Financial Reporting Council

Stephen Haddrill

CEO, Financial Reporting Council

FEE Audit Conference

23 June 2015

Thank you for inviting me to speak today.

The Audit Directive and Regulation is a large and complex piece of legislation. There is not a great deal of time to put it in place: already a year has passed since it was decided. It includes a considerable number of member state options, which add to the complexity. We await decisions by UK Government on many of these and it is not for me to say what our new Government will decide. I can, however, give a view on some of the thinking in the FRC, especially on those matters which will fall to us to shape in the light of the Government's decisions.

Let me start with the FRC's over-arching objectives:

- First and foremost is that change promotes audit quality in the interests of investors.
- Second that competition in the audit market is strengthened in a way that supports quality through innovation.
- Third that the regulatory regime that emerges provides confidence to investors and to firms by being fair, understandable and independent.

To achieve these objectives we need to recognize that laws and regulations do not deliver success without the active support of those they apply to and those who benefit from them. Both in the design of regulation and its operation we need the involvement of investors, audit committees and the firms themselves. Audit quality will not be achieved unless the firms, audit committees and regulators work together, informed by investor needs.

Let me provide one crucial example of this. Audit retendering and rotation can drive innovation and audit quality or they can drive a price war and a reduction in quality. Exactly the same regulations can produce either outcome. The legislation seeks to mitigate the risk by making clear that the audit committee not the company executive take the lead in assessing tenders. But more is required. Audit committees need to own the quality agenda heart and soul and that requires incentivisation, not instruction. This is why in the UK when we introduced retendering we also made provision for fuller audit committee reporting, extended auditor reporting and the sharing of audit inspection findings with audit committees. Both audit committee and auditor reporting have attracted positive investor responses, encouraging committees and firms to pursue quality and innovation. Our inspection findings give committees an agenda for dialogue with the firm.

This approach has been a success so far and as we move forward we must maintain a strong triangle of regulator, audit committees and firms working together, with engaged investors.

This spirit of cooperation is also necessary because the complexity of the legislation and the interaction of member state options will generate problems in practice that need to be sorted out with goodwill. Fee has identified some of these problems already. As regulators we must remember that we are implementing single market legislation and achieve as much coherence and convergence as possible. And if it is not possible initially, we must stand ready with the Commission to address problems as they arise.

Now, why, you might ask, do we not all just implement the directive in the same way. For example, in relation to the much debated issue of the sale of non-audit services to audit clients. We have consulted on this in the UK and it is a good example of why a one size fits all approach does not command consensus. Some in the profession have called for us not to go beyond the requirements of the legislation in terms of the items on the black list. On the other hand investors have called on us not to reduce current UK requirements which do go beyond the EU legislation. There have also been mixed views on our suggestion of a white list to provide certainty on what can be sold. Some have welcomed this, others argue that it will in effect stultify the exercise of discretion by audit committees.

In the absence of clear responses to our consultation, we have not yet reached a view on these points. Although I will say that whether we have a white list or not we are committed to a principles-based approach that expects audit committees to apply their judgement.

That brings me to the nature of our inspection work in future. At present we inspect the largest ten firms on a regular basis with a much less frequent scrutiny of some others in the mid-tier. The legislation requires us to review all firms who undertake “PIE” audits including every insurance company and many small financial institutions. The list of auditors may approach 100. Many will have only one or two PIE audits and the risk to the public interest is minimal compared to the audits of major banks and insurers. We must be proportionate in our approach to inspection and coordinate with the professional bodies who do a perfectly good job of inspecting such firms already. We must be alive to the risk of independent inspection driving firms out of the PIE market and reducing competition. We must keep inspection costs in check and we must also consider whether our normal open reporting on firm performance is appropriate in relation to a small firm given that we will only inspect a small sample of its work.

As a regulator we must always ensure that we are achieving our goals in the most efficient and effective way. The implementation of the directive is not just about new regulation of the profession. It should also be a moment when we test how well we go about our job as regulators. We should not adopt new powers that challenge those we regulate without challenging ourselves. Are we proportionate? Do our standards promote quality or inhibit innovation? Do we help firms to drive quality or does our criticism make them risk averse? Are we sufficiently accountable to and a channel for the views of investors and the public? We are addressing these issues now and I believe they are as important to the achievement of our goals as the implementation of legislation itself.

To make legislation work we need to nurture a coalition of investors, auditors and audit committees in the cause of quality. To do that we as regulators must challenge ourselves to earn the trust and confidence needed to lead effective change.