



## FEE Response to the European Commission Green Paper on Audit Policy

FEE has considered the general and specific questions in the Green Paper on Audit Policy of 13 October 2010 and provides hereafter its responses to the questions. These responses include both the main point(s) answering the questions raised along with FEE's more detailed explanations.

In addition, FEE has prepared a letter outlining the key elements based on which FEE believes a way forward could be developed to enhance the auditors' contribution to the economy and the public interest. This letter is available on

[http://www.fee.be/news/default.asp?library\\_ref=2&category\\_ref=214&content\\_ref=1322](http://www.fee.be/news/default.asp?library_ref=2&category_ref=214&content_ref=1322)

### Responses to Questions

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

- (1) In respect of general remarks on audit policy, reference is made to our cover letter which precedes. All our comments are based on the concept of the audit of entities as per Article 11 of the Fourth EU Directive, which defines the entities subject to statutory audit.

#### **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?**

FEE appreciates that the Green Paper emphasises the importance of the audit of financial statements for the stability of capital markets and financial systems, as part of a comprehensive financial reporting system. In this context, FEE is of the view that more could be done by a coordinated effort of entities' management, those charged with governance<sup>1</sup> and the auditor to better set out the societal role of the audit.

- (2) When doing business, and within the financial reporting system, an audit is only one element which contributes substantially to the stability and credibility of markets and the economy at large. Taking the risk to invest in realising an idea or concept or commercialising an invention, product or service is key to any potentially successful entity. Among many other aspects of doing business, there is also a need for proper risk management, corporate governance, accounting, financial reporting, auditing, supervision, etc. European and national laws and regulation govern all these aspects of doing business in a more or less convergent manner.

<sup>1</sup> Those charged with governance are the person(s) or organisation(s) with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity. This includes normally the board of directors and the audit committee but also an owner-manager in a small entity. In this response the use of "board" and "board of directors" is considered equivalent and should be understood as management board or supervisory board depending on the specific circumstances. These will, to some extent, depend on the situation at national level, i.e. whether the system for boards is a one-tier or two-tier system.

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- (3) In this respect, it should be noted that the audit profession also contributes significantly to EU Gross Domestic Products (GDP) as a services supplier. The accountancy profession employs several hundreds of thousands of people and recruits and trains a significant number of young graduates every year. Most importantly, during the crisis, the audit profession helped troubled financial institutions and governments to restructure and build resilience against worsening market conditions.
- (4) As far as an audit is concerned, its current purpose is to enhance the degree of confidence of intended users in the accounts or financial statements. This is achieved by the expression of independent opinions by auditors as to whether the financial statements, as prepared by entities, give a true and fair view in accordance with the relevant financial reporting framework<sup>2</sup>.
- (5) We understand the 'veracity of financial statements' to be the same as the 'true and fair view of the financial statements in accordance with the relevant financial reporting framework'. FEE would however agree that there is a need to better set out or explain the role of the audit: what it is, what its purpose is and what its limitations are.
- (6) As far as the entities are concerned, management and those charged with governance, normally the board and the audit committee, would have more knowledge about the entity which the investor community could be interested in than is currently disclosed within the existing boundaries of financial reporting. This is reinforced by the current trend toward better governance, corporate social responsibility and sustainability. As the information is available within entities, more could be done to explain and disclose such matters.
- (7) Similarly, auditors perform much more audit work than is expressed within the current boundaries of their audit report. Although audit has not been viewed as the reason for or part of the financial crisis, it could be considered that auditors should do more to explain and report on such matters. With this in mind, FEE would agree that the role of the audit could be better explained, both with regards to its purpose as well as its conclusions.
- (8) As such, also considering any lessons learned from the financial crisis by entities as well as by auditors, more could be done by both the entity and the auditor to better set out the societal role of the audit as well as its benefits to all participants in the financial reporting system. Any additional information provided should serve a real demand of the investor community and should not damage the commercial interests of entities, an issue which is further debated in our responses to Questions 4 and 8 below.
- (9) We welcome further debate on this with all relevant stakeholders.

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<sup>2</sup> As per Articles 51a and 37, respectively, of the Fourth and Seventh EU Directives

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

FEE believes that the general level of "audit quality" is constantly enhancing and we are committed to continue to improve "audit quality" in the future, building on the significant improvements that have already been made and are being made in this area.

- (10) As representative of the European audit profession, FEE constantly contributes to promoting high quality audits. Therefore, FEE supported and continues to support the requirements set out in the Statutory Audit Directive which has largely contributed to enhancing "audit quality" following the introduction of requirements on approval and registration of auditors, their education, training, continuous professional development, ethics and independence, auditing standards, quality assurance, public oversight, investigations, audit committees, for which "audit quality" should also be a primary concern. In a number of EU Member States, it is unfortunately too early for the benefits of these reforms to have fully materialised.
- (11) Our commitment to "audit quality" is also our main driver to support the adoption of the International Standards on Auditing (ISAs) and the International Standard on Quality Control (ISQC) 1<sup>3</sup> as promulgated by the International Auditing and Assurance Standards Board (IAASB) for all statutory audits in the EU as ISAs are high quality auditing standards as further discussed below and in our response to Question 13.
- (12) Although the level of "audit quality" is considered to be high, as noted by various audit oversight bodies<sup>4 5 6</sup>, improvement should continue to be made as indicated by two audit oversight bodies which have recently published their reports<sup>7 8</sup>. Therefore, FEE will continue to influence the quality of audit work through discussion with its member bodies and is looking forward to support the European Commission in its agenda to further enhance "audit quality".
- (13) Unfortunately, the overarching question as to how "audit quality" should exactly be defined remains yet to be answered, even after consultation on this issue by the International Organisation of Securities Commissions (IOSCO)<sup>9</sup> of late 2009. The meaning and evaluation of "audit quality" is likely to differ depending on the perspective from which "audit quality" is assessed as regulators and investors may have different perceptions of, and thus criteria for, such an evaluation than the audit profession. That is why a workable common definition of "audit quality" seems to be extremely challenging, if not impossible to achieve.

<sup>3</sup> ISQC 1 on Quality Controls for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements

<sup>4</sup> <http://www.frc.org.uk/images/uploaded/documents/AIU%20Annual%20Report%202009-10%20Final.pdf>, Section 1.3 Impact of AIU Inspections.

<sup>5</sup> See [http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rep192.pdf/\\$file/rep192.pdf](http://www.asic.gov.au/asic/pdf/lib.nsf/LookupByFileName/rep192.pdf/$file/rep192.pdf)

<sup>6</sup> [http://www.cpac-ccr.ca/EN/content/Public\\_Report\\_2009\\_Eng.pdf](http://www.cpac-ccr.ca/EN/content/Public_Report_2009_Eng.pdf)

<sup>7</sup> <http://www.frc.org.uk/images/uploaded/documents/AIU%20Annual%20Report%202009-10%20Final.pdf>, Section 1.3 Impact of AIU Inspections.

<sup>8</sup> <http://www.afm.nl/en/professionals/afm-actueel/rapporten/2010/rapport-accountantscontrole.aspx>

<sup>9</sup> See summary of responses on <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD337.pdf>

- (14) Therefore, indicators, characteristics, features or drivers of “audit quality” might be useful tools and they have been identified. Leadership (including tone at the top), relevant ethical requirements, integrity, objectivity, professional competence, due care, confidentiality, professional behaviour, education and training, culture, robust auditing and other standards, internal quality control and external oversight all contribute to “audit quality”. Even when using such features or drivers of “audit quality”, judgement will always have to be used when considering “audit quality”.
- (15) Although robust auditing standards are only one driver of “audit quality”, we support the adoption of ISAs and ISQC 1 for all audits of financial statements in the EU. The application of ISAs ensures the international comparability of European audits of financial statements as well as secures the uniform quality of audits of financial statements performed within the EU. The application of ISAs also ensures an efficient and effective audit for those entities with cross-border operations within and outside of the EU.
- (16) Reference is also made to the IAASB project focused directly on the concept of “audit quality”. It plans to release a paper in the next few months aimed at raising awareness of the concept of “audit quality” and its main components.
- (17) The concept of “audit quality” is also relevant in respect of Question 6 on professional scepticism to which response we refer.

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

Audits of financial statements are currently not explicitly providing comfort on companies’ financial health, which seem more future-oriented. More could be done by management and those charged with governance of entities to report the assumptions on which the ability of the entity to continue as a going concern as used in the preparation of financial statements is based and to also disclose key risks associated with the entity’s business model on the longer term. Auditors are well positioned to provide assurance on this.

- (18) As far as financial health of a company is concerned, management and those charged with governance of the company need to assess the risks associated with the business model, estimate their financial impact and report and disclose accordingly in their financial statements and annual report. The higher the degree of uncertainty is the more reliance needs to be put on estimates, the more judgements are to be used and the more difficult it becomes for the company, its management and those charged with governance to publicly report numbers and disclose commercially sensitive information.

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- (19) Within the financial reporting system an entity's management and those charged with governance are responsible for the preparation of financial statements and other financial information in accordance with the applicable financial reporting framework, being it national or international accounting standards. An auditor's responsibility is to express an opinion on such financial statements. When the European Commission suggests that financial statements and auditor reports may not be "fit for purpose" it should be noted that any discussion about the auditor's role needs to start with the underlying financial reporting framework and its ability to meet the needs of users and other stakeholders. FEE therefore believes that a comprehensive evaluation of the whole financial reporting system may be needed.

#### Disclosure of going concern assumptions

- (20) The going concern assumption is a fundamental principle in the preparation of financial statements and, therefore, management is currently required to assess the entity's ability to continue as a going concern when preparing financial statements. This assessment involves making a judgement, at a particular point in time, about inherently uncertain future outcomes of events or conditions. The following factors are relevant to that judgement:
- The degree of uncertainty associated with the outcome of an event or condition increases significantly the further into the future an event or condition or the outcome occurs. For that reason, most financial reporting frameworks that require an explicit management assessment specify the period, usually 12 months, for which management is required to take into account all available information;
  - The size and complexity of the entity, the nature and condition of its business and the degree to which it is affected by external factors affect the judgement regarding the outcome of events or conditions;
  - Any judgement about the future is based on information available at the time at which the judgement is made. Consequently, subsequent events may result in outcomes that are inconsistent with judgements that were reasonable at the time they were made.

Currently, the related financial statement disclosure is usually limited to a mention that the financial statements are prepared on a going concern basis; management's assessment itself is usually not disclosed. In many instances, management will report on the going concern assumptions internally or privately to the entity's (supervisory) board and/or audit committee.

Going forward, management and/or those charged with governance could report publicly to stakeholders on these going concern assumptions in the management or director's report as included in the annual report of the entity.

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- (21) The auditor's responsibility with regard to going concern is to obtain sufficient appropriate audit evidence about the appropriateness of management's assumptions in the preparation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue for the next 12 months as a going concern. Whilst undertaking the work as part of the statutory audit, the auditor cannot predict with any degree of certainty the occurrence or outcome of future events or conditions, and, therefore, there is always some implicit uncertainty surrounding this opinion. Examples of this would include the US real estate bubble and the subsequent sudden collapse in confidence across capital markets, the dramatic meltdown in liquidity available and the sharp contraction of funds available to the banking and economic system.

Currently, the auditor is not required to make any specific reference to the work he undertakes regarding going concern other than in circumstances where the management's use of the going concern assumption in the financial statements is inappropriate, or where there are material uncertainties that need to be brought to the attention of the reader of the financial statements, such as where a bank facility is still under negotiation.

#### Disclosure of key business risks

- (22) Going forward, management and/or those charged with governance of an entity could also disclose key risks associated with the entity's business model (longer than 12 months) and its longer term sustainability addressed in financial and non-financial terms. This is also already considered within many entities as part of the normal strategic review but only reported internally. If stakeholders, particularly shareholders and other users, are interested in receiving such information, and entities are prepared to disclose such information, it could be described in the management or director's report as included in the annual report of the entity. When considering such disclosures they should be proportionate to the nature, size and complexity of the entity.
- (23) In addition, the auditors' role could be extended to provide assurance on the statements in the annual report of the entity made by management and/or those charged with governance on this forward looking information. Whether this could be part of the statutory audit or part of a separate engagement has to be discussed taking into account national laws and regulations. This would also require a benchmark or standards on which such assurance could be provided.
- (24) The provision of such information by management and/or those charged with governance and any auditors' involvement with it would be a significant change from current laws and regulations for financial reporting and auditing in most EU Member States. Therefore, further debate on these proposals with all relevant stakeholders is needed to balance the information needs of the investor community with the disclosure of business information without damaging the commercial interests of entities. The potential liability of all parties involved should also be considered.
- (25) Reference is also made to our responses to Question 8 in this respect.

**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?**

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There would be benefit in better explaining the audit methodology in the audit report or elsewhere, if there is investors' community demand for this, as FEE agrees that stakeholders, especially investors, may be unaware of the limitations of an audit. However, a higher level of assurance will not be obtained by "going back to basics" by the auditor using substantive procedures instead of the risk based approach. More information on key matters arising from the audit could be published in the annual report, if stakeholders see a need for this information in the public domain. Publication of this additional information may only be relevant for public interest entities.

