
POLICY PLATFORM

| Policy Letter

Comment on the European Commission's Green Paper "Audit Policy: Lessons from the Crisis"

Hans-Joachim Böcking and Marius Gros
Chair of Auditing and Corporate Governance

December 2010

Goethe-University Frankfurt
Faculty of Economics and Business Administration

European Commission
DG Internal Market and Services
Commissioner Michael Barnier
rue de Spa/Spastraat, 2
B-1000 Bruxelles/Brussel
Belgium
markt-greenpaper-audit@ec.europa.eu

Faculty of Economics and
Business Administration

Chair of Auditing and Corporate Governance

Prof. Dr. Hans-Joachim Böcking
Dr. Marius Gros

Phone +49 (0)69-798 34748
Fax +49 (0)69-798 35012
E-Mail hjboecking@wiwi.uni-frankfurt.de
mgros@wiwi.uni-frankfurt.de

<http://www.accounting.uni-frankfurt.de/boecking>

December 7th 2010

Dear Commissioner Barnier

Green Paper Audit Policy: Lessons from the Crisis

We are writing to comment on the Green Paper “Audit Policy: Lessons from the Crisis”. We appreciate the opportunity to comment on the European Commission’s Green Paper and support the Commission’s efforts to question and analyze the role auditors played within the financial crisis. Hereinafter please find our responses to the 38 questions which have arisen.

Question (1): Do you have general remarks on the approach and purposes of this Green Paper?

We explicitly welcome the initiative. It seems appropriate to discuss some questions on a fundamental level again, especially with the background of the recent financial crisis. There is also a need for a critical assessment of the premises of regulation. The academic findings, for example, presented in the literature, as well as the underlying assumptions, should be subject to a critical review.

Question (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?

With respect to the expectation gap, it is crucial for regulators and auditors to clearly highlight the additional value of an audit. For this purpose, it is helpful to define the societal role of the audit with respect to the accuracy of financial statements more precisely. In this context, cost-benefit calculations should be considered, as well as strategies for reducing the expectation gap.

Question (3): Do you believe that the general level of "audit quality" could be further enhanced?

In our view, the general level of audit quality can be increased primarily by an extension of the duties of care and/or by tightening regulations on liability. Both should at least be further discussed. These measures could be suitable to counteract the observable reduction of audit fees paid by the audited entities. Neither negotiations of remuneration, nor the competition between auditors should lead to a reduction of audit quality. Stricter sanctions may provide incentives for audit firms to abandon an audit engagement if the fees offered are not sufficient to ensure an accurate audit. Conversely, a possible violation of the duties of care may arise for the appointing body if only fees which are insufficient to assure an accurate audit are offered. In order to carry out its monitoring tasks, the supervisory body, respectively its audit committee and its financial expert, must be interested in an accurate audit rather than a smooth and low priced one. It is, therefore, crucial to assess not only the performance of the auditor, but also to review the appropriateness of the agreed audit fees in the event of damage or loss.

Question (4): Do you believe that audits should provide comfort on the financial health of companies? Are audits fit for such a purpose?

The economic situation – to be presented in the financial statement – relates to the net assets position, the results of operations, segment information and the financial position. Accordingly, it is a task of the auditor to assess the presentation of the financial position, e.g. by auditing the statement of cash flows. Furthermore, the risk reporting in the management report (or in the annual report by means of Section 9 of the Fourth Directive) is part of the audit and should be assessed with regard to completeness and plausibility. Because of this, the auditor is (only) able to increase the certainty of the presentation of the financial solidity at the balance sheet date and to assess the plausibility of the assumptions made regarding prospective information.

Question (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?

Extended reporting is surely able to bridge the expectation gap and to clarify the role of audits with regard to professional market participants. With regard to the remaining market participants, the fundamental benefits, the purpose and the scope of the audit should be better explained initially. Extended and individually phrased auditors' reports could contribute to this.

