



EUROPEAN COMMISSION

Brussels, 4 February 2010

**SUMMARY OF RESPONSES**

**GREEN PAPER**

**AUDIT POLICY: LESSONS FROM THE CRISIS**

## **Background**

The Commission published a Green Paper on the 13<sup>th</sup> of October 2010 seeking views from stakeholders and the broader public on a range of issues related to the statutory audit ('audit'). The consultation closed on the 8<sup>th</sup> of December although certain responses came in after the deadline.

In all, almost 700 responses were received. This is the highest level of responses of any consultation in the Internal Market and Services area since the completion of the public consultation on Solvency II in February 2008 and is certainly the widest consultation response coming out of the financial crisis. The responses have come from various stakeholders; these include members of the profession, supervisors, investors, academics, companies, government authorities, professional bodies and individuals. Although the majority of the responses are from within the European Union, there have been a number of responses from third countries.

This summary has been prepared to provide a qualitative synthesis of the analyses carried out of the various responses. Although there are some very detailed responses, not all respondents have replied to all the questions. In fact, there are certain responses that are very short and some that make a statement without responding to any particular question.

Through this summary, our endeavour is to provide an accurate depiction of the broad spectrum of responses. As for any public consultation, there are some responses at the extremes of the opinion spectrum with outright rejection of almost everything on the one hand and unflinching support for most ideas at the other. We have tried to provide an idea of the different levels of support and rejection as well as the stakeholder groups concerned. The stakeholder groupings used throughout the summary emanate from the procedures used by us to process all the replies; they are not intended to 'club' any particular respondent in a category as there may well be instances where the respondent could have been included in another category. In any case, in order to facilitate a trail back to the individual responses, the latter will be published using the same categories as those appearing in this summary. For ease of reference back to the Green Paper we have also used the same section headings as in the Green Paper.

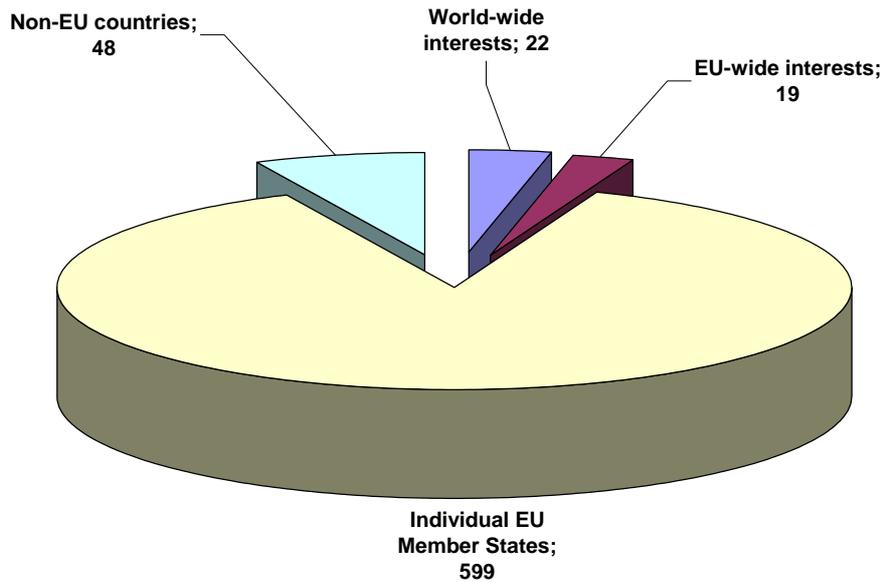
It is worth noting that the four biggest audit networks ('Big Four') have each submitted one response on behalf of the whole network. The summary often refers to the Big Four and endeavours to represent a 'collective' position although there are nuances and differences on certain issues; to get a clearer detailed view of their response we would refer the reader to the individual responses that have been published along with this summary.

It is also important to highlight that 42% of all responses have originated in Germany. A noteworthy aspect of the responses is the substantial interest expressed by the small and medium sized audit practitioners from Germany as well as other Member States.

In various instances, for the purposes of accuracy as well as in recognition of the clarity of certain messages, we have reproduced the text provided in the response. The variation in the length of the various sections is a reflection of the number of questions posed in the Green Paper as well as the level of interest elicited amongst respondents.

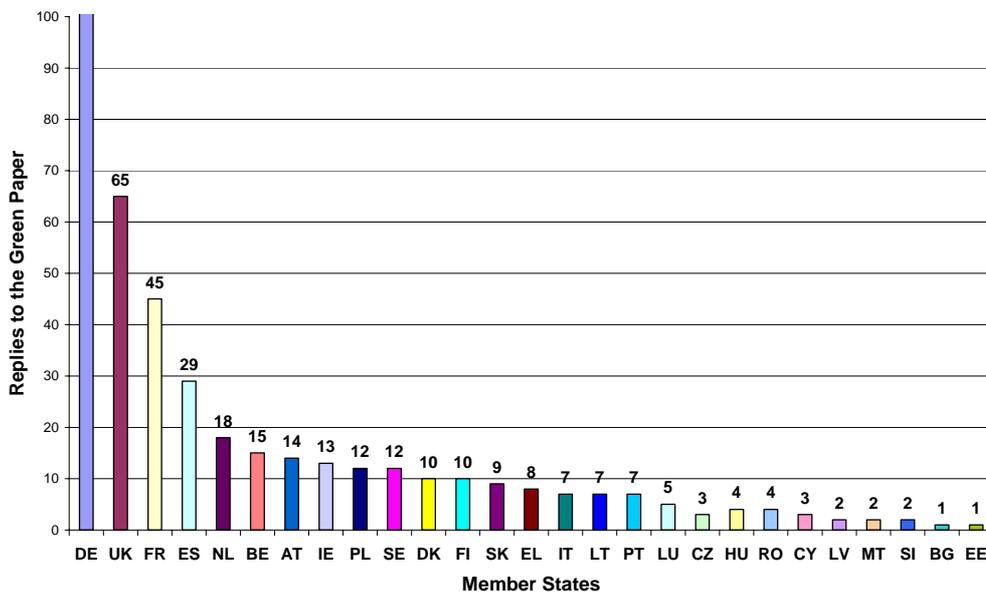
**Stakeholders**

87% of replies (from the total of 688 replies) were received from the European Union Member States (see figure 1). The consultation attracted groups representing either pan European (19 replies) or worldwide (22 replies) interests. Respondents representing world-wide interests included internationally operating audit firm networks and associations. Among the EU wide stakeholders (19 replies), these were primarily European associations representing the interest of companies (preparers). There was also considerable interest in the consultation from non-EU countries (49 replies).



**Figure 1.** Geographical distribution of the replies to the Green Paper

There were 599 replies received from individual EU Member States (see figure 2). The replies from Germany, UK, France and Spain made up more than 2/3 of all replies received from individual Member States. The replies from the international audit firm networks have not been included under replies from member states.



**Figure 2.** Distribution of replies by a Member State [DE: 291 replies]

Figure 3 presents more detailed information on the replies received from other non-EU countries. Almost half of the non-EU replies have been received from the United States.

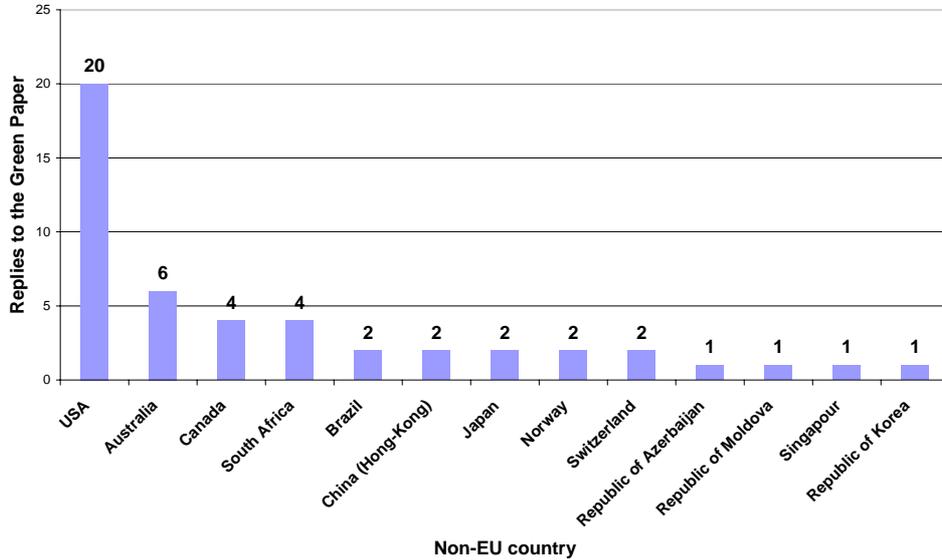


Figure 3. Responses from non-EU countries

In terms of the interest groups, a majority of responses represented the interests of the audit profession – 59% of the total number of responses (see figure 4). It should however be noted here that there were more than 200 replies identical in their content; these were all received from the German audit profession. The second biggest group of respondents were the preparers of the accounts and businesses in general (21% of the total number of responses). There has also been good representation of public authorities and users, respectively 57 and 22 responses. The remaining replies included academia (28 replies), audit committees (9 replies) and other replies (20 replies), of which the majority came from private persons.

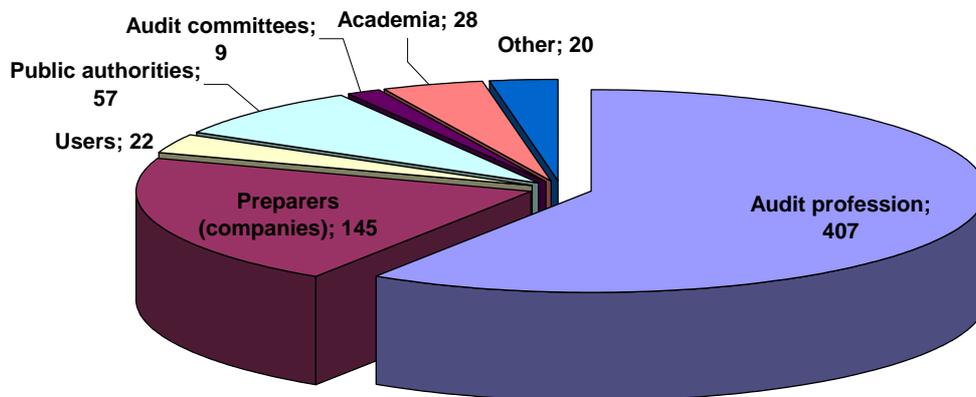


Figure 4. Responses by interest groups

Among the representatives from the audit profession, sole practitioners and other small audit firms were the most responsive amounting to 286 replies (see figure 5) with German small and medium practitioners being particularly active. There were 94 replies from the professional associations. The Big Four networks provided their replies on behalf of all their respective members. Other international networks, a vast majority of which form part of the European Group of International Audit Firms (EGIAN) or/and of the Forum of Firms, were also well represented.

