

FEE Conference – Brussels

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Good afternoon

I am delighted to be here today and to speak at this prestigious event and my thanks to FEE for their kind invitation. It is quite a challenge to speak following Commissioner Barnier and quite daunting to know that I will be followed by Mr Doty.

I am here in my capacity as a major user of audit services in my roles as Chairman of the Audit Committee of the RBS Group and BP.

My remarks today will cover two main areas:

- Matters connected with competition and choice in the listed company audit market and, in particular, multinationals in the light of the EC Green Paper and other recent reports; and
- Secondly, the role of corporate governance and, in particular, the role of the audit committee in addressing issues, concerns and perceptions regarding the robustness, independence and hence quality of the external audit process and also the Audit Committee's effectiveness in monitoring.

I must preface my remarks with the usual caveat that these are my views and not necessarily those of the organisations on whose boards I sit or other organisations with which I am connected. Inevitably my remarks will have a UK bias and I recognise that not all member states are in the same stage of development of corporate governance standards and, possibly, financial reporting.

1. Competition and Choice in the Listed Company Audit Market

The financial crisis has raised many issues but the two we are most concerned about today relate to auditors and there has been a lot of debate on whether the auditors should have spotted or indeed prevented events that everyone else failed to do and also many commentators have challenged, with the benefit of hindsight, the effectiveness of corporate governance.

The main issues raised with respect to auditors can, I think, be summarised broadly as follows:

- Firstly, is there sufficient competition in the audit market, especially for large companies; and
- Secondly, do long term audit relationships threaten independence and impair audit quality.

Possible solutions suggested by the EU and echoed, at least in part, in other countries are that somehow or other new entrants should be encouraged into the large corporate audit market and that mandatory audit firm rotation or mandatory tendering will address independence and audit quality issues.

Let us be clear that the competition and choice debate is a global issue. Yes, certain large firms have a bigger share in certain markets than others but on a global basis the Big 4 firms have a significantly greater footprint in terms of audit market share and geographical coverage than those firms immediately outside this group.

We all know that this situation has arisen due to some intended events ie the mergers of certain firms in the late 1980s and early 1990s and some unintended ie the demise of Andersens. The big question is whether the dominance of four large audit firms in the listed company sphere is a problem? Let there be no doubt that I share the same objective as Commissioner Barnier which is to protect the interests of shareholders and other stakeholders of public companies through ensuring the highest quality of external audit.

Part of the problem we are dealing with is a lack of transparency over what auditors actually contribute and also a lack of transparency over how their role is monitored by the audit committee but more of that later.

There is no doubt that there has been a relatively small amount of audit tender activity amongst major corporates in recent years. This in part underpins the assertion that existing relationships may become too close and, absent a major audit quality issue, auditor reappointment has become almost automatic. I do not disagree that the audit tender market for major corporates has become somewhat stagnant but let us explore some of the reasons for this. In my view it is a combination of some or all of the following:

- A lack of proactivity amongst the major firms to market audit services absent an audit tender;
- This may lead to a lack of perceived differentiation in the audit services available;
- The hassle factor associated with the tender and the possible change of auditor;
- The possible lack of full choice because of wide non-audit relationships that a company may have with the other major firms;
- On a more positive note, continuous improvements in audit quality supported at least in the UK by the view of the independent regulator;
- A lack of interest by stakeholders in who the auditors are provided that it is a recognised name; and
- Finally a belief that audit risk increases significantly in the first two years of any change – which is not a view that I agree with.

I believe that a more active tendering market would be desirable but am firmly of the view that this should be market driven and not imposed by statute or regulation. As far as audit concentration is concerned more players would be welcomed but concentration is not the same as lack of competition. Many industries have high levels of concentration but nevertheless remain highly competitive. My main concern is that the quality of audit remains high and is seen to be so.

Let me therefore share with you some thoughts on mandatory audit firm rotation, mandatory re-tendering and joint or shared audits.

Mandatory audit firm rotation:

The question is would a policy of mandatory audit firm rotation enhance audit quality? Would audit firm rotation lead to more independent auditors who would exercise greater professional scepticism or does it possibly decrease audit quality in the early years of a changeover as an audit firm takes time to build up its knowledge of a new client.

I am a firm believer that audit firm rotation is not the silver bullet. Knowledge of the business is crucial to a high quality audit but mandatory firm rotation does not enhance audit quality.