- (26) FEE agrees with the European Commission's observation that stakeholders, especially investors, may be insufficiently aware of the limitations of an audit including materiality, sampling techniques and testing, the responsibility of management and those charged with governance, the role of the auditor in the detection of fraud, risk-based auditing, etc. which may result in an expectation gap.
- (27) During the audit, the auditor cannot obtain absolute or – as noted for discussion in the Green Paper – a "very high" level of assurance in relation to the audit opinion. Due to both limitations arising from the nature of financial reporting and the inherent limitations of an audit, this is not possible<sup>10</sup>. The reasons for this arise from the following:
- Many financial statements' items are necessarily derived from subjective decisions or assessments, and therefore always include a certain degree of uncertainty which cannot be overcome by applying additional audit procedures;
  - Time and cost restrictions caused by the need to report the audit findings preclude a 100% audit;
  - In particular, fraud is often perpetrated using collusive behaviour and measures to prevent its detection, in which management or those charged with governance may be involved.
- (28) Therefore, a higher level of assurance cannot be obtained by "going back to basics" as suggested in the Green Paper, whereby there would be a "stronger focus on substantive verification" by the auditor using substantive procedures. The objectives of an audit can only be achieved through a meaningful combination of a risk-based assessment of internal controls and substantive procedures.

<sup>10</sup> This was further analysed by FEE in its Paper on Selected Issues relating to Financial Statement Audits: <http://www.fee.be/fileupload/upload/FEE%20Paper%20Selected%20Issues%20in%20Relation%20to%20Financial%20Statement%20Audits%20Abridged%200710712200721121.pdf>

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- (29) What audit does and does not do need to be clearly spelt out and understood by users. There would be benefit in better explaining the audit methodology if there is a demand from the investor community for such information in order to make better informed investment decisions. Whether this is a matter to be addressed in each individual auditor's report or in general terms elsewhere would also depend on collective users' demand. In any case, a balance needs to be found between providing more information on the audit methodology and creating an information overload which would hinder the objective to enhance users' understanding. Users could always refer to the ISAs in this respect whereby it needs to be acknowledged that a fair level of understanding of accounting, financial reporting and auditing is required.
- (30) As far as auditor communication is concerned, we welcome the IAASB project on ISA 700<sup>11</sup> which seeks insights on user perceptions and market expectations of the standard auditor's report, including what additional information they believe might help enhance the communicative value of the auditor's report. This includes the consideration of a communication to users of financial statements and the related auditors' reports on the meaning of an audit. We welcome this project because the development of the auditor's report is best done at global level. Transparency and comparability would suffer from regional divergences in auditor's reports. The development of a common standard for auditor's reports within the EU would therefore not add value.
- (31) Although we support the assertion that the principle of substance over form is relevant in respect of auditor's conclusions and that this would lead to better information being available to the users, we believe that the balance between reporting to the public at large and private reporting to those charged with governance of the entity, including the audit committee, needs to be carefully considered.
- (32) As required by Article 41 of the Statutory Audit Directive for public interest entities and/or as required by ISA 260<sup>12</sup> and ISA 265<sup>13</sup>, the auditor reports to the audit committee (or the supervisory board in other entities) on key matters arising from the audit, including material weaknesses in internal controls in relation to the financial reporting process, auditor's independence, significant qualitative aspects of the entity's accounting practices and policies, accounting estimates and financial statement disclosures, significant difficulties encountered during the audit and/or other significant matters in the auditor's professional judgement.
- (33) In case the investor community expects to benefit from it, it should also be considered whether for public interest entities such matters should also be reported publicly by management, the audit committee or board(s) in a respective statement within the annual report or by the external auditor in the auditor's report. This should be debated further with all involved stakeholders, including preparers, the audit profession, investors and users to further analyse ideas and information needs for this additional information. In case action is taken regarding such disclosures, caution is needed to avoid unintended consequences resulting from misunderstanding the entity's financial viability.

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<sup>11</sup> ISA 700 on Forming an Opinion and Reporting on Financial Statements

<sup>12</sup> ISA 260 on Communications With Those Charged with Governance

<sup>13</sup> ISA 265 on Communicating Deficiencies in Internal Control to Those Charged with Governance and Management

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

FEE believes that "professional scepticism" should continue to be reinforced. This should be done by further training and by adopting the ISAs as the application of these standards clearly underlines this concept.

- (34) The concept of professional scepticism is closely linked to the concept of audit quality as addressed in our response to Question 3 to which we refer.
- (35) As mentioned in the Green Paper, raising the auditor's awareness as to the importance of professional scepticism, also in relation to the entity's business model, enables the auditor to actively challenge those financial statement disclosures and management assumptions used in recognition and measurement that are material from a user's perspective. The help and support of the entity's audit committee is indispensable in order to make this work.
- (36) Some audit oversight bodies have criticised the audit profession for not applying a sufficient amount of professional scepticism. The auditing profession has taken note of this criticism and has among other things enhanced this concept when training partners and staff in auditing and ethical standards and when applying them in practice. The auditor should not rely solely on the honesty and integrity of the management and those charged with governance, but must obtain evidence and evaluate the persuasiveness of this evidence. This is also applicable in relation to indications of error or fraud. Some audit firms and professional bodies have introduced additional training regarding the application of professional scepticism in addition to issuing various publications in this area and further initiatives in this regard should be encouraged.
- (37) Applying the ISAs reinforces the performance of audits with professional scepticism and therefore their use should be encouraged. This is one of the reasons for FEE's support for the adoption of the International Standards on Auditing (ISAs) promulgated by the International Auditing and Assurance Standards Board (IAASB) for all audits of financial statements in the EU.
- (38) We also note that scepticism is only one of the skills of an auditor. The skills required of an auditor are far wider than applying professional scepticism and as far as education is concerned, a move to a principles and outcomes based approach for auditor's competences would be a major improvement.

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

Qualifications are binary by nature and are used as a persuasive tool towards the entity. There is therefore no need to reconsider the related perception. The use of “emphasis of matter paragraphs” is also useful, although they have a different objective than qualifications.

- (39) The Green Paper correctly states that auditors usually issue auditors’ reports without modification or qualification. The reason for the limited number of qualified or modified auditor’s reports is that material misstatements identified by the auditor are normally rectified by management or those charged with governance upon the auditor’s request.
- (40) FEE acknowledges that qualifications are binary by nature. However, the threat of a qualification or modification is a very persuasive tool to convince management and those charged with governance of the entity to comply with the requirements or good reporting practices instead of having the auditor state in the audit opinion that the entity is not doing so.
- (41) In addition, from a user perspective, it is clearly preferable to have financial statements that are in accordance with the requirements instead of having financial statements with a qualified audit report where the impact of the qualification needs to be derived by the user. This approach usually works effectively in practice, so that, where qualified opinions are issued, the negative perception is justified. Therefore, FEE does not see a need to reconsider the negative perception attached to qualifications at this point in time.
- (42) Additionally, it also needs to be borne in mind that some securities markets and listing rules require unmodified auditor’s reports as a prerequisite for the publication of the financial statements of the listed entities. An unmodified auditor’s report can also be required by bank covenants. Such requirements serve to ensure misstatements or inadequate or inappropriate disclosures are corrected.
- (43) However, modifications or qualifications are different from the application of emphasis of matter paragraphs in the audit report<sup>14</sup>. Such paragraphs are used to:
- Draw user’s attention to matters presented or disclosed in the financial statements that are of such importance that they are fundamental to users’ understanding of the financial statements; or
  - Other matters other than those presented or disclosed in the financial statements that are relevant to the users’ understanding of the audit, the auditor’s responsibilities or the auditor’s report.

In these circumstances, an emphasis of matter paragraph can be useful and where appropriate, its use should be encouraged further.

<sup>14</sup> For instance, the French Commercial Code requires auditors to publicly justify their audit opinion.

- (44) We agree with the assertion in the Green Paper that the auditor provides an opinion on the fair presentation of the financial statements, but not on the economic performance of the entity relative to other entities or with investors' expectations at large. Any comparison of the auditor's opinion with the results of credit rating agencies would be misplaced. In this respect, we refer to our responses to Questions 2 and 4.
- (45) We refer to our response to Question 8 for further considerations on the provision of more value to stakeholders.

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

The entity could report the assumptions on which its ability to continue as a going concern as used in the preparation of financial statements is based and also disclose key risks associated with the entity's business model and its longer term sustainability. Auditors are well positioned to also provide assurance on this.

- (46) Reference is made to our responses to Questions 4, 5 and 10 where we note that the provision of additional information to external stakeholders within the financial statements could be considered if there is a demand from the user community in order to make better informed investment decisions, provided this would not harm the commercial and other interests of the entity.
- (47) Additionally, we believe that the balance between the reporting needs of various users should be carefully considered as not all users have the same information needs. Various ways forward are to be considered:
- Should such reporting be made by public interest entities only and/or be made by all types of entities?;
  - Should such reporting be made by parties associated with the entity, including management and those charged with governance including the (supervisory) board and the audit committee and/or be made by the external auditor and/or be made by the regulator or supervisory authorities?;
  - Should such reporting be made to the public at large and/or be made to those charged with governance of the entity, including the audit committee or the (supervisory) board?
- (48) As already explained in Question 4, in case of a general user demand, management and those charged with governance including the audit committee of a public interest entity could, in a proportionate way, in addition to information already included in financial statements:
- Report the assumptions on which the ability of the entity to continue as a going concern for the next 12 months as used in the preparation of financial statements is based;
  - Disclose key risks associated with the entity's business model and longer term sustainability as a basis for forward looking information.

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Additionally, the provision of some level of assurance on corporate governance statements by the auditor can increase the degree of confidence of users in corporate governance information. The financial crisis provided evidence of an excessive focus on short term performance; this lack of consideration for long term sustainability harms entities, markets, governments, and society. Related reporting and assurance requirements are already mandated by EU legislation<sup>15</sup> or are already seen as common practice in some EU Member States. Such involvement could be further encouraged.

In these circumstances, the auditor could provide assurance on this information in addition to the current auditor's involvement with the financial statements and annual report.

**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?**

FEE believes that the dialogue as well as the related communication between the external auditor, the supervisory board, the audit committee, the internal auditors and with the shareholders could be further strengthened and formalised.

- (49) Frequent and effective dialogue between those charged with governance, including the supervisory board and the audit committee, and the internal and external auditors is essential in the wider context of good corporate governance as well as in the direct cooperation between the parties involved in public interest entities. Communication in the form of an open and direct dialogue based on two way communication will contribute to this ultimate goal.
  
- (50) The current functioning of audit committees is based on different practices in various countries due to the history and tradition of such bodies. The Statutory Audit Directive sets out some common principles for audit committees and their functioning, which provide guidance for the establishment and implementation of such committees across the EU Member States. Recent internal FEE analyses have shown that it is still premature to draw any conclusions about the current practice of the functioning of audit committees in a European context due to the lack of experience in a significant number of EU Member States partly brought about by the late transposition of the Statutory Audit Directive by these EU Member States.
  
- (51) To further aid the establishment and effective functioning of the governing bodies, the dialogue could be further strengthened and formalised as well as the related reporting between the external auditor, the supervisory board, the audit committee, the internal auditors and with the shareholders.

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<sup>15</sup> Following Articles 46a, 51 (1) and 37(1) of the EU Fourth and Seventh Directives

- (52) The audit committee plays a pivotal role in facilitating such communication. The starting point for such enhanced internal communication could therefore be the strengthening of audit committees and clarifying their roles and responsibilities vis-à-vis other parts of the governance structure of the entity. In most EU Member States, external auditors of public interest entities report information to those charged with governance that is not considered appropriate to be included in the (public) audit report, but considered sufficiently important to be submitted as part of the (private) reporting by the external auditor to those charged with governance. Putting such information in the public domain could have unintended consequences and potentially do harm to the entity. In some EU Member States such information, like the long form report, is also submitted to supervisory authorities, such as financial supervisory authorities or tax authorities. In this context, issues related to confidentiality and secrecy built into law at national level can arise and should be taken into account when considering further.
- (53) It is required that the external auditor of a public interest entity provides additional information to those charged with governance of the entity, which might include:
- Explanation of the nature and extent of the audit work as well as the audit findings and conclusions;
  - Comments on application of options in the financial reporting framework;
  - Significant estimation uncertainties, errors or omissions regarding bookkeeping, accounting or internal control;
  - Use of discretionary scope in judgements;
  - Scope of consolidation and issues brought up by subsidiary auditors;
  - Conditions that normally would be expected to influence the user's views on the financial statements;
  - Material weaknesses in internal control;
  - Whether the entity's risk position is understandable from a user's perspective;
  - The extent of non-audit services delivered to the audited entity;
  - Measures taken to mitigate threats to the auditor's independence.

In some EU Member States like in Austria, Germany and some Nordic countries, the requirement to provide additional information to those charged with governance is subject to a regulation and is included in a special long form report.

- (54) It should be noted that in jurisdictions without regulation on the form of such reports, the information is usually included in other documents submitted by the external auditor to those charged with governance such as in management letters and presentations to the audit committee based on the responsibilities each of these parties have to fulfil within the financial reporting system.

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- (55) Adoption of the ISAs would also be helpful in this respect. ISA 260 and ISA 265 contain requirements and detailed guidance on communication between the external auditor and those charged with governance, including the board and the audit committee whereas ISA 610<sup>16</sup>, currently being revised, includes requirements and guidance on the relationship between the external and internal auditor.

**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?**

With the current evolution of corporate reporting and of stakeholders' demands, auditors seem well placed to provide independent reliable assurance in the fields of Corporate Social Responsibility (CSR) as well as Environmental, Social and Governance reporting (ESG) in general, provided that specific assurance frameworks are developed.

