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**GREEN PAPER**

**Audit Policy: Lessons from the Crisis**

**(Text with EEA Relevance)**

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## Audit Policy: Lessons from the Crisis

(Text with EEA Relevance)

### 1. INTRODUCTION

The measures adopted both in Europe and elsewhere in the direct aftermath of the financial crisis have focussed on the urgent need to stabilise the financial system<sup>1</sup>. While the role played by banks, hedge funds, rating agencies, supervisors or central banks has been questioned and analysed in depth in many instances, limited attention has been given so far to how the audit function could be enhanced in order to contribute to increased financial stability. The fact that numerous banks revealed huge losses from 2007 to 2009 on the positions they had held both on and off balance sheet raises not only the question of how auditors could give clean audit reports to their clients for those periods<sup>2</sup> but also about the suitability and adequacy of the current legislative framework. It seems thus appropriate that both the role of the audit as well as the scope of audit are further discussed and scrutinised in the general context of financial market regulatory reform.

The Commission is keen to assume leadership at the international level on this debate and will seek close co-operation from its global partners within the Financial Stability Board and the G20. Audit, alongside supervision and corporate governance, should be a key contributor to financial stability as it provides assurance on the veracity of the financial health of all companies. This assurance should reduce the risks of misstatement, and in doing so, reduce the costs of failure that would otherwise be suffered by the company's stakeholders as well as by the broader society. Robust audit is key to re-establishing trust and market confidence; it contributes to investor protection and reduces the cost of capital for companies.

In this context, it is important to stress that auditors have an important role to play and are entrusted by law to conduct statutory audits. This entrustment responds to the fulfilment of a societal role in offering an opinion on the truth and fairness of the financial statements of audited entities. The independence of auditors should thus be the bedrock of the audit environment. It is time to probe into the true fulfilment of this societal mandate. Certain stakeholders have expressed concerns<sup>2,3,4</sup> with regard to the relevance of audits in today's business environment. For other stakeholders it may be difficult to understand that an institution's financial statements may suggest "reasonableness" and "material soundness" even if the same institution was, in fact, distressed financially. Given that these stakeholders may be unaware of the limitations of an audit (materiality, sampling techniques, role of the auditor

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<sup>1</sup> Commission Communication of 4 March 2009 to the Spring European Council, "Driving European Recovery" - COM(2009) 114. Commission Communication of 4 March 2010 COM(2010) 2020 Commission Communication: EUROPE 2020 A strategy for smart, sustainable and inclusive growth.

<sup>2</sup> House of Commons Treasury Committee, Banking crisis: Reforming corporate governance and pay in the City p76, 2009 <http://www.publications.parliament.uk/pa/cm200809/cmselect/cmtreasy/519/519.pdf>

<sup>3</sup> "Should statutory audit be dropped and assurance needs left to the market?" Stephen Haddrill, ICAS Aileen Beattie memorial event –28 April 2010.

<sup>4</sup> Maastricht Accounting, Auditing and Information Management Research Centre: The Value of Audit, 1 March 2010.

in the detection of fraud and the responsibility of management), this engenders an expectation gap. The Commission therefore advocates the need for a comprehensive debate on what needs to be done to ensure that both audits of financial statements and auditor reports are "fit for purpose".

From a broader structural perspective, the Commission notes that the past two decades have seen the consolidation of large firms into even larger firms. After the demise of Arthur Andersen there are now a handful of such large, global firms, with an even lower number of firms being able to perform audits of large, complex institutions. The potential collapse of one of these firms could not only disrupt the availability of audited financial information on major companies, it would also be likely to damage investor trust and confidence and could impact the stability of the financial system as a whole. It is thus possible to consider that each of these large, global firms has attained systemic proportions<sup>5</sup>. As is the case for other large institutions in the financial sector, there is a need to explore further the ways to mitigate this risk.

Another important consideration is if any audit firm should be allowed to become so important that the demise thereof would seriously disrupt the market<sup>5</sup>. Although efforts by large firms to minimise the risk of failure have been commended, the concerns relate to the central question on whether such "too big to fail" firms could potentially create the risk of moral hazard. It is to address such concerns and in keeping with the approach being considered in the banking sector, that the concepts of orderly failure, including living wills, should be explored on a proactive basis for such systemic firms.

The Commission recognises that continuity in the provision of audit services to large companies is critical to financial stability<sup>6</sup>. To this extent, options such as the ramping up of the capacities of non systemic firms and exploring the pros and cons of "downsizing" or "restructuring" systemic firms should be further examined. The Commission would also like to explore the possibilities to reduce existing barriers to entry into the audit market, including a debate on existing ownership rules and the partnership model employed by most audit firms.

Any market configuration should be accompanied by an effective supervisory system which is fully independent from the audit profession. Structural changes within global networks should not be allowed to result in any gaps or exclusions from oversight.

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<sup>5</sup> Results of the public consultation by the Commission (IP/08/1727) on 15/07/2009: "...given the lack of players perceived as having the capacity to audit financial institutions, the collapse of one of the Big 4 would be even more serious for this category of client. Such a loss would also have a serious impact on public confidence for audit services. Given the key role of auditors in the relationship between companies and investors, it could also result in a crisis of confidence in financial markets. The current concentration in the market for large public company audit services therefore poses a threat to financial market stability."

[http://ec.europa.eu/internal\\_market/auditing/docs/market/consultation2008/summary\\_report\\_en.pdf](http://ec.europa.eu/internal_market/auditing/docs/market/consultation2008/summary_report_en.pdf). See also the study on the ownership rules that apply to audit firms and their consequences on audit market concentration, Oxera, October 2007.

