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Eddy Wymeersch

GREEN PAPER
Audit Policy: Lessons from the Crisis

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Abstract

This paper represents the response of the undersigned to the EU Commission's consultation on auditing services[1]. It draws attention to the need to clearly position the auditor in the agency relation to the shareholders, to make him clearly accountable to them, and this by introducing a shareholder committee in charge of appointing the auditor, determining his remuneration and receiving his report.

It further proposes to organise an oversight system on the audit professionals along the lines recently introduced in the field of financial services, based on a hub and spoke system.

Finally with the respect to the concentration issue that may have systemic aspects, it proposes to better organise the procedures for designating auditors by making the process more open, fair and transparent. Moreover, the top audit firms should organise themselves for possible systemic shocks.

1http://ec.europa.eu/internal_market/auditing/otherdocs/index_en.htm

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Audit Policy: Lessons from the Crisis
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Question 1. The position of the auditor in the company's functioning

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

The Green paper does not clearly analyse the position of the auditor in the company's framework. His role is that of giving credibility to the accounts that are presented by the management and the board, as these would not be considered reliable without the external, expert and independent opinion of the auditor. Shareholders could of course themselves inspect the books and verify the accuracy of the accounts, what they do in some small or private companies. However apart from lack of expertise, there is essentially a collective action problem: the task has to be delegated to one or several experts.

This short analysis is needed to clearly situate the position of the auditor: he acts, as a neutral expert, on behalf and for the account of the shareholders, to provide reasonable assurance of the financials. Therefore he should be selected and appointed by the shareholders, who will also fix his remuneration and to whom he should report back. This theoretical scheme is far from reality: in fact the auditor is appointed by the board, on proposal of the audit committee and usually with a clear nod from the management. The remuneration of auditors was, and in many instances still is *de facto* fixed by the management, whether by making a certain budget available in the overall budget, or by contracting out advisory or organisational task to the audit firm, or an affiliate. Moreover, as the appointment is considered as a safeguard against future liabilities, some type of moral insurance, boards and management usually agree on appointing the "best" auditor, usually one of the leading auditing firms.

Many of the problems with the audit function are related to this state of affairs. In order to remedy it, one should restore the conceptual scheme, and involve the shareholders more actively. This creates a collective action problem, as not all shareholders can usefully be involved in the appointment procedures and closer monitoring of the auditor. Therefore, as has been tested in Sweden and to a certain extent in the Netherlands, a shareholder committee would better be put in charge of these functions. It would not only restore the real accountability line, but also eliminate much of the ambiguity that may exist in the present organisation, where usually the appointment is nominally voted upon by the AGM.

There will be many questions that have further to be resolved: how this committee is to be appointed, who will be sitting on this committee, what will be its powers? It will

be objected that these functions are already exercised by the audit committee, what is true, but does not offer the same guarantees in terms of accountability and independence.

It would be useful that the Commission's standpoint contains a clear analysis of these issues, as they will be determinant for much of the further analysis.

Questions

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

Question 4 e.s. The content of the audit reports

The present audit reports, as they accompany the published annual accounts, have reached a high degree of standardisation: it is an all or nothing approach, with clear cliff effects if a qualification is added. One understands that this might have been required for reasons of fear of liability, especially in the US legal space. However, these reports are essential as they add reasonable assurance and protection with respect to the reliability to the accounts, which is of course the first concern and should not be underestimated. But otherwise their *substantive* added value is very limited and form dominates over substance. The customary reports give the impression that the auditor has proceeded to a mere mathematical verification of the accounting data, and that the accounts are a true reflection of the reality. In practice, this is much more complex and is inadequately reflected in the reports. The reports implicitly make a statement on some unexpressed elements especially on the going concern hypothesis, as the absence of this would radically modify the accounting basis. But not all investors know what that hypothesis exactly covers, e.g. that the assumption runs covers only one year of continuity. Other assumptions remain unexpressed, e.g. on the internal risk controls, where some external checks are usually undertaken, or on forensic matters, where the situation may be even more complex. It seems reasonable to require that the user of the accounts would have a better idea on the assumptions on which the auditors express themselves and what steps they have undertaken to gain this "reasonable assurance". More explicit statements would also make room for the all or nothing approach that is now prevailing is most reports, as it would allow the auditor to express a more nuanced opinion on the underlying assumptions of his statement.

Due to recent changes in legislation, auditors are also called upon to express opinions on other than accounting matters, e.g. statements on corporate governance. There is no

sufficient clarity as to what is the exact function of the auditor in this respect, and may lead to opinions whereby the auditor substitutes himself to the board, or the management, thereby creating a risk of self-audit. This blurring of tasks deserves clarification.