- (56) There is an equal need for independent verification of reporting in the fields of Corporate Social Responsibility (CSR) and of Environmental, Social and Governance reporting (ESG) as there is for financial reporting. The reliability of this information to assess in particular the entity's future prospects is critical and more and more taken into account by traditional investors (i.e. not only socially responsible investors (SRI)).
- (57) Management needs reliable ESG information to manage the entity's environmental and social risks to have a solid basis for decision making and to provide reliable information to shareholders, consumers and clients. With the globalisation and increasing complexity of supply chains, CSR reaches smaller and more remote entities on which management, those charged with governance and stakeholders need high quality reliable information. ESG information can also help to obtain access to finance. Shareholders' demand is increasing both in terms of quantity of information but even more in terms of quality and reliability of information. Clients and consumers are more and more conscious to buy from sustainable suppliers and search for trustworthy information about an entity's practices.
- (58) Auditors are generally well placed to ensure the reliability of CSR reporting. They have broad expertise and experience in auditing corporate information and providing assurance on non-financial information, go through rigorous training (with stringent continual professional development requirements), follow well-established and widely recognised standards when conducting their work, are bound by a strict code of ethics and are subject to regular external quality control mechanisms and public oversight.
- (59) Considering the need for robust, consistent and harmonised reporting and assurance, FEE encourages the European Commission to contribute with all stakeholders to the development of appropriate assurance frameworks for CSR and ESG reporting.

<sup>16</sup> ISA 610 on Using the Work of Internal Auditors

- (60) The growing trend towards 'integrated reporting', bringing financial, governance, environmental and social reporting as well as management reporting into a consistent framework should be noted as it carries considerable promise and is likely to result in significant change. Although it is still early days to assess the impact of integrated reporting, it emphasises the importance of some of the key factors which are critical in responding to the crisis. FEE therefore calls on the European Commission to support the development of 'integrated reporting'.

**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?**

FEE is supportive of mechanisms for more open and regular communication between auditors and relevant stakeholders in relation to public interest entities and large privately held entities. This could be achieved by accompanying half yearly and quarterly financial information by a review report by the statutory auditor as such more regular contact will have positive implications for audit quality. Additionally, the role of the auditor at the annual general meeting of public interest entities and large privately held entities could be enhanced. However, the length of time available and necessary for an audit should not be shortened in an arbitrary manner.

More open and regular communication

- (61) We are in principle supportive of mechanisms for more open and regular communication between auditors and relevant stakeholders in relation to public interest entities and large privately held entities. This needs to be carefully examined as the auditor should not have to communicate to stakeholders and the public at large at any greater frequency than management and those charged with governance. For instance, it is already common practice in some EU Member States that the publication of half yearly financial information by the entity is accompanied by a review report issued by the statutory auditor.
- (62) If the European Commission wishes to improve the frequency of interim reporting, we believe that the publication of quarterly financial information by the entity could provide more comfort to stakeholders. It is common practice that the publication of half yearly interim financial information by the entity is accompanied by an interim review report by the statutory auditor. Similar procedures could be applied for quarterly financial information to improve the reliability of such reporting and contribute to more regular reporting by the auditor to those charged with governance.

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- (63) Additionally, the role of the auditor at the annual general meeting of public interest entities and large privately held entities could be reconsidered:
- Whereas shareholders can ask management or those charged with governance to respond to questions in the annual general meeting, shareholders could also ask the auditors to be present and to respond to questions in relation to the audit in the annual general meeting. This is already the case in some EU Member States, like Denmark, France, the Netherlands, Sweden, the UK, etc.;
  - In addition, whereas management or those charged with governance share information with the shareholders in relation to the financial statements of the entity, auditors could share information with the shareholders in relation to the auditor's involvement and performance of the audit<sup>17</sup>.

Reduced time gap between the year-end and the date of the audit opinion

- (64) We believe that the length of time available and necessary for an audit cannot be shortened in an arbitrary manner. Although some might consider the auditor's opinion to be "too little too late", there is a trade-off between the relevance and reliability of the audit evidence and hence of the audit opinion. The desire for more current information and the need to have appropriate time for the performance of the audit to ensure the required audit quality are in conflict.
- (65) In reality, the time gap between the year-end and the date of the audit opinion is relatively short. Most listed and regulated entities publicly announce preliminary results within weeks after the end of their financial year. In some EU Member States, the listing rules require statutory auditor's permission for the publication of this preliminary announcement, which in effect indicates that the audit of the published financial information is finalised. Subsequently, management of an entity needs a number of weeks to prepare and publish the complete financial statements and the annual report including all required disclosures – currently under heightened scrutiny - which is accompanied by the auditor's opinion. In other EU Member States, the publication of preliminary results follows an informal auditor's indication that the audit of this financial information is substantially finalised.
- (66) More generally, it should also be noted that national and EU laws and regulations as well as listing rules for listed entities of national stock exchanges include maximum terms for the filing of financial statements. Although such terms are usually quite lengthy, such entities often file their financial statements significantly earlier to respond to investor demands for financial information.
- (67) Therefore, we do not believe that it is necessary or possible to expect entities and auditors to reduce the time gap between the year-end and the date of the audit opinion, especially for listed and regulated entities.

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<sup>17</sup> As per the Swedish Corporate Governance Code of February 2010, auditors present their reports to the owners at the annual general meeting in the annual audit report (Part II, Section 5)

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

We believe that the measures discussed above and a continued structured dialogue between all interested parties would be appropriate to enhance the value of audits.

- (68) We refer to our responses to Questions 4, 5, 6, 7, 8, 9, 10, 11 and 26 for our comments on the measures which could be envisaged to enhance not only the value of audits but the value of reporting, financial reporting frameworks and corporate governance of entities in more general terms.

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

FEE fully supports the adoption of ISAs for all statutory audits in the EU without further delay.

- (69) FEE fully supports the adoption of ISAs for all statutory audits in the EU as the use of one set of international auditing standards will continue to increase audit quality and enhance confidence in the reliability, comparability and consistency of financial statements in the EU as well as the acceptance of audit reports beyond their home jurisdictions whether within or outside the EU. The adoption of ISAs for all audits in the EU also means that the development of a common standard for audit reports in the EU would not add value. ISAs also address many issues raised in the Green Paper such as reinforcing professional scepticism and requirements for group auditors, enhancing auditor's communication, improving cross border mobility and coordination between national audit oversight bodies. Moreover, it will lead to added benefits when providing qualification, education, training and continued professional development.
- (70) The use of one set of auditing standards throughout the EU will be a prerequisite for closer cooperation and more integration of public audit oversight bodies on an EU level, as discussed in further detail in our response to Question 25.

**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)?**

FEE believes that the ISAs should be made legally binding throughout the EU through an EU Regulation for all statutory audits.

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### ISAs legally binding throughout the EU

- (71) FEE believes that the ISAs, including ISQC 1 (or equivalent system at least as demanding) should be made legally binding throughout the EU. Therefore, we are fully supportive of an EU Regulation as the legally binding instrument to be used by the European Commission to adopt ISAs for use in the EU in which the application material should be given a special status as further explanations of the requirements of an ISA and guidance for carrying them out while in itself not imposing a requirement. In this respect, it is important to note that only a legally binding EU instrument will achieve full harmonisation and common practice and the aim of having ISAs adopted in all 27 EU Member States.
- (72) We would also strongly recommend limiting modifications to the contents of the clarified ISAs to a minimum. In this respect, European Commission add-ons and European Commission and EU Member State carve-outs would not be acceptable and Member State add-ons only if resulting from national legal and regulatory requirements, after having passed the European Commission acceptance due process.

### Endorsement approach

- (73) The Statutory Audit Directive sets out that the Commission shall adopt international auditing standards only if they:
- Have been developed with proper due process, public oversight and transparency, and are generally accepted internationally;
  - Contribute a high level of credibility and quality to the annual or consolidated accounts in conformity with the principles set out in the Fourth and Seventh EU Directives which require that the annual accounts shall give a true and fair view of the entity's assets, liabilities, financial position and profit or loss; and
  - Are conducive to the European public good.
- (74) FEE believes that these endorsement criteria for ISA endorsement remain appropriate as general principles that can be built into the legislative process within the European Union. Some elements of the existing IFRS endorsement process could also be considered carefully.
- (75) However, IFRSs and ISAs are different and serve two different purposes; i.e. the IFRSs are to support the economic decisions of investors in entities whilst the ISAs are to contribute to a high level of credibility and quality of the audit. This is also recognised in the endorsement criteria for IFRSs and ISAs which differ in principles and approach.
- (76) Therefore, the endorsement processes for the two sets of standards do not need to be similar. FEE is of the view that the current endorsement process for IFRSs would be too complex and extensive if applied for ISAs as fewer stakeholders are expected to be involved. There appears to be no need for a body equivalent to the European Financial Reporting Advisory Group (EFRAG) to provide technical expertise on the use of ISAs within the European legal environment.

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- (77) FEE believes that the preparatory work both in regard to development of new standards and considering endorsement of final standards could be carried out by the European Commission based on consultation with relevant European stakeholders. These tasks would require appropriate technical resources within the European Commission.
- (78) FEE is of the view that the ISAs should be endorsed in two steps:
- The existing clarified ISAs should be endorsed en bloc;
  - Any new ISAs should be assessed one by one on a timely basis.
- (79) It is important to note that the endorsement of auditing standards and the oversight of audit firms should be performed by separate bodies to avoid the significant conflict of interest which could otherwise arise.
- (80) The involvement of EU Member States and the European Parliament would also need to be considered and is a matter for decision-making in the EU institutions. EU Member States could be involved via the Auditing Regulatory Committee by voting on the existing standards and on each new ISA. A scrutiny process in the European Parliament and the European Council can also be considered.

*Stakeholders Consultative Panel for ISAs in Europe*

- (81) For the European Commission to carry out a comprehensive consultation of stakeholders during the development of standards, a Stakeholders Consultative Panel for ISAs in the EU could be set up. This Panel could consist of all relevant stakeholders which would be investors, regulators, audit regulators, business representatives, national audit standard setters as well as the audit profession. The Stakeholders Consultative Panel for ISAs in the EU could be chaired by the European Commission and its responsibilities could be:
- Collection and assessment of input from all relevant European stakeholders with regards to ISAs through meetings and through invitations for written input;
  - Provision of input to enable the European Commission to proactively contribute to the IAASB due process during the development phase of new ISAs with the aim of arriving at high quality standards.

Encouragement of the use of ISAs

- (82) We do not believe that it would be sufficient to only encourage the use of ISAs through non-binding legal instruments like a Recommendation or a Code of Conduct as this is likely to result in a status quo in EU Member States' adoption of the most current version of ISAs. In this respect, it is important to note that some EU Member States, including some of the major ones, will only adopt the ISAs if there is a legally binding instrument at European level. Not adopting ISAs through a legally binding measure would hinder the further development of the internal market and make the EU lose its current leadership role in the world in the area of accounting, financial reporting, governance and auditing.

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

FEE welcomes considerations of the needs of SMEs and SMPs. ISAs are developed to be adaptable for application in audits of entities of any size and thus also those of SMEs and those performed by SMPs. Additional adaptations are therefore not needed.

- (83) The approach to consider the needs of SMEs and SMPs is generally most welcome. A large proportion of FEE members work in or are small practitioners for SMEs. Our in-depth work and research in this matter has shown that ISAs are adaptable, scalable or proportionate to meet the needs of SMEs and SMPs. Additional modifications are therefore not needed.
- (84) The specificities of smaller audit firms and smaller entities' audits are taken into account in the standards themselves as well as in the guidance to the standards. There is adequate IAASB material as well as guidance from the IFAC SMP Committee together with material from FEE, the UK Auditing Practices Board (APB) and others available which demonstrates that ISAs can be proportionately applied and documented relative to the nature, size, risks and complexity of the audited entity and that ISQC 1 (or equivalent system at least as demanding) can be proportionately applied by smaller audit firms.
- (85) The ISAs are proportionate as in cases where an ISA or a requirement within an ISA is not relevant in a particular audit, that ISA or requirement is not applicable and should not be documented. ISAs acknowledge the use of professional judgement which is also applicable for the documentation requirements included in the ISAs. The experience with adoption of ISAs for SMEs from other jurisdictions outside the EU, such as Australia and Norway, has confirmed this view.
- (86) However, remaining perceptions that ISAs may not be fully adaptable to SMEs stem from concerns related to regulators' expectations in relation to audit documentation. This concern relates to the enforcement of the standard not the standard itself. As further discussed in Question 25, further harmonisation with regards to audit oversight would address this issue and would therefore be beneficial. These concerns of auditors are often due to a lack of clarity of the expectations of audit oversight bodies or due to the oversight bodies' expectations being akin of those for audits of public interest entities which are unreasonable for audits of SMEs.
- (87) Consequently for SMEs, the basic approach to an audit does not change just because of the size of the entity. The performance may change and be adapted to the specific circumstances. This approach is enhancing confidence in the reliability, comparability and credibility of financial reporting in the EU and beyond in the public interest. The message from the auditor to the users therefore remains consistent. The statutory auditor has obtained reasonable assurance that the financial statements are free from material misstatements, regardless of the size or type of the entity that has been audited. This is often referred to as "an audit is an audit", an important principle underpinning market confidence, which is further elaborated in our response to Question 35.