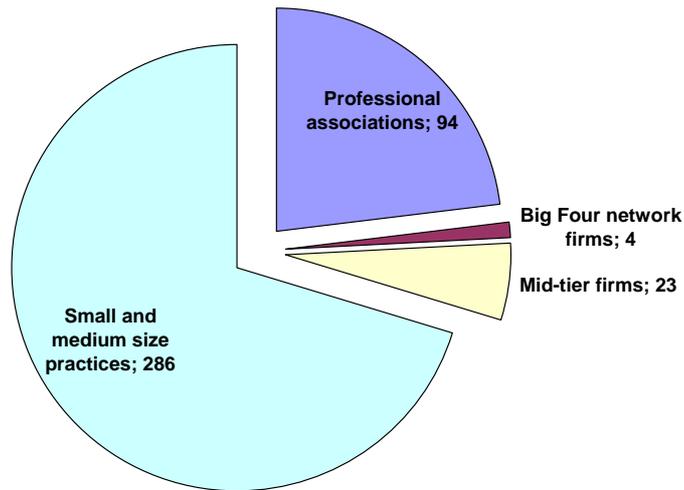


Figure 5. Responses representing the interests of the audit profession

The interests of the preparers of financial statements have been represented well by various business associations – 49 replies out of 145 (see figure 6). The financial industry has been the most responsive economic sector (20 replies). There were only two companies identified as SMEs, though their views were also reflected by some professional associations.

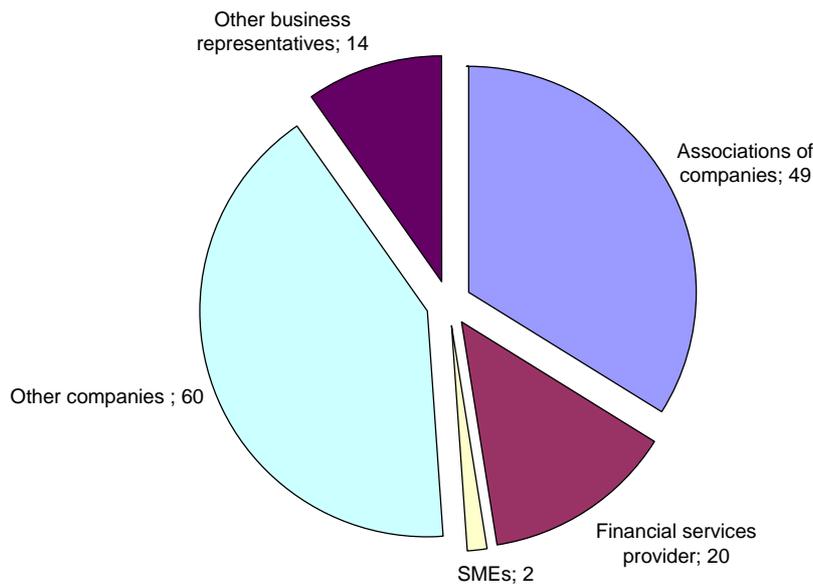
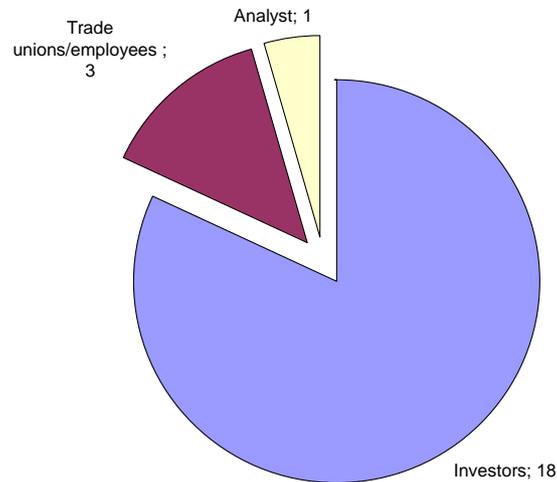


Figure 6. Responses representing the interests of preparers of the audited financial accounts

When it comes to the user stakeholder group, most of them represented investors (figure 7), but there were also replies representing the interests of employees and analysts, respectively 3 and 1 replies.



**Figure 7.** Responses representing the interests of the users of audited financial accounts

#### GENERAL VIEWS

There is general acceptance of the Green Paper. The issues raised, despite having been discussed before, are of particular interest in light of the recent financial crisis – a crisis that is still affecting the economies of many nations.

There persists an expectation gap between the actual scope of audit and the public perception of what audits are intended for. It is thus important to improve transparency on the conduct and outcome of the audit to narrow that expectation gap. It is equally important to 'adjust' the work carried out in function of the requirements of the main stakeholders.

It has been indicated that the societal role of auditors is clear, but clarification or better articulation could be helpful.

Academics suggest that there is a need to align the role of auditor more with expectations of the general public by enhancing audit reporting and disclosure to add more value to the audit. The current legal framework is not sufficient to safeguard auditor independence and structural changes are needed. Inspections in some countries show that 'big' is not equal to 'high quality'.

Although, the majority of individual business preparers do not see a real need to redefine the scope or role of auditors, some of them also agree that improvements could be achieved by redefining the role of audit regarding the veracity of financial statements as well as an increase in the quality of audit. Some respondents find audit too focused on tax issues rather than on a true and fair view of the financial statements.

## 1. ROLE OF THE AUDITOR

### The Profession

#### *Professional bodies and associations linked to the profession*

The majority reply that reporting on the financial health is not the purpose of an audit and that, currently, audits are not fit for this purpose. The current role is to express an opinion on the financial information provided by management i.e. to give reasonable assurance on the true and fair view of the financial statements.

The respondents generally confirmed that more information could be provided but many maintain that the expectation gap is unlikely to be closed. Nonetheless, what an audit does and does not do should be clearly spelt out especially with more disclosures on the work conducted on key areas of judgement, the major queries raised and management explanations thereto, issues of material concern and models/techniques used for valuation, etc. Some suggested more disclosures on risk, judgements and estimates. Another suggestion was to ask the users what information they would require.

The vast majority of respondents do not consider that more substantive testing or 'going back to basics' will automatically result in higher assurance.

The majority of respondents replied that qualifications should remain 'negative'; they should not be graded as they are binary in nature. Although some did suggest that qualified opinions could be better explained in the audit report.

There were also suggestions that the audit committees could report more on discussions with auditors, e.g. key areas of judgements and audit issues in the financial statements. Some also suggested strengthening the independence of the audit committee and internal audit.

The replies were mixed as regards the role for an auditor in CSR. Caution was urged as key aspects of this area require further clarification and now may not be the right time to introduce CSR requirements. In any case, a prohibition on non-audit services could affect CSR.

The majority of respondents think that the time gap between the year end and the date of the audit report cannot be shortened without damaging audit quality. A few suggested more interim reporting.

Suggestions to enhance audit quality include enhancing auditor involvement with the front end of the annual report, providing greater assurance outside the report and improving communication between auditors, regulators & company.

Quite a number of respondents feel that the role of the auditor could be expanded if those charged with governance were to provide more information in the annual report (e.g. assumptions underlying going concern and the key risks associated with the entities' business model) and the auditor could then provide assurance on this information.

One respondent proposed an explicit provision in EU Regulation that EU auditors act in the public interest when performing statutory audits.

The majority of respondents believe there is a need to better set out the role, purpose, scope and limitations of audits. The interaction of audit with other functions in the

corporate governance framework should be better understood and awareness of concepts such as going concern and emphasis of matter should be enhanced. Moreover, audit oversight has an important role in audit quality.

### ***Big Four***

On the specific questions, the Big Four are of the opinion that although some measures may be helpful in strengthening the role of audit, several topics run the risk of negatively impacting audit quality, imposing disproportionate costs on business and affecting shareholder's rights. They also alert the Commission on the global implications, including potential unintended consequences of any EU proposals. The Big Four remind the Commission that the auditor's mandate is to issue an opinion as to whether the financial statements give a true and fair view in accordance with the relevant reporting framework.

### ***Mid Tier Firms and Small and Medium Sized Practitioners (SMPs)***

The non Big Four believe that audit quality is not an 'absolute' but rather a state of incremental attainment at any given time. A view has been expressed that 'audit quality' may be adversely affected by the pressure, in many countries, to reduce audit fees.

German replies draw the attention to the point that the German "Lagebericht" (management report), which has to be audited as well, already includes forward looking information. In order to enhance the value of audits, it is proposed that the German long form report could be a basis to provide further information.

Some SMPs point out that the standardisation of the auditors' report has deprived the auditor's opinion of any meaningful content.

### **Investors**

Most investors believed that auditors should also provide comfort regarding the financial health of companies, but only within their current remit and without any extension of the auditors' role. Specifically, investors underline the importance of the going concern assumption, both in terms of its disclosures by the company and its validation by auditors, as well as the correct valuation of assets. Moreover, investors suggested that auditors should improve their reporting by explaining what they have done during an audit.

All investor representatives agree that professional scepticism should be reinforced. Investors would like to see audit firms ensuring a stronger and more visible "tone from the top" as well as the consistency of key judgments across clients. Mentoring, junior staff training, continuing education, reducing the amount of junior staff per audit partner should also be seen as crucial to developing and reinforcing scepticism. The promotion system should also be well adapted to support the use of professional scepticism. Investors also think that independent inspections should focus more on the use of professional scepticism and in this regard it is important that review notes are retained by auditors. An audit committee should also be in a position to assess the professional scepticism applied by auditors. Fair value valuation and going concern validations are specific areas where investors believe the use of professional scepticism should be improved.

