PCAOB AUDITOR'S REPORTING MODEL PROPOSAL

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THE UK INVESTMENT MANAGEMENT ASSOCIATION

OPENING STATEMENT

THE INVESTORS' PERSPECTIVE OF CHANGES TO THE AUDITOR'S REPORT IN THE UK

- The annual report and accounts are about management's accountability to its investors – its shareholders who put up the risk capital and bear the residual risk. Management is entrusted with shareholders' funds and the annual report and accounts should show how effectively it put those funds to use and the performance derived from those funds. Essentially they are a confirmatory document published sometime after the events to which they relate.

- The fact that these accounts are subject to an audit is vital to investors' confidence in those companies in that markets value the information and investors believe what they are told about their investee companies.

- For some time investors have had concerns about the quality of the audit - the auditor's accountability to investors and the transparency of the audit. Many of these concerns were a product of the fact that investors felt excluded from the audit process and real findings - they were largely invisible. Whilst the binary opinion, pass or fail, is important, the rest of the audit report tended to include more details of what the auditor did not do rather than what he did.

- The FRC's framework effective for accounting periods starting on or after 1 October 2012 were welcome in introducing a more enlightened audit report. They have been the most significant advance in auditor reporting in decades. Investors were positive about the changes and can now compare the depth and clarity of different audit reports.

- The framework requires auditors to disclose audit materiality – this should mean investors are better able to assess the quality of the accounts and the auditors' work. Most importantly, the new audit report tells investors what the auditor assessed as the main risks of misstatement – effectively what the critical accounting policies and estimates were. What is important here is that this is a risk based approach.

- Investors do not want a list of procedures. They want to know what the key risks are, why they are key risks, how the auditor responded to them and what he found. This information will help investors identify and understand the significant judgments in the accounts. They can then further challenge executive management and hold the audit committee and external auditor to account. Greater understanding should contribute to the relationship between management and investors. It should enhance trust, ultimately reducing the company's cost of capital and increasing the value generated for investors and their clients, the end beneficiaries.

- These requirements were effective for accounting periods starting on or after 1 October 2012. It was commendable that certain companies' auditors adopted the proposals early.

- Concerns have been raised whether this information could be market sensitive. In this context, the main role of accounts is as a confirmatory document to the market – they are produced some time after the period to which they relate. Information that is price sensitive has to be disclosed under the market abuse regime. Moreover, investors' decisions are more likely to be based on the preliminary announcements, earnings releases, and investor presentations than the accounts themselves. The important thing being that all this information can be tied back to the accounts and these accounts are independently assured through the audit.

- There have also been concerns that this reporting could result in mixed messaging. In this context, the preparation of the accounts is the responsibility of the company and its board - it is they that should make the necessary disclosures about the company's position and performance. As regards the transparency in the proposals under discussion – only the auditor can report on what he did.

- However, whilst the FRC's audit report tells investors the key risks and how they were addressed in the audit scope, investors are questioning why it stopped there. The FRC has not required auditors to take the next obvious step and answer the question "what did you find". How aggressive or cautious did you find the company's estimates or judgments?

- Auditors already discuss this insight with the audit committee and provide views on the degree of caution or aggression underlying management's judgments year on year. Investors would value this insight too. It is welcome that although not required to do so, two company's audit reports, Rolls Royce and New World Resources, did in fact address what the auditor found.

- Lastly, several standard setters are looking at proposals to change the audit report. The European Commission, the IAASB as well as the PCAOB. Investors invest internationally – taking IMA - around 67 % of all equities managed by IMA members are held internationally. Investors want harmonized international standards for audit reports. Whist there is a high level of consistency in a number of the proposals, unintentional and unnecessary differences should be avoided.

- To conclude, investors have had concerns about audit quality and the transparency of the audit process for some time. Steps are being taken to address this and the FRC's package of reforms has adopted enjoys the support of the investment community – the real end clients of the audit process.