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**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?**

FEE is of the opinion that significant safeguards have already been put in place in response to the possible conflict of interest and threat to the auditor's independence in relation to appointment and remuneration, including the requirements regarding involvement of the audit committee or supervisory board in these matters in public interest entities. As auditors regard their independence as essential, further improvements to safeguarding the auditor independence can be envisioned in public interest entities, as far as transparency and the role of the shareholders, supervisory board and/or audit committee is concerned.

Conflict of interest

- (88) Article 37 of the Statutory Audit Directive states an important principle: the auditor is appointed by the annual general meeting of shareholders or by members of the audited entity. EU Member States may allow alternative systems provided that the independence of the auditor from management and executives members of the board or the management board of the audited entity is ensured.
- (89) Internal FEE surveys indicate that in practice the auditor is appointed by the shareholders based on a recommendation by the (supervisory) board or by the audit committee.
- (90) The main possible concern related to the auditor's appointment is to effectively ensure the independence of the auditor from the audited entity and in particular from its management and executive directors or management board. The Statutory Audit Directive introduced a number of effective provisions which are safeguards to mitigate the possible conflict of interest in relation to the appointment of an auditor:
- Article 22 of the Statutory Audit Directive ensures that the auditor is independent of the audited entity when carrying out a statutory audit and is not involved in the decision-making of the audited entity. This is in practice ensured by compliance with a code of ethics, either based on the European Commission Recommendation of 16 May 2002 on Statutory Auditors' Independence in the EU: A Set of Fundamental Principles, the previous IFAC or new IESBA Code of Ethics or national codes of ethics;
  - Article 32 of the Statutory Audit Directive requires the public oversight system to have the ultimate responsibility for the oversight of the adoption of standards on professional ethics (which include the compliance with independence standards), internal quality control of audit firms and auditing;
  - For public interest entities, Article 42 of the Statutory Audit Directive requires that the audit committee of a public interest entity reviews and monitors the independence of the statutory auditor or audit firm and in particular the provision of additional services to the audited entity.

Therefore, no additional safeguards seem to be needed in this regard.

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- (91) The entity is currently responsible for remunerating the auditor. Usually, the (supervisory) board or audit committee are responsible for agreeing the detailed terms of the auditor's remuneration. With the above mentioned safeguards already in place, it appears appropriate to leave these finalising steps of the appointment process to the governing bodies of the entity, acting on behalf of the shareholders.

#### Possible improvements for public interest entities

- (92) As indicated above, the decision-making power for the appointment of the auditor rests with the shareholders in their annual general meeting. This system for appointment of the auditor can function in all entities as it should be recognised that smaller entities often do not have independent directors, a supervisory board or an audit committee which can be involved in the appointment of the auditor in public interest entities.
- (93) As far as public interest entities or larger entities are concerned, they often have independent directors, a supervisory board or an audit committee and their involvement with the appointment of the auditor help in further mitigating the threat of conflicts of interests, as discussed above. For public interest entities, which are under heightened stakeholder scrutiny, further strengthening of the process for appointment and remuneration of the auditor could usefully be addressed as part of the overall corporate governance of such entities. The following additional guidelines could be considered and included in corporate governance codes:
- *Increased independence of the auditors' selection process:* Although management support is needed during the identification and selection process of candidate audit firms for the audit of their entity, all decision-making power to recommend an auditor for appointment should rest with the supervisory board, the independent members of the board of directors or the independent members of the audit committee, as is already the case in some EU Member States. This would be to underline that the process is independent of management both in appearance and in mind.
  - *Enhanced shareholders' engagement:* More generally, shareholders' involvement should be further encouraged, for instance in Sweden, a shareholders' nominating committee puts proposals for the appointment of the auditor (and directors) to a vote in the annual general assembly. However, practice shows that the extent of this involvement may be limited and a proper balance must be struck between desirability, feasibility and expectations.
  - *Increased transparency of the auditors' selection, appointment and remuneration process:* This could be ensured by introducing a provision in corporate governance codes encouraging entities to disclose the rationale of proposals and/or decisions in relation to the auditor's appointment both in case of renewal of the term and in case of change to a new auditor highlighting its proper grounds.

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

FEE strongly believes in preserving the fundamental rights of shareholders of all entities to, among others, appoint the auditor they believe can most effectively fulfil its mandate considering all relevant factors. In very exceptional and limited cases, there may be a degree of involvement in the appointment of an auditor by a third party or regulators.

(94) Shareholders have a number of fundamental rights as owners of the entity in which they invested, for instance:

- Voting powers on major issues like mergers, liquidation, etc.;
- An entitlement to financial information and to dividends;
- The right to sue for wrongful acts and to transfer ownership;
- The right to nominate directors and auditors.

(95) Requiring appointment of auditors by a third party or a regulator would create confusion. Introducing “statutory inspection” replacing “statutory audit” would radically change the role and nature of audit. Having third party appointment of the auditor would also result in:

- The need for the third party or regulator to obtain significantly more information for the appointment of the auditor which could lead to a high degree of influence by the third party or regulator on the entity as a whole;
- The rights and obligations of shareholders would be waived to the third party or regulator if the shareholders are not allowed to decide on risk mitigating measures, such as appointment of the auditor;
- There are legal consequences for the third party or regulator making the selection and appointment of the auditor for a private entity:
  - It would imply all complexities of a tripartite relationship depending on national civil law. The third party or regulator would negotiate a contract for the entity with the auditor whereby the entity would be obliged to remunerate the auditor without having been included in the contractual negotiations, e.g. without influence on the amount of audit fees. Such contract for the burden of a third party (the entity) may not necessarily be possible in all EU Member States. It would also have legal consequences regarding a potential liability of the third party or regulator towards the entity for any disadvantageous impact related to the selection process of the auditor;
  - The entity or its shareholders should have appeal rights against the third party or regulator in case they do not agree with the nomination of a particular auditor.

(96) The appointment of an auditor requires the consideration of many factors, some of which are:

- Competences and skills of the firm and the individual auditors involved;
- Specialised industry knowledge and sectorial experience;
- Breadth and scope of local expertise, territorial coverage and match between the organisational structure of the entity and the auditor;
- Strengths of the audit approach and proposal put forward;

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- Set of expertise and service offering by the audit firm matching with the needs of the entity;
  - Benefits linked to the auditor's reputation.
- (97) All these factors are carefully weighed before those charged with governance select (an) auditor(s) and the shareholders decide on which auditor to appoint, as, in general, audit is a risk mitigating safeguard for the audited entity. If another party is charged with these tasks, such a party would be expected to acquire the same level of knowledge of these factors which might be cumbersome and costly. The possible conflict of interest as mitigated by safeguards already in place following the introduction of the Statutory Audit Directive, as discussed in Question 16, would not change significantly if the appointment was done by a third party, as new conflicts of interest would arise.
- (98) However, in some exceptional cases in certain EU Member States, although not necessarily considered as auditors' appointment by a third party as suggested in the Green Paper, there is a degree of third party or regulator's involvement in the appointment of an auditor. For instance:
- For financial institutions, the financial supervisory authority may have the right to veto the appointment of an auditor;
  - Entities receiving funds from the government can have a governmental body involved in the appointment of the auditor;
  - Where an entity has no auditor or refuses to appoint an auditor, the regulator or another public authority can be required to appoint an auditor as a temporary solution.
- (99) Aside from such examples, FEE concludes that third party appointment of auditors for any kind of entity would carry more drawbacks and risks than benefits.

**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?**

In the vast majority of EU Member States, mandatory rotation of audit firms is not believed to enhance auditor independence or increase competition, but to create real threats to audit quality and to result in practical difficulties in the audit of an international group.

- (100) The considerations put forward in the Green Paper in relation to mandatory rotation of an audit firm were analysed in a previous FEE Study on Mandatory Rotation of Audit Firms<sup>18</sup> which reviewed the main reports by governments, regulatory bodies and academics on this subject. The main arguments made in these reports and coming from practice in favour of such rotation as well as against were surveyed are set out below. Since then, other studies or reports on the practice of mandatory audit firm rotation have not identified additional pros and cons.

<sup>18</sup>

<http://www.fee.be/fileupload/upload/FEE%20Study%20on%20Mandatory%20Rotation%20of%20Audit%20Firms%2004102112005561253.pdf>

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Pros:

- A long-term relationship between an auditor and an audit client creates a risk of excessive familiarity that might impair objectivity and independence. Mandatory rotation of audit firms would not allow such long-term relationships to develop;
- A simultaneous requirement of mandatory rotation of key audit partners, auditor' independence requirements, corporate governance measures to comply or explain principles regarding the selection and appointment of the auditor are all mitigating safeguards that collectively address the same concern of independence that mandatory rotation of audit firms is addressing.

Cons:

- The majority of studies found that the mandatory (i.e. forced) rotation of audit firms inadvertently threatens audit quality;
- The initially attractive idea of mandatory rotation could in fact undermine the EU's work to build public trust in financial reporting. By allowing mandatory rotation as an add-on to the effective auditor independence measures already included in the Statutory Audit Directive (mandatory key audit partner rotation, quality control requirements, independent public oversight, etc) audit quality could be undermined as there is an increased threat to audit quality in the first years of audit, due to reduced knowledge of client operations (for the 'new' auditor).
- While cost should not be a decisive argument when set against audit quality, mandatory rotation could lead to:
  - Increased financial costs for business; and
  - An increase in time management allocates whilst the 'new' auditors get to know the business.
- Mandatory rotation of audit firms has been shown to increase market concentration in the large firms.

(101) A number of EU Member States, including Austria, Greece, the Slovak Republic and Spain have introduced or experienced mandatory audit firm rotation, but have subsequently concluded to remove the mandatory requirement. Only one EU Member State, Italy, continues applying mandatory rotation of audit firms for public interest entities.

(102) Reference is also made to our response to Question 29 in respect of the impact of mandatory audit firm rotation on the audit market structure.

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**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?**

FEE does not support a total prohibition of non-audit services by auditors in general or for certain audited entities. Instead, FEE recommends the adoption of the Independence Section 290 of the IESBA Code of Ethics for both public interest and other entities as it includes a robust approach to the provision (or not) of non-audit services. For audit clients that are public interest entities, the provisions regarding non-audit services would then be further restricted compared to the current requirements in the EU.

- (103) Based on the International Ethics Standards Board for Accountants (IESBA) Code of Ethics for Professional Accountants, the provision of non-audit services to audit clients which lead the auditor to audit his own work (self-review threat) is prohibited. Further prohibitions exist to counter other threats to the auditor's independence. This is especially the case for auditors of public interest entities. Depending on local laws and regulation, most financial institutions would be considered to be public interest entities, in particular those financial institutions that are considered to be systemic.
- (104) Therefore, FEE is of the opinion that due consideration should be given to the adoption of the Independence Section 290 of the IESBA Code of Ethics for both public interest and other entities in addition to the current independence laws and regulation in the EU based on Recital (12) and Article 22 of the Statutory Audit Directive and the EC Recommendation on Auditor's Independence of 2002. The adoption of this part of the IESBA Code of Ethics in the EU would also resolve the issues resulting from the divergent transposition of Article 22 of the Statutory Audit Directive and the EC Recommendation.
- (105) The IESBA Code applies the same threats and safeguards or principles-based approach to independence as the Statutory Audit Directive and the EC Recommendation. Threats to the independence of the auditor should be mitigated by safeguards and if no safeguards can reduce the threats to an acceptable level, the auditor is prohibited to carry out the work. In addition to the Statutory Audit Directive and the EC Recommendation, the IESBA Code of Ethics includes more detailed provisions related to providing non-audit services to audit clients.
- (106) The IESBA Code applies these principles for the provision of non-audit services as set out for all audit clients, regardless of size of the entity. However, for audit clients that are public interest entities, the provisions regarding non-audit services are even more restrictive as follows:
- Management responsibilities: the auditor is not to assume any management responsibility for the audit client (this prohibition applies regardless of whether or not the audit client is a public interest entity);
  - Preparing accounting records and financial statements: the auditor cannot provide any accounting and bookkeeping services to the audit client, except in emergency situations;
  - Valuation services: an auditor cannot provide any valuation services to an audit client if the valuations would have a material effect on the financial statements that will be audited;

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- Taxation services: the auditor cannot prepare tax calculations for the purpose of preparing accounting entries, except in emergency situations;
- Internal audit services: the auditor cannot provide any internal audit services that relate to a significant part of the internal controls over financial reporting, etc.;
- IT-systems services: the auditor cannot provide any services related to the design or implementation of IT systems related to financial reporting;
- Recruiting services: an auditor cannot provide services with respect to recruiting senior management that is to exert significant influence over the preparation of financial statements;
- Litigation, legal and corporate finance services: similar provisions as for management responsibilities.

In addition, the IESBA Code of Ethics prohibits evaluation and compensation of key audit partners based on the success in selling non-audit services<sup>19</sup>.