Most investors were of a view that audit reports should be more qualitative and the negative perception towards audit qualifications should be reconsidered. As a solution, investors propose more informative auditor opinions, more frequent use of the "emphasis

of matter" statements or even the review of the audit terminology used in audit reports, such as "emphasis of matter", "true and fair override". Some investors pointed out that if the audit report gave an indication on the quality of financial statements, i.e. how far the company is pushing the boundaries of accounting standards, it would provide much more useful information to investors, and would dissuade companies from taking an aggressive stance.

The audit profession needs to more actively consider the 'true and fair override' such that auditors do not sign off simply because statements comply with accounting standards. The 'true and fair override' is required under accounting standards, but seems never to be applied in practice.

While few thought audit firms could be in a position to also audit CSR, others believed that non-audit firms may be better specialised to provide assurance on such matters.

### **Public Authorities**

Most respondents argue that the current role of an auditor is an assurance concerning historical information, not forward looking information. Auditors should not replace the role of rating agencies and analysts, nor of those entrusted with governance. Still, there were some public authorities that were more open to an analysis of the benefits of such a change in the current role of the auditor.

Most respondents agreed that it is important to bridge the expectation gap, to the extent possible, by explaining the methodology used by auditors to users. More detailed suggestions on the matter included: the auditor should explain the purpose of performing risk assessment procedures and of obtaining an understanding of the entity, the entity's environment and internal controls, as well as the purpose of evaluating the design of those controls. Auditors could also explain how they have arrived at certain judgments, evaluations and decisions. It was also suggested that an "extended" audit report, which contains further description of the methodology applied and which is made available to the audited entity and relevant supervisory authority, could be helpful to reduce the expectation gap.

Most respondents agree that professional scepticism should be reinforced.

Some respondents proposed greater transparency by audit committees on the outcome of the audit together with improved engagement with investors; this should help minimise the shortcomings in a binary audit opinion and the implementation of a "graduated ladder" of reporting options which would help auditors express their views regarding the company's finances more specifically (rather than just having the sole option of 'qualification').

Most respondents agreed that there should be more regular communication by the auditor to the stakeholder but that the time gap between the year end and the issue of the audit opinion should not be reduced. Reducing the time available for the auditor to gather and analyse audit evidence would present a risk to audit quality. It was also argued by some that it is vital that any changes to audit regulation at EU or Member State levels are evidenced by an assessment of the economic impacts that demonstrates that the benefits exceed the costs.

CESR, CEIOPS and CEBS do not think that the role of the auditor should be extended to provide comfort on the financial health of companies. Auditors are not (and should not become) credit rating agencies predicting or assessing the future solvency of companies. However, they support improving the communication of the auditor towards stakeholders

on this issue: further discussion on improving the explanatory notes to the going concern assessment would be welcomed.

There could be benefits in auditors better explaining audit methodology to users, but this may not necessarily reduce the expectations gap. They agree that there is room for improvement on professional scepticism. CEIOPS would encourage experts to start a debate on whether different categories of qualifications in audit reports could be feasible.

They agree that there is a need for better communication between auditors, audit committees and external stakeholders. Improved communication, inside or outside the audit report, would be beneficial and might help diminish the expectations gap of stakeholders.

### **Academics**

Apart from adding reasonable assurance and protection with respect to the reliability of the accounts, academics who responded to the consultation generally think that the substantive added value of audit reports is very limited. Form dominates over substance.

More transparency is needed on audit quality, and the reporting of it by regulators and oversight bodies. Expanding the content of the auditor's report is critical not only to reduce the expectations gap but also to provide greater incentives for high quality audits. A qualified audit report should send a clear and important message to the market place; this is not the case at the moment. Fraud detection should be indispensable as it's invariably linked to the major disappointments with the present system.

Additional information should give more prominence and visibility on work performed by the auditor (also linked to the expectation gap), consider the use made of the annual report by stakeholders and where additional information can help, avoid an information overload (as is already the case in annual reports) and have more explicit and informed professional judgements explained in the financial statements.

Professional scepticism can be achieved through rotation after fixed (8 year) periods as the auditor would be sure in this case that another audit firm will be engaged and that the incoming auditor will review the previous auditor's work.

The Green Paper does not sufficiently analyse the position of the auditor in a company: "giving credibility to the accounts that are presented by the management and the board as these would not be considered reliable without the external, expert and independent opinion of the auditor". In reality, auditors are nominated and their remuneration is fixed by management. To give power back to shareholders, a shareholder committee as tested in Sweden should be considered. There is a need to align the role of auditor more with expectations of the general public by enhancing audit reporting and disclosure on audit. The current legal framework is not sufficient to safeguard auditor independence and structural changes are needed. Inspections in some countries show that 'big' does not necessarily equal 'high quality'.

Society would benefit if it were to view and treat the auditor as a potential whistleblower, accompanied by appropriate rewards and incentives. Especially as the overall incidence rate of fraud was recently estimated to be in the 7%-13% range of all publicly held organisations, i.e. detected fraud could well be the proverbial tip of the iceberg.

### **Preparers, businesses and organisations of companies**

There is strong support from business respondents that audits should never be considered to provide comfort on the financial health of companies since this would transform audit opinions into credit ratings. There is also strong support for enhancing the communication between auditors and supervisors (specifically in the banking sector), while lifting any restrictions on auditors to share client-specific information with the supervisors.

Auditor's role should be to give assurance on the financial statements based on historical data. If users require more information, they would be able to form their opinion on the health of the company, based on the financial statements, possibly guided by rating agencies or other professionals in assessment (e.g. equity analysts).

Over the past years, one can see a shift in the focus of audit. Typically auditors want to secure completeness, correctness and timeliness of the financial data (balance sheet, P&L, cash flow overview and notes) of a company. Respondents have noticed a shift from this focus to examining compliance with IFRS.

With regard to the ideas of the Commission to come back to a more basic and substantive test of the balance sheet, they can only support them in relation to the audit of small entities for which a system-based approach does not make sense (too limited number of staff). In contrast, respondents are not in favour of this idea for medium-sized, larger entities and large groups. A 'risk based approach' (i.e. an approach based on the risks of material misstatements in the financial statements) is more efficient. It should be maintained with possibly extensive feedback on effectiveness of internal controls. However, even with a risk based approach, it might be useful to limit the focus of the audit to financial data and not broaden its scope to auxiliary areas and reports.

Although, the majority of individual business preparers do not see a real need to redefine the scope or role of auditors work, some of them agree that some improvements could be envisaged by redefining the role of audit with regard to the veracity of financial statements as well as improving quality. These discussions should be on a level of materiality and scope of audit programmes; this in turn would help closing the expectations gap. Some respondents also find audit too focused on tax issues rather than on a true and fair view of the financial statements.

On the specific questions, business respondents are of the opinion that although some measures may be helpful in strengthening the role of audit, several topics run the risk of negatively impacting audit quality, imposing disproportionate costs on business and affecting shareholder's rights. The role of the regulators should also be revisited because many auditors have increased their focus on checklists in order to meet the demand of audit inspection units. This situation can distort the quality because it has led to a 'perceived degeneration' of an audit into a review on IFRS compliance instead of providing a professional judgment.

On the audit methodology issue, all respondents admitted that the audit methodology should be better explained to the public and the users but this explanation should not be included within the audit opinion.

On the audit report, the preparers seem to agree that their language should be revisited (very defensive and difficult to understand). The opinion should clearly state the responsibility of the auditor and the work performed. Auditors should provide more detailed information as well as more information on key judgments. They can also justify their opinion as is currently the case in France.

Finally, regarding the qualified audit report, there is a general belief that its current form is satisfactory but it might be beneficial to look into further explanations on the reasons for qualification. If the signal is changed to for example “nearly qualified” the value of audit might decrease as a mixed signal does not make sense. Conversely, if the auditor fails to qualify his opinion when it should have been qualified, audit regulators or inspectors should be able to file law suits or impose disciplinary sanctions. A potential solution could be the introduction of several categories of opinions.

Finally on the question to know whether a short or long report should be put in place, the respondents do not seem very concerned as most people do not read the audit report as such. They only focus on the ‘qualification’ status or ‘emphasis of matter’ paragraphs. But what should really matter in the report is how the auditor has planned and conducted the audit (i.e. the audit methodology).

To reinforce professional scepticism, audit regulators should be able to refer the auditor to a disciplinary tribunal.

Nobody believes that the auditor should play a role in the field of CSR. The objective is not to give new markets to auditors. Moreover, auditors often do not have the skills to understand CSR reports (often qualitative information). Companies should use specific experts if they seek some sort of assurance in this field.

## **2. INTERNATIONAL STANDARDS ON AUDITING (ISAs)**

Views are mixed on the possible adoption of ISAs in the EU.

### **The Profession**

#### ***Professional bodies and associations linked to the profession***

There is very broad support for binding ISA adoption. Some professional bodies, however, suggested that Member States should be allowed to introduce modifications to ISAs which would be needed because of national legislation/practice (e.g. company law). It was also suggested that ISAs should include the international standards on quality control (ISQC1), widely applied by firms. Concerning the role of the IAASB, professional bodies also explained that currently auditors are not sufficiently represented in the IAASB.

#### ***Big Four, Mid Tier Firms and SMPs***

There is broad support for the adoption of ISAs in the EU as binding instruments and without any further adaptation for SMEs and SMPs; the latter are catered for already in the standards themselves as well as the guidance provided. However, there are a number of responses from SMPs requesting sensitivity to the additional administrative burden.

### **Investors**

Most investors supported application of consistent auditing standards not only in the EU, but also globally. Most respondents rather support a flexible non-binding approach, such as a recommendation, which could also be subject to a form of review in order that the Commission and other relevant stakeholders can reasonably satisfy themselves that standards are proving to be 'fit for purpose'. It was believed that the non-binding approach would not reduce an impetus to higher audit quality by making auditors more

focused on the overall purpose of the audit to ensure a 'true and fair view' rather than following compliance-focused audits.

