



CCBE RESPONSE TO EUROPEAN COMMISSION GREEN PAPER ON AUDIT POLICY

Conseil des barreaux européens – Council of Bars and Law Societies of Europe

association internationale sans but lucratif

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General remarks

The Council of Bars and Law Societies of Europe (CCBE) is the representative organisation of around 1 million European lawyers through its member bars and law societies from 31 full member countries, and 11 further associate and observer countries. The CCBE responds regularly on behalf of its members on policy issues which affect European citizens and lawyers.

On 13 October 2010, the European Commission published a Green Paper on Audit Policy: Lessons from the Crisis (the 'Green Paper'). Noting the existence of large international audit firms whose disappearance might cause a systemic risk, the Commission considered it appropriate to initiate a global reflection on the organisation, operation and role given to such companies.

The CCBE has twice had the opportunity to give its view on the legal framework of audit firms:

- In 2001, the CCBE sent a number of recommendations to the European Commission following its public consultation launched in December 2000 on the independence of statutory auditors. The CCBE stressed the need to preserve the independence of auditors in their mandates. The CCBE also drew the attention of the European Commission to the fact that the achievement of mandates outside statutory audits by audit firms should be conducted transparently. This transparency must be exercised both in respect of the organs of the audited company and the public.
- In 2009, the CCBE had the opportunity to meet officials from the European Commission in charge of the Internal Market to discuss the performance structures of audit firms. The CCBE then told the Commission that audit and law markets were fundamentally different, which explains the high concentration in the audit market.

The CCBE shares the view expressed by the European Commission in its Green Paper that audit firms play an essential role in the accuracy of financial reporting, investor protection and market confidence.

However, the liability of auditing firms in the economic and financial crisis should not be overrated. The main reasons for the crisis essentially lie in the lack of national regulations and supervisors failing to perform their monitoring tasks. Nobody has ever questioned the liability of audit firms in the context of the crisis.

Consequently, the CCBE submits its response to the questions of the Green Paper to the Commission and EU institutions.

I. Introduction

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

The CCBE believes it would have been more appropriate to distinguish between the scheme applicable to large companies (listed companies in particular) and smaller companies. Indeed, the complexity and challenge presented by audit widely differ depending on whether it is a large company or a smaller company. In its approach, the Commission could effectively have established a distinction between these two types of structures.

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?***

The societal role of the audit is not well defined and it is also probably unreasonable to assign a genuine "societal role" to the audit.

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

It is always possible to enhance the general level of audit quality. Such improvements should be assessed in light of the cost incurred by the approach taken and whether it would have been wiser to strengthen the implementation of the existing scheme.

II. The auditor's role

4. ***Do you believe that audits should provide comfort on the financial health of companies? Are audits fit for such a purpose? Audits are they adapted for this purpose?***

The CCBE believes that it does not fall within the mandates of audit firms to provide an assessment of the 'financial health' of a company when the company's scope goes beyond mere financial information: the 'financial health' of a company does not only depend on its financial statements, but also on its strategy, the developments of markets in which it operates, legal and tax issues, etc. Auditors should not express views on the future viability of an entity.

However, the CCBE believes that the mandate of audit firms, as it seeks to make a quality assessment for the financial statements of an entity, is suitable for this purpose.

5. ***To bridge the expectation gap and in order to clarify the role of audits, should the audit methodology employed be better explained to users?***

Yes. The approach and the mandates undertaken by an audit firm should be clearly explained to users. Moreover, it should not only be methodology that is better explicated, but also the very role of the audit.

6. ***Should "professional scepticism" be reinforced? If so, how?***

From a general point of view, it is clear that auditors must exercise their critical-thinking skills so that they perfectly fulfil their role of supervising financial information.

However, the CCBE would like to clarify two points:

- (I) 'Professional scepticism' should only be exercised on significant elements. In other words, it would be useful to introduce a materiality threshold so as not to distract auditors from important matters on which they should focus in their work;

(II) Moreover, this approach should not overshadow the liability of the directors themselves in the preparation of financial statements.

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

It might be useful to change the negative perception of qualifications in audit reports although it must be said that law may be powerless in governing the economic actors' perception of the facts of a matter.