- (107) Our views on the provision of non-audit services are strengthened by the outcome of the IESBA and UK Auditing Practice Board (APB) consultation on the approach to non-audit service provision by auditors to the entities they audit. Respondents to the 2006, 2008 and 2009 IESBA consultations on the Code also covering the provision of non-audit services, which included responses from regulators, oversight authorities and independent standard setters, did not call for a complete ban on non-audit services. In the UK, the overwhelming majority of respondents to the consultation, which included numerous companies and investors, endorsed the retention of the threats and safeguards approach to auditor independence requirements, together with disclosure to investors and other stakeholders, to allow them to make their own assessment of whether proper governance has been exercised in this area. This is a critical endorsement of an approach which in our view is most likely to result in a proportionate balance of cost to business and investor confidence.
- (108) A complementary safeguard in relation to the provision of non-audit services to audit clients which are public interest entities might be to consider enhanced involvement of those charged with governance in their procurement, especially of the audit committee, as is customary in some countries. For any significant provision of non-audit services, the audit committee could be requested to give preliminary approval and to also disclose the preliminary approval process in the annual report, the corporate governance statement or the audit committee report.
- (109) In addition, the already required disclosure in the notes to the financial statements of the split between audit fees, non-audit fees and other fees has contributed to enhanced transparency on the provision of non-audit services to public interest entities by statutory auditors. This is clearly beneficial to users of financial statements.

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<sup>19</sup> Paragraphs 290.228 and 290.229

- (110) The Green Paper mentions the possibility of a total prohibition on the provision of non-audit services by “pure” audit firms to both audit clients and non-audit clients. We do not support such total prohibition. Auditing is a highly complex and multi-disciplinary service in response to the complexity of the business models of the audited entities, especially in financial institutions, but also in other industries. In performing auditing, advisory and non-audit services members of the profession obtain complementary and specialised knowledge and competence, which ensures that each of these services can be provided efficiently and to the expected quality. It is also a reality that this variety of work attracts talented young graduates and other highly skilled resources to join audit firms, enabling audit firms to offer high quality audit services.

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

FEE agrees that the maximum level of fees an audit firm can receive from a single client should be addressed as excessive reliance on one audit client is a potential threat to the auditor’s independence. The IESBA Code of Ethics sets the threshold above which appropriate safeguards should be applied for public interest entity clients to protect the auditor’s independence at 15% of the total fees received. The adoption of the relevant part of the IESBA Code could therefore address this concern.

- (111) As explained in our response to Question 19 in the threats and safeguards approach, FEE agrees that excessive reliance on one audit client is a potential threat to the auditor’s independence, for which appropriate safeguards should be applied. A threats and safeguards or principles-based approach is very suitable to address this threat rather than a regulation or rule.
- (112) Therefore, FEE supports the adoption of the Independence Section 290 of the IESBA Code of Ethics for all statutory audits. Paragraphs 290.220 to 222 of the IESBA Code of Ethics limit the fee proportion which can be received from a single audit client. It requires for all audits that threats posed by a large proportion of fees from one audit client to be considered and if necessary acted upon. This proportionate approach is particularly appropriate for SMPs in their market segment.
- (113) For public interest entity audits, specified safeguards of independent review and discussion with those charged with governance are required where the proportion exceeds 15% of the total fees received by the audit firm. This 15% is not a rule but a threshold above which the audit firm has to apply appropriate safeguards.
- (114) It should also be noted that a total prohibition on the provision of non-audit services by audit firms to both audit clients and non-audit clients would reduce the total fees received by such “pure” audit firms which would make their dependency on audit clients higher. A total prohibition on the provision of non-audit services in this way could thus create or increase rather than reduce potential threats to the audit firm’s independence.
- (115) We also believe there could be improvements in transparency, governance and disclosure by public interest entities in their financial statements and annual reports, both in terms of clarity of

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fees paid to auditors for audit, assurance-related and non-audit services and in terms of an explanation of the approach to the provision of non-audit services taken by those charged with governance including the audit committee.

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

FEE is supportive of transparency of audit firms, including transparency of financial statements, in particular for audit firms auditing public interest entities. Depending on the jurisdiction, such information might currently already be made public but further EU harmonisation might appear appropriate.

Financial statements of audit firms

- (116) FEE is supportive of transparency of audit firms in general and notes that increased transparency of audit firms has already been introduced with the requirements for audit firms auditing public interest entities to publish a transparency report following Article 40 of the Statutory Audit Directive. This report includes information regarding annual turnover of the audit firm divided into categories.

Depending on the jurisdiction, more audit firms have over time become limited liability partnerships or limited liability companies. All limited liability companies, including limited liability audit firms, have to comply with the requirements of the EU Fourth and Seventh Company Law Directives. Depending on the transposition of these Directives in a particular EU Member State, this will also require publication and audit of financial statements of audit firms, whether at the level of a single national legal entity that has to prepare annual financial statements and/or as a parent company of various audit firms that has to prepare consolidated financial statements. Some audit firms also publish their financial statements on a voluntary basis.

- (117) In addition, as the publication of financial statements forms part of good governance and enhances transparency, FEE believes that audit firms auditing public interest entities should publish their financial statements, even where the legal form of the audit firm does not make this mandatory.

Statutory audit of financial statements of audit firms

- (118) The Green Paper suggests that the financial statements of an audit firm should be audited by a public body at national or European level to avoid conflicts of interest with competitors.

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- (119) The publication of financial statements of audit firms should follow the same requirements as for other entities. The same should apply for the audit of an audit firm. Many audit firms are already being audited and the same auditor appointment, audit performance and independence requirements apply and should be applied for them. The latter would entail that safeguards have to be applied to mitigate any independence threats and if no safeguards can eliminate or reduce the threats to an insignificant level, this particular auditor or audit firm cannot carry out the audit of the audit firm. Therefore, we do not believe that there is a need for a statutory body to carry out the audit of an audit firm.
- (120) In practice, audit firms often choose an auditor that is not a direct competitor. If considered relevant, such an approach could be part of the corporate governance for audit firms. Reference is also made to our response to Question 22 in respect of governance of audit firms, of which the publication of financial statements is one aspect.

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

FEE believes that the adoption of ISQC 1 (or equivalent system at least as demanding) throughout the EU would further enhance fundamental governance principles in EU audit firms. Additionally, the appointment of independent directors to the board could be further explored for audit firms auditing a significant number of public interest entities. The comply or explain approach appears to be appropriate for corporate governance measures in audit firms equally as it is for other entities.

- (121) FEE notes that a large number of audit firms, especially the ones auditing public interest entities, already have governance principles of corporate entities incorporated in their daily business. Such principles include:
- Adequate policies and procedures to ensure compliance with its legal and regulatory requirements;
  - Having sound administrative and accounting procedures, internal control mechanisms, effective procedures for risk assessment, and effective control and safeguard arrangements for information processing systems;
  - Having a structure, ownership and management which avoid having influence on the independence of the performance of audit work.
- (122) Many audit firms also apply ISQC 1 which requires the establishment and maintenance of a system of quality control to ensure that the audit firm and its staff comply with professional standards and applicable legal and regulatory requirements. This would entail that, in case ISQC 1 would be adopted throughout the EU for all audit firms as we encourage the European Commission to do in our response to Questions 13 and 14, some corporate governance provisions would be put in place. A coordinated initiative for the development of further corporate governance measures for audit firms and the adoption of ISQC 1 would therefore be beneficial.

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(123) FEE recommends that the impact of applying corporate governance principles and disclosures in audit firms, as already applied in some EU Member States, is further analysed when considering new initiatives in this area. Furthermore, any extraterritorial effect of new measures should be carefully considered as a requirement covering global networks would cover audit firms outside the EU jurisdiction.

#### The appointment of independent directors in the board of an audit firm

(124) As discussed in our response to Question 21, we believe in transparency and good governance for audit firms as we believe that audit firms should not be treated differently as compared to other corporate entities just because they are audit firms. Therefore, the appointment of independent directors to the board of an audit firm, as highlighted in the Green Paper, could be interesting to explore further.

(125) Audit firms that already have independent directors seem to benefit from the experience that such individuals bring to the audit firm. Such an initiative could have a positive impact on independence in appearance and in mind of the audit firm and its auditors.

(126) The European Commission recommends having an appropriate balance of non-executive or supervisory and executive or managerial directors in listed entities and most corporate governance codes for listed entities include such principle. Audit firms are however not listed entities (except for a few rare exceptions) and have a distinctively different ownership structure, making transporting this principle of independent directors to audit firms less straightforward.

(127) The scope of audit firms having independent directors on the board of audit firms should be carefully considered. The costs for smaller audit firms to comply with it or to explain why it has not complied with it would not appear to outweigh the benefits of having independent directors or be a necessary tool for the stakeholders of smaller audit firms. FEE would therefore be of the view that such and other further corporate governance measures for audit firms should only apply to audit firms that audit a significant number of public interest entities. A significant number of public interest entities should be considered in comparison with the number of such entities in the market at national level.

#### Embedding corporate governance principles in audit firms

(128) FEE is a long standing supporter of setting robust, high quality principles and benchmarks for corporate governance for entities at EU level. FEE believes that a similar approach would be appropriate for corporate governance of audit firms.

(129) Regulation is not a substitute for effective governance and good governance complements regulation in promoting audit quality. FEE also finds the approach of “comply or explain”, which is widely used for corporate governance for corporate entities, a suitable and appropriate measure of good governance in audit firms. In addition, any corporate governance measures need to be proportionate as explained above.

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- (130) The Green Paper makes reference to the regulation on credit rating agencies with regards to the organisational structure of audit firms. We believe that the differences between credit rating agencies and audit firms should be carefully considered for policymaking purposes and these should be kept in mind when designing the appropriate governance principles for audit firms.
- (131) FEE would encourage the Commission to work closely with the European audit profession and all other relevant stakeholders in the development of European corporate governance measures for audit firms.

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

FEE is of the view that audit firms should continue to be able to select the ownership structure that fits their needs as long as the full independence of the statutory auditor is preserved, the profession's ability to attract and retain adequate high quality human resources is enhanced and audit quality continues to increase.

- (132) According to the Statutory Audit Directive, non-auditors already have the possibility to buy shares up to 99,9 % and hold voting rights up to 49 % in audit firms, if national company law allows. However, EU Member States have transposed this provision of the Statutory Audit Directive in very different ways creating a very fragmented picture of ownership structures across the EU.
- (133) There appears to be merit in enabling audit firms to raise external capital, as this may help smaller audit firms to develop their capacities and grow more rapidly. However, investors may prefer investing in larger audit firms which would in reality make it even more difficult for smaller audit firms to grow and enter the audit market of public interest entities.
- (134) The traditional partnership model has proven benefits regarding auditors' independence, investment in audit quality and audit firms' capacity to invest in attracting, training and retaining talent. It is critical that any alternative ownership model is equally conducive to the profession's long term sustainability and the investment in delivery of high quality audit services.
- (135) The Green Paper's assumption that audit firms could not have adequate resources to meet a potential liability claim is not conducive to attract external investors. External investors only invest where the investment offers attractive profit perspectives based on a reasonable risk/reward ratio. The current auditors' liability regime will undoubtedly be a significant deterrent to external investors. Therefore, these two matters should be examined jointly as a combined reform of the ownership regime and of auditors' liability would have a better opportunity to result in effective changes.

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- (136) Investors may, legitimately, want to exercise their rights and have influence on the entity in which they have invested. Therefore, FEE agrees with the views expressed in the Green Paper that the full independence of the auditor carrying out the statutory audit will have to be carefully preserved when introducing alternative ownership structures. In this respect, it should be remembered that the investor model with external investors holding the majority of the capital, control and votes in audit firms has existed in certain countries before the Statutory Audit Directive and was finally abandoned because of its perceived threats to auditors' independence.
- (137) To adequately respond to demands of entities and the increasing complexity of business models in certain industries, it will be important that alternative models further facilitate the possibility to invest in the development of multi-disciplinary audit firms and networks which imply that audit firms continue to be able to provide non-audit services (as explained in our response to Question 19).

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

As FEE fully supports the view that the group auditor should bear full responsibility for the audit report in relation to consolidated financial statements as stated in the Statutory Audit Directive, group auditors should be appropriately involved and have access to the audits of subsidiaries. Adoption in the EU of ISA 600 on group audits would reinforce this as this ISA includes similar provisions.

- (138) We fully agree that the group auditor should bear the full responsibility for the audit report in relation with consolidated financial statements, as required by Article 27 of the Statutory Audit Directive. Therefore, the group auditor should have access to the reports and other documentation of all auditors reviewing sub-entities, subsidiaries or components of the group and 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.
- (139) The requirements of ISA 600<sup>20</sup> have been strengthened considerably during the IAASB clarity process and cover all these aspects of a group audit as desired to be re-enforced by the European Commission. Adoption of the ISAs for use for all statutory audits in the EU as already discussed in Question 13 is therefore also in this respect the most appropriate way forward.
- (140) Unfortunately, we have to note that, although required by Article 27 of the Statutory Audit Directive, national laws and regulations in relation to professional secrecy of statutory auditors and audit firms in certain EU Member States are not conducive to make auditors of components or subsidiaries share information with the group auditor. This has been experienced especially in cases where the group and component auditors are not of the same audit network.

<sup>20</sup> ISA 600 on Special Considerations - Audits of Group Financial Statements (Including the Work of Component Auditors)  
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**Question 25: Which measures should be envisaged to improve further the integration and cooperation on audit firm supervision at EU level?**

FEE agrees that the integration and cooperation of audit firm supervision could be further improved at European level. FEE recommends that the EGAOB is transformed into a new Level 3 Committee to achieve much closer cooperation between national oversight authorities. FEE believes that this committee could also consider the establishment of colleges of audit oversight bodies for the oversight of pan-European audit firms whose registration also covers a number of EU Member States. FEE also recommends the establishment of a Stakeholders Consultative Panel for Audit Oversight in the EU which should be led by the new Level 3 Committee for audit oversight. The integration of audit oversight in another EU committee or authority would present significant shortcomings.

