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Opening Statement

PCAOB Public Meeting on Auditor Reporting

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Thank you chairman for your kind remarks and for inviting me to speak to you this morning.

I am here in my capacity of an audit committee chair thus representing part of the non-executive director community but I also have a great interest in seeing the auditing profession move forward.

Having spent 30 years as an audit partner in a Big 4 accounting firm, during which time I helped develop communication to audit committees, had 6 years in Europe representing the accounting profession discussing changes to our profession and to the auditor reporting model and now, as the chair of one audit committee and a member of another, at last, I can say that we have finally started to tackle the long standing "information gap" concerns which for so long have been described by stakeholders as an "expectation gap".

You heard comments yesterday about how long it has been since there was a change in the auditors report. 80 years was mentioned for the US and Nick Land commented about 150 years in the UK. The 150 years goes back to the middle of the Industrial Revolution when trade expanded, companies got bigger and external capital was sought in ever increasing amounts. The owners were not the managers anymore so the audit, as we know it, was formulated to give assurance to the owners that the financial statements properly reflected the company's financial position. So having said that, it is quite clear to me that the purpose of the audit is for the auditor to inform the investor. Thus the need to provide more than just "pass or fail" recognising that the "pass or fail" is fundamentally important to the investor.

I appreciate in the UK we have a different legal system and a different litigation environment. We also have a set of principles based standards rather than a rules based approach. The new auditor reporting standard is only 16 pages long, including application material, therefore, the auditor can use his judgement as to how to report on the requirements in the Standard. Quite different to what is normal here in the US.

We heard from Nick Land yesterday that the new auditor reporting model in the UK had caused some tensions between auditors and management. When I was working in Brussels, it was stated by the European Commission at one point, that they wanted to engender some tension between the audit committee and management in order to create better Corporate Governance. The question must be - "is it tension or is it challenge"? If it

is the latter then that can only be healthy and for the audit it can only result in a better quality audit.

So with this backdrop let me focus a little bit on what happened in the UK?

In the UK, the Financial Reporting Council, encouraged by Parliament and investor groups, firstly looked at the Governance Code for company reporting, focussing on the role of the Audit Committee and what it should cover in the Audit Committee Report, and then, as the audit Standard Setter in the UK, looked for changes in auditor reporting by considering changes to ISA 700, as adopted in the UK and Ireland.

To give credit where credit is due, by looking at both audit committee reporting and auditor reporting the FRC have addressed, or moved a long way to addressing, the shortcomings of two of the three legs of the Corporate Reporting "stool". The third leg is the Financial Reporting framework, which also needs some changes, but two out of three is a good start. This is why I think the SEC and FASB also have a role to play here in the US and not leave change in this area just in the hands of the PCAOB.

Turning to my personal experience of the changed environment in the UK, let me focus on the company where I chair the audit committee and what, if any, were the differences in reporting I have seen as a consequence of the changes.

By way of scene setting, we are a financial institution, the second largest building society in the UK, with \$55 billion of assets. We are involved in savings and loans but also have a regulated financial advice business, have some complex financial instruments, undertook two significant mergers during the financial crisis and account under IFRS.

As a consequence we have a number of significant judgements to make each year and also carry some significant risks.

So, at 31 December, what did our auditors report on? Well let me start by saying there comments were mainly on the risks which could result in material misstatements in the Financial Statements relating to critical accounting policies and estimates and the judgements made by management.

Firstly, let it be said that the audit opinion, i.e. the "pass or fail", came right up front in the first paragraph so no confusion there.

They made specific comment about going concern and the work that they had undertaken but also had to comment whether they had identified any material uncertainties that may cast significant doubt on the Group's ability to continue as a going concern.

They had to define materiality and the level of audit differences that would be reported to the audit committee. This was covered yesterday so no need to say more now.

The most significant change, however, was the requirement to identify the areas of risk that our auditors considered could give rise to material misstatement in our financial statements and how the audit scope responded to those risks.

In our audit, the risks identified were:

Loan loss provisions – a particularly important risk due to the change in the economic levers

Fair value adjustments – an important judgement as we set up these provisions a few years ago when we undertook our mergers and when the economic conditions were quite different than now.

Revenue recognition – always considered a material risk under ISA's.

Provisions for customer remediation – as a result of some legacy and current issues identified by the regulator we had to make provision for future payments to our customers and potential fines to the regulator.

