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**28 APRIL 2010**

*“Should statutory audit be dropped and assurance needs left to the market?”*

The financial crisis of the last two years has its roots in a hundred causes. One of the more important is the significant failure of corporate governance in the banking sector.

By governance I do not just mean the principles of the Corporate Governance Code. Governance encompasses a chain of activity and stewardship. From the strength of risk management within the company and its internal controls, to the quality of the oversight of the Board, to the quality of public reporting, to the stewardship role of investors.

Audit is a key part of high quality governance. The auditor sees the company's approach to risk. The auditor challenges management's judgement on the financials. The auditor reports to shareholders on whether the company is providing a true and fair view of the business. The investor only sees the tip of the iceberg of work. But nevertheless investors are relying on that work being done.



And in practice they are more in need of good audit than ever before. Yes, there is more analysis about companies than before. More reports and more studies. But investors themselves have less power to challenge because shareholdings are becoming more and more fragmented.

In the year I was born, 1956, another son of Croydon, Lesley Brown stood up at the AGM of BSA and demanded that the Board dismissed Bernard Docker, the Chairman and Managing Director, because of the extravagant lifestyle he led at the company's expense. Mr Brown was investment manager of the Prudential. He launched an era of increasing shareholder power being wielded by the big insurance companies and pension funds. Now that power is waning. The life insurance industry holds less than 15 per cent of the shares on the London market. Their own capital is in bonds, not equity. Overseas investors are taking a larger share. So as influence is lost, good corporate reporting and strong auditor oversight become all the more important.

But just when audit is needed more, the impression is growing that it is delivering less. Why?

First, accounting standards have allowed management more discretion in the valuation of assets, values that are hard to pin down for complex instruments. The auditor cannot say that discretion and judgement should not be used.



But it is not surprising that people ask about the value of audit if it can allow a wide range of valuations of the same asset.

Second, the role of the auditor has apparently become more confined. The days of auditors talking quietly to regulators are long ago. Indeed the crisis developed partly because everyone with an oversight role concentrated on their job rather than thinking also about what they could add to the work of others in the interests of a wider objective of financial stability.

At the FRC we do believe there is a need to review the value of audit and whether it can be enhanced. And we will be producing our thinking on this later in the year.

I do not want to pre-empt debate, but there are clearly some key issues that we need to address:

- How do we achieve a strong alignment between the auditor and the interests of the shareholder? Shareholders are remote from audit. Management are in the room. Do we need to do more to reinforce the auditors' sense of responsibility to investors?
- Do we need to change the form of the audit report to make it more useful? Can the auditor say more about how much risk is being carried and about the nature of valuations: are they central estimates or at the edge of riskiness?



- Do we need to see more said in the front of the report about risk and the business model and should the auditor provide greater assurance about such matters?
- Can auditors give more help to regulators and avoid conflicts of interest in doing so? They have in the past and they should again.

Now to return to the question. If more has to be done by audit, can that be achieved by the market or do we need statutory reform?

It is hard to see how the market can deliver in a world of fragmented shareholder power. The UK has had a statutory requirement since 1844 and I doubt that now is the time to abandon it. And in any event European law would step in even if we wanted to.

But statutory provisions tend to provide a minimum standard. There is a role for the market in setting higher expectations of auditors. So far the market has not played that role. Quite the opposite. It is more likely to applaud lower audit fees than higher quality. So the challenge is to find ways for investors and auditors to come together. To learn about each other's concerns and so support innovation in audit and better understanding. I would hope that investors would mount an effort to achieve that. And certainly we at the FRC stand ready to help.