Some investors also raised an issue on the governance of the auditing standard setter IAASB. This body may be potentially conflicted as it is part of IFAC which is funded by the professional associations and large audit firms. In this respect, investors asked for a review of the IAASB governance so that a broader constituency including investors are involved in the development of ISAs.

### **Public Authorities**

There is broad support for ISAs albeit not always for a binding approach. CESR, CEIOPS and CEBS support the adoption of ISAs in the EU as binding instruments (by Regulation, through comitology). CEBS would be opposed to adaptations and carve outs, but could accept national additions. CESR suggests, however, that it would be beneficial to retain an ability to amend standards prior to endorsement, should the European public interest so require.

### **Academics**

There is support for ISAs in the EU through regulatory binding standards. The risk of non-application of ISAs by the US should, however, be taken into account.

### **Preparers, businesses and organisations of companies**

Companies, nevertheless, expressed less enthusiasm for ISAs. Companies are not opposed to the application of ISAs by EU binding instruments for medium, large and listed entities provided that their reservations are addressed. These reservations relate firstly to the need to reinforce the governance and due process of IAASB with participation of all interested parties. At the moment the composition of the board is unbalanced (mainly accountants) which may lead to conflicts of interest. Secondly, these reservations relate to the need to put in place a specific assessment and adoption approach in the EU with appropriate guarantees:

- The approach should not be similar to the one existing for enforcement of IFRS. The new approach should be more flexible especially in a context where ISAs were drawn up by a body which is not accountable to European institutions.
- Explicitly allow amendment of standards that would include requirements on companies.
- The adoption procedure should be in direct cooperation with stakeholders (in particular companies) to make sure that ISAs do not set up new corporate responsibilities. The ISAs should remain 'legal environment-neutral' to facilitate the international convergence of external auditing standards towards ISAs.
- The adoption procedure of the ISA should not limit the responsibility of auditors.

Some companies have also expressed their concern about the risk of ISAs pushing the core of audit into being even more "compliance-driven" as opposed to focusing on the veracity of financial statements. ISAs, as they stand now, would inappropriately describe the role of auditors and not take sufficiently into account the diversity of the audit model in Europe. In addition, there would be an important cost dimension associated to the adoption of ISAs.

For SMEs and SMPs, there is a willingness to further explore this area. Some of the replies express concerns that ISAs should be further developed to be better suited for SMPs and SMEs.

### **3. GOVERNANCE AND INDEPENDENCE OF AUDIT FIRMS**

#### **3.1. Appointment of auditors (Q.16/17)**

##### **Profession**

##### *Professional bodies and associations linked to the profession*

Although most respondents replied that the Code of Ethics and/or effective audit committees are sufficient to address any potential independence risk, others acknowledge the conflict in the current status quo. Although the vast majority rejects appointment by third parties, some did state that in very exceptional cases (systemically important entities) there could be some third party involvement e.g. the right of a supervisor to veto the appointment of the auditor, governmental involvement where companies are in receipt of public funding or where an entity has no auditor or refuses to appoint one.

##### *Big Four*

There is strong endorsement of the fundamental premise that 'independence should be the unshakeable bedrock of the audit environment.'

On the appointment of auditors the Big Four do not believe there is a conflict and believe that the current system works well, in particular relying on the existence of an effective audit committee. The Big Four believe that appointment by a third party would disenfranchise shareholders and audit committees. Some believe that there may be certain instances where a regulator could be involved in the appointment of auditors; one Big Four, however, limits this to specific circumstances where a prudential supervisor or stock market regulator may need to appoint an audit firm to perform specific procedures in relation to the audited entity. The same network also explains that such an arrangement would expose such regulator (third party) to a much greater level of risk because they would be held accountable by shareholders for every perceived audit failure.

It has also been suggested that where the previous auditor has resigned due to disagreement with the entity then there may be some justification for third party appointment of the replacement auditor.

The Commission has also been requested to investigate the possibility of establishing an independent body to work with Audit Committees in reviewing their audit appointment procedures, with an explicit agenda for ensuring: regular and open tendering, independence from management in setting audit remuneration and reduction in market concentration.

##### *Mid Tier Firms and SMPs*

The non Big Four believe that the main conflict to be avoided is that of management having a role in the appointment of the auditor. There is a submission that in the case of large banks which benefit from the 'too big to fail' public guarantee there may be a case for regulatory appointment of the auditors.

Mid tier firms are of the opinion that the role of the audit committees should be strengthened with regard to the appointment of auditors. There is also strong support for regular tendering through a fair process. Mid tier networks do not support a prohibition of non audit services.

On the other hand, some SMPs point out that it is critical that the auditor is appointed and remunerated by the audited entity. Therefore, they call for a fixed scale of fees. Moreover, this group is of the opinion that in the segment of listed companies a third party, maybe a regulator integrated within a European supervisory body, could appoint the auditor at least as long as a sufficient number of SMPs have access to the listed company segment. The appointment and remuneration by a third party in the sector of SMEs is not seen as justifiable mainly due to the administrative burden.

### **Investors**

Most investors agree that there is an inherent potential conflict of interest where the auditor is appointed by the audited entity, but believed that a number of measures already exist to mitigate that risk and that further measures could be invoked if necessary.

Most investors oppose "a scenario where the audit role is one of statutory inspection wherein the appointment, remuneration and duration of the engagement would be the responsibility of a third party, perhaps a regulator, rather than the company itself" as referenced in the Green Paper. In the view of investors, such a scenario would seriously undermine the accountability of auditors and their relationship with shareholders. However, some investors noted that in some specific cases the intervention of a third party, such as a supervisory authority, in the appointment of a new auditor might be necessary, such as in the situation where the auditor report and the financial statements are found to be misleading by a group of shareholders or the supervisory authorities.

As possible ways to deal with these conflicts, the following measures were pointed out:

- a) Shareholders should always approve the auditor. Specifically, the appointment or re-election of the auditor should always be subject to annual approval by the shareholders, whereas appointment should be made by the independent members of the audit committee. As a reappointment of the auditor often hinges on the quality of their long-term relationship with the management board, the responsibility to decide on the auditor's (re)appointment should no longer, formally, or in practice, be with the management board.
- b) The Commission should take steps to empower shareholders and to make the auditor more accountable, whereas an independent audit committee must be independent and fully engaged in the audit process. It should provide a check and balance not only to prevent the conflict being abused, but also to improve their reporting to shareholders.
- c) There should be minimum standards of transparency regarding the relationship between the company and its auditors. This will ensure that shareholders make appropriately informed voting decisions. Such disclosures might, for example, include the amounts paid to the auditor in respect of audit and non-audit fees for, say, the last three years, the length of tenure of the audit firm, the date the audit was last put out to tender, and the company specific reasons why the Board is recommending election/re-appointment.
- d) There should be more transparency regarding the change in auditor and the views of the out-going auditor, which is a major weakness in European corporate governance.

Too often, companies and the out-going auditor cite reasons of confidentiality as justification for not disclosing the reasons for the change such that there is no meaningful transparency, which is most unsatisfactory. This is a governance-critical change on which there should be effective accountability. Changes in auditors should be better explained and that auditors and companies should not be able to use commercial confidentiality as a reason to opt out of a more meaningful statement. Shareholders need to be assured that there are no relevant matters that they should take into account when assessing the change and voting on the appointment of the new auditor.

- e) The remuneration of employees and partners in audit firms should be more aligned with ensuring high quality audits, rather than their contributions to turnover and profit.
- f) An independent regulator should have a power to disagree on the entity's selection of an auditor and consequently the entity should appoint another auditor.

### **Public Authorities**

The majority of respondents agreed that there is an inherent conflict of interest, which arises due to the fact that auditors are appointed and remunerated by the same entity. While Public Authorities were reluctant to suggest that a unified approach should be adopted, prohibiting the appointment and remuneration of auditors by the audited entity in every case, they did suggest that in certain situations, it should be forbidden. As an alternative to the current situation they suggested the following:

- auditors should be appointed and remunerated by the audit committee of the audited entity, as this committee is independent from the executive of the entity;
- appointment of the auditor by a third party could be justified in the case of certain public interest entities. It is already a practice in some Member States that a regulatory authority has the "right of veto", which is regarded as an efficient way to control the procedure of auditor's appointment.

### **Academics**

The company's audit committee should consist entirely of independent directors. The audit committee should be responsible for setting the auditor's remuneration. Some competition on fees should exist, but one should avoid other services being used to make up for lower audit fees. A floor for fees, checked by supervision could be a way forward; the fees in the public sector are sometimes ridiculously low.

The appointment of the auditor by the company is usually influenced by management. This can lead to "lowballing" (a low price for audit in order to have profitable consulting assignments) but lowballing can be addressed by more transparency on fees paid, limited non-audit services, fixed period appointment of auditors and approval of non-audit services by shareholders or non-executive directors or supervisory boards. If non-audit services were limited, this would no longer be the case.

## **Preparers, businesses and organisations of companies**

Many businesses think the appointment by a third party is not feasible and should be limited to very rare cases (e.g. co-operatives' practices in some Member States<sup>1</sup>) but in general the designation should remain the task of the general assembly. They nevertheless believe that there may be certain instances where a regulator could require the company to elect a new auditor in the case that the current auditor was proved to be unable to perform any audits.

### **3.2. Rotation (Q18)**

#### **Profession**

##### *Professional bodies and associations linked to the profession*

There is a general rejection of mandatory firm rotation. A few respondents consider that there should be a limitation of engagement for Public Interest Entities (PIEs) (a 10 year limitation was suggested).

##### *Big Four*

The Big Four oppose limitation of continuous engagement of audit firms. They claim that studies have proven that mandatory rotation of firms harms audit quality and in any case such ideas are premature as the statutory audit directive is still being implemented with regard to partner (as opposed to firm) rotation.

##### *Mid Tier Firms and SMPs*

Mainly, mid tier firms do not support mandatory rotation explaining that it will increase costs, impair audit quality without any certainty on being able to address concentration.

