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FINANCIAL REPORTING COUNCIL, TO THE EUROPEAN COMMISSION  
CONFERENCE ON FINANCIAL REPORTING AND AUDITING ON  
THURSDAY 10 FEBRUARY 2011**

It is a great pleasure to address you today and I look forward to participating in the discussion afterwards.

The Financial Reporting Council is the UK's independent regulator responsible for promoting high quality corporate governance and reporting to foster investment. We regulate audit, we are responsible for the UK Corporate Governance and Stewardship Codes, we are the UK's accounting standards body and set its actuarial standards. We aim to create a framework in which investors get fair, balanced and reliable information and so to provide confidence to the capital markets.

There is no need to convince you about either the importance or the urgency of the questions we are here to discuss.

With the publication of the Green Paper, we all sense that change is in the air and want to help shape it. In such an atmosphere every stone is turned over and, after the worst financial crisis for eighty years, that is how it should be.

As we do so, however, let's keep a clear perspective on what went wrong and what did not. Credit markets failed. Banks failed. Banking regulation failed. The equity markets did not fail. In the UK, since the collapse of the Northern Rock bank at the start of the crisis, companies raised over £160 billion on the

London Stock Exchange alone to recapitalise themselves. With the banks shut, investors have kept Europe's businesses afloat, providing in London almost as much finance as the Bank of England's quantitative easing.

The equity markets have learnt the hard way not to believe all the banks tell them. But across the market as a whole they do have confidence in financial information and in the way companies are governed.

That does not mean there is no need for change. The crisis shone a bright light into some dim corners and the Commission is right to ask some tough questions.

In responding to the Commission's proposals, I want to talk first about the future of auditing, and then consider whether the audit profession is currently fit to enter that future.

Audit developed in the nineteenth century to address a very different corporate and economic environment. It provided assurance about 'the numbers'. The companies being audited were mainly simple and predictable. They did not have complex financial instruments in their balance sheets.

As companies have changed, so have the interests of investors and, indeed, of regulators. Once the focus was the reliability of dividends. Now it is with the strategy of the business and its risks. They also want assurance about whether companies are playing fair in the highly complex but vital assessments of the value of their assets, about the safety of what is going on in the valuations black box from which no light escapes.

Clearly, traditional historic accounting information does not meet these needs.

The gap between what audit does and what users expect from an audit of the financial statements has been growing for the last 20-30 years, despite previous attempts to bridge it. Now is the time for fresh thinking to address that expectations gap and to bring the value of audit closer to investor needs in the modern economy.

We think that greater transparency of the specifics of the audit will both incentivise renewed auditor focus on their relationship with the investor and provide investors with more of the auditor's insight about the company that they want. We must give users more information about the prospects of the company and a better picture of the future of the business and of the judgements made in the course of the preparation of the financial statements. We must give more insight into whether the preparation of these statements was contentious and subject to debate within the organisation or with the auditors. Were they regarded as aggressive or cautious, supported or unsupported by corroboration, information or evidence? We must also do this without undermining the primary responsibility of the directors for the information given to users.

That is why the FRC is proposing that there should be:-

- A fuller narrative report by the company to the shareholders, which should say more about its prospects and risks. This should include a report by the audit committee to shareholders setting out why it is satisfied that the Annual Report, read as a whole, is fair and balanced.
- Secondly, a report by the auditors that identifies any significant matters in the Annual Report that have been discussed with them and they believe deserve special attention by the shareholders and a clear

statement by them about whether they agree with the Audit Committee's report or not.

In short, we want investors to learn about the business and its future from the directors; we want the directors to say more about the things that really keep them awake at night; and we want to empower auditors to challenge management by requiring them to say whether the Board have really given a balanced and fair view on these matters as well as on the accounts.

We believe that these proposals will serve investors effectively, but success depends on some change in attitudes.

Companies need to stop producing boilerplate text prepared by their lawyers to minimise their liabilities. As regulators, we must face up to the risk that we sometimes drive a culture based on awareness of liability rather than on transparency and openness.

And we need an audit profession that has the same outlook. One that is not afraid to challenge management. One that is sceptical of assertions made without apparent good foundation – that does not see its role as confirming management's view, but identifying the truth.

These values are alive in the profession, but we all know that they are also under threat. Under threat from the pressure to keep clients and win new business. Under pressure from the fear of liability suits. Under pressure from shrinking reporting timetables. The next decade will ask more of auditors, but without facing up to these risks they will deliver less. And then investors will look for alternative forms of assurance and new sources of information.

As regulators, we must work with the profession and with investors to create an environment in which those risks can be managed and auditing will emerge stronger, not weaker.

In my view, the risks arise partly because investors have not exerted their authority on the relationship between the company and the auditor and in part because they are not fully empowered to do so. They vote on auditor appointments, but almost always without questioning the quality of work being done or promised by the auditor. I therefore hope that the Commission will consider how to forge a better balanced triangle between companies, auditors and investors: how we can create a partnership in which each plays their full role.

The alternative is more and more regulation to counterbalance the fundamental flaw in the system: that auditors are appointed by those they are appointed to scrutinise rather than those they are meant to serve. That regulation is expensive and can never entirely substitute for real investor engagement.

How we enhance the investor's involvement is not easy to discern. Should it be through their closer scrutiny of the appointment of audit committee members? Should it be through more direct involvement of the largest investors in the auditor appointment?

Before I close, let me say something about the role of greater competition in bringing about change.

Competition is a good and healthy basis for any market. It provides choice, creates downward pressure on prices and fosters innovation. But in intervening to promote competition, we must be clear about our objectives.

We see two goals. The first is enhanced audit quality. We must not do anything in the name of competition that puts quality at risk. For example, we believe that compulsory joint audits would increase cost and could damage quality by creating confusion about who is responsible for what. It would also do nothing for competition if both of the auditors were Big Four firms. Mandatory rotation could also play into the hands of the big firms if companies drop smaller partnerships when they retender.

However, we do believe more competition is important and we would like the Commission to consider a number of proposals that we feel could increase choice, including:

- Encouraging banks and other financial institutions to use non-Big Four firms as a source of advice to their risk committees. This would give such firms an exposure to large companies they might not otherwise have access to and may in time provide them with an opportunity to tender for the audits of some of these entities.
- Giving serious consideration to amending the current rules on audit firm ownership, allowing audit firms to access external capital to fund expansion.
- Prohibiting the use of “Big Four only” clauses in banking and loan covenants .

The second goal in considering how to expand the number of major players is to reduce the risk of a market of just three firms if one of the Big Four were to fail, a situation that we could not tolerate.

Clearly, measures that help competition to grow will reduce this risk over time. Let me emphasise – over time. But the fact is that if a firm got into trouble now the world’s audit regulators do not have a contingency plan, nor the authority, for handling the crisis that would result.

Creating a plan is therefore imperative. This will require co-operation between authorities, between audit regulators and competition authorities, between regulators and firms and probably beyond the boundaries of the EU. I would like to see the competition authorities make clear now that they would not tolerate a market dominated by just three firms. We also need to discuss with the firms what plans they have for handling a crisis – do they have their equivalent of the bankers’ “living will”. But above all, we need discussion of what to do to start as soon as possible and I welcome the Commission’s evident interest in playing its part.

I would like to leave you with one final thought. This is a once in a generation opportunity to set the direction of travel for the future of corporate reporting and audit across the European Union. We should discuss and debate the key issues energetically and constructively and then take the steps necessary to achieve our objective – corporate and financial reporting, with independent assurance, that meets users’, and especially investors’, needs and commands the confidence of the market.

Thank you.