<sup>6</sup> IOSCO <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD269.pdf>: "The independent audit function is a contributor to investor confidence in the capital markets. A contingency situation involving an audit firm can temporarily disrupt the normal operations of the audit function in a capital market. Disruptions in the availability of audit capacity and audit services can also occur on an international scale if a global audit firm is involved in a contingency that develops into a crisis. By anticipating issues and conditions that may arise and creating securities regulator contingency plans, IOSCO members can seek to minimize potential disruptions and thereby support confidence in the markets."

There could be a genuine single market for the provision of audit services based on enhanced harmonisation of rules and the creation of a "European passport" for auditors which would allow them to provide services on an EU wide basis.

Against this background, the Commission would like to open a debate on the role of the auditor, the governance and the independence of audit firms, the supervision of auditors, the configuration of the audit market, the creation of a single market for the provision of audit services, the simplification of rules for Small and Medium Sized Enterprises (SMEs) and Practitioners (SMPs) and the international co-operation for the supervision of global audit networks. The Commission is launching this Green Paper as part of its holistic approach that includes other initiatives within the context of financial stability. This Green Paper also builds on the results of earlier studies and consultations carried out by the Commission on these matters. In particular, the Green Paper of 2<sup>nd</sup> June 2010 on Corporate Governance in financial institutions and remuneration policies<sup>7</sup> addresses a number of concerns regarding the audit of financial institutions. The present Green Paper seeks to cover auditing in a comprehensive way, and goes beyond the Green Paper on Corporate Governance. Relevant feedback relating to auditing on the Green Paper on Corporate Governance will be considered when evaluating the responses to the present Green Paper.

The Commission stresses the need for a differentiated and calibrated approach which is adapted and proportionate to the size and characteristics of both the audited company and its auditor and will seek, in the case of any potential proposal that may emerge as a result of this Green Paper, to modulate any such proposals to take this into account. What may be necessary for large systemic institutions may not be appropriate for other listed companies or for SMEs or SMPs. Any measures which the Commission would propose as a follow-up to the present consultation would be subject to better regulation principles, including cost-benefit analyses and impact assessments.

The Commission will be proactive in seeking comments from the broadest possible base of stakeholders such as investors, lenders, management, employees, government authorities, auditors, tax authorities, credit rating agencies, equity analysts, regulators, business counterparties and SMEs.

A broad consultation will allow the Commission to assess the interplay of different policy options while maintaining a commitment to financial stability. This consultation will also assist the Commission in calibrating the intensity of any future measures in a manner that is appropriate to the size and nature of the entities in question. In addition the Commission will launch an external study to assess the implementation and impact of current rules as well as to gather further data on the structure of the audit market. The results of the study will be available in 2011.

## Questions

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|-----|---|
| (1) | Do you have general remarks on the approach and purposes of this Green Paper?   |
| (2) | Do you believe that there is a need to better set out the societal role of the audit with regard to the veracity of financial statements? |
| (3) | Do you believe that the general level of "audit quality" could be further enhanced?   |

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<sup>7</sup> COM(2010)284 final.

## 2. ROLE OF THE AUDITOR

The annual accounts of limited liability companies are required to be audited<sup>8</sup> by law. The fact that companies' financial statements are audited does not mean that there is an obligation on the auditor to ensure that audited accounts are entirely free from misstatements. When reporting that financial statements give a true and fair view in accordance with the relevant financial reporting framework<sup>9</sup>, auditors provide "reasonable assurance"<sup>10</sup> that the financial statements as a whole are free from material misstatement, whether due to fraud or error<sup>11</sup>. Auditors thus seek to minimise the risk<sup>12</sup> that historical financial information, presented in compliance with a given accounting framework, is "materially" misstated. The Commission notes that the statutory audit has evolved from substantive verification of income, expenditure, assets and liabilities to a risk based approach.

Current practice would seem to indicate that the "reasonable assurance" referred to above is less targeted at ensuring that the financial statements give a true and fair view and more geared to ensuring that the financial statements are prepared in accordance with the applicable financial reporting framework. The banking crisis has shown that audit opinions should focus on "substance over form" which includes ensuring that there is no arbitrage of the differences in regulatory frameworks between jurisdictions. It is important to note that the International Financial Reporting Standards (IFRS) are based on the premise of the principles of true and fair view and substance over form<sup>13</sup>.

The knowledge gathered by external auditors through their work may be useful to supervisors and the Commission recognises the need to strengthen cooperation between auditors and the supervisory authorities<sup>14</sup>. It, however, notes that any further co-operation between auditors and supervisors, although highly desirable, should not be allowed to blur the respective responsibilities of auditors and supervisors.

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<sup>8</sup> The Fourth Council Directive 78/660/EEC of 25 July 1978 on the annual accounts of certain types of companies, the Seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts, Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions and Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings require that the annual accounts or consolidated accounts be audited by one or more persons entitled to carry out such audits. Directive 2204/109/EC of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market requires in Article 4(2)(a) that issuers' financial reports comprise audited financial statements.

<sup>9</sup> Article 51a 1(a) of Directive 78/660/EEC on the annual accounts of certain types of companies.

<sup>10</sup> Reasonable assurance is usually defined as a high, but not absolute level of assurance.

<sup>11</sup> International Standard on Auditing (ISA) 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 11. Fraud in the context of an audit means an intentional act by someone in a company to obtain an unjust or illegal advantage. The concept of fraud probability may be developed further in this context as an important feature.