#### **Investors**

With respect to limitation in time of the continuous engagement of an audit firm and mandatory rotation, investors had divergent views. Some investors did not support mandatory rotation, but supported mandatory re-tendering after a specific period of time. Investors believed that more transparency from companies and audit committees on audit appointments, re-tendering and other information is needed, with the greater involvement of shareholders.

#### **Public Authorities**

Many public authorities did not support the introduction of mandatory rotation. Others stated, however, that such a measure would be beneficial, some suggesting that the audit firm should rotate at the same time as an audit partner. One of the recommendations concerning the issue was to allow the audit committee to decide whether the firm needs to be rotated, as this would enable committee members to apply their minds to real

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<sup>1</sup> As regards auditing practices in some co-operatives, one respondent recalls that in Austria, Germany and Italy for cooperative banks, which are members of a national/regional cooperative association, the auditor may be appointed by this association and not by the audit cooperative. According to their members, this appointment model preserves the independence of the auditor.

threats to independence, instead of applying rotation of firms in compliance with a rigid rule.

### **Academics**

On rotation, there is support from some. A possible way forward may be a maximum period together with a period of overlap between the old and new firms so that information and knowledge can be transmitted from the previous auditor to the new auditor. If all auditors were to be submitted to the same discipline, there would be no losers as in principle all candidates would be able to find other mandates. It would also enlarge the expertise in the firms.

There could be a combination of internal and external rotation. The cost of rotation should be examined in the context of the period as well as in terms of the (societal) costs caused by lack of trust in audited accounts due to impaired auditor independence. Rotation combined with fixed period appointment would decrease any bias in the auditor's judgement to please management/shareholders to assure reappointment. Also, as the incumbent auditor knows that a new audit firm would come into the company, there would be more pressure to do 'proper' audits. Mere internal rotation does not contribute to independence; it's surprising that this route was chosen in the Directive.

Auditor appointment for a fixed 5-7 year period, with mandatory rotation of both audit firm and auditor after that period combined with limiting the dismissal of an auditor to cases of material reasons and with the approval of Courts will reinforce the independence of auditors. This should at least be obtained for PIEs such as banks and insurance companies (systemic).

Theoretical and experimental research suggests that mandatory audit firm rotation may be beneficial but only under very specific circumstances, e.g., when the cost to changing auditors is low, the market for audit services is not competitive, and reputation has limited effect on auditor performance. Other research has indicated that audit failures are likely to occur in short tenure cases as well as long tenure cases, although the causes may differ, i.e., when an auditor's tenure is short they are less likely to detect fraud but when an auditors' tenure is long they are more susceptible to forces that motivate management to manage earnings.

### **3.3. Non-Audit services (Q.19)**

#### **Profession**

##### ***Professional bodies and associations linked to the profession***

The vast majority also say no to the prohibition of non-audit services. A few respondents indicated that perhaps there could be some restrictions for PIEs. In any case, the audit committee should have more input in the area of non-audit services.

##### ***Big Four***

The Big Four generally oppose a prohibition on non audit services although there is some appreciation for considering / restricting non audit services to audit clients. Moreover, the Big Four believe that any such provision would weaken the general economic independence of audit firms and the range of skills they can offer; they also believe that adding new limits would run against the grain of the Commission's aims to remove administrative and legal burdens to encourage the service sector, a growth area for

Europe. It has also been argued that the provision of services to a non audit client has no impact on the statutory audit of a totally unrelated entity.

The Big Four believe that there are already rigorous requirements on independence while non Big Four support more disclosure from, in effect, the Big Four. The Big Four support EU adoption of the International Standard on Quality Control 1. Another measure could be a requirement for audit committee approval for non audit services. It has also been suggested that there may be a public interest in having stricter rules in the case of systemic financial institutions in order to enhance general confidence in the audit of such companies. One view is: 'Accordingly, we would support a review of the position in respect of 'systemic companies' as part of a comprehensive set of measures addressing this segment of the market.'

Disciplinary sanctions have also been raised in the context of a firm providing services that are proven to conflict with independence standards. Moreover, it is considered that audit committees should ensure that fees for non audit services do not contain a hidden subsidy for a low audit fee and there is a call for greater transparency from the audit committees on fees and on appointment decisions.

#### ***Mid Tier Firms and SMPs***

The prohibition of non-audit services by audit firms is considered an important measure to maintain independence by some SMPs. However, they state that such prohibition should only be applied to PIEs and that systemic financial institution should be included in any prohibition any case. This group, however, appeals for "safe harbours" regarding the prohibition of non-audit services for there 'smaller' clients; they point out that especially for SMPs it is important to perform such services otherwise their existence could be threatened.

#### **Investors**

On the basis of the majority of the replies, the following could be noted:

- a) Those non-audit services which have no natural connection with the audit must be discouraged or even forbidden as they are the main source of conflicts of interest and provide the audit firm with a competitive advantage which is unwarranted.
- b) There should be requirements to establish appropriate protections to mitigate the risks of some non-audit services.
- c) There should be much better disclosure of the non-audit services carried out by the auditor so that shareholders can raise concerns with auditors and audit committees on the basis of useful and relevant information. Companies should provide enhanced disclosure about the quantity and type of services provided. Audit committees should also play a role in the assessment of non-audit services and the reporting to shareholders.

Some investors requested more clarity and consistency on what non-audit services are and suggest developing a list of non-audit services that are allowed and those that are prohibited. As regards specific examples of non-audit services, investors referred to internal audits where they noted with concern that "the provision of both internal and external audit services by the same firm has obvious implications for audit independence in that the external audit firm will in effect audit its own work and may be taking on management functions. Some investors noted the importance of uniformly implementing the independence requirements throughout the EU.

### **Public Authorities**

It was argued that the provision of non-audit services increases the auditor's knowledge of the company and thus also increases audit quality. The provision of non-audit services should thus not be prohibited for all clients. It is an issue that needs to be judged on a case by case basis. It was, however, noted that agreeing on the list of prohibited non-audit services could be a way forward.

In the case of listed companies, PIEs and financial institutions it would be appropriate to allow the audit committee to take responsibility for taking the decision regarding the provision of non-audit services for a company that is already an audit client. Their decision should be based on known facts and not necessarily by applying a specific rule.

### **Academics**

There is broad support for either a full cessation of non-audit services, as the best guarantee for independence, or the prohibition of non-audit services to audit clients. The latter would allow the audit firm to keep the necessary expertise without losing appearance of being biased.

In any case, audit and non-audit services should be pre-approved by the audit committee. A ban on the provision of non-audit services by audit firms would no doubt have a positive effect on third parties' perception of auditor independence. Research shows, however, that not all non-audit services have a negative effect on the perception of independence.

For certain non-audit services, however, a ban appears inevitable. Knowledge spillovers from consulting services are not used to increase audit quality but to reduce audit costs. Consulting services may be beneficial to the auditor and client, but the ensuing lack of independence harms the interests of external stakeholders. A lack of independence can neither be justified by efficiency arguments nor by the chance of increased effectiveness in the auditing and consulting areas.

Auditor independence should be monitored and violations should be published. The provision of non-audit services impairs independence in appearance. The recipient of financial reports (such as investors) must believe in the auditor's independence, i.e. independence in appearance is required. For most advisory services, but not all, a significant impairment of perceived auditor's independence was found. Internal separation of audit and non-audit services within an audit firm does not increase the perceived independence.

The maximum percentage of non-audit services acceptable to investors is 25% of fees paid by the audited company to its auditor. There is also broad support for the US Securities and Exchange Commission's principle based approach: (1) an auditor should not audit his or her own work; (2) an auditor should not function in the role of management and (3) an auditor should not serve in an advocacy role for his or her client.

The prohibition of all or many non-audit services to an audit client would lead to a decrease of the total remuneration received by an audit firm from a single customer. This side effect is seen positively.

### **Providers of non-audit services**

Competitors such as lawyers and tax advisors do not believe that auditors should be providing non audit services.

### **Preparers, businesses and organisations of companies**

They cannot support an EU-wide prohibition of non-audit services; from the perspective of audit quality, it appears important to maintain the diversity of skills (multidisciplinary) in audit firms. Some, however, suggest exploring prohibition on the combination of audit and non-audit services to the same clients.

#### **3.4. Maximum level for fees (Q.20)**

##### **Profession**

Both Big Four and non Big Four support a limit on the fees from any one client as a percentage of the total fees. They also support transparency although not necessarily new rules.

##### **Academics**

The maximum limits for remuneration from any one client (in Denmark 20%, in Germany 30 or 20%) are not enough to exclude the risk of economic dependence. The loss of such a large client could threaten the existence of the audit firm seriously, and thus undermine independence significantly. For this reason, a limit of 10% is considered adequate. In addition, it has been pointed out that the risk of economic dependence not only exists at the level of the audit firm, but also at the level of the local office or even the partner concerned. In this respect it is also proposed that the Commission addresses the question of whether maximum compensation limits need to be introduced at these lower levels.

#### **3.5. Transparency, governance and structure of audit firms (Q.21, 22, 23)**

##### **Profession**

###### ***Professional bodies and associations linked to the profession***

Many respondents consider that alternative structures could be explored but the independence of auditors should be safeguarded and auditors' liability regimes would need to be revised.

###### ***Big Four***

Both Big Four and Mid Tier Firms support the exploration of alternative structures on a voluntary basis. On alternative structures, especially with regard to access to third party capital there is recognition that the capital would flow to the dominant firms. One non Big Four firm suggests a radical review of rules relating to the ownership and funding of audit firms, with a view to encouraging new investment in audit firms outside of the Big Four.

###### ***Mid Tier Firms and SMPs***

A vast majority of SMPs, especially those in Germany, speak out against allowing audit firms to raise capital from external resources; external interests could threaten the independence of auditors.

### **Investors**

A vast majority of investors agreed that it is in the public interest, particularly for larger audit firms and irrespective of their ownership arrangements, to have audit firms' financial information available to the public. Among other things, financial information, including information on legal claims, should help to evaluate the soundness of the financial position of a given audit firm, which might have implications on the audit quality. Some also believe that the improved transparency should help to disaggregate "audit and other assurance business and the performance and the capital devoted to the auditing business". Moreover, publication of financial statements would make companies and investors better informed and thus would help them to 'distinguish between audit firms and not necessarily prefer one from the Big Four'.