Integration and cooperation on audit firm supervision at EU level

- (141) FEE agrees that measures could be taken to further the integration and cooperation of audit oversight at EU level based on the principles already included in the Statutory Audit Directive. This would be beneficial to achieve a harmonised level of audit quality in the EU Member States as well as to be able to address and resolve cross-border issues with regards to audit oversight. Therefore, FEE supports any initiative that would reinforce cooperation at European level and foster convergence in the application of requirements and ensure a common approach to inspections of audit firms across the EU Member States.
- (142) FEE also agrees that it is important to have an audit oversight system that is independent and that avoids conflicts of interest with the audit profession. However, audit oversight bodies need market knowledge and up-to-date technical auditing expertise to continue contributing to improve audit quality. Appropriate safeguards need to be in place to achieve this objective, such as allowing a minority of practitioners to be involved in the governance of the oversight system as rightly foreseen by the Statutory Audit Directive.
- (143) Choosing from the proposed models in the Green Paper, transformation of the European Group of Auditors' Oversight Bodies (EGAOB) into a newly formed Level 3 Committee responsible for audit oversight is the short term solution. A Level 3 Committee for audit oversight would facilitate a much closer cooperation between the audit oversight bodies already established at national level under the requirements in the Statutory Audit Directive which would be beneficial to all parties involved, the audit oversight bodies themselves, the European Commission and the audit firms being supervised. A Level 3 Committee for audit oversight would ideally be responsible for:
- Facilitating dialogue between national audit oversight bodies;
  - Enhancing harmonisation of working methods, such as selection methods, inspection methodologies, inspection reports, the issuance of recommendations and the application of sanctions between national audit oversight bodies;
  - Exchanging views regarding decisions in specific inspection cases at national level without having decision making power at EU level and without acting as a standard setter;
  - Discussing cross border issues related to audit oversight.

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- (144) The national audit oversight bodies would retain the same responsibilities as they have today, i.e. carrying out inspections and having the final decision making power in inspections and investigations.
- (145) Integrating audit oversight into one of the supervisory authorities for securities, banking and insurance, respectively (ESMA, EBA or EIOPA) would present significant drawbacks. This is due to the significant differences in scope of supervision of any of these three supervisory authorities as compared to audit oversight, both with regard to the entities supervised and the areas of supervisory responsibilities covered. These supervisory authorities focus primarily on listed and public interest entities while audit firms focus on all entities to be audited. Therefore, the oversight of audit firms by these authorities carries the risk that the audit profession would be split into first class auditors auditing public interest entities and second class auditors auditing other entities. This would result in additional requirements for entry into the audit market of public interest entities and further strains on the supply of audit services in this market segment. In addition, some significant conflicts of interest for the supervisory authority could arise if audit oversight is incorporated in one of the other Level 3 Committees considering their main areas of supervision, like transparency of financial information, etc. Given that audit oversight mainly requires high-quality human resource with appropriate audit expertise, the possibilities for achievement of significant synergies between the various areas of supervisory responsibilities do not seem achievable.

#### Oversight of pan-European audit firms

##### *Short term*

- (146) The establishment of a Level 3 Committee should also consider the development of colleges of audit oversight bodies for the oversight of pan-European audit firms, by which we understand audit firms whose registration also specifically covers a number of EU Member States.
- (147) This could be addressed by setting up colleges of audit oversight bodies for each pan-European audit firm that would have the responsibility for the planning and performance of the common inspections of a pan-European audit firm, including exchange of information and coordination of the college's activities, such as on-site common inspections. The colleges should appoint a coordinator. Experience regarding the functioning of colleges in the banking sector, noting the structural differences between financial institutions and audit firms, could be beneficial and useful to explore when further developing colleges of audit oversight bodies. The new powers for the new financial supervisory authorities related to mediation in case of diverging views between national supervisors could also be further explored in the context of audit oversight.

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### *Long term*

- (148) Pan-European audit oversight could be considered as a long term solution for the oversight of pan-European audit firms. Such a model could replace the colleges of audit oversight bodies established in first instance, as described above, dealing with oversight of pan-European audit firms. Having pan-European audit oversight of these audit firms would entail that the decision-making power for the outcome of an inspection is moved from national level to EU level. The pan-European Supervisory Authority could still delegate operational inspection work to the national audit oversight body. The major benefit of this model would be the elimination of the risk of diverging inspection conclusions on one and the same pan-European audit firm between different national audit oversight bodies. This would further the harmonisation of audit oversight in EU Member States.
- (149) The Green Paper makes reference to the proposed regulation on credit rating agencies with regards to the pan-European oversight of audit firms. It should be noted that differences between credit rating agencies and audit firms should be carefully considered in this context, especially with regards to the existence of audit firm networks in addition to the legal structure of the audit firms which is not necessarily existing for credit rating agencies.
- (150) In the short term as well as in the long term, audit oversight bodies across the EU should be encouraged to further cooperate with their counterparts in other jurisdictions outside of the EU. This enhanced cooperation could be done through the International Forum of Independent Audit Regulators (IFIAR) as further discussed in our response to Question 38.

### Stakeholders Consultative Panel for Audit Oversight in the EU

- (151) In order to have an open and fruitful dialogue between the audit oversight bodies organised in the new Level 3 Committee and the relevant stakeholders, FEE recommends the establishment of a Stakeholders Consultative Panel for Audit Oversight in the EU. This Panel should consist of all relevant stakeholders which would be investors, the European Commission, regulators, audit regulators, business representatives, national audit standard setters as well as the audit profession. The Stakeholders Consultative Panel for Audit Oversight in the EU would operate underneath the new Level 3 Committee for Audit Oversight and its responsibilities could be:
- Exchanging views between stakeholders and audit oversight bodies regarding the application of auditing standards;
  - Providing input to the work programme of audit oversight at European level;
  - Suggesting areas where audit oversight at European level could improve harmonisation and coordination.

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

The communication between financial institutions, their auditors and financial regulators should be more frequent compared to the frequency of communication between large listed companies, their auditors and other regulators. The exchange of information should be done as a three-way communication between the entity, the relevant regulator and the auditor, and the information exchanged should relate to the area of supervisory responsibility of the regulator in question.

Communication between regulators and auditors in general

- (152) In general, communication can always be improved for the benefit of the involved parties and FEE is supportive of enhanced communication with regulators.
- (153) The cooperation between external auditors and the regulators should include management and/or those charged with governance of the entity. Unlike the often one-way communication from the auditor to the regulator in the past, we believe this should be a three-way communication. This should include meetings with all parties in combination with sharing of information to as well as from the auditor and the regulator. In addition, the exchanged information should not be made public. In this respect, an impact assessment should consider whether enhanced communication is more a matter of behavioural change of the parties involved rather than further regulation. It should be noted that in practice, national laws may prevent the regulator from submitting information about an audit client to its auditor and vice versa. Therefore, such barriers would need to be removed in order for all parties involved in the three-way communication to benefit in full from the potential enhancement in the quality of reporting, auditing and supervision.
- (154) With regard to reporting on (suspicion of) fraud within entities, FEE is supportive of enhanced communication with the relevant authorities regarding material financial matters detected during the audit. Some European countries already have such provisions in place and expanding this to EU level could be considered as a way of increasing the communication between the auditor and the relevant authorities.
- (155) In this context, the Commission should consider the scope of entities to which this increased communication would apply as the term “large listed companies” is not a defined term in EU legislation. Communication is more relevant in relation to large systemic financial institutions than in relation to smaller entities and, therefore, this should be taken into account when further developing this issue.

Communication with financial services regulators

- (156) The recent EC Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies dealt with this issue. In line with our comments to that consultation we are of the view that the role of supervisory authorities is not only geared towards the supervision and regulation of individual entities but also of markets as a whole. Auditors are only involved with individual entities.

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- (157) Communication between auditors and regulators, with appropriate involvement of the audited financial institution, is viewed as most important when it comes to financial services regulators. The scope for regulators and supervisory authorities is wider compared to the scope of the work of external auditors. Supervisory authorities identify and report on global risk factors and systemic risks in the financial markets with regards to financial institutions whereas external auditors should be occupied with the specific risks their clients face.
- (158) Such a fruitful exchange of information on a regular basis could be beneficial to all parties recognising that it is important to get an appropriate balance of rights and obligations between the different parties involved. For the auditor, such increased communication could enhance the audit quality and make audits more efficient as more relevant information would become available to the auditor when carrying out the audit work.

#### Communication with other regulators

- (159) The extent of communication between auditors and various regulators and their information needs will differ depending on the areas on which they focus.
- (160) Securities regulators, financial services industry regulators and other regulatory authorities, such as criminal or tax authorities, all have different interests in market surveillance, investor protection, transparency of financial information and enforcement of accounting standards, risk management, liquidity, solvency, etc.
- (161) Communication between external auditors and securities regulators would ordinarily only be relevant when specifically defined or when an enforcement case involving an audit client is pending and should not be required to take place on a regular basis.
- (162) Communication in relation to audit quality control and assurance should only take place between external auditors and their public audit oversight body and not with other regulators.

#### **Question 27: Could the current configuration of the audit market present a systemic risk?**

The current configuration of the audit market does not present a systemic risk as the term is understood in a financial market context. While the audit market is important and entails risks of market disruption, they are not of a systemic nature. Similarly, no single audit firm seems to create a systemic risk. In a specific segment of the audit market, that of the audit of large multinational entities, supply could be stimulated.

- (163) Exporting the concept of “systemic risk” currently used in the debate on financial institutions to the audit area is prone to cause misunderstandings as these two sectors are different in nature and serve different purposes that have a public interest dimension. Certain audit firms are indeed large and their disappearance could have significant consequences, but we do not believe this would have a systemic impact on the market.

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- (164) In case of a failure, the market has already demonstrated its capacity to reorganise, as clients and human capital can easily be transferred. Entities may experience some delay in filing their financial statements but would not suffer collateral damage or risk their survival. In addition, governments would not need to intervene and invest public money into the audit firm concerned.
- (165) Large does not necessarily mean systemic. Generally, a large audit firm network would not disappear abruptly and without prior signs. The problems that have led to the disappearance of large audit firm networks in the past were due to developments over a certain period of time (client failure, litigation) so that the market had time to adapt. It appears that the capacity for providing audit services as a whole did not significantly change in practice.
- (166) When viewing the audit market, the different segments of the market would need to be identified. On a very specific and narrow segment, that of the audit of large multinational entities, the number of suppliers is perceived as too limited. Outside of the market of the audit of public interest entities, there is generally ample supply (and demand), as there is a large number of participants on both the supply and demand sides of this segment of the audit market. In addition, the degree of concentration in the market of large multinational entities is not entirely exceptional compared to other sectors of the economy and results from clients' demands, historical developments and past regulatory decisions.
- (167) Policy responses to this issue are much debated. As FEE is a body covering all sectors of the profession, our approach focuses on contributing to this debate from a public interest perspective. In this respect, we look forward to the outcome of the expected EC study on the effects of the 'acquis' on statutory audits of annual and consolidated accounts including the consequences on the audit market, as initiatives in this field have to be carefully assessed.

**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?**

Having more than one statutory auditor is currently an option EU Member States and entities can voluntary use but do so infrequently in practice. It should not be discouraged, but the effects of mandating it remain uncertain. While certain jurisdictions see merits in joint audits, others have abandoned this approach. The use of joint audits and audit firm consortia should be left to market forces or national regulators who are closer to market circumstances and local cultures.

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### Audit firm consortia

- (168) Although the concept of audit firm consortia is unclear, FEE understands it as any other consortium. Consortia are already allowed under the current regime of the Statutory Audit Directive as long as the different audit firms involved retain sole responsibility for the audit. No regulatory intervention would therefore be necessary to allow entities to appoint an audit firm consortium. However, to our knowledge, no EU Member State regulator has mandated audit firm consortia in their jurisdiction nor have entities across the EU in general, voluntarily appointed an audit firm consortium, probably because it creates practical, organisational and legal issues.
- (169) At this stage, the effects of mandating audit firm consortia remain uncertain. The further impact of mandating the composition of such a consortium is even more uncertain. In general, there is little support for forcing a solution for which there is no market demand nor any practical experience or understanding of the economic and structural impact of the solution.

### Joint audits

- (170) There is more experience in the field of mandatory joint audits, which were or are used in certain jurisdictions. In Denmark, the mandatory joint audit requirement has been abandoned as it was considered to be an administrative and financial burden that did not necessarily result in benefits for the business regarding audit quality, etc. The practice of joint audit in Denmark originated from an audit market without audit firms having the capacity to carry out audits of very large, complex and global companies. The requirement of joint audit was therefore used as a second partner review which under the current audit market situation and auditing standards is dealt with within the audit firm through independence requirements, review partner requirements, key audit partner rotation and effective internal and external quality control.
- (171) France is currently the primary example in the EU where joint audits are mandatory for the audit of certain consolidated financial statements<sup>21</sup>. There are no requirements regarding the size of the audit firms carrying out the joint audit, as this may be quite difficult to implement in legislation and in practice. Consequently, in many cases the two audit firms involved are large global networks. While it appears that joint audits have had the benefit of enabling certain firms to grow, its real impact on the higher segment of the audit market has been limited with only one additional audit firm being involved on a regular basis.
- (172) The impact on the dynamics of the audit market of solutions involving audits performed by more than one audit firm is difficult to assess. Some believe that it may actually significantly complicate the management of independence requirements and reduce the number of audit firms that an entity can appoint.