<sup>12</sup> Auditors reduce audit risk by means of various procedures, including identification of a company's risks, an assessment of relevant internal controls, tests of samples, direct confirmations from third parties, discussions with management, etc. Determining the level at which a misstatement would be material is a key step in this regard.

<sup>13</sup> IAS 1, paragraphs 17 and 21 and IFRS framework. Other relevant principles include neutrality, completeness and prudence.

<sup>14</sup> See question 3.1 in Green Paper on Corporate Governance in financial institutions and remunerations policies- COM (2010)284 - page 15: "Should cooperation between external auditors and supervisory authorities be deepened? If so, how?" In the various responses received so far, there seems to be a general support for improving co operation between external auditors and supervisors.

## 2.1. Communication by auditors to stakeholders

It is important to clearly define what sort of information should be provided to stakeholders by the auditor as part of its opinion and findings; this would not only imply revisiting the audit report but also considering additional communication on audit methodology explaining to what extent there has been substantive verification of the audited company's balance sheet.

### *Higher level of assurance to stakeholders*

From a user perspective, auditors should provide a very high level of assurance to stakeholders on the components of the balance sheet and the valuation of those components at the balance sheet date. The Commission wishes to explore the case for "going back to basics" with a strong focus on substantive verification of the balance sheet and less reliance on compliance and systems work i.e. tasks that should primarily remain the responsibility of the client and in the main be covered by internal audit. Auditors could disclose which components were directly verified and which were verified on the basis of professional judgement, internal models, hypotheses and management explanations. To provide a "true and fair view", auditors should ensure that substance prevails over form.

### *Auditor behaviour*

Whilst the primary responsibility for delivering sound financial information rests with the management of the audited entities, auditors could play a role by actively challenging management from a user's perspective; it would be critical to exercise "professional scepticism" vis-à-vis the audited entity<sup>1516</sup>. Such scepticism could also be exercised with regard to the key disclosures in the financial statements and may also result in an appropriate "emphasis of matter"<sup>17</sup> in the audit report. What needs to be avoided, however, is a proliferation of disclosures that have less meaning for stakeholders.

### *Qualified audit reports*

One of the major issues in the audit environment is the negative perception attached to a "qualified" audit report. This has perpetuated an "all or nothing" paradigm where "qualifications in an audit report" have become anathema to both clients and auditors. Unlike rating agencies and equity analysts there is no categorisation by auditors of audited clients; this derives from the fact that the auditor is expressing a fairness view on the financial statements and not really on the relative performance or for that matter even on the relative quality of financial statements of one reporting entity when compared with another. One has to consider whether informative matters e.g. potential risks, sectoral evolution, commodity

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<sup>15</sup> The Financial Services Authority (FSA) and the Financial Reporting Council (FRC) have issued a discussion paper in June 2010 which questions whether the auditor has always been sufficiently sceptical and has paid sufficient attention to indicators of management bias when examining key areas of financial accounting and disclosure which depend critically on management judgement. – <http://www.frc.org.uk/press/pub2303.html>

<sup>16</sup> Professional scepticism may also play an important role in the detection and prevention of fraud.

<sup>17</sup> An emphasis of matter paragraph is included in the audit report when an unusual item occurs but which, in the opinion of the auditor, is fundamental and therefore requires disclosure to enable the user(s) of the financial statements to have a better understanding. It is also worth noting that an "emphasis of matter" paragraph does not affect the auditor's opinion on the financial statements.

and exchange rate risk, etc. being provided together or as part of the auditor's report may provide more value to stakeholders<sup>18</sup>.

#### *Better external communication*

The auditor's responsibilities to communicate may be revisited in order to improve the overall communication process and hence raise the perception of the value added by an audit. For instance, the UK has recently revised its model to render the auditors' reports more concise and is considering making them more informative. The French Commercial Code requires the auditors to publicly justify, together with their report on the annual accounts, their audit opinion. This includes their appreciation of a company's choices or use of accounting methods, of material or sensitive accounting estimates, and also, if necessary, of elements of internal control.

Another potential consideration may be the extent to which information of public interest that is available to auditors should be communicated to the public. Examples of such information may be the company's exposure to future risks or events, the risks to intellectual property, the extent to which intangible assets would be adversely affected, etc.

Another aspect that needs to be considered is the timeliness and frequency of communication by the auditor to stakeholders. It is often argued that the auditor's opinion is "too little too late".

#### *Better internal communication*

Regular dialogue should be assured between the company's Audit Committee, the external i.e. statutory auditor as well as the internal auditor. This would ensure that there are no loopholes in the total coverage of compliance, risk monitoring as well as the substantive verification of assets, liabilities, revenues and expenses. A good example of such communication is found in the German legislation, which requires the external auditor to submit a "long-form report" to the supervisory board. Such a report, which is not available to the public, summarises in greater detail than the auditor's report the fundamental findings of the audit on the going concern assumption and associated monitoring systems, future development and risks facing the company, material disclosures, irregularities encountered, accounting methods used or any "window dressing" transactions.

Such enhanced dialogue should, however, not be allowed to compromise the independence of the statutory auditor.

#### *Corporate Social and Environmental Responsibility (CSR)*

CSR refers to the way in which companies integrate social and environmental concerns into their business operations and in their interaction with their stakeholders on a voluntary basis.

Clearer reporting rules may contribute to a better valuation of EU companies and a better focus on sustainability issues by companies and investors.

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<sup>18</sup> The IOSCO (International Organisation of Securities Commissions) has made suggestions to enhance the auditor's report with a view to reduce the expectation gap, to avoid technical jargon, and to revisit the binary nature of audit opinions. Improving the auditors' reports is also on the IAASB's [International Auditing and Assurance Standards Board] agenda for the coming years.