All investors shared the view that the governance of audit firms could be further improved.

A vast majority of investors supported a review of the ownership structures that limit external capital investment in the business. The replies noted that changes in ownership structures might facilitate greater competition and choice in the market.

### **Academics**

Essential information, regarding internal quality review procedures, partner remuneration, promotions is often missing from transparency reports. There should be transparency regarding the composition of audit networks, ownership in networks and legal structures.

### **3.6. Group auditors (Q.24)**

#### **Profession**

**Big Four.** They also support the access to documents of Group auditors. One Big Four firm points out that joint audits and mandatory rotation would have a fundamental (negative) impact on the ability of the group auditor to manage the group audit on a coordinated basis.

#### **Investors**

Investors supported Commission views and suggestions regarding group audits that would make sure that there are no barriers or constraints for the group auditor for the purpose of a group audit to have access to the information of auditors of subsidiaries. However, some emphasized that "it needs to be handled carefully to avoid further entrenching the position of the Big 4".

#### **Academics**

Group auditors should have access to the reports and other documentation of all auditors of components of the group.

#### **4. SUPERVISION**

##### **The Profession**

###### *Professional bodies and associations linked to the profession*

The vast majority of those who commented on the future structure of the EGAOB favoured a level three authority.

There should be appropriate enforcement of EU requirements for auditors of financial institutions to alert authorities if they become aware of certain issues; this has also been suggested for all PIEs; increased communication is favoured especially for banks and large financial institutions.

###### *Big Four*

There is support for EU wide co-ordination of audit oversight bodies although the Big Four do not support integrating them into the new European Supervisory Authorities as this could lead to divisions within the audit profession and variation in oversight practices and ultimately audits.

There is also support on strong two way communication between auditors and regulators for the audit of systemically important financial institutions. There is a suggestion that auditors could contribute to discussions at the newly created European Systemic Risk Board.

###### *Mid-Tier Firms and SMPs*

There is support for EU wide co-ordination. Some SMPs welcome the approach of creating a European Supervisory Authority.

##### **Investors**

There was wide support that the supervision of audit firms in the EU should be performed on a more integrated basis. To increase consultation and communication between the auditors of large listed companies and the regulators, the dialogue should be a two-way process so that supervisors also alert auditors regarding particular areas of concern.

##### **Public Authorities**

There should be agreements with third countries to share information, subject to adequate confidentiality requirements, and reliance on countries' inspections processes, formation of a college of regulators, and the transformation of EGAOB into a level three authority for audit supervision.

##### **Academics**

One could follow the scheme developed for the new European Supervisory Authorities, except that the European body should have inspection powers on the national supervisors and if needed also on the firms supervised by the latter. For multistate auditing firms, a system of supervisory colleges could usefully be developed to especially deal with the cross border links in auditor networks.

For international purposes the European body would be the direct interlocutor for non-EU supervisory bodies, and would channel their questions and coordinate the answers of the national supervisors.

One member of audit committee should be nominated by a regulator.

### **Preparers, businesses and organisations of companies**

There is support for EU wide co-ordination of audit oversight bodies.

## **5. CONCENTRATION AND MARKET STRUCTURE**

### **5.1. Systemic risk? (Q.27)**

#### **The Profession**

##### *Professional bodies and associations linked to the profession*

The majority of respondents consider that there is no systemic risk. The market could cope in the event of a collapse of a Big Four. A number suggest that addressing the liability issue would reduce the risk of a collapse. A small number, however, consider that the current configuration presents a systemic risk.

##### *Big Four*

They believe that failure of one or more of the largest firms could under rare circumstances cause a temporary disruption in capital markets and although the risk is not similar to that presented by banks there is risk, in such an instance, to the continuity of audit services and to the choice of auditor in the market. The Big Four believe that this risk emanates from the litigation environment coupled with the lack of effective liability limitations for statutory audit work, in the UK and the US.

##### *Mid Tier Firms and SMPs*

They consider that the current configuration of the audit market poses a systemic risk to market stability. They go on to say that the choice is often even less than four as a company may not wish to appoint its competitor's auditor. Also, another auditor may be providing non audit services and may thus not be eligible to provide audit services. Should one of the four dominant networks leave the market for any reason, there is a real likelihood of severe disruption in the audit and capital markets resulting in some of the largest companies being unable to find a suitable auditor in the short term, with a consequent adverse effect on the capital markets. It is likely that such effect would be greater than previous withdrawals from the market.

They also highlight the problems associated with the 'too big to fail' moral hazard.

On top of the risks indicated in the actual 'oligopoly' structure, there is an additional risk of undue influence by this 'oligopoly' on regulators, be it national or international.

#### **Investors**

The degree of concentration in the audit market and the Big Four dominance of the audits of most international companies are not good for competition and choice. If the Big Four were to be reduced to the Big Three this could undermine financial stability and market confidence, though not necessarily cause an economic crisis. Investors considered that a

more open and vibrant audit market would serve the public interest better. The Commission was urged to move with a greater sense of urgency and 'provide bold leadership in order to make serious headway towards a sustainable audit market, which would be consistent with maintaining financial stability and strengthening market confidence.'

### **Public Authorities**

Most of the Public Authorities agreed that the current market configuration does present a systemic risk. Those against structural measures explained that there is the possibility of increased cost and the objective of raising the profile of the small and medium firms does not necessarily mean that the 'big four' firms should be 'diluted'. Among the positive side of joint audits, there would be benefits to non big four firms such as:

- Obtaining necessary experience for audit of public interest entities, large corporations, audits in specific areas, etc.
- Getting the opportunity to prove competence for audit of public interest entities, large corporations, audits in specific areas, etc.
- Getting the opportunity to gain the trust of the biggest audits clients, financial institutions, etc.
- Reducing negative results in the case of "systemic firm" collapse.

A **competition authority** explains that the limited choice of auditors and existing competition problems in the market mean that if one of the Big Four audit firms were to exit the market for auditing large companies, existing competition problems in the market could be exacerbated. High barriers to expansion might make it difficult for smaller firms to step up to replace it. There might also be a short-term risk of some companies being unable to purchase audit services, leading to a loss of confidence in the financial status of large listed companies and/or high-risk companies and possibly among investors more generally. Thus the existing high barriers to entry, leading to high market concentration, can be seen as contributing to the risk of wider, systemic failure whereby the failure of a network could have substantial negative effects on the wider economy.

An **independent regulator** believes that the degree of concentration represents a systemic risk to capital markets. It suggests that public and investor confidence would be undermined and equity, bond and lending markets would fall significantly as a result: 'In the longer term, existing problems around lack of choice would be exacerbated. Additionally, if the event were audit-related, the remaining firms may become reluctant to audit companies in high risk industries and may even begin to withdraw from certain sectors of the market. At a minimum, a market with three or fewer large firms capable of auditing the largest and most complex clients is likely to require a significantly more intrusive regulatory environment and therefore cost.'

CESR, CEIOPS and CEBS agree that the current level of concentration in the audit market presents risks for financial markets, as a failure of one of the largest audit firms could cause severe market disruption. However, they do not see such risks as being the same as those posed by the banking sector during the financial crisis. When identifying appropriate measures to mitigate the risks posed by the structure of the audit market, the distinctive characteristics of the audit sector need to be taken into account. Any action in this area should be taken at the international level.

## **Academics**

Concentration is a risk, though whether or not systemic is open for discussion. But regardless of this, the concentration issue has to be dealt with also for reasons of adequate competition, diversity of practices and opinions and the effectiveness of supervisory action (a supervisor confronted with unacceptable behaviour by a major audit firm would be very hesitant to take action against that firm if that action could trigger a crisis, possibly with systemic consequences). This might also create "moral hazard" on behalf of audit firms.

## **Preparers, businesses and organisations of companies**

There is no clear consensus that the failure of one or more of the largest firms could present a systemic risk but they all recognise that the situation might create serious difficulties for the certification of the annual account of multinational listed entities (three global networks is not enough). Amongst the reasons pinpointed is that the firms cannot themselves be considered as systemic but they recognise that the situation can contribute to dysfunctions of systemic importance. According to some of them, the current configuration does not present insurmountable difficulties which cannot be handled. Preventive actions should include 'contingency plans'.

### **5.2. Audit firm consortia (Q.28)**

#### **The Profession**

##### *Professional bodies and associations linked to the profession*

On joint audits, there are mixed responses. A leading body feels that this could dynamise the audit market but very rigorous tests regarding audit quality, costs and liability issues should be undertaken before making it mandatory. There should also be objective research on the experience in France.

##### *Big Four*

On mandatory joint audits and consortia, the Big Four are negative as they believe it will impair audit quality and will cause co-ordination problems. They also believe that such an artificial attribution to smaller firms of a share in the market for larger audits could risk becoming a disincentive to them to grow.

##### *Mid Tier Firms and SMPs*

Mid tier firms and SMPs strongly support joint audit and consortia where at least one non-systemic firm is included. They also highlight that joint audits are tried and tested and have worked in keeping concentration lower in France than in other Member States; they explain that in France there is currently an additional firm at the top end of the market. There have been other players but they were acquired by the Big Four. They also indicate that concentration is also lower in France at the next level of the market than in other Member States. Some believe that the participation of more networks and audit firms in the larger as well as public interest audits will enhance competition and can potentially raise quality.

It has been submitted that consortia should not be fixed between any specific firms but should be put together on a case by case basis.

It has also been submitted that the main benefit of consortia is that more firms are able to directly demonstrate high quality in a range of services to a wider range of companies which in turn bolsters the firms' credibility. Greater understanding of more firms delivering high quality services becomes a virtuous circle leading over time to more firms with a meaningful share of a larger company audit market; in spite of the requirement for compulsory joint audit in Denmark being lifted five years ago, 16 of Denmark's 64 largest public companies still use joint audit voluntarily. One major non Big Four firm claims to have gained important joint audit assignments in France, Denmark, Cyprus and Belgium where it believes it would otherwise have had limited chance of winning the sole audit.