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<sup>21</sup> The latest relevant survey in France is one on audit fees which was carried out by the French securities regulator, Autorité des Marchés Financiers (AMF) in July 2010. It analysed the audit fees paid to statutory auditors in 2009 by CAC 40 and Euro Stoxx 50 entities and by a sample of 40 entities in the B and C compartments of Euronext. The analysis showed that out of the 79 audit engagements in the CAC 40, the fifth largest audit firm in France, Mazars, had 12 engagements. There is only one audit of the 79 audit engagements where neither a “Big Four” audit firm nor Mazars participated. The remaining audits were done jointly by two “Big Four” audit firms, and all audits had at least one “Big Four” audit firm. For the entities in the EuroStoxx 50 segment, all of the 71 audit engagements were held by a “Big Four” audit firm and Mazars. For B and C compartment entities, 26 out of the 72 audit engagements in this segment were held by another audit firm than a non-“Big Four” audit firm and Mazars. The survey can be accessed via the following link [http://www.amf-france.org/documents/general/9557\\_1.pdf](http://www.amf-france.org/documents/general/9557_1.pdf).

**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?**

We conclude that, after due examination, the effect of mandatory audit firm rotation on market structure will not meet the expectation of reducing concentration. In addition, other public policy objectives such as audit quality also need to be taken into account and it would, in general, entail more costs and risks than benefits.

Tendering is a corporate governance best practice that should be decided by those charged with governance of the audited entity, as should the most appropriate time and frequency to tender. The incremental benefits of making it mandatory after a defined fixed period of time would, as any automatic mechanism, reduce flexibility.

- (173) In general, it should be noted that in most segments of the audit markets there is ample supply and choice. There is also strong competition between the audit firms participating in the highest segments of the market, the market for audits of the largest listed global entities or the market for public interest entities (depending on the jurisdiction). However in the audit market of large multinational entities, the number of suppliers is perceived as too limited.

Mandatory audit firm rotation

- (174) In Question 18, FEE concluded that in the vast majority of EU Member States, mandatory rotation of audit firms is not believed to enhance auditor independence or increase competition, but to create real threats to audit quality and to result in practical difficulties in the audit of an international group.
- (175) The experience of practitioners in the EU Member States where audit firm rotation has been mandatory is that, contrary to expectation, rotation may rather increase concentration. Very often, when rotation time comes, smaller audit firms see their audit clients appoint larger audit firms. It is also not obvious whether such audits subsequently come back to smaller firms, as the audits rather tend to rotate amongst large audit firms.
- (176) A number of EU Member States, including Austria, Greece, the Slovak Republic and Spain have introduced or experienced mandatory audit firm rotation. It should be noted that they concluded it should be removed. Only one EU Member State, Italy, continues applying mandatory rotation of audit firms for public interest entities.

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### Mandatory re-tendering

- (177) It appears that audit committees frequently opt voluntarily for re-tendering their audit. The impact on audit quality needs to be carefully assessed when considering the potential change in practice. Audit committees are best placed to carry out this assessment. Mandating tendering and defining a fixed period of time to do so would reduce the flexibility of the audit committee and its ability to take specific circumstances into account and exercise judgement. Due to the risks associated with a change of auditors or the anticipation of a change, the audit committee should retain such flexibility.
- (178) As explained in further detail in our response to Question 16, reappointment could be efficiently addressed through enhanced disclosure of the rationale of reappointment which may be less expensive and disruptive and more conducive to gradual change in market dynamics. Reference is also made to our response to Question 16 for further improvements to the process of appointing an auditor.
- (179) In addition, making tendering mandatory is likely to enhance pressure on audit fees and increase costs for audit firms (and these costs would have a proportionally higher impact on smaller audit firms)<sup>22</sup>.
- (180) Some in the audit profession have a general perception or even experience that mandatory re-tendering would disadvantage smaller audit firms as audit mandates would shift to larger audit firms rather than the other way around.

### **Question 30: How should the "Big Four bias" be addressed?**

FEE believes in free competition. Any clause or action that restricts competition should be prohibited. Any party, whether a financial institution or a regulator, should be prevented from imposing clauses that require or recommend one auditor rather than another.

A European quality certification for audit firms may present certain benefits. However, it may equally create additional barriers to market entry. Its potential benefits should be assessed once the concept is supplemented with details.

<sup>22</sup> For a regulator's viewpoint on the matter, see Douglas Niven, Australian Securities and Investment Commission: Maintaining high audit quality, Company Director, August 2010

“Big Four only” contractual issues

- (181) “Big Four only” contractual clauses or other practices (including regulators’ behaviour) that would tend to impose a certain auditor should be prohibited on the ground of their (potential) restrictive effect on competition. Subject to further legal analysis, all market players should be better informed of the legal status of such restrictions. However, enforcement of such restrictions remains a matter for national authorities. There are also significant issues related to evidence, as such distortive recommendations can take other forms than a clause in a contract and may be difficult to prove.
- (182) The European Commission could consider to further analyse this matter and make its position known. This could be done through an EC Recommendation.

European quality certification

- (183) The Green Paper’s suggestion for a European quality certification for audit firms aimed at recognising their aptitude to perform audits of large listed companies may present certain benefits. Experiences from certain jurisdictions where a similar concept has been tried could be taken into account. However, when further exploring such an approach, its potential impact on concentration should be carefully considered, as it may equally create additional barriers to market entry.
- (184) In general, the main elements remain: equally high quality of audits and of audit methodologies. These are currently supported by external audit quality assurance reviews and public oversight applied to all firms in a proportionate manner. Furthermore, avoiding public policy measures that would split (at least in perception) the audit profession should be avoided as this would be in contradiction to this goal. The adoption of ISAs for all audits and auditors would greatly contribute to the Commission’s objective in this respect.

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

The audit profession is prepared to work with the relevant regulators to develop contingency plans, which might be challenging in practice. The development of living wills for audit firms is neither necessary nor practical.

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### Contingency plans

- (185) As discussed in further detail in our response to Question 27, we do not believe that the current configuration of the audit market presents a systemic risk as the term is understood in a financial market context. However, the audit profession recognises that the audit market entails risks of market disruption, especially in the market of large listed multinational entities. As contingency plans could contribute to mitigating the consequences of an audit firm's failure, the audit profession is prepared to work with the relevant regulators to develop contingency plans, however challenging their development in practice might be.
- (186) Regulators may wish to coordinate these at a European and global level while having consideration for the legal specificities and market characteristics of all jurisdictions.

### Living wills

- (187) Developing living wills would be even more challenging compared to contingency plans. These would need to be prepared by each audit firm in each jurisdiction in order to be valid under the relevant national legal framework. In addition, referring to our analysis of the absence of a risk of a systemic nature, we believe living wills are neither necessary nor practical.

### **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?**

We believe that the rationale for the past consolidation of large audit firms is still valid. We do not believe a reversal is possible.
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- (188) Since 1987, several mergers of major accountancy firms have taken place. The consolidation of large audit firms over the past decades is primarily a consequence of markets' demand arising from the growing globalisation of the economy requiring increasingly complex global audits, in particular in certain sectors (e.g. banking and insurance). It also results from regulatory decisions.

In a global economy, it is crucial for audit firms' networks to have the relevant human capital, regional coverage and diversity of expertise in order to offer high quality audit consistently across the world. Today, the rationale for these mergers is more valid than ever.

- (189) A reversal of the consolidations of the past decades would not result from market forces. Insofar as this seems to mainly refer to a mandatory split of certain firms, it would imply regulatory intervention on audit firms' structures. It is uncertain whether this would be appropriate, but moreover it appears to be extremely difficult and complex with yet unknown and uncontrolled consequences. Given the international structures in place, it may even be impossible from a legal and practical point of view.

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- (190) In addition, such action could be highly disruptive and the time that market players would need to adapt to the new situation could be unpredictably long.

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

FEE strongly supports the development of the internal market and the further mobility of audit professionals. Audit professionals should be able to benefit from the EU internal market as any other profession. Barriers to mobility should be reduced to the extent possible. This could be achieved by further harmonisation of the aptitude test and the legal framework related to approval, education and registration of auditors.

- (191) The rights of EU citizens to establish themselves or to provide services anywhere in the EU are one of the cornerstones of the Single Market. Completing the Single Market is an essential element of the EU 2020 Strategy and a key factor for EU performance.
- (192) FEE supports initiatives that can contribute to the completion of the Single Market. Cross border mobility of audit professionals could be primarily enhanced by reducing the barriers to such mobility. To this end, FEE would support further harmonisation of the legal framework related to qualification and market access, including measures concerning approval, registration and aptitude test.
- (193) Harmonisation of the education requirements across the EU Member States would facilitate cross border mobility in practice. The current EU minimum platform for education of statutory auditors dates from 1984. FEE proposes to improve this based on *competences* which should be expected from statutory auditors to perform high quality audits. Projects undertaken by some professional accountancy bodies themselves such as the Common Content Project also contribute to this goal in a pragmatic way by reducing barriers linked to education and training.
- (194) The aptitude test that is required as compensation measure when statutory auditors seek establishment in another EU Member State can be oral or written or both. In some countries it is offered at regular intervals, in others on specific demand. The elimination of such differences by harmonising the aptitude test process could contribute to facilitating market access and thus enable and encourage cross-border mobility of auditors.
- (195) In addition, there are still important unresolved questions for example relating to the interaction and operation of the Services Directive and the Directive on Recognition of Professional Qualifications<sup>23</sup>. In case of auditors seeking establishment in another EU Member State, it is still unclear whether a local professional address and/or a stable infrastructure in the host EU Member State is required for approval and registration. The practice across EU Member States varies significantly.

<sup>23</sup> As discussed in the FEE Paper on "Internal Market For Services and the Accountancy Profession: Qualifications and Recognition", November 2007 [http://www.fee.be/publications/default.asp?library\\_ref=4&content\\_ref=761](http://www.fee.be/publications/default.asp?library_ref=4&content_ref=761)

- (196) It is also still unclear whether there is freedom to provide statutory audit services on a temporary and occasional basis in another EU Member State without establishment. Though FEE believes this is not the case, the question is particularly relevant for auditors practicing in border regions, especially in smaller EU Member States with a similar or almost identical legal system.
- (197) There are generally however other barriers such as differences in national legislation (e.g. tax and company law) as well as language which will remain difficult to overcome.
- (198) Adoption of international standards related to accounting, auditing and independence (IFRSs, ISAs, IESBA Code of Ethics) would be instrumental in setting up an environment that is conducive to enhancing the mobility of auditors across borders and harmonising the quality of audit services – and their understanding by stakeholders – across jurisdictions. As mentioned above, the Common Content Project is also helpful in respect of harmonisation.

**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?**

The idea of a European passport for auditors and audit firms is attractive. Its real contribution to the internal market will depend on its conception, implementation and achievement of further harmonisation of national laws and regulations. Today, it appears a longer term objective that should be supported as a principle.

- (199) The suggestions outlined in the Green Paper include both maximum harmonisation and a European passport for auditors and audit firms. A European passport for auditors and audit firms would imply EU-wide registration with common professional qualification requirements and having common governance, ownership and independence rules.
- (200) Maximum harmonisation could be a long term goal within the Single EU Market, and we believe that a first step would be the full and consistent implementation and enforcement of the Statutory Audit Directive to which enhanced harmonised audit oversight, as discussed in our response to Question 25, would contribute.

Auditors

- (201) As the cornerstone of the audit profession is the individual auditor, freedom to provide audit services within the EU should start by focusing on the individual auditor. Such an ambitious objective may require some time and consideration should be given to whether a European passport - or professional card as introduced or currently debated for other professions - could be introduced before the achievement of substantial harmonisation, as discussed above. More specifically, one of the main barriers will be the differences in EU Member States' tax laws and company laws amongst others, as well as language.

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- (202) FEE understands a European passport to enable auditors with a qualification in one EU Member State to carry out statutory audits in another EU Member State without any additional qualification in the host EU Member State. This would entail that the requirements for an aptitude test in the host EU Member State would be removed.
- (203) In this respect, the ethical requirements in the relevant parts of the IESBA Code of Ethics, if adopted in the EU, would require auditors to have sufficient knowledge and competence to carry out an audit, also if outside of their home Member State. This would apply regardless of the EU Member State in which the auditor operates. In the case of introducing a European passport without maximum harmonisation or without mandating the relevant parts of the IESBA Code of Ethics, the aptitude test should be maintained.

#### Audit firms

- (204) The perspective of a European passport could be very helpful for audit firms. Some of them already moved towards a pan-European audit firm. Based on these experiences, the European Commission could further investigate what measure would be necessary to encourage this momentum.
- (205) One should also consider whether it is appropriate to mandate a European passport for all auditors and/or all audit firms. It should be available to allow auditors and/or audit firms with cross-border ambitions to operate in another EU Member State without additional barriers to entry. It should however not be mandated, especially not for smaller audit firms, as they might not have any use for it and want to avoid the administrative and other burdens to obtain it.

**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?**

Audit exemption thresholds and mandating statutory audit of SMEs should continue to be an EU Member State option within the framework of the EU Fourth Directive. It would be inappropriate to discourage or encourage it at EU level.

We do not support a "limited audit" and we believe that a statutory review is only relevant under the existing audit exemption thresholds and should not be regulated at European level. The performance of these services by suitably qualified professionals subject to relevant ethical, independence, quality control and oversight standards enhances the quality of the financial statements of SMEs.