In order to ensure the sufficient quality and credibility of the reported information, the question should be raised whether there might be a need for an independent check on the reported information and whether auditors should play a role in this regard.

#### *Extension of the auditor's mandate*

The focus of audits so far to a large extent has been based on historical information. It is important to consider the extent to which auditors should be assessing forward looking information provided by the company, and given their privileged access to key information, the extent to which auditors should themselves provide an economic and financial outlook of the company. The latter would be particularly pertinent within the context of "going concern".

Forward looking analysis, at least for large listed companies, has so far been covered by equity analysts and credit rating agencies. The role of the auditor should thus be extended in this direction only if there is real value added to the stakeholders.

#### **Questions**

- (4) Do you believe that audits should provide comfort on the financial health of companies? Are audits fit for such a purpose?
- (5) To bridge the expectation gap and in order to clarify the role of audits, should the audit methodology employed be better explained to users?
- (6) Should "professional scepticism" be reinforced? How could this be achieved?
- (7) Should the negative perception attached to qualifications in audit reports be reconsidered? If so, how?
- (8) What additional information should be provided to external stakeholders and how?
- (9) Is there adequate and regular dialogue between the external auditors, internal auditors and the Audit Committee? If not, how can this communication be improved?
- (10) Do you think auditors should play a role in ensuring the reliability of the information companies are reporting in the field of CSR?
- (11) Should there be more regular communication by the auditor to stakeholders? Also, should the time gap between the year end and the date of the audit opinion be reduced?
- (12) What other measures could be envisaged to enhance the value of audits?

## **2.2. International Standards on Auditing (ISAs)**

The International Standards on Auditing (ISAs) and International Standards on Quality Control (ISQCs) are set by the International Assurance and Auditing Standards Board (IAASB), a board of the International Federation of Accountants (IFAC). The Commission is working with its main international partners and organisations towards the improvement of the governance and accountability of the standard setting bodies.

Between 2006 and 2009, the IAASB performed a thorough revision and clarification of the ISAs under the so-called "Clarity Project". The "clarified ISAs" should apply for the first time

to the audits of 2010 fiscal years. The "clarified ISAs" might be seen as more robust in a number of areas than the ISAs used for the audits until the 2009 fiscal years. In particular, the clarified ISAs may be able to bring appropriate responses to changes in the nature of audit evidence regarding fair value accounting, the reporting of estimates and sensitivities, or the approach to transactions with related parties.

The Commission notes, as a result of its consultation in 2009<sup>19</sup>, the overall support of EU stakeholders to an adoption of the ISAs at EU level. Respondents considered that common standards under the form of the "clarified ISAs" and ISQCs would contribute to harmonised and qualitative audits which in turn support the quality and credibility of the financial statements. Some respondents asked for further work to be done to adapt the ISAs to the needs of SMEs and SMPs.

The clarified ISAs have either been already adopted or are in the process of being adopted by a majority of Member States and are also being applied by the major networks of audit firms. They have also been introduced by many third countries, though not by some of our key international partners such as the United States. The Commission is considering when and how to introduce ISAs in the EU. The introduction could be done via binding or non binding Community law instruments.

#### Questions

- (13) What are your views on the introduction of ISAs in the EU?
- (14) Should ISAs be made legally binding throughout the EU? If so, should a similar endorsement approach be chosen to the one existing for the endorsement of International Financial reporting Standards (IFRS)? Alternatively, and given the current widespread use of ISAs in the EU, should the use of ISAs be further encouraged through non-binding legal instruments (Recommendation, Code of Conduct)?
- (15) Should ISAs be further adapted to meet the needs of SMEs and SMPs?

### 3. GOVERNANCE AND INDEPENDENCE OF AUDIT FIRMS

As in many professional businesses, audit firms must actively manage their conflicts of interest. However, unlike many professional businesses, auditors play a statutory role; an audit is required by law. It is intended as a statutory safeguard for investors, lenders and business counterparties who have a stake or a business interest in entities that are incorporated as limited liability companies. Independence should thus be the unshakeable bedrock of the audit environment.

The Directive on Statutory Audit (2006/43/EC) (hereinafter referred to as "the Directive") requires that statutory auditors be subject to principles of professional ethics and lays down a number of principles for independence, ranging from behavioural aspects to considerations around ownership, fees, rotation or companies' governance (audit committees). These

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<sup>19</sup> See summary of comments on the consultation, March 2010 at [http://ec.europa.eu/internal\\_market/consultations/2009/isa\\_en.htm](http://ec.europa.eu/internal_market/consultations/2009/isa_en.htm)

principles have been transposed into the Member States' legal environment through either national specific codes, or through binding principles on top of the IFAC Code of Ethics<sup>20</sup>.

Notwithstanding the legal provisions as well as the Code of Ethics referred to above, the Commission would like to reinforce the independence of auditors and address the conflicts of interest which are inherent to the current landscape characterised by features such as the appointment and remuneration of the auditors by the audited firm, low levels of audit firm rotation or the provision of non audit services by audit firms.

#### *Appointment and remuneration of auditors*

Auditors are appointed and paid by the entity that needs to be audited, and this as part of a commercial tendering process. The fact that auditors' responsibility is to the shareholders of the audited company and other stakeholders although they are paid by the audited company creates a distortion within the system. The Commission is considering the feasibility of 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<sup>21</sup>. Such a concept may be especially relevant for the audit of the financial statements of large companies and/or systemic financial institutions. This matter should be explored taking into account, on the one hand, the risk of increased bureaucracy and, on the other hand, the possible societal benefits of demonstrably independent appointments.

