the University of Manchester.

Appendix 2: Regulatory developments in the area of mandatory audit firm rotation

Since the publication of the investors' position paper, the audit policy proposals have continued to move through the EU legislative process, including deliberations in the European Parliament and the Council of the European Union. Meanwhile, some member states have taken their own steps in the area of audit policy.

The EU moves closer to an agreement

In December 2013, the Parliament and the member states agreed on a final set of rules, which now awaits formal ratification by the member states and Parliament. Once ratified, it will be phased in over a period of several years.[13]

In the key areas of contention, the rules roughly split the difference between the Commission's original position and the Parliament's amendments. In his statement on the agreement, Michel Barnier, European Commissioner for Internal Market and Services, laid out the key provisions:[14]

- **Mandatory rotation.** Maximum audit firm tenure will be 10 years, which will be extendable to 20 years with retender at 10 years, or 24 years with joint audit.
- **Non-audit services.** Certain non-audit services will be prohibited, and permissible non-audit services will be capped at 70% of the audit fees.
- **Auditor's report.** There will be more disclosure in the auditor's report.

The Netherlands and the United Kingdom address audit policy

Significant activity in the area of audit policy has taken place in some member states as well, though with varying outcomes. In December 2012, the Netherlands approved new legislation restricting the non-audit services that auditors can provide and imposing an eight-year rotation period. The restrictions on non-audit services took effect on 1 January 2013, though there is a two-year transition period for preexisting contractual obligations. The effective date for mandatory rotation is 1 January 2016, so companies that will have had the same auditor for eight consecutive years on that date will need to change the auditor before that date.[15]

In the United Kingdom, the Competition Commission considered mandatory rotation and other options, but in October 2013, it published a final report that established mandatory tendering rather than rotation. FTSE 350 companies will have to tender the audit at least every 10 years, less often than the five years it proposed in July.[16] The Competition Commission expects the rule will come into force from the last quarter of 2014.

It is not yet clear how member states will adapt their current policies in the light of any final EU agreement.

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[13] Michel Barnier, "Commissioner Michel Barnier Welcomes Provisional Agreement in Trilogue on the Reform of the Audit Sector," news release, 17 December 2013.

[14] Ibid.

[15] EY, *New legislation covering "Organisaties van Openbaar Belang" (OOB)* (London: Ernst & Young Global Limited, 2013), page 7.

[16] UK Competition Commission, "CC Finalises Measures to Open up Audit Market," news release, 15 October 2013.

Appendix 3: Participants

Members participating in the dialogue with investors sit on the boards of 16 large-, mid- and small-capitalization public companies:

- Dame DeAnne Julius, Audit Committee Chair, Roche
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi
- Ms Guylaine Saucier, Audit Committee Chair, AREVA
- Mr Jack Tai, Audit Committee Chair, Royal Philips Electronics
- Ms Martine Verluyten, Audit Committee Chair, STMicroelectronics and Thomas Cook

EY was represented in the meeting by:

- Mr Christian Mouillon, Global Risk Management Leader
- Mr Mark Otty, Area Managing Partner EMEIA