The issue of fraud detection has not been mentioned in the Green paper and should be considered indispensable as standing for the most devastating element in actual practice. It deserves special attention, as major disappointments with the present system are due to the inability to detect fraudulent or disputable practices (see Enron, Parmalat a.o.). Although the difficulties in detecting fraud, especially management fraud, are well known, nevertheless additional efforts should be made to enable the audit firms to investigate more in depth fraudulent or other doubtful practices in the accounting and reporting systems. A more explicit link with the internal functions – internal audit, risk management, compliance - should usefully be considered, and expressly mentioned in the report.

As to the frequency of the reports, unaudited statements already give sufficient insight in the issuer's activities: they are published under the board's and management's responsibility. It seems not necessary to require them all to be fully audited. Whether a limited would really help is debatable.

On forward looking information, except to the extent mentioned above – e.g. on risk factors- forward looking statements are the realm of the management, and the auditors would not be well placed to assume responsibility.

Finally some "professional scepticism," both from the auditors and the independent directors is to be welcomed. But can this regulated?

Questions

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

Answers

There are good arguments for introducing ISAs in the EU through a process of Regulatory Binding Standards, as is now applied in the field of financial services. To what extent these ISAs meet the need of actual practice is another question calling for adequate monitoring of the process whereby ISAs are created.
However, the risk of non-application of the ISAs by the US should be taken into consideration, along with the willingness in other parts of the world to adopt he ISA. This should involve a stronger EU participation in developing or at least monitoring the development of the ISAs.

Questions

(16) Is there a conflict in the auditor being appointed and remunerated by the audited?

Entity? What alternative arrangements would you recommend in this context?
(17) Would the appointment by a third party be justified in certain cases?
(18) Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?
(19) Should the provision of non-audit services by audit firms be prohibited? Should any such prohibition be applied to all firms and their clients or should this be the case for certain types of institutions, such as systemic financial institutions?
(20) Should the maximum level of fees an audit firm can receive from a single client be regulated?
(21) Should new rules be introduced regarding the transparency of the financial statements of audit firms?
(22) What further measures could be envisaged the independence of auditors?
(23) Should alternative structures be explored to allow audit firms to raise capital from external sources?
(24) Do you support the suggestions regarding Group Auditors? Do you have any further ideas on the matter?

Answers

Question 16
It is difficult to argue that being paid by the audited entity, the auditor can always act fully independently. As mentioned above, it would be useful to go back to the basic agency relationship between shareholders and auditors. This would also facilitate the role of the auditor who from time to time opposes the opinion of a management that may not always be driven by the best interest of the company.
As to the levels of remuneration, there is a concern that due to competitive bidding for mandates, fees have come down and therefore non-audit services allow to provide for the necessary complement. On the one hand, competition is further needed, on the other that should not allow driving down the fees to that level: a floor may be needed, to be checked by the overseer of the profession. I call special attention to auditors in the public sector, where fees are sometimes ridiculously low.

Question 17
Appointment by the shareholders, through a shareholder committee, would obviate the need for appointing by a third party. The latter would create probably new issues, such as liability in case of manifest erroneous choice, or even worse, not timely removal of an auditor whose performance was substandard. Appointing the auditor by the financial supervisor has been tried in some states, and was abandoned. It may also create new issues of conflicts of interest, e.g. when bank auditors would be appointed by the banking supervisor, whereby the latter might be hesitant to criticise its own appointee.

The objective of independence is fully shared, but should not be reflected only upon appointment, but is a continuous requirement, and deserves some form of external supervision.

Question 18
Rotation of auditors is different from rotation of firms. On the one hand the period for building up sufficiently in-depth knowledge would plead for continuity at least for a considerable number of years, on the other the risk of the auditor becoming to familiar with the company creates a real risk. The intermediate solution might be to fix a maximum limit, along with a period of overlap between the old and the new firms so that information and knowledge can be transmitted. If all auditors would be submitted

to the same discipline, there would be no losers, as in principle all candidates would be able to find other mandates. It would also enlarge the width of expertise in the firms.

Rotation would be facilitated if the number of candidate firms were sufficiently large: see question 27 e.s.

Question 19
Some firms have already stopped offering non-audit services. This is the discipline that is best suited to guarantee independence and avoid some forms of self-audit. However, one might also consider a less strict rule whereby non-audit services can be offered only to companies where the service provider does not act as an auditor. This would at least allow the firm to keep the necessary expertise within the firm, while avoiding any appearance of being biased.
A prohibition to ban all non-audit services would have an effect on remuneration of the auditor, and should adequately be taken into account.
Adequate disclosure should accompany this process.