#### *Mandatory Rotation*

Situations where a company has appointed the same audit firm for decades seem incompatible with desirable standards of independence.<sup>22</sup> Even when "key audit partners" are regularly rotated as currently mandated by the Directive, the threat of familiarity persists.

In this context, the mandatory rotation of audit firms – not just of audit partners – should be considered. The Commission acknowledges arguments relating to a loss of knowledge as a result of rotation. It would nevertheless like to examine the pros and cons of such rotation, especially with a view to instilling and maintaining objectivity and dynamism in the audit market. To prevent partners from changing firms to "take along" certain clients with them, rotation rules, if adopted, should ensure that not only firms, but partners are also rotated.

#### *Non audit services*

There is no EU-wide ban preventing auditors from offering non audit services to audit clients. According to Article 22 of the Directive, audit services should not be provided in cases where "an objective, reasonable and informed third party would conclude that the statutory auditor's

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<sup>20</sup> The Code of Ethics developed by a board of the International Federation of Accountants is used as a benchmark by practitioners due to adherence of their professional chamber or their firm to the IFAC standards. Codes developed by regulators at national level are generally more stringent than the IFAC Code.

<sup>21</sup> Such a model has still not been tested (with the exception of German cooperatives and savings banks).

<sup>22</sup> In a study performed in 2006, more than half of the respondent companies reported that their auditor has served the company for more than 7 years, and 31% reported that the change of an auditor has not occurred for more than 15 years: the general tendency is the bigger the audited company, the lower the switching rate. (Study by London Economics on the Economic Impact of Auditors' Liability Regimes; September 2006, table 22, page 43: [http://ec.europa.eu/internal\\_market/auditing/liability/index\\_en.htm](http://ec.europa.eu/internal_market/auditing/liability/index_en.htm)).

or audit firm's independence is compromised". This rule applies also to the provision of non audit services. Article 22 has so far been implemented in a very divergent manner across the EU. For example in France there is a total ban concerning the provision of non audit services by the auditor to its clients as well as strong restrictions on the possibility for the members of the network of the auditor to provide services to the members of the group of the audited entity. In many other Member States, rules are less restrictive and the provision of non audit services by auditors to their audit clients remains a regular feature<sup>23,24</sup>.

The Commission would like to examine reinforcing the prohibition of non-audit services by audit firms. This could potentially result in the creation of "pure audit firms" akin to inspection units. Since auditors provide an independent opinion on the financial health of companies, ideally they should not have any business interest in the company being audited.

#### *Fee structure*

A limit to the proportion of fees an audit firm can receive from a single audit client compared to the total audit revenues of the firm<sup>25</sup> could be envisaged along with appropriate disclosures. It would be useful to examine the case for and against such limitations, especially with regard to their application to small audit firms.

#### *Publication of Financial Statements*

Another aspect that should be considered is how to achieve more transparency with regard to the audit firm's own financial statements. For global networks, transparency should cover the whole network. In addition, it is worth exploring whether the financial statements of such firms should be audited and, given the potential conflict in being audited by a competitor, whether statutory bodies that audit accounts of public bodies at the national or even the European level should carry out such audits.

#### *Organisational requirements*

Audit firms should strengthen their corporate governance and organisational requirements to further mitigate conflicts of interest and reinforce their independence. Inspiration could be sought in the Regulation on Credit Rating Agencies<sup>26</sup>. Another reference is the code of governance for audit firms, which has recently been introduced in the UK<sup>27</sup>. The code establishes, amongst others, the principle that audit firms should appoint independent non-executives within their governance structure, and that shareholders of the audited companies should have dialogue with audit firms to enhance mutual communication and understanding.

#### *Revisiting Ownership Rules and the Partnership Model*

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<sup>23</sup> It should be noted that under US laws, the auditors of listed companies are prohibited from providing a number of non-audit services to their clients. This has ramifications in the EU for the provision of non audit services to the companies listed in the US.

<sup>24</sup> However in this regard, the UK FRC has recently made specific observations - press release POB PN 60 of the Audit Inspection Unit of the Financial Reporting Council, 14 September 2010.

<sup>25</sup> For example: paragraph 290.222 of the IFAC Code of Ethics states that an auditor of a public interest entity shall disclose its clients situations where the fees from that client represent more than 15% of the total fees received by the firm.

<sup>26</sup> Regulation (EC) No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies.

<sup>27</sup> Audit Firm Governance Code of the FRC and Institute of Chartered Accountants in England and Wales (ICAEW), January 2010.

At present, the Directive requires that auditors hold a majority of the voting rights in an audit firm and control the management board<sup>28</sup>. The Commission thinks that the rationale for these provisions should be revisited<sup>29</sup>.

So far, audit firms have operated under the partnership model (whether organised via a partnership or via a limited company). However, given that there has been considerable growth in the size and complexity of some large companies, it is unclear if even one of the systemic firms will have adequate resources to meet any potential liability claims. It is thus worth exploring alternative structures that would enable audit firms to raise capital from other sources. These alternative structures would need to put in place safeguards (for example in terms of governance) to ensure that external owners do not interfere with the audit work.

Such a move could also help non systemic firms to gain access to more capital and allow them to ramp up capacities and grow more rapidly.

### *Group audits*

Audits of large groups which operate in multiple jurisdictions are usually carried out by large global networks in view of the high level of resources such audits require. The Commission shares the concerns of a number of audit oversight bodies around the world which consider that the role of the group auditor needs to be reinforced. Arrangements need to be put in place to allow the group auditor to assume its role and responsibilities. Group auditors should have access to the reports and other documentation of all auditors reviewing sub-entities of the group. Group auditors should be involved in and have a clear overview of the complete audit process to be able to support and defend the group audit opinion.