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### Statutory audit

- (206) FEE welcomes the Green Paper's considerations related to SMEs. This question seems to address possible policy measures to replace the current requirements for statutory audit as defined in the EU Fourth Directive<sup>24</sup>.
- (207) The rationale for the level of the audit exemption threshold varies considerably between EU Member States. This is due to the differences in areas such as tax inspections, the requests for audited financial statements from the financial sector or, more generally, the degree of maturity of the market economy. Therefore FEE is of the view that setting audit exemption thresholds and discouraging or encouraging the statutory audit of SMEs should continue to be considered at EU Member States level within the framework of the EU Fourth Directive.
- (208) FEE is especially concerned by the reference in the Green Paper that audits of SMEs should be discouraged as the decision whether to require or obtain audits should be left to the market and users of financial statements. In addition, it seems to disregard the diversity of national realities and the principle of subsidiarity as well as the SMEs sector's needs, in particular financing and trading needs.
- (209) While expectations for "good corporate governance" in our capital markets are clearly understood and upheld through strong regulatory oversight, the role of regulatory oversight of small and medium sized businesses is less clear. The objective of reducing 'red tape' and 'regulatory burden' is well founded when used to remove a 'one-size-fits-all' approach to regulation. However, it is important that certain checks and balances remain in place, so that SMEs can deliver jobs and growth as well as establish state of the art management practices as they develop.

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<sup>24</sup> Statutory audit of SMEs

The Fourth EU Directive on financial statements sets out the threshold under which EU Member States have the option to exempt limited liability companies from the auditing requirement. Small and medium-sized entities (SMEs) are not required to have a statutory audit if they do not exceed the limit of two of the following three criteria for two consecutive years:

- Balance sheet total: €4.400.000
- Net turnover: €8.800.000
- Average number of employees during the financial year: 50

The application of the audit exemption threshold varies considerably between EU Member States and is not used in all EU Member States.

EU Member States decide based on the size of their economy and companies, the strength of their fiscal system and tax inspections, the strength of their anti-money laundering laws and regulations, the demands of their banking system etc. whether to put more or less emphasis on annual statutory audits. For the purpose of this response, FEE considers "SMEs" to be companies that meet this definition that sets the audit exemption threshold.

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(210) External audit also supports good governance in SMEs. Application of both auditing and accounting standards provide a framework which allows the external auditor to provide recommendations appropriate to the SMEs circumstances. The recommendations that result from an external audit, as required under auditing standards, may be instrumental in helping SMEs implement an appropriate management structure and internal control environment. Consequently, in addition to improving the reliability of financial information used for decision-making, an external audit can equip smaller businesses with an understanding of how to develop management practices that enable them to grasp opportunities while mitigating risk. These skills are essential for continued growth and prosperity in a vibrant SME market.

(211) As mentioned in our response to Question 15, we would like to stress that ISAs can be used for the audit of SMEs as they are proportionate and can be tailored to meet the needs of SMEs.

“Limited audit”

(212) Audits are carried out in accordance with auditing standards, whether international or national, to ensure consistent high quality audits. This supports the long standing belief that there is only one benchmark, audit, whereby the level of assurance obtainable from an audit exceeds the level obtainable from other types of assurance engagements. This entails that if an auditor intends to issue a report under ISAs or other auditing standards, then compliance with all *relevant* ISAs or all other applicable auditing standards is necessary. As mentioned in our response to Question 15, this concept is generally referred to as “an audit is an audit” which FEE continues to support.

(213) The form of words "limited audit" does not corresponds to any concept. It does not and should not exist because:

- A “limited audit” contradicts the principle of “an audit is an audit” and confuses market expectations and assumptions;
- It is assumed that “limited audit” is different from, but resulting in a higher level of assurance, than “statutory review”;
- In a “limited audit”, the auditor would attempt to perform limited procedures in order to detect misstatements resulting from fraud or error which reflect requirements commensurate with the requirements applicable to a full audit;
- No national or international "limited audit standards" exist which would be needed to perform such "limited audits";
- There is a significant risk that the public, users, finance providers, shareholders, etc. will not understand "limited audits" or the difference with a “full audit”, which would increase the expectation gap on and misunderstanding of the level of assurance attached to financial information.

(214) Therefore, the introduction of a “limited audit” with a new level of assurance would have negative consequences on markets and is not supported by FEE.

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### “Statutory review” and compilation of financial statements

- (215) We believe that a “statutory review” is only relevant to be performed in entities which net turnover, balance sheet total and/or number of employees do not exceed the existing audit exemption threshold, as these thresholds should remain unchanged at EU level. The regulatory increase in audit exemption thresholds over the last few years in a number of EU Member States, within the limits of the EU Fourth Directive, has exacerbated the demand for other services for SMEs.
- (216) As most review services are developed for audit-exempt entities as determined by EU Member States, we believe that mandating such services should be dealt with or regulated if so wished on an EU Member State level. However, we recommend that such a service be based on the international standard to avoid any further market fragmentation and barriers to the internal market. The revised international standards for review will be available soon (ISRE 2400). It should be noted that EU Member States currently already have the option to introduce statutory reviews for audit exempted entities, if they so wish. To our knowledge, only one EU Member State, Estonia, has gone this route.

A statutory review<sup>25</sup> of financial statements instead of a statutory audit is a service in which a practitioner expresses a conclusion in negative form based on the performance of at least analytical procedures and inquiry of management.

- (217) Another service which could be envisioned is an engagement to compile financial statements in which accounting rather than auditing expertise is used to prepare financial statements<sup>26</sup>. This is not an assurance service as no assurance report is issued but rather a report on the preparation of the financial statements by a suitably qualified accountant. We also recommend that such a service be based on the international standard of which a revised version will be available soon (ISRS 4410).
- (218) Whether to mandate or encourage voluntary use of either of these services is a matter to be determined based on client needs and market demands in general at EU Member State level and appears not to be suitable for European regulation because of the diversity of EU Member State economies.

### Services depending on whether a suitably qualified (internal or external) accountant prepared the accounts

- (219) We recommend that review and compilation engagements as discussed above are performed by suitably qualified professionals subject to relevant ethical, independence, quality control and oversight standards as compliance with such standards should enhance the quality of the financial statements which formed the subject of such engagements. This is not depending on or influenced by whether a suitably qualified (internal or external) accountant prepared the accounts.

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<sup>25</sup> In FEE's understanding, this would be a service in accordance with IAASB's ISRE 2400 on Review Engagements which is currently under review by the IAASB.

<sup>26</sup> In accordance with IAASB's ISRS 4410 on Compilation Engagements which is currently under review by the IAASB.

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**Question 36: Should there be a "safe harbour" regarding any potential future prohibition of non-audit services when servicing SME clients?**

FEE does not support a total prohibition on the provision of non-audit services by auditors. Therefore, we do not see a need for a "safe harbour" for non-audit services provided to SME clients. Instead, FEE recommends the adoption of the Independence Section 290 of the IESBA Code of Ethics for audits of both public interest and other entities. For audit clients that are not public interest entities including SME clients, the provisions regarding the provision of non-audit services are less restrictive.

- (220) Regarding a general potential future prohibition of non-audit services, reference is made to our response to Question 19. The approach should be the same fundamental independence requirements for all clients, with additional requirements and prohibitions for public interest entity clients, not fewer requirements for SME clients.
- (221) Current independence laws and regulations in the EU are based on Article 22 of the Statutory Audit Directive on Independence and Objectivity and also on the EC Recommendation on Auditor's Independence of 2002. Both are based on the threats and safeguards or principles-based approach whereby circumstances or relationships that create or may create a threat to independence are eliminated or reduced to an acceptable, insignificant level by the application of (a) safeguard(s) or otherwise such circumstances or relationships should be prohibited.
- (222) This has led to a variety of national applications of independence systems whereby some are based on the EC Recommendation on Auditor's Independence, some on the International Code of Ethics and some are based on a restrictive approach whereby the provision of services to audit clients is acceptable when explicitly permitted.
- (223) Further harmonisation could be achieved in the application of independence approaches throughout the EU in case the Independence Section (290) of the International Ethics Standards Board for Accountants (IESBA) Code of Ethics for Professional Accountants would be adopted for use in the EU.
- (224) The Independence Section of the IESBA Code of Ethics is based on the threats and safeguards approach but is supplemented by requirements, guidance but also prohibitions where a self-review or other threat to independence is created by circumstances, relationships or provision of certain services to clients in general and also to audit clients. As far as the provision of non-assurance or non-audit services to audit clients is concerned, the general provisions are the same for all entities as a self-review or other threat to independence is universal, but when appropriate, a distinction is made between the provision of such services to audit clients that are public interest entities and those that are not public interest entities.

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- (225) In particular, due consideration should be given to the adoption of the Independence Section 290 of the IESBA Code of Ethics for both public interest and other entities. In fact, the Code is proportionate and less restrictive as far as the provision of non-audit services when servicing SME clients is concerned, also in relation to taxation services, recruitment services and preparation of accounting records and financial statements.

**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 recommend adopting ISQC 1 (or equivalent system at least as demanding) for all audit firms including smaller audit firms as it is scalable to their needs. Scalability was also built into the requirements on oversight by supervisors in the Statutory Audit Directive and appear acceptable to us. Further differentiation between internal and external quality control rules for larger and smaller audit firms is not desirable.

- (226) Reference is also made to our response to Questions 15 and 35 in this respect. In our response to Question 35, we did not support a "limited audit" and we indicated that we believe that a statutory review is only relevant to be considered under the current audit exemption threshold and should not be regulated on an EU but on a Member State level.

Internal quality control

- (227) In case review or compilation engagements are performed, we believe that ISQC 1 (or equivalent system at least as demanding) should be applied as it is best practice for internal quality control rules for EU audit firms. As mentioned in our response to Question 15, ISAs are scalable and the same arguments are valid for ISQC 1. ISQC 1 is already adaptable, scalable or proportionate to meet the needs for application by SMPs. Considerations specific to smaller firms are taken into account in the standard itself as well as in the guidance to the standard. This is also discussed in guidance issued by the IFAC SMP Committee and other guidance available which demonstrates that ISQC 1 can be proportionately applied and documented by smaller firms. However, further guidance from the IAASB specifically for smaller firms and others would be welcomed.
- (228) Some concerns of smaller firms regarding the documentation requirements of ISQC 1 are, however, often due to lack of clarity or disproportionate expectations of auditor oversight bodies often due to the oversight bodies' expectations being akin of those for bigger audit firms auditing public interest entities which are not relevant for audits of SMEs.

Oversight by supervisors

- (229) With regards to oversight by supervisors, some scalability has already been introduced in the Statutory Audit Directive and in the EC Recommendation on Quality Assurance for Public Interest Entities which have been transposed in various ways at national level. This approach remains relevant, also in any future structure of oversight at EU as well as at national level.

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- (230) Depending on how audit oversight is structured at EU level, as discussed in our response to question 25, due consideration should be given to the proportionality of oversight of smaller audit firms.

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

FEE encourages supervisors at international level to enhance their cooperation in order to achieve a level playing field for supervision, as high quality auditing standards will only reach their full potential if their application is consistent at a global level. Such enhanced cooperation could take place through IFIAR, the International Forum of Independent Audit Regulators.

- (231) As discussed in our response to Question 25, FEE is of the view that audit oversight would benefit from greater cooperation and harmonisation at European level. We believe that greater communication and cooperation between auditors and their supervisors would result in improved audit quality and in FEE's view, also in higher quality of the supervision carried out by the various oversight bodies in the EU.
- (232) In general, a level playing field for supervision is the aim, both at European level and at international level. Although the measures for enhanced cooperation may be different in different jurisdictions, all stakeholders involved, i.e. investors, business representatives, regulators, the European Commission, national public audit oversight bodies, the audit profession, the suggested new Level 3 Committee for audit oversight and their counterparts in other third country jurisdictions can benefit from such enhanced cooperation at international level. This enhancement would also address cross-border considerations and harmonisation involving EU audit firms for their application of auditing, ethical, independence, quality assurance and other standards as well as for supervision of their application.
- (233) In our view, global high quality auditing, independence and other standards, as highlighted in our responses to Questions 13 and 19 above, will only reach their full potential if their application is globally consistent. This goal can be achieved by those developing high quality standards that enable consistent application in close cooperation with those bodies supervising their application in a coordinated way.

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(234) The procedures currently being established for the mutual recognition of public oversight systems as well as for the exchange of audit working papers with third country jurisdictions based on the system of mutual reliance are all appropriate measures in this direction. As the international coordination is developing at the moment, reviews of the progress made can only be encouraged to be done on an ongoing basis in the coming years, as a level playing field established through mutual co-operation would be beneficial, especially with regards to reciprocal oversight of audit firms between EU and other jurisdictions. In addition, increased dialogue between the EU audit oversight bodies, in particular within the framework of a new specialised audit oversight Level 3 Committee and their counterparts outside the EU, should be encouraged to take place on a regular basis by exchange of views and experience regarding planning, performance and results of the oversight activities carried out. This enhanced cooperation could take place through the already established International Forum of Independent Audit Regulators (IFIAR) that should be encouraged to further improve their activities at a global level. In addition, as only 16 of the 27 EU Member States are currently members of IFIAR, the remaining EU Member States should be encouraged to enhance their cooperation with other oversight bodies at international level to further contribute to achieving a level playing field for audit oversight.

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