Question (6): Should "professional scepticism" be reinforced? How could this be achieved?

Firstly, we refer to our response to question 3, and would like to point out the necessity of a critical assessment of existing and possible sanctioning mechanisms and their effectiveness. With effective sanctioning mechanisms in place, auditors may only accept audit fees which allow for an accurate audit.

The current supervision of auditors and especially sanctions imposed on auditors due to undetected material accounting errors in the financial statements of their clients, detected by enforcement, are considered – even on a national level – as a black box.

Question (7): Should the negative perception attached to qualifications in audit reports be reconsidered? If so, how?

Although we agree with the underlying idea that the “either or not mentality” is to be reconsidered, we currently do not see any possibility of effectively reducing the negative perception of qualified audit opinions. Due to the long period it takes to perform an audit, the audited entity will correct any errors which have occurred that could possibly lead to findings, if feasible, before the audit is completed. For this reason, only findings which could not be easily corrected or which were not corrected in time would lead to qualified audit opinions. As a result, the negative perception of qualified audit opinions in these cases seems in some ways to be logically consistent.

Question (8): What additional information should be provided to external stakeholders and how?

Because publicly traded companies are not only monitored by internal monitoring mechanisms and supervisory bodies, but also by the “market for corporate control”, there should be an enhancement of the auditors’ reports, which should be individually phrased and should include the material results and findings of the audit.

If – following the German law – the Commission decides to install a “long-form report”, which in principle is only delivered to the supervisory body or the audit committee, it should be considered under which circumstances the report should be made public (e.g. financial disorder or bailout request, filing for bankruptcy). Furthermore, it is to ensure that the “long form-report” does not only reflect already publicly available information.

Question (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?

We can assess this issue only in a very limited way. Possibly the communication could be strengthened by the obligation to communicate, even though there is no urgent reporting requirement. The absence of any specific incidents could be communicated in the form of a disclaimer. The requirement to release a disclaimer could increase the level of accuracy.

Question (10): Do you think auditors should play a role in ensuring the reliability of the information companies are reporting in the field of CSR?

The reliability of all potentially decision-relevant information published due to periodic disclosure requirements should be subject to an audit or review.

Question (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?

The published interim or quarterly reports – if mandatory – should also be subject to an audit or a review. The result of the audit or the review should be made publicly available. Although audit opinions near to the balance sheet date (fast-close) are desirable in principle, this should not lead to a decrease in audit quality. Therefore, there should be no measures taken to reduce the gap between the balance sheet date and the date of the audit opinion.

Question (12): What other measures could be envisaged to enhance the value of audits?

Firstly, the existing value, purpose and scope of the audit have to be clearly communicated. The expectation gap has to be reduced as far as possible.

Question (13): What are your views on the introduction of ISAs in the EU?

The implementation of International Standards on Auditing is consistent with the application of International Financial Reporting Standards with regard to the EU's current regulatory approach for publicly traded entities. However, it should be considered that currently both the development of IFRS and ISA are significantly influenced by the auditors' profession.

Question (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)?

Although the application of ISAs is currently not mandatory, a voluntary (full or partial) application by auditors is observable in some member states, e.g. in Germany. In our view the application of ISAs should only become mandatory for the audit of publicly traded entities. The endorsement approach should be structured in the same way as the approach that is currently applied for the endorsement of IFRS. Non-binding legal instruments, such as a code of conduct or recommendations, are in our opinion insufficient.

Question (15): Should ISAs be further adapted to meet the needs of SMEs and SMPs?

No, the application of ISAs should only be mandatory for the audit of publicly traded entities. Due to the possibility of voluntary (full or partial) application, the market can decide whether or not to apply ISAs or to consider the need for SMEs and SMPs.

Question (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?