Several countries, including Spain and Turkey, have adopted and subsequently dropped mandatory audit firm rotation because it did not achieve what it was introduced to do. That effectively leaves Italy as the last man standing or possibly the catalyst for more countries to follow. Additionally, setting aside the quality aspect there is no guarantee that audit firm rotation will succeed in providing increased choice in the marketplace. A likely scenario might be that companies will rotate on a continuous cycle around the Big 4 firms.

I am aware that audit firm rotation has recently been mooted by James Doty as a means of helping as a safeguard in relation to auditor independence. However, in reality, in my view the requirement for rotation of audit engagement partner every seven years under the IESBA Code (International Ethics Standards Board for Accountants) is already a sufficient safeguard in this respect, I am aware that the length of this partner rotation period is less in certain jurisdictions. Additionally, the composition of boards of directors is not static either and this also helps to reduce the independence risk that is perceived to exist.

Therefore I do not support this proposal as I do not believe that it will enhance audit quality nor do I believe that it will necessarily increase the level of choice which currently exists, but I think that the audit risk point associated with change is somewhat overplayed.

Of course, I spent a whole career trying to convince non-audit clients, and often successfully, that a change to my firm was good and enhanced audit quality.

Re-tendering:

I do not support setting in stone that a company has to re-tender its audit every x years. As I have already mentioned I would prefer for audit committees to be more transparent in this area by setting their re-tendering policy and then reporting via a 'comply or explain' mechanism as to whether they have adhered to their policy. Where in certain circumstances a company deems that it is not an opportune time to put its audit out to tender then this should be clearly and appropriately explained to stakeholders. Ultimately, I believe that market pressures will force companies to operate within certain re-tendering periods without the need for regulatory intervention.

I also have to caution here that re-tendering would not necessarily result in a change in the market dynamic but at least it would provide the opportunity, in theory, for non Big 4 firms to tender for the audit and help to ensure that the market was competitive. I say, in theory, because it would ultimately depend on the audit committee to determine what firms were invited to tender unless a requirement was introduced which stipulated that a non Big 4 had to be invited to every tender.

Joint or shared audit:

Nowadays, this is not commonly used around the globe. Twenty years or so ago, joint audit was far more prevalent. However, sometimes things disappear from fashion and then reappear, so we cannot merely dismiss the merits of joint audit on this assumption.

Currently, France requires joint audit and South Africa also requires it for banking institutions. There are other countries where joint audits still take place on rare occasions on a voluntary basis. There is of course a great debate as to whether joint audit increases or decreases audit quality. The ‘four eyes’ principle of those in favour is batted back by those who believe it can lead to cracks in the audit and merely increases cost. My own experience is that there is a risk that joint audits can lead to gaps in coverage, albeit a low risk, but they do increase cost. Similar issues apply to shared audits, with one audit firm reporting at group level, but another responsible for a part of the group. Also, two audit firms working alongside each other could lead to a less open relationship between the auditors and the audit committee, given the territorial concerns of the audit partners of the competing firms.

I believe that a more active audit market can be achieved by:

- Firms being more proactive in promoting their audit services;
- Key stakeholders taking a keener interest in audit appointments;
- More disclosure on the date auditors were first appointed; and
- Companies establishing and disclosing a policy that requires that the audit relationship is formally considered for re-tendering at given intervals with a ‘comply or explain’ approach.

I also believe that 2 related issues should be addressed:

- The level of assurance provided on corporate reporting; and
- Greater transparency on the effectiveness of the audit process.

It is not within the scope of my remarks today to broaden the debate on the level of assurance provided on corporate financial reporting. But let me just say, there has been a dramatic increase in additional financial information provided by companies beyond what is commonly known as the statutory accounts. Audit has remained firmly rooted in statutory accounts and has not changed in line with corporate reporting. This in my view needs to be examined.

But let me now turn to the second part of my remarks regarding the role of corporate governance and specifically the role of the audit committee and here I will deal with the transparency issue.

2. Corporate Governance and Audit Committees

It is clear from the EC Green Paper on Audit Policy that there is some scepticism amongst the European Commission as to the merits or otherwise of the role of the audit committee. I do not share that scepticism and was recently the co-signatory to a letter to the European Commission along with the audit committee members of some of the leading public companies in Europe and North America representing over €850 billion in market cap and 2.5 million employees which highlighted the importance of the role of non-executive directors, and in particular the role of the audit committee

There has been a dramatic evolution in the effectiveness of company board of directors in the past 10 years. Much of this was driven by the reaction to the Enron et al collapses which included the revised 8th Directive on Statutory Audit, as well as ongoing improvements to the corporate governance codes in Member States but also, as a result of economic reality, boards have met more frequently and for longer hours, and they have engaged more deeply on the issues challenging companies.