### **Questions**

- (16) Is there a conflict in the auditor being appointed and remunerated by the audited entity? What alternative arrangements would you recommend in this context?
- (17) Would the appointment by a third party be justified in certain cases?
- (18) Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?
- (19) Should the provision of non-audit services by audit firms be prohibited? Should any such prohibition be applied to all firms and their clients or should this be the case for certain types of institutions, such as systemic financial institutions?
- (20) Should the maximum level of fees an audit firm can receive from a single client be regulated?
- (21) Should new rules be introduced regarding the transparency of the financial statements of audit firms?
- (22) What further measures could be envisaged in the governance of audit firms to enhance the independence of auditors?

<sup>28</sup> Article 3 of the Directive 2006/43/EC on Statutory Audit.

<sup>29</sup> Public consultation on control structures in audit firms and their consequences on the audit market, July 2009: [http://ec.europa.eu/internal\\_market/auditing/market/index\\_en.htm](http://ec.europa.eu/internal_market/auditing/market/index_en.htm)

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| (23) | Should alternative structures be explored to allow audit firms to raise capital from external sources? |
| (24) | Do you support the suggestions regarding Group Auditors? Do you have any further ideas on the matter?  |

#### 4. SUPERVISION

Public oversight systems, play a central role in the supervision of audit firms. Oversight systems should be organised to avoid any conflict of interest with the audit profession. Current rules could be reinforced with a view to ensuring the full independence of the public oversight systems of all Member States from the audit profession.

The supervision of audit firms in Europe must be performed on a more integrated basis, with closer cooperation between the national audit oversight systems. One possible option could be to transform the EGAOB into a so-called "Lamfalussy Level 3 Committee". This is the kind of committee which currently exists in the areas of securities, insurance and banking (Committee of European Securities Regulators (CESR), Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) or Committee of European Banking Supervisors (CEBS)). Such a Committee could reinforce co-operation at the European level and foster convergence in the application of the rules and ensure a common approach to inspections of audit firms. The Committee could provide high quality advice to the Commission on audit matters. Another option could be the establishment of a new European Supervisory Authority<sup>30</sup> or the integration of audit matters into one of the supervisory authorities which are being established under the Commission's financial supervision proposals on which agreement was recently reached by the Council and the Parliament.

At present the cross-border management entities that cover an audit network's operations in various Member States are not supervised; only each "national" component of the network is supervised at Member State level. This mismatch between pan European audit networks and national supervision should be addressed. The supervision of international audit networks could be done at the European level similarly to what was recently proposed for Credit Rating Agencies<sup>31</sup>.

The Commission considers that there is also a need to reinforce the dialogue between regulators and auditors. This dialogue should be a two-way process so that supervisors also alert auditors regarding particular areas of concern. In the specific case of financial institutions and providers of investment services, auditors are required under EU law to report promptly to the competent authorities any fact or decision which is liable to constitute a material breach of laws, affect the ability of the company to continue as a going concern, or lead to a qualified audit report<sup>32</sup>. The auditors of investment firms are required to report each year to the competent authorities on a number of issues<sup>33</sup>. The Commission has no information on whether this provision has been effectively respected during the crisis and

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<sup>30</sup> Any option for a new Committee or a Supervisory Authority would also need to be assessed in terms of the impact on the EU budget.

<sup>31</sup> Proposal for the Regulation of the European Parliament and of the Council on amending Regulation n°1060/2009 (EC) on credit rating agencies, Com (2010)289 final.

<sup>32</sup> Article 55 of Directive 2004/39/EC of 21 April 2004 on Markets in Financial Instruments. Article 53 of Directive 2006/48/EC of 14 June 2006 on the taking up and pursuit of the business of credit institutions.

<sup>33</sup> Article 20 of the Implementing Directive 2006/73/EC of 10 August 2006.

whether such reporting to competent authorities by auditors took place in individual cases<sup>34</sup>. The Commission would like to consider whether communication between the auditors and the relevant securities regulator should become mandatory to all large or listed companies; special consideration could also be given to communication with appropriate authorities in the case of fraud within companies.

#### Questions

- (25) Which measures should be envisaged to improve further the integration and cooperation on audit firm supervision at EU level?
- (26) How could increased consultation and communication between the auditor of large listed companies and the regulator be achieved?

### 5. CONCENTRATION AND MARKET STRUCTURE

The market for audits of listed companies is, in the main, covered by the so called Big Four audit firms<sup>35</sup>. In terms of the revenues or fees received, the total market share of Big Four audit firms for listed companies exceeds 90% in a vast majority of EU member states<sup>36</sup>. Entry into this top-tier section of the audit market has proven very difficult for many mid tier audit firms despite their capacity to work in the international audit market.

Such concentration might entail an accumulation of systemic risk and the collapse of a "systemic firm" or a firm that has reached "systemic proportions"<sup>5</sup> could disrupt the whole market.

The market appears to be too concentrated in certain segments and deny clients sufficient choice when deciding on their auditors.

Moreover, being an auditor of large listed companies seems to create a reputational endorsement; such a positive association would then help the large firms in securing further high profile audit engagements and thus contribute to lack of dynamism in the market.

Non Big Four firms on the other hand continue to suffer from a lack of recognition of their capacities by the largest companies. It would appear that there are also instances of "Big Four only" contractual clauses that are sometimes imposed on companies by e.g. financial institutions as a condition to grant a loan.