### **Investors**

There are divergent views among investors regarding the mandatory formation of consortia with the inclusion of at least one smaller, non systemic audit firm. Many investors did not support this proposal, mainly fearing an increase of costs of audits, the dilution of responsibility or the lack of beneficial effects. Other investor representatives however did "not fear the use of audit firm consortiums on a more formal basis, provided that the company audit committees properly own the relationships and offer appropriate and effective challenge to the auditors such that the firms in the consortium each deliver a quality audit and challenge each other to improve their approach".

### **Public Authorities**

If joint audit were introduced in the EU, the Commission should establish clear lines of responsibility for the joint audit opinion as well as to consider a resolution mechanism for differences in opinion between consortium members.

For CESR and CEIOPS, joint audits should not be considered as a means for dealing with audit market concentration or making the market more dynamic. Joint audits might pose a number of issues in terms of responsibilities, differences in the level of workload and audit approach. In addition to this, the issues might be more complex when referring to joint audits between Big Four and mid-tier or small audit firms (e.g. this will only lead to the audit work being performed by the big audit firm, which can rely on its network and workforce to look at the firm as a whole, especially for cross-border activities; in such circumstances, this would reduce the benefit of having a joint audit).

### **Academics**

Making joint audits mandatory seems excessive, but as an optional solution it should be welcomed. In general, radical remedies should be avoided in favour of gradual improvement.

### **Preparers, businesses and organisations of companies**

On the joint audit concept, preparers are not opposed to its principle if it is well balanced, well-framed and with very strict requirements. Whilst some companies consider that the appointment of more than one auditor has some benefits (e.g. collusion with the management would be more difficult), for a majority of companies, the benefits do not outweigh its disadvantages (e.g. costs incurred 15-20% higher than for conventional audit, overlapping of audit parts, etc.).

The pros of the French joint audit are that they enhance audit quality: four eyes are better than two. The negatives relate to the 'burdensome nature' of the process. The French model works well because the joint audit is balanced and profitable. If the Commission

goes for the French model, it should apply only to listed companies, as the additional costs would be hardly 'bearable' for smaller entities. In any case, companies always have the choice of two auditors.

### **5.3. Mandatory rotation and retendering (Q.29)**

#### **The Profession**

##### ***Professional bodies and associations linked to the profession***

There is strong rejection of mandatory rotation but support for tendering on a regular basis (e.g. every 3 or 5 years mentioned) or even mandatory tendering; the audit committee should review appointment on a regular basis and should have a policy for re-tendering and clear criteria for selection, more transparency on reappointment.

##### ***Big Four***

The Big Four oppose limitation of continuous engagement of audit firms. They claim that studies have proven that mandatory rotation of firms harms audit quality and in any case such ideas are premature as the statutory audit directive is still being implemented with regard to partner (as opposed to firm) rotation.

##### ***Mid Tier Firms and SMPs***

Mainly, mid tier firms do not support mandatory rotation explaining that it will increase costs, impair audit quality without any certainty on being able to address concentration. On tendering they are more supportive, provided such tendering is not mandatory. They are open to the possibility of at least one non Big Four firm being able to participate in a transparent tendering process in which quality should be a key criterion. It has also been suggested that tendering could be mandatory for listed companies every 5 to 7 years. Some SMPs, however, are of the opinion that mandatory rotation will increase competition amongst auditors and is an important tool to strengthen independence. Six years is to be considered as an appropriate period of time. However, this group also states that this should be considered in any case for all public interest entities.

There is also support for regular and fair tendering suggesting a two stage short listing and full proposal process, drawing on the practice in the public sector. There is a submission that shareholder involvement in the process is critical because the current practice of seeking shareholder approval at the AGM is usually too late to have sufficient influence on the decision. An example of the UK public sector audit market has been provided where independent bodies representing the 'owners' monitor audit appointments, audit quality, value for money and tenders.

#### **Public Authorities**

Mandatory rotation of audit firms may have the opposite effect to saving cost and enhancing audit quality. It might also increase the probability of collusion among audit firms in order to coordinate acquisition of clients. However, there were some who supported mandatory audit firm rotation, suggesting that the maximum period of engagement should be the same as for audit partners.

There is broad support for mandatory re-tendering.

None of CESR, CEIOPS and CEBS see mandatory rotation of audit firms as a significant measure that would substantially open up the audit market, although they see value in debating its possible contribution to auditor's independence.

### **Academics**

A key instrument has not been worked out in the Green Paper: the nomination procedure for the auditor, apart from involving shareholder committees, should include strict internal rules (call for candidates, independent selection, objective comparative analysis, selection on stated reasons submitted to shareholders).

### **Preparers, businesses and organisations of companies**

On rotation, preparers cannot support the mandatory rotation of audit firms. Regarding the tendering process, they are in general in favour but insist that the company should decide in certain circumstances to keep the same auditor if benefits of continuity are demonstrable. The selection criteria should be defined ahead of the tendering process in order to justify the decision and this information should be communicated to make sure that some of potential candidates are not discriminated against. Finally, audit fee should not be decisive in the choice of auditors. Selection criteria should also include a mix of parameters that are individually decided from company to company: for example, expertise in a specific domain, the geographical coverage, strong foothold in some regional markets, the network, size of specific audit team and audit fees. Re-tendering should also be a matter of vigilance by strong, independent Audit Committees who monitor the performance, quality, independence and objectivity of their auditors. Last but not least, a mandatory rotation of firms is incompatible with a joint audit regime at the moment as the offer is not sufficient.

## **5.4. "Big Four bias" (Q.30)**

### **The Profession**

#### *Professional bodies and associations linked to the profession*

There is support for ideas such as the prohibition of Big Four clauses, publication of inspection reports, open tendering procedures, transparent selection and (re)appointment criteria.

#### *Big Four, Mid Tier Firms and SMPs*

Firms believe that 'Big Four only' clauses should be discouraged or prohibited and non Big Four firms believe that such clauses should be eliminated. The Big Four point out, however, that reputation is built-up over a long period of time, through consistent high quality performance, which implies huge investments in human resources and enabling technology and lack of circumstances that endanger a reputation.

There is support for some sort of European certification of quality.

### **Investors**

Most investors believed that greater transparency was needed to address the issue of a Big Four bias:

- a) companies and their audit committees should report their policy approach towards audit tendering;

- b) audit committees and/or the board should make themselves available to explain to major investors any changes of auditor. This should provide a useful ‘check and balance’ in the process and assist in ensuring a mutual understanding of the circumstances and the process outcome. Any covenants restricting a company's choice of auditor should be disclosed.

### **Public Authorities**

CESR explained that greater transparency on audit quality, both by auditor oversight bodies and from the audit firms themselves, could help to address the Commission's question about whether the perceived extra level of comfort in appointing a Big Four firm is due to “perceptions” rather than “merit”. CEIOPS sees value in the European quality certificate but warns about the possible creation of entry barriers for smaller firms.

### **Academics**

Audit quality for the Big Four and mid-tier is comparable, but investors perceive the Big Four as providers of better quality. However, one possible reason for investors trusting Big Four more could be that Big Four would have "deeper pockets" should something go wrong.

### **Preparers, businesses and organisations of companies**

Whilst preparers recognise that the use of Big 4 only clauses can constitute a barrier to entry, one of the reasons of this bias is the use of the IFRS as only the Big Four firms today may be able to maintain sufficient knowledge of these standards although even in these networks the local offices sometimes struggle to maintain sufficient knowledge.

## **5.5. Contingency plans (Q.31)**

### **The Profession**

#### ***Professional bodies and associations linked to the profession.***

Many respondents agreed that regulators could prepare contingency plans. There is no support for living wills.

#### ***Big Four***

The Big Four do not all support living wills along the lines of banks because of the non-systemic risk posed. The ones that do support such considerations are of the view that audit firms may work with their regulators to develop contingency plans to address concerns of a disorderly failure.

### **Investors**

Most investors agreed that it would be sensible for audit firms or regulatory authorities to develop contingency plans, including living wills, to help address the impact of a firm failure on the audit market. Some suggested that such plans should be made public, in order that shareholders and other parties can study them. It was conceivable that the contingency plans might be included in the annual financial statements of the audit firm.

### **Public Authorities**

Most of the Public Authorities agreed that contingency plans would be key in the future.

It has been submitted that: 'Contingency plans should be developed that, as a minimum, seek to:

- reduce the risk of a firm leaving the market without good reason;
- reduce uncertainty and disruption in the event of a firm leaving the market;
- ensure that, in the event of a firm failure, the future audit market is not dominated by three or fewer firms.

In order to accomplish these objectives, the contingency plan will need to include:

- A mechanism whereby firms inform regulators of any emerging issues which could threaten a national firm and/or its network.
- Arrangements aimed at stabilising the firm and preventing immediate collapse through the exodus of clients and staff while an investigation is carried out.
- An objective incident assessment to understand the root cause of the incident, whether the issue is systemic to the firm and/or network and whether the firm in part or in whole is worth saving. The assessment should be independent of any subsequent regulatory or disciplinary action.
- A response plan, which would include a decision on whether the relevant regulator(s) felt able to provide continued support to the firm and on what terms. If continued support was considered inappropriate, or if it was clear that the firm would not survive because of the actions of clients and other market participants, then the plan would need to include provision for an orderly transition of clients and staff to one or more other firms.'

CESR, CEIOPS and CEBS agree that contingency planning should be developed to mitigate these risks. CESR suggests that planning should be done at sector level and by individual audit firms and audited companies. As the largest audit firms are part of international networks international co-ordination might be necessary.

### **5.6. Rationale for consolidation (Q.32)**

#### **The Profession**

##### *Professional bodies and associations linked to the profession*

A few comments were made on possible actions that could be taken instead of seeking a reversal of the past consolidation; promote growth of mid-tier firms, confine consolidations in the future.

### ***Big Four***

On the consolidation over the past two decades, the Big Four believe that the rationale is still valid and point to the fact that the 1998 merger between Price Waterhouse and Coopers and Lybrand and the 2002 takeover by Deloitte and Ernst and Young of certain Andersen partners and activities were approved by the European Commission.