In addition to attending an average of eight to ten board meetings per year, and in some cases many more, non-executive directors have taken it upon themselves to meet more frequently with members of management and with internal and external auditors, both formally and just as importantly informally in order to gain insight into management effectiveness and to provide guidance.

Today, board committees are more active, delving deeper into key issues, such as accurate financial reporting, executive remuneration and board composition. They also undertake evaluations of board performance to understand where improvements in oversight can be made. Non-executive directors are elected by company shareholders to represent their collective interests by providing oversight of company management. As such, it is their responsibility to make decisions in the best interest of all company shareholders and to hold management accountable. If shareholders object to the way non-executives carry out our responsibilities, then they can remove them from the board. Non-executives take their responsibilities very seriously, and can help the Commission achieve many of its objectives by doing so.

As with anything there is always room for improvement and the role of the audit committee is no exception. Given the expectations gap that has come to exist among stakeholders regarding the role and functioning of the audit, I support several considerations put forward by the Commission and other stakeholders:

- A more comprehensive auditor's or audit committee's report that would provide more information regarding the work involved in the audit. I personally favour this being the responsibility of the audit committee. Such a report should go beyond routine housekeeping information and provide greater insight into the actual work of the committee during the year. Some indication of how it spent its time, what issues it focused on would provide more colour to an otherwise pretty monochrome report. It is also important for the audit committee to explain how they evaluated the effectiveness of the external audit process. This could include assessing:

- The experience and expertise of the senior members of the engagement team
- The proposed scope of the audit work planned and executed
- The quality of dialogue between the external auditors, the audit committee and senior management
- The clarity, quality and robustness of written reports presented to the committee by the external auditors
- The views of management on the performance of the external auditors

There have been significant improvements in audit committee reporting in recent years – Barclays is in my view a very good example – and I would urge companies and regulators to define best practice in this regard to provide consistency across companies and across geographies.

- Enhanced reporting from the external auditor to the audit committee, to provide more detail and to point out issues that the audit committee should raise with management. There is no established benchmark standard for external auditor reporting to the audit committee. This has evolved through a combination of the audit firm's own initiatives and the demands or expectations of their clients. There is some work taking place in the UK to provide benchmark guidance which I welcome.

Concern has also been expressed about the potential lack of auditor scepticism. This is not something that I have experienced either as a provider of audit services or, more recently, as a user of audit services. I think part of the problem is a lack of transparency and possible misunderstanding of how the audit process actually works. Auditing is an interactive and, in a sense, consensual process.

Most companies would discuss highly judgemental issues with their auditors before determining their position. So, in a sense, neither party begins with a definitive position that has to be reconciled in some way with the other. Nevertheless, the clear indication of the level of prudence adopted by the company in judgemental areas should be a standard component of such a report together with an indication of areas where the auditor has had to 'push' a company towards a more acceptable position.

Although the role of the audit committee was not addressed in the green papers on corporate governance or audit policy, I believe it is critical that the Commission more clearly articulate the responsibility of the independent audit committee to select, remunerate and assess the performance of the external auditor, beyond what is outlined in the 8th Company Law Directive.

I was glad to see that the report from the European Parliament was positive in relation to the role that the audit committee plays in a proper system of corporate governance. The EU Statutory Audit directive was not transposed into many EU countries legislation until very late in the day – 2009 in some cases.

Conclusion

So, in conclusion, I am not of the view that there is a major issue with audit quality as a result of market concentration or longevity of relationships. Nevertheless, I would recommend that we explore ways of stimulating more activity in the audit tender market without having to resort to mandatory auditor rotation or mandatory audit tendering.

I also believe that a review is needed to address the expectation gap between the current scope of external auditor activity and market perception and possible expectations.

Finally, more transparency needs to be given to the role of the audit committee as I actually believe that in most cases that they are doing a much better job than they are being given credit for.

I am confident that the audit committee chairs in the EU and the US would be happy to meet with Commissioner Barnier and Mr Doty to discuss these issues. In my view constructive dialogue is essential to ensure we do not introduce measures which may have unintended consequences.

Thank you for your attention. I would now be happy to answer any questions which you may have.