Question 20
The question is again one of independence, and therefore should be brought under that general heading.
There is no clear evidence that at least the larger audit firms risk becoming too dependent from one client. If this was the case, the firm's internal governance body should be held to account. Appropriate professional oversight could guarantee a sufficient distribution in income streams, without necessarily introducing a fixed, arbitrary figure.

Question 21
The independence issue will never adequately be dealt with by enacting specific rules, as the number of situations is innumerable and a bright line criterion will never lead to determining independence, but only lack of independence. A general principle, with adequate internal and external monitoring would be preferable. This is a question of internal organisation of the audit firms, where internal ethics and independence procedures should be introduced, with external oversight. A comparison can be made with the credit rating agencies.

Question 23
See further answers 27-32

Question 24
The issue of group audits cuts across concerns of opening up the audit practice to other firms than the "Big Four", as only a handful of these other firms have a worldwide network on which they can rely. Both objectives can be met if better cooperation techniques between audit firms in different jurisdictions are introduced, covered by equivalence agreements at the level of the supervisors.

Questions

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

Answers

Question 25
The supervision of audit firms is at present open to improvement, and deserves strengthening also in view of the international developments.
In order to achieve an orderly structure, it is advisable to develop a hub and spoke structure, comparable to the one applicable for financial services, where national supervisors – that have to be in charge of all aspects of the supervision - would insure the first line of supervision, to be coordinated at the European level by a European body. One could follow the scheme developed for the ESAs, except that the European body should have inspection powers at least on the national supervisors and if needed also on the firms supervised by the latter. Developing cooperation and regulatory convergence would be part of the task of the European body, e.g. by way of adopted the ISAs. For multistate auditing firms, a system of supervisory colleges could usefully be developed, dealing especially with the cross border links in auditors' networks.
For international purposes the European body would be the direct interlocutor for non-EU supervisory bodies, and would channel their questions and coordinate the answers of the national supervisors.

Adequate powers have to be given to this body, including budgetary means.

Question 26
With respect to listed companies – other than financial institutions -, the national traditions of communication between the supervisor and the auditor may be quite different from state to state. Whether it is general practice that the supervisors regularly dialogue with the auditors on individual firms should be further investigated. In some jurisdictions at least, this is only the case when particular events draw the attention, e.g. in case of negative, or even qualified reports.

However, apart from the exchange of views about individual cases, there is a more developed dialogue on general issues, where issues confronting the audit profession are discussed, whether in conferences, hearings, or similar settings. This should be strongly supported and should be within the remit of both supervisors and auditors' professional organisations. National dialogue is to be strengthened by Europe-wide initiatives.

Questions

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

Answers 27-32

There cannot be much doubt that the present concentration in the audit market creates a significant risk, but whether it would be systemic or not is open to discussion. In any case the issue of concentration has to be dealt with, also for reasons of adequate competition, diversity of practices and opinions, and effectiveness of supervisory action. Indeed, a supervisor confronted with unacceptable behaviour by a major audit firm would be very hesitant to take firm action against that firm if the risk exists that its action – e.g. the closure or suspension of that audit firm- would trigger a major crisis, possibly leading to systemic consequences. On the other hand, this might create some type of "moral hazard" on behalf of the audit firms.

Therefore there are good reasons to tackle this issue. Apart form greater diversity – see infra – there should be a discussion about the way of preventing the collapse of a major audit firm. Stricter follow-up by the supervisor would be one step and should be included expressly in its mandate. Developing emergency solutions would be another one. Differently from a collapsing bank, an audit firms does not have to be immediately rescued, but mainly the continuity of the services to the clients have to be assured. Moreover, a default of a major firm – especially if it puts in doubt the reliability of the financial statements - may have significant effects in the markets, leading in some cases to panic. Audit firms may consider schemes whereby they indicate what would happen if the firm has to cease operations: would the mandates be transferred to a new firm, composed of some of the partners of the old firm? What would be the limitations on creating this new firm, authorisations, appointment by general meetings, etc. Should there be a solvency safety net, consisting of sufficient own funds, liquidity provision, or third party guarantees? Could only part of the mandates be transferred to another firm, and than which ones: listed companies only? Should the supervisor have the right to order the firm to stop activity and on a mandatory basis, transfer all the mandates to a third party? Although it is difficult to predict all the instruments that may be necessary, it is advisable that the audit firms develop themselves scheme for emergency cases, and have these overseen by the supervisor. The European supervisory authorities could usefully develop schemes that would mitigate these risks. But the main point remains: these issues have to be discussed and credible solution prepared.