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

It is not within the remit of audit firms to provide information directly to external stakeholders. This falls to regulators.

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?*

The CCBE believes in fact that regular exchanges should take place between external auditors on the one hand, and internal auditors and the audit committee on the other. The frequency of these exchanges should be left to the discretion of external auditors and the company.

10. *Do you think auditors should play a role in ensuring the reliability of the information companies are reporting in the field of CSR?*

CSR is a very relative concept which varies according to each company, each business line and each place. The CCBE considers that audit firms are not in a position to provide an assessment regarding CSR. This information should be disclosed under the responsibility of issuers in their financial statements.

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?*

As mentioned under question 9, it is not for auditors to communicate directly with stakeholders.

In addition, shortening the time between the end of the year and the date of issuance of audit opinions does not seem to be useful: audit firms should be given the necessary time to carry out their mandates, which can sometimes be complex.

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

According to the CCBE, it is not desirable to extend the mandate of external auditors to the future developments of the company which depend on the microeconomic and macroeconomic context. Audit firms do not have the necessary means and skills to make judgments on the matter, which is the sole responsibility of the directors.

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

The CCBE is not in a position to give an opinion on this issue.

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)?***

The CCBE is not in a position to give an opinion on this issue.

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

The CCBE is not in a position to give an opinion on this issue.

III. Governance and independence of audit firms

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?***

In the CCBE's opinion, an auditor's independence is primarily independence of judgment and the mere fact that an audit firm is paid by the audited company is not likely - with some exceptions (e.g. a client paying the audit firm also being an important part of the firm's results) - to impair the independence of judgment of the auditors.

It should be borne in mind that audit firms have a mandate for which their liability is engaged.

Accordingly, the CCBE believes that the liability attached to the mandates of audit firms is sufficient to preserve their independence of decision and there is no need to change their remuneration method. Moreover, if the remuneration of audit firms were provided by a government agency, this would only shift the problem, as the cost would necessarily and ultimately be borne by the audited.

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

The nomination of an audit firm by a third party is not justified, except in exceptional specified circumstances, with this prerogative being reserved solely for the regulator of large companies.

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?***

The CCBE believes that it is a necessity to reconcile, on the one hand, the effectiveness of the audit, arising from perfect knowledge of the company and, on the other, the independence of auditors. Accordingly, the CCBE supports a rotation of the mandates of audit firms at a minimum frequency of every six years but only for large companies being audited (mandatory rotation for mandates in smaller companies seems inappropriate).

19. ***Should the provision of non-audit services by audit firms be prohibited? Should any such prohibition be applied to all firms and their clients or should this be the case for certain types of institutions, such as systemic financial institutions?***

The CCBE finds it difficult to precisely define the services which fall within auditing and those which do not. The boundary between these types of mandates would be difficult to determine. Thus, legal advice, which by nature gives rise to a conflict of interest, should not be carried out concurrently with audit services. It may be assumed that this applies to all services which represent more than 25% of the fees charged by the audit firm. In any event, it is essential that these mandates be revealed to social bodies and the public in a transparent way, as the CCBE already recommended in 2001.

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

Yes. The CCBE also stresses the need for transparency concerning fees charged by an audit firm for mandates unrelated to the audit of accounts or received by a single client.

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

No. The CCBE believes that audit firms should not be subject to special rules of transparency in their financial statements.

However, increasing the transparency of their situation of dependence towards some of their clients might be considered (details of fees of top-ten clients with a distinction between genuine audits and other mandates, indication of the percentage of income generated by these clients with a distinction by geographic area, turnover of files, etc.).

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

Audit firms could effectively appoint several independent directors who would hold the majority in bodies dealing with conflicts of interest and/or the various governance bodies of such firms.

In this context, the CCBE recommends that audit firms should publicise the criteria used to assess the independence of these directors and those used to measure the effects of their actions on the independence of the firm towards its customers.

Independent directors should have a right of access to all information they deem relevant and could inform shareholders of any major disagreement.

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

Yes. The CCBE believes it may be appropriate to explore structures which would allow audit firms (especially smaller firms) to raise external capital and ensure their development. In any event, the independence of audit firms should be guaranteed.