The Commission would therefore like to consider the following measures:

#### *Joint audits / audit consortia*

Joint audits as such are only enforced in France, where listed companies are required to appoint two different audit firms, who share the audit work and jointly sign the audit report. This practice, however, should be developed further to "dynamise" the market to allow mid-

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<sup>34</sup> Commission Staff Working Document (accompanying Green Paper on Corporate Governance in financial institutions and remunerations policies) SEC (2010) 669 - page 33, point 6.1.1.

<sup>35</sup> Deloitte & Touche, Ernst & Young, PricewaterhouseCoopers and KPMG.

<sup>36</sup> Study by London Economics on the Economic Impact of Auditors' Liability Regimes; September 2006, table 5, pages 22-23. [http://ec.europa.eu/internal\\_market/auditing/liability/index\\_en.htm](http://ec.europa.eu/internal_market/auditing/liability/index_en.htm)

tier non-systemic firms to become active players in the market segment of the audits of large corporations, which until now has proven elusive. To encourage the emergence of other players and the growth of small and medium sized audit practices, the Commission could consider introducing the mandatory formation of an audit firm consortium with the inclusion of at least one non-systemic audit firm for the audits of large companies. Such consortia would need to be established with clear lines of responsibility for the overall audit opinion as well a resolution / disclosure mechanism for differences in opinion between consortium members.

The concept of "joint audit" could also be one way of mitigating disruption in the audit market if one of the large audit networks fails.

#### *Mandatory rotation of auditors and re-tendering*

Mandatory rotation can not only enhance the independence of auditors as discussed earlier; it could also operate as a catalyst to introduce more dynamism and capacity into the audit market. One could envisage a mandatory rotation of the audit firm / consortium after a fixed period. To prevent partners from changing firms to "take along" certain clients with them, rotation rules should ensure that not only firms, but partners are also rotated. Such mandatory rotation should be accompanied by mandatory tendering with full transparency as regards the criteria according to which the auditor will be appointed. Quality and independence should be key selection criteria in any tendering procedure. Otherwise, if only a very small proportion of audits of leading listed companies come up for open and fair tender in any given year, attempts to dynamise the market would have limited effect.

#### *Addressing the "Big Four is Best" bias*

As a result of the consolidation at the upper end of the market, there appears to be a higher level of "comfort" with the appointment of a "Big Four" firm as a company's auditor. The Commission would nevertheless like to understand how much of this is attributable to "perceptions" and how much to "merit". Making such assessment is facilitated by transparent reporting of inspections as is currently the case in the UK<sup>37</sup>.

The Commission will also seek to address the issue of contractual clauses that are informally referred to as "Big Four only clauses"<sup>38</sup>. One avenue to explore might be the creation of a European quality certification for audit firms which would formally recognise their aptitude to perform audits of large listed companies.

#### *Contingency plan*

The Commission will work with Member States, audit firms and other stakeholders, including international fora, to discuss a contingency plan. Such a plan should allow for a rapid resolution in the event of the demise of a systemic audit firm, avoid disruption in the provision of audit services and prevent further structural accumulation of risk in the market.

Within the context of a contingency plan, it has to be noted that the formation of consortia could play a significant role. In the instance of the demise of one of the consortium members,

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<sup>37</sup> Press release POB PN 60 of the Audit Inspection Unit of the Financial Reporting Council, 14 September 2010.

<sup>38</sup> "Restrictive bank covenants keep Big four on top" (Christodoulou, 2010), Accountancy Age, 17 June 2010.

the "surviving" firm should be able to ensure continuity of the audit until more "permanent" arrangements are in place.

In keeping with the approach being considered in the banking sector, the concepts of orderly failure, including "living wills", especially in the case of systemic audit firms, should also be explored on a proactive basis.

#### *Reassessment of the drivers of previous consolidation*

The Commission would like to examine to what extent the consolidation of the larger firms has delivered the innovation in audit methodology that was expected; this is of particular relevance in the context of the audit of financial institutions where the latter developed a plethora of products and processes that became increasingly complex over the period.

The Commission would welcome views on whether the broader rationale for consolidation of large audit firms over the past two decades (i.e. global offer, synergies) is still valid or whether there is a need for a rethink. Moreover, in view of the systemic risk represented by the large, global firms, the Commission would also welcome views on whether the consolidation of the past decades should be reversed.

#### **Questions**

- (27) Could the current configuration of the audit market present a systemic risk?
- (28) Do you believe that the mandatory formation of an audit firm consortium with the inclusion of at least one smaller, non systemic audit firm could act as a catalyst for dynamising the audit market and allowing small and medium-sized firms to participate more substantially in the segment of larger audits?
- (29) From the viewpoint of enhancing the structure of audit markets, do you agree to mandatory rotation and tendering after a fixed period? What should be the length of such a period?
- (30) How should the "Big Four bias" be addressed?
- (31) Do you agree that contingency plans, including living wills, could be key in addressing systemic risks and the risks of firm failure?
- (32) Is the broader rationale for consolidation of large audit firms over the past two decades (i.e. global offer, synergies) still valid? In which circumstances, could a reversal be envisaged?

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

Some progress was recently achieved with the transposition by the Member States of Article 3 of the Directive, which provides for a possibility of cross border ownership in audit firms. Following the implementation of this article by the Member States, some big networks achieved a higher degree of integration. However, many barriers to integration of the European audit market remain and cross-border mobility of audit professionals is still low.

Regulatory layers at national, European and international levels have led to a degree of complexity that creates barriers to the cross-border operation of audit firms, especially for smaller and medium sized firms. Such complexity has also prevented smaller networks from growing and making inroads into the market for the large company audits. The lack of co-ordination at European and international levels concerning public oversight and quality assurance systems might also deter the development of smaller networks of audit firms.