Both the auditor and the audited entity have to make sure that the remuneration agreed on enables the auditor to conduct an accurate audit. The appointment and negotiation of remuneration by a third party, such as a state authority, is an excessive intervention in an autonomous market, which currently does not seem to be justified or even necessary. If the supervisory body (e.g. the audit committee and its financial expert or the shareholders' meeting as the body which finally appoints the auditor) takes care of its monitoring task, it must be (self-) interested that the audit is carried out accurately and not just smoothly and low priced.

Question (17): Would the appointment by a third party be justified in certain cases?

An appointment by a third party appears to be justified in the case of insignificant self-interest in an accurate audit shown by the appointing body, respectively its members in charge. This might be relevant for specific banks and insurance companies.

Question (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?

While economic considerations may support long term engagements which can also improve the auditors' understanding of the audited company, external rotation could strengthen the independence of the auditor/audit firm. We suggest that the decision about a maximum length of audit engagement should be made by each company (respectively its audit committee) individually. The audit committee, which includes in general at least one independent financial expert, should have the best knowledge of which auditor can offer the best quality and which audit fees should be paid in order to ensure a high quality audit.

We would like to add that the requirement of a regular tendering process, without requiring a mandatory change of the audit firm, would be advisable. Such a procedure could be helpful to evaluate the quality of the current auditor and to make comparisons with the offers from other audit companies (benchmarking), e.g. every 3 to 5 years. In the case that the audit committee decides not to change the auditor, a statement on the reasons for the decision should be compulsory.

Question (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?

The existing regulations on the prohibition of self-audits, as well as their practical application, would have to be critically reviewed. Some academic findings regarding non-audit services regularly refer to the fact that non-audit services improve the auditors' understanding of the company and can therefore increase audit quality. In our view, these academic findings are not suitable for audit-related consulting services conducted for an audit client (e.g. advice on accounting for complex business transaction or the introduction of new reporting standards or regulations, valuation services, preparation and support for (special) audits, or optimization of the clients' accounting process). These audit-related consulting services should be clearly defined and their provision prohibited at audit clients; regardless of the industry sector or the type of institution, in order to avoid any possibility of self-auditing and conflicts of interest.

Question (20): Should the maximum level of fees an audit firm can receive from a single client be regulated?

A maximum level of fees received from a single client measured as a proportion of the audited firm's turnover may enhance the independence of audit firms. However, the regulations already implemented in the member states have to be evaluated first before taking any further action.

Question (21): Should new rules be introduced regarding the transparency of the financial statements of audit firms?

As for other entities, the legal form should be the principal criterion that determines the applicable regulations. Notwithstanding the allocation of the firm's turnover to audit and non-audit services (at least subdivided in tax advice and other advisory services) should be transparent.

Question (22): What further measures could be envisaged in the governance of audit firms to enhance the independence of auditors?

The turnover audit firms obtain from non-audit services could be limited by introducing a cap. The cap could be measured as a proportion of the audit firm's total turnover.

Question (23): Should alternative structures be explored to allow audit firms to raise capital from external sources?

It is important to keep in mind that external sources of capital might have short term interests. This could negatively affect the audit quality if the external source is interested in maximizing short term profits. Therefore the audit firms themselves should have sufficient capital reserves (e.g. out of partner capital contributions). According to this, a minimum capital requirement for audit firms should be discussed.

Question (24): Do you support the suggestions regarding Group Auditors? Do you have any further ideas on the matter?

We are not able to complete a final assessment of this question at the present time.

Question (25): Which measures should be envisaged to improve further the integration and cooperation on audit firm supervision at EU level?

The regulations regarding supervision and sanctioning mechanisms, as well as their practical application, should be harmonized and be designed transparently.

Question (26): How could increased consultation and communication between the auditor of large listed companies and the regulator be achieved?

Basically, we are not able to answer this question. Possibly the communication could be strengthened by the obligation to communicate, even if there is no urgent reporting requirement. The absence of any specific incidents could be communicated in the form of a disclaimer. Such a disclaimer could increase the level of accuracy and could serve as the legal basis for sanctions in case of later damages.