Capitalisation of costs – we are undertaking a very significant upgrade of all our business systems over the next 3 years with both internal and external experts involved and totaling hundreds of millions of pounds

Hedge accounting – always an issue under IFRS

Treasury instruments – valuation of derivatives and certain investment securities, some of which do not have an active market, therefore, valued through the use of financial models, and

Deferred Taxation - for reasons well articulated yesterday

You can see from this list that these risks require the company, and the auditor, to exercise a high level of judgement and all, or a combination of any two or more, could have a very significant impact on the reported profit and the financial position of the group. Information that is helpful to the investor and other stakeholders.

As a financial institution those matters were seen to be useful to the understanding of our financial position.

In the **Rolls Royce** audit report mentioned so often in the submissions yesterday, the risks identified there centred on revenue recognition, recoverability of intangibles, accounting for subsidiaries and associates due to the many collaboration agreements, liabilities arising from sales financing arrangements, bribery and corruption and presentation of “underlying” profit. Very important to understanding the Rolls Royce position so tailored to that company's circumstances but quite different to those disclosed in my financials.

So, what about the audit committee and auditor engagement? Was there any difference as a consequence of enhanced requirements in reporting by both bodies?

Compared to previous years, there was certainly more engagement between the members of my audit committee and the auditor. This was partly due to enhanced audit committee reporting but also due to the changes in the audit report. Both were new requirements in 2013 and both focused on the risks identified and judgements made around the financial statements. We had a common interest to say what we had done and why we had done it.

There was early engagement and improved dialogue during the audit process. The audit committee was more engaged during the audit planning phase, focused heavily on the key matters within the financial statements and were far more engaged with management and the auditors to ensure appropriate judgements were being made and that the reporting of these judgements was appropriate. A real step up in the interest given to the audit process and the significant risks identified.

There was more detail provided by the auditor to the audit committee as to how they had satisfied themselves as to the key judgements and there was more challenge to management that, in fact, was well received rather than creating tension. Altogether it was a much more positive experience for all and seen as a much more useful process.

As far as the audit team members were concerned they were far more aware of what was important in the business and they seemed to show a higher level of skepticism and overall challenge whilst doing their work.

Let me make some concluding remarks:

From my experience across two audit committees, with two different audit firms, I am certain that the quality of the audit was improved as a consequence of the changes brought in by the FRC. It also helped us move away from boilerplate reporting. Every company is different so the risks and significant matters identified needed different disclosure. I don't subscribe to the notion that auditors will revert to boilerplate. There will be refinements made in the future but I think they recognise the need to inform not just comply.

Another added value as a result of better auditor reporting will be that, across a number of years, stakeholders will be able to identify any changes in the risk profile within the company. Another helpful piece of information for all stakeholders. Nick Land mentioned that he did not expect a lot of change next year in the Vodafone audit report but if there was a change and new risks were emerging then that really is information worth having.

Another positive is in relation to identifying or helping identify sector issues. Analysing audit reports across particular sectors can inform on emerging issues. We tend to focus on the concern over company analysis of competitor disclosed information. It could be that when you do the analysis one company stands out as an outlier thus prompting questions can be asked.

Let's focus on some of the positives coming out of enhanced reporting rather than have a fixation on the negatives.

I believe changing the two reporting models was a positive move in the UK. I hope that the US joins Europe and much of the rest of the world by making the move to enhanced auditor reporting as being proposed by the PCAOB but also look at Audit Committee reporting as a minimum.

We need consistency in auditor reporting irrespective of the jurisdiction where a company resides.

It would be better if we could have just one reporting model across all jurisdictions but the current PCAOB proposals help us move closer together. I think looking at the risks rather than looking at the effort should be considered by the PCAOB but no one party will get everything right first time. We will improve matters and regulation will evolve just like everything else. Darwin said, evolution is a given - we should all take heed of this and evolve.

If the US does not embrace change, I am sorry to say this, but, in my view, it would be nonsense if the largest capital market on earth provided the least amount of information to the investor community on the key matters influencing the financial information upon which those investors are making their decisions.

In the UK, in the rest of Europe and, internationally, through IAASB the wind has changed. Let us all sail in the same direction and I would encourage the PCAOB to move forward just as the rest of the world is moving forward.