The question of concentration is different from the previous one, although of course related. The issue is real and likely to stay on the agenda, even after having enlarged the present "Big Four" with one or two new parties.

There are many approaches that could be used to support a drive for more diversity and more competition. None of these will present a fully satisfactory solution. Therefore it is important that the regulation opens the way for having each of the identified approaches made possible at the national level. This would mean in practice that those jurisdictions that see more benefit in opening up the financing of the firms could follow that path, and those that prefer the joint audit should also do so. In order to safeguard the level playing field all instruments should be opened up in all jurisdictions, leaving the choice to the parties directly involved.

With respect to the different specific proposals, the mere opening up of the financing of the audit firms entails a definite risk of creating more problems than solutions: indeed the new financiers will necessarily have a certain leverage on the firm's action, thereby creating a risk of new conflicts of interest. Nothing prevents presently firms to

attract more capital, provided this is done in a non-dilutive way. So e.g. could a separate financing structure subscribe bonds issued by the audit firm, whereby the financing structure would have no influence on the management of the firm? In fact this approach does not require a change of the law.

As to the joint audit, the advantages and objections are well known and the opinions are very divided. To make it mandatory everywhere seems excessive. But an optional solution, leaving the choice to the company and its shareholders should be welcomed.

As to a mandatory split up of the largest audit firms, in the absence of clear showing of abuse, this would seem unjustified.

Rather than radical remedies, that may upset the market and do more damage than good, some gradual improvements should be considered.

There is one instrument that has not been mentioned in the Green paper, i.e. to address the procedure for nominating the auditor. Apart from the remarks supra about involving a shareholders committee, the nomination should be the subject of strict internal rules, consisting of a public call for candidates, a selection by independent members of the board, a comparative analysis of the proposals based on objective criteria, a selection on the based of the stated reasons, the latter being submitted to shareholders as far as the selected candidate is concerned. This would allow smaller firms to be candidate for all mandates, it would avoid "path dependency" as the incumbent firms would not be sure to be reappointed, while the process would become more credible also v.a.v. the markets, what would be especially useful if not one of the big four is selected.

Many public sector institutions entrust the review of their account to audit firms. Diversity may be supported by introducing formal procedures for their appointment based exclusively on pre-established and verifiable criteria.

There will not be much doubt that the present concentration will continue to exist for a prolonged period of time, and that solutions will not be achieved very soon. But over time, more diversity seems realisable, and steps can be undertaken to insure that present concentration levels are reduced.

Beyond market forces, concentration is also due to the increased need for worldwide operations, the challenges of keeping track with developments in many jurisdictions, the increased technological requirements leading to the need for greater investments in IT support, broader data gathering on developments, such as price evolutions needed for assessing marking to market. It is important that firms that aspire to occupy a more prominent place should be able and willing to invest the considerable sums needed for building a large network, and consecrate ample means to the formation and training of their staff. This issue also is related to the topic of non-audit services (question 19).

The issue of auditors' liability has not been mentioned in the Green paper. This issue deserves however some attention as it influencing the willingness of young auditors to assume full responsibility for the functioning of an audit firm. The EU states have adopted different positions going from outright limited liability to full liability of the firm and of the individual auditor. Moreover, one can presume that in some jurisdictions additional disclaimers may have been included in the agreement between firms and companies. It is not known whether these differences lead to regulatory arbitrage.

The liability regime should correspond to the two main objectives of any liability regime, i.e. indemnity for the victim, and incentives for avoiding negligent conduct. Indefinite liability acts perhaps as a powerful deterrent, but taking into account the very vast sums that may be involved, does not respond to the indemnity objective, as no individual, even no insurance is able to cover liability running up in the billions. Too low a minimum level of liability should be avoided for the opposite reasons.

A three-pronged system could answer both concerns:
- Up to a certain minimum level, the auditor should clearly be liable himself, without excluding the possibility to have the liability covered by insurance;
- Above the minimum and up to a certain ceiling, to be fixed at a reasonably high level, the firm should be liable, inducing peer oversight. Insurability would be a factor to be taken into account;
- Above that level, audit firms should not be liable. That rule would avoid firms being driven out of business in case of massive damages exceeding insurability limits. A sufficiently high ceiling would limit the effects of the rule to the largest firms, with potentially systemic characteristics.

Questions

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

Answer

A system of mutual recognition, with a passport should be introduced. It is amazing that freedom of establishment has not been fully implemented in this field.

This presupposes that firms in all EU Member states are subject to the same professional standards, and that supervision is of comparable quality. The basic framework should not be very different from the one adopted for financial services, whereby services can be rendered, of even branches opened upon a mere notification. This too will contribute to more competition in this market.

Financial Law Institute

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