Certain provisions of the Directive could also be seen as a potential source of the fragmentation in the market:

- Article 3 of the Directive requires the approval and registration in each Member State where the services are to be provided;
- Article 14 of the Directive provides for an aptitude test in each Member State for an auditor to be allowed to provide services.

The above requirements differ from the general rules applicable to other regulated professions<sup>39</sup> and act as a barrier to the mobility of individual auditors.

A single European market for the provision of audit services could be based on enhanced ("maximum") harmonisation and a "European passport for auditors". This would imply creating a European-wide registration with common professional qualification requirements and common governance, ownership and independence rules applicable across the European Union. If European supervision of auditors were reinforced along the lines discussed in Section 4, one possibility to explore further could be to require these auditors to be registered and brought under the oversight of a single regulator in a manner similar to what was recently proposed for Credit Rating Agencies<sup>40</sup>. Such a system could also encourage more competition in the market for large audits as it would simplify the development of European audit networks and reduce the costs of providing audit services on a Europe wide basis.

### Questions

- (33) What in your view is the best manner to enhance cross border mobility of audit professionals?
- (34) Do you agree with "maximum harmonisation" combined with a single European passport for auditors and audit firms? Do you believe this should also apply for smaller firms?

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

### 7.1. Small and Medium Sized Enterprises (SMEs)

While SMEs get value from an audit in terms of enhanced credibility of financial information, statutory audits have also been identified as a potential source of administrative burden.

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<sup>39</sup> Rules stated in the Directive 2005/36/EC on Professional Qualifications and in the Service Directive 2006/123/EC.

<sup>40</sup> Proposal for the Regulation of the European Parliament and of the Council on amending Regulation n°1060/2009 (EC) on credit rating agencies, Com (2010)289 final.

Serious efforts should be made to create a specific environment for the audit of SMEs. These could imply:

- Discouraging the statutory audit of SMEs.
- Alternatively, where Member States want to maintain some form of assurance, introducing a new type of statutory service adapted to the needs of SMEs such as a "limited audit" or a "statutory review" where auditors would perform limited procedures so as to detect misstatements due to error or fraud. The approach of mandating a limited review for small companies has been followed by Estonia, and is being considered by Denmark. Switzerland also follows such an approach; limited reviews are generally accepted in the USA.
- In the instance of the prohibition of non audit services as discussed in Section 3 above, consideration could be given to providing for a safe harbour which, subject to appropriate safeguards being in place, would allow the auditor of an SME to continue providing certain non audit services to that company – e.g. assistance in their access to credit, in tax returns, payrolls, or even accounting.

## **7.2. Small and Medium Sized Practitioners (SMPs)**

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.

### **Questions**

- (35) Would you favour a lower level of service than an audit, a so called "limited audit" or "statutory review" for the financial statements of SMEs instead of a statutory audit? Should such a service be conditional depending on whether a suitably qualified (internal or external) accountant prepared the accounts?
- (36) Should there be a "safe harbour" regarding any potential future prohibition of non-audit services when servicing SME clients?
- (37) Should a "limited audit" or "statutory review" be accompanied by less burdensome internal quality control rules and oversight by supervisors? Could you suggest examples of how this could be done in practice?

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

In relation to international cooperation on audit firm oversight, the Directive provides the basis for close cooperation with audit oversight bodies in third countries.

The first step in international cooperation is building mutual trust through the exchange of audit working papers between European oversight bodies and their counterparts in third countries. Such an exchange of audit working papers requires a Decision from the Commission, with the agreement of Member States and the European Parliament, which

declares that third countries' systems adequately protect professional and personal data. Member States' authorities may enter into bilateral arrangements for the exchange of audit working papers with their counterparts in those third countries whose oversight systems have been declared "adequate". Following Commission adequacy decisions adopted this year, such arrangements are possible as regards the co-operation with the audit oversight bodies of Australia, Canada, Japan, Switzerland and the United States.

The second step would be mutual reliance between Member States and those third countries which have equivalent provisions on matters such as inspections of audit firms. The Commission, with the agreement of the Member States and the European Parliament, is in the process of adopting a Decision to determine which third countries are equivalent to the EU. Mutual reliance will allow for a more effective and efficient oversight of global audit firms. It will also avoid duplication of efforts in the supervision of cross border firms at an international level.

As mentioned before, the supervision of the auditors of large groups which operate in multiple jurisdictions is a matter of concern. In addition to any arrangements which need to be put in place to allow the group auditor to assume its role and responsibilities, the Commission will discuss with its international partners what other measures should be adopted at the global level for the supervision of group audits and global audit networks.

#### **Questions**

(38) What measures could in your view enhance the quality of the oversight of global audit players through international co-operation?

## 9. NEXT STEPS

This Green Paper will be open for public consultation until the **8th of December 2010**. Responses should be addressed to [markt-greenpaper-audit@ec.europa.eu](mailto:markt-greenpaper-audit@ec.europa.eu). All contributions will be published on the DG Internal Market and Services website unless a contributor requests otherwise, as will a Feedback Statement summarising the responses to this consultation. It is important to read the specific privacy statement attached to this Green Paper for information on how your personal data and contribution will be dealt with.

The Commission will host a high level Conference on **10<sup>th</sup> February 2011**. The Conference will aim at discussing the present Green Paper and the main findings of this consultation with all stakeholders and explore possible ways forward. Once this consultation phase is closed the Commission will announce any appropriate follow up measures and proposals in 2011.