Question (27): Could the current configuration of the audit market present a systemic risk?

The breakdown of an audit firm could lead to a scarcity in the supply of audit services which could affect the functionality of capital markets, at least for a (very) short time. To what extent this is systemic – in the narrow sense – has to be critically analyzed. However, the breakdown of Arthur Anderson had no lasting effect on the functionality of capital markets. The auditors can join other audit firms or build up new ones.

Question (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?

This would be a measure to enhance small and medium sized audit companies, which could destroy the current oligopoly in the medium or long run. Whether this measure is necessary, appropriate and (e.g. politically) acceptable still has to be analyzed. The current oligopoly is a result of market actions.

Question (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?

According to our answer to question 18, the length of the period after which rotation or just tendering takes place could be determined by each company, respectively its audit committee, individually. Tendering offers the company the possibility of evaluating the quality of the current auditor and of making comparisons with offers from other audit companies. In the case that the audit committee decides not to change the auditor, a statement on the reasons for the decision should be compulsory.

Question (30): How should the "Big Four bias" be addressed?

Firstly, the existence of any market distortion at all has to be analyzed. If this is the case and it affects competition, an appropriate measure of the existing regulatory framework (e.g. antitrust laws) has to be employed to overcome this problem.

Question (31): Do you agree that contingency plans, including living wills, could be key in addressing systemic risks and the risks of firm failure?

If a breakdown of an audit firm was actually systemic, it should be a given fact that authorities, liquidators and other persons in charge could rely on accurately administrated and stored business documents, so that the company could be wound up quickly. To us, the business model of an audit company does not appear as complex as some other contract structures in the financial industry.

Question (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?

In principle, the decision to reverse the consolidation should be an entrepreneurial decision by the audit firms. It depends on individual cost-benefit analysis and business objectives.

Question (33): What in your view is the best manner to enhance cross border mobility of audit professionals?

First of all, it is important that this does not lead to a harmonization of the required qualification to the lowest common level. The latter would negatively affect the audit quality.

Question (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?

In principle, we appreciate the idea of a "European passport for auditors and audit firms", because this provides the possibility of installing minimum requirements. Firstly, a consensus on the definition of minimum requirements has to be achieved.

Question (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?

We consider the actual reliefs offered for SMEs as sufficient. A lower service level would unavoidably lead to a lower level of reliability of the audit result.

Question (36): Should there be a "safe harbour" regarding any potential future prohibition of nonaudit services when servicing SME clients?

No, in accordance with our answer to question 19, we point out that the implementation and the application of the prohibition on self-audit has the highest priority. Additionally, there should not remain any possibility to conduct audit-related consulting services, which could lead to a self-audit or a conflict of interests.

Question (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?

We reject a lower service level in the sense of a "limited audit" or "statutory review".

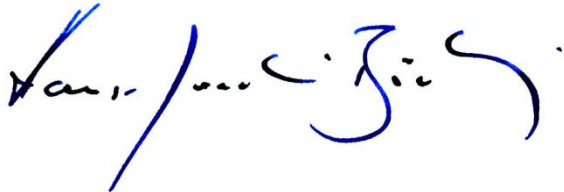
Question (38): What measures could in your view enhance the quality of the oversight of global audit players through international co-operation?

The co-operation of supervisory authorities has to be strengthened and the sanction possibilities should be extended. In addition, the measures already undertaken and sanctions imposed by enforcement should be more transparent. As stated in our answer to question 6, the current oversight of auditors and especially sanctions imposed on auditors, due to undetected material accounting errors in the financial statements of their clients, detected by enforcement, are considered – even on a national level – as a black box.


If you would like any further explanation or clarification of these responses, please do not hesitate to contact us.

Yours sincerely,

Frankfurt/Main, December 7th 2010



(Prof. Dr. Hans-Joachim Böcking)



(Dr. Marius Gros)