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

Yes. The CCBE is of the opinion that it is essential for audit firms to have the means to carry out worldwide mandates when companies are located in several countries. In this context, cooperation and exchanges between the audit firms of different subsidiaries of a same group should be encouraged. In this context, an 'audit charter' could be set up within the group to allow the audit firm of the headquarters to deal with the local audit firms and, if necessary, to carry out specific mandates on site.

IV. Supervision

25. *Which measures should be envisaged to improve further the integration and cooperation on audit firm supervision at EU level?*

The CCBE considers it essential to ensure the supervision of audit firms at European level, similar to what already exists for credit rating agencies.

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

It is indeed necessary for the auditors to be able to deal with the regulatory authorities as is already the case for credit institutions.

V. Concentration and Market Structure

27. *Could the current configuration of the audit market present a systemic risk?*

The CCBE believes that the concentration of the audit market among a few international players does indeed present a systemic risk.

28. *Do you believe that the mandatory formation of an audit firm consortium with the inclusion of at least one smaller, non-systemic audit firm could act as a catalyst for dynamising the audit market and allowing small and medium-sized firms to participate more substantially in the segment of larger audits?*

According to the CCBE, the creation of 'audit firms' consortia' (as the existing regulation in France) may:

- (i) Enable smaller audit firms to have larger mandates;
- (ii) Reduce the risk of conflict of interest which may exist between a large audit firm and a large company.

However, the CCBE believes that the obligation to set up 'audit firm consortia' should be reserved for large companies with the ability for smaller companies to set up a voluntary mechanism.

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? What should be the maximum?*

As mentioned under question 18, the introduction of a mandatory rotation of audit firms every five years is suggested.

30. *How should the "Big Four bias" be addressed?*

The CCBE considers it appropriate to introduce a European quality label given to audit firms to ensure their competence as well as the existence of rules and procedures to ensure their independence.

In addition, the use of 'audit firm consortia' is also likely to improve the Big Four's opinion by having smaller firms associated to their work.

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

According to the CCBE, such contingency plans do not prove useful, especially regarding audit firms.

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? Under what circumstances a reversal could be envisaged?***

The consolidation of large audit firms resulted from a strategy to provide one-stop service for businesses. The benefits of this strategy no longer seem appropriate since they raise a systemic risk. However, a reversal seems difficult. In this context, the emergence of smaller audit firms should be promoted, including through promoting 'co-audit' mandates.

VI. Creating a European market

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

Recognition of qualifications for auditors within the European Union is the best way to increase cross-border mobility for the audit profession.

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?***

It is difficult to give a view on its usefulness. The CCBE supports the establishment of a 'European passport' the terms and goals of which still remain unclear at this stage. The CCBE therefore suggests increasing the opportunities of mutual recognition for auditors' qualifications in the Member States, which could then adapt these qualifications to their local characteristic, which would facilitate the mobility of audit firms. This passport would directly benefit smaller audit firms, which are the most affected by restrictions on freedom of establishment within the European Union. The Big Four are already actively involved in the Member States, so they show little interest in a 'European passport'. This measure would help the mobility of smaller audit firms.

VII. Simplification: Small and medium enterprises and small and medium firms

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?***

According to the CCBE, it is necessary to adapt the 'statutory audit' to the specificities of SMEs in order that the introduction of a 'limited statutory audit' be appropriate. This was also the approach encouraged by the European Commission with the enactment of the Small Business Act on 25 June 2008.

However, this 'limited statutory audit' would only be at the expense of quality and accuracy of financial statements. Accordingly, the CCBE believes that a 'limited statutory audit' should be reserved to SMEs whose financial statements were originally drafted by an independent accountant (certified public accountant or such).

36. ***Should there be a "safe harbour" regarding any potential future prohibition of nonaudit services when servicing SME clients?***

The ban on providing non-audit services is justified since conflicts of interest may arise regardless of the nature of the business, be it a large or a small business.

Therefore, an exemption for SMEs does not seem desirable. However, it would be necessary to introduce a reasonable transitional period during which non-audit service contracts could still be performed.

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?*

The CCBE is sceptical about introducing less restrictive rules the content of which is unknown. As a general rule, relief of any regulation should be considered with caution.

VIII. International Cooperation

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

The CCBE considers it appropriate to strengthen the co-operation between auditing supervisory authorities.