### ***Mid Tier Firms and SMPs***

They do not believe that the consolidation was necessary. Although a break up is considered complex and difficult, there is a suggestion that the Big Four should not be allowed to further acquire significant firms e.g. in Brazil the largest non Big Four firm was recently acquired by a Big Four firm.

It is pointed out that that it is difficult to imagine a situation where any member of the Big Four would voluntarily restructure itself into two or more smaller entities, or where the directors of large entities and advisers would turn away from the Big Four and appoint smaller firms in the current configuration.

There is a radical suggestion to impose restrictions on market share: a monitoring group comprised primarily of investors, and possibly regulators, could place tapered limits on the absolute number of audits that any one firm can carry out for defined sectors e.g. largest 100 companies ranked by market capitalisation over say a five year period.

### **Investors**

Some investors contest the decision allowing certain mergers of audit networks. Most investors did not, however, agree that there should be a reversal or a forced break up of the Big Four, which in itself could disrupt the market and cause additional problems.

Nevertheless, some investors claimed that market forces failed to deliver meaningful solutions and thus radical measures should be sought. They believed that there should be an "unambiguous encouragement to the larger audit firms to restructure their operations - possibly by demerger or other strategic combinations. This should be combined with an undertaking by the Commission to conduct a further review of the audit market structure in, say, 2-3 years time with terms of reference that will require it to mandate structural changes to the firms if it is not satisfied that the structural issues have been addressed. This approach of an "iron fist in a velvet glove" would rightly give the audit firms the opportunity to shape their own destiny within a reasonable time period whilst at the same time provide clarity of intent on the part of the Commission to intervene if the major audit firms fail to respond constructively to its initiative. One should not be prescriptive as to how many firms and networks there should be but eight or more feels like a sensible benchmark to use. To achieve this objective the Commission should co-ordinate its efforts with its global counterparts."

Some respondents also suggested creating "pure" audit firms by the splitting up of audit and non-audit services.

It has been submitted that investors and regulators have consistently identified the risks associated with concentration in the large corporate audit market. They seek a larger pool of quality providers with a meaningful share of the large corporate audit market to address the issues of concentration risk, market stability and innovation.

## **Public Authorities**

On the consolidation over the past two decades, CESR believes that it may be appropriate for national competition authorities to consider whether measures might be taken to address market structure in specific jurisdictions, taking into account the specificities of each national market and industry sector. CEBS outlines that it has no view on optimal market structure, but that any proposal on this issue should be carefully assessed to ensure that neither the quality nor the efficiency or the availability of statutory audit work is reduced.

## **6. CREATION OF A EUROPEAN MARKET**

### **Profession**

A number of respondents cautioned that from a practical perspective auditors must know local tax and legal requirements as well as language. Responses are generally quite positive to a European passport if more harmonisation is achievable. However, even those who favour 'maximum harmonisation' see difficulties in this area. Time is needed to assess implementation of the directive; moreover, education, qualifications and training should be harmonised. Those in favour of the European passport state that differences in national laws, tax rules and language remain problematic. This could, however, be a long term project.

There is broad support for closer alignment of examination and training requirements and maximum harmonisation across the EU.

### **Investors**

While some investors supported a single European market for the provision of audit services, others believed that a European passport would be detrimental to audit quality, where cross-border liability issues may also arise. Some investors were sure that the cross-border mobility is not an issue for Big Four audit firms but could be increased for the others by encouraging auditors to gain competence in one or more other languages. Finally, most investors supported harmonisation of qualification and training requirements, whilst "avoiding a rush to the bottom".

### **Public Authorities**

Many respondents stated that co-operation between professional bodies on auditor qualifications should be encouraged. On the issue of the European Passport many Public Authorities were reluctant to embrace this proposal as they argued that such a measure might harm quality and would be difficult to implement. Still, many respondents argued that maximum harmonisation is a measure that will help the audit market as long as quality is preserved.

CEBS believes that a European market for auditors would require harmonised auditing and independence standards across the EU, including a code of ethics. However, one would also need to take into account the differences in national legal systems which are relevant for auditors (e.g. company law etc), which could make it hard to move to maximum harmonisation in the short term. CEBS also questioned whether a large EU market would benefit SMPs; most of the benefits of a more integrated audit market would accrue to larger firms only. CEIOPs underlined that a European quality certificate (recognising aptitude to perform audits of large listed companies) could be of interest, but the requirements should be designed to avoid the creation of entry barriers.

## **Academics**

Harmonisation has an important role but Member State differences should not be overlooked.

## **Preparers, businesses and organisations of companies**

Although some support the idea of a single passport, they do not believe a single passport could be put in place because they find it difficult to remove the aptitude test as it focuses on national legislations (national corporate law, social, taxation, civil law, national accounting principles, language, etc.). When auditors issue an opinion, it is important to make sure that they are familiar with the domestic laws.

## **7. SIMPLIFICATION: SMALL AND MEDIUM SIZED ENTERPRISES AND PRACTITIONERS**

### **The Profession**

#### *Professional bodies and associations linked to the profession*

A majority do not support a limited audit. 'An audit is an audit' and should not be diluted. Exempted companies should be free to choose a statutory review on a voluntary basis. Confusion should be avoided when mentioning 'limited' audits.

#### *Big Four*

The Big Four do not support the development of less stringent rules of internal control and suggest that the oversight of firms could be provided by local professional bodies. The non Big Four believe that the rules and oversight could be less stringent. Amongst this Group of respondents, one large firm is, however, more closely aligned with the Big Four with regards to this section.

#### *Mid Tier Firms and SMPs*

Some SMPs feel that they are surrounded by an ever growing regulated environment which may not necessarily suit their practice or the immediate needs of their SME clients. To ensure appropriate conditions for the development of such firms, the "limited audit" or "statutory review" referred to above could be accompanied by proportionate rules on quality control and oversight by audit regulators. This would allow SMPs to reduce their administrative costs while helping them to service their clients better.

Others support exemption thresholds but remain reserved about a second tier audit, especially if any alternative assurance implies a de facto audit, albeit under another name. On the question of a 'safe harbour' there are mixed views as independence should remain the pillar of all audits, big or small.

### **Investors**

Among those who responded, there was a general understanding that "an audit is an audit" and that there is no value for investors in having a 'less than true and fair view' audit for SMEs. Some also raised doubts if limited audit would be able to provide the necessary assurance for the purposes of compiling the parent's (non-SME) audited consolidated accounts. Nevertheless, some investors thought that a limited review could

be possible for SMEs. There was no appetite among investors to support "safe harbours" or less strict internal quality control or oversight rules.

### **Professional bodies and associations linked to the profession**

A majority do not support a limited audit. 'An audit is an audit' and should not be diluted. In any case, ISAs are scaleable. Exempted companies should be free to choose a statutory review on a voluntary basis – it should not be regulated at EU level. Confusion should be avoided when mentioning 'limited' audits.

A few respondents stated that if the EC were to prohibit non audit services, SMPs should have a "safe harbour". Very few supported a less burdensome quality control/oversight although one replied that it should be less burdensome and could be done by the local professional body.

CESR believes that international cooperation with audit oversight bodies in third countries is fundamental to addressing the issues arising from the supervision of large groups which operate in multiple jurisdictions and from the supervision of global audit networks. CEBS supports discussion with international partners and suggests that an international solution could be the most appropriate to address many of the issues raised by the Green Paper. CEIOPS made no comments.

### **Public Authorities**

The views of the public authorities on this issue were split between those in favour of a limited audit and those arguing that a limited audit is unnecessary and might cause confusion amongst the stakeholders. Most respondents agreed that the provision of non-audit services to SME audit clients poses less of a risk than for larger public interest entities, and might be beneficial to SMEs from a cost and time perspective. Thus, they did not object to auditors of such companies being permitted to provide a wider range of non-audit services than may be provided to listed companies, provided that the degree of the auditor's objectivity is clear.

The more general view of the majority of respondents was that all audits should be conducted using the same auditing standards (for the avoidance of confusion). Some also argued that it might be good to exempt from audit a wider group of entities than is currently the case. It was, however, noted that internal control rules should stay the same.

CEBS noted that audited financial statements are currently used by banks as part of the credit granting process. Any proposal to reduce the level of assurance given on SMEs financial information could have unintended consequences for the availability of credit for such business. CESR and CEIOPS made no comments.

### **Academics**

There is no real reason to require a statutory audit for all corporations. Most SMEs don't need one. For private entities, the users (banks, lenders, other users) should decide what type of service is needed.

### **Preparers, businesses and organisations of companies**

SMPs feel that they are surrounded by an ever growing regulated environment which may not necessarily suit their practice or the immediate needs of their SME clients. To ensure appropriate conditions for the development of such firms, the "limited audit" or

"statutory review" referred to above could be accompanied by proportionate rules on quality control and oversight by audit regulators. This would allow SMPs to reduce their administrative costs while helping them in servicing their clients better.

Some preparers think that audits adapted to the needs of SMEs would decrease the cost of audits, but at the same time they have concerns related to the fear that such adapted audit formats would not be taken seriously by banks for example thus losing credibility.

## **8. INTERNATIONAL CO-OPERATION**

### **Profession**

There is broad support for continuing efforts on mutual recognition and more co-operation and information exchange.

### **Investors**

The Commission should make a clear commitment and secure political support at the highest possible level to enhancing the quality of global audit oversight. This could involve championing the commitment at G8 and G20 levels as well as securing the support of relevant bodies entrusted with financial stability responsibilities.

### **Professional bodies and associations linked to the profession**

There should be enhanced mutual reliance (recognition) at both EU & global level; more convergence in standards, ethics and public oversight practices.

### **Public Authorities**

There was support for agreements with third countries in respect of information sharing and international collaboration.

### **Academics**

There should be international co-operation

### **Preparers, businesses and organisations of companies**

Preparers fully support any initiatives that would lead to increase international cooperation between audit regulators as this is obviously the only efficient way to conduct audit inspections of large networks. However, they recognise the difficulty of the task as it concerns the flow of sensitive business and commercial data.