

CEBS comments on the European Commission's Green Paper on Audit Policy

Introduction

1. The Committee of European Banking Supervisors (CEBS) welcomes the opportunity to comment on the European Commission's Green Paper on *Audit Policy: Lessons from the Crisis*.
2. CEBS, the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) have worked together in preparing comments. While our joint letter sets out a common 3L3 position on the most important issues addressed by the Commission in the Green Paper, this annex gives more detail on these main topics from CEBS' viewpoint and comments on further aspects that are particularly important from the perspective of banking supervisors.
3. CEBS' comments have been co-ordinated by the Expert Group on Financial Information, and especially by its Subgroup on Auditing, which is chaired by Ms Pat Sucher, from the UK FSA.

General remarks on the approach of the Green Paper (Q1-3)

4. Through their opinions on annual accounts, external auditors are an integral part of the public oversight model and contribute to the financial stability of the market. As banking supervisors, we therefore have an interest in ensuring that auditors fulfil their role in the public interest and that audit work is carried out to a high standard.
5. We welcome the Commission's Green Paper and support the Commission seeking views from stakeholders on a comprehensive range of issues in the wake of the financial crisis.
6. However, we note that, due to the breadth of topics discussed in the paper, some of the measures put forward by the Commission pull in different directions. We believe that the Commission, in pursuing this work, should set out a set of clear objectives for the developments it wishes to see in this area. Once such a set of objectives has been articulated, stakeholders will then be better placed to offer views on how effective particular measures would be at achieving these objectives. The Commission's Financial Services Action Plan could provide a useful model against which progress could be measured in this area.
7. Such a framework will also be essential to develop a robust impact assessment, which CEBS regards as critical in this area.
8. We note that the Statutory Audit Directive has only recently been implemented. In developing a framework for the future development of audit policy, it would also be helpful for the Commission to analyse how Member

States have implemented this Directive, and subsequently to consider whether this exercise identifies areas for improvement.

9. We agree that, in some areas, there is scope for improvement in the quality of audit work performed by external auditors and that progress could be made in bridging the expectation gap between society's expectation of the role of the auditor and the work actually performed.

Role of the auditor (Q4-12)

10. The scope of statutory audit does not currently provide comfort on the financial health of companies, and we consider providing comfort on financial health to be very different to giving an opinion on the truth and fairness of an entity's financial statements. In developing its response, CEBS has considered the Commission's proposals mainly in the light of how they might affect the value added by and the quality of statutory audit work given the current scope of statutory audit. We believe that the existing scope of statutory audit should be the starting point for any initiatives to enhance the role of the auditor and the quality of audits.

11. CEBS has some doubts as to whether auditors would be able to provide a high level of assurance on forward looking information. By its nature, forward looking information is inherently uncertain and the actual outcome will depend upon many factors. There is also limited objectivity with regard to such information, and as such it is very difficult for auditors to gather evidence to support an opinion on the information itself (beyond considering whether the information has, for example, been properly compiled). Defining the scope of such engagements would also be challenging.

12. CEBS considers that the long term health of a company is the responsibility of that company's management and the results of management's assessment are dependent on many estimates and assumptions about future events and circumstances. We do not believe that providing comfort on a company's financial health currently falls within the scope of statutory audit, nor should do; as noted above, we are not convinced that auditors would be able to provide a high level of assurance on forward looking information.

13. Auditors' assessment of management's going concern assumption is, perhaps, the closest equivalent within the statutory audit work to providing assurance on a company's financial health. Under ISA 570, auditors have a responsibility to obtain sufficient appropriate audit evidence in this area and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern. This assumption is one of the factors that leads to an expectations gap in practice. We do not believe this responsibility should be extended, but do see merits in improved communication by auditors to stakeholders on the implications of this assumption in practice, and the type of audit evidence gathered which supports management's assumption.

14. CEBS believes that there could be benefits in auditors better explaining audit methodology to users, but is not convinced that this would reduce the expectations gap. Indeed, CEBS believes that the expectations gap arises mainly from stakeholders' misunderstanding of the respective roles and responsibilities of preparers and auditors in communicating with stakeholders (although an expectations gap may also arise in the case of individual audits

where application and enforcement of auditing standards has not been sufficiently rigorous).

15. CEBS does not believe that the Commission should seek to remove the negative perception associated with qualified audit opinions. The auditor should only give a qualified opinion where there are concerns about the company's financial statements.

16. CEBS agrees that there is room for improvement, in some cases, in the way that auditors apply professional scepticism. However, we believe that the improvements should be sought in this area by first considering how application and enforcement of current standards could be enhanced, rather than seeking to reinforce professional scepticism by new rules.

17. We note that the Commission wishes to explore the case for "going back to basics": to increase the auditor's focus on substantive verification and to reduce audit work carried out reviewing systems and controls. We agree that a high level of assurance should be given on components of the balance sheet, but also on all other aspects of the annual accounts. CEBS believes that it is unrealistic to perform solely a substantive balance sheet audit on a large bank, where (for instance) the payments system might process millions of transactions per day. However, as recent audit inspection reports have noted, auditors could do better in ensuring that they have undertaken sufficient year end testing. Therefore, there is a need to enhance auditor application of current auditing standards. We believe that the clarified ISA 540 (which applies for audits of periods ending on or after 15 December 2010) should lead to improvements in the balance struck between substantive and internal controls testing in the key area of accounting estimates.

18. We would also be cautious about an approach which led auditors to apply less scrutiny to internal controls. We note that some jurisdictions (both within the EU and elsewhere) have introduced requirements to increase explicit assurance provided on internal control systems. Given the breadth of Commission's review of audit policy in the Green Paper, it could be interesting for the Commission to also seek stakeholders' views on the costs and benefits of developing the audit in this area.

19. From CEBS' perspective, it is necessary to distinguish clearly between what should be disclosed in the Annual Report by preparers and what further communication would be better presented by auditors. We believe that preparers do have and should retain the primary responsibility for communication with the company's stakeholders. Although auditors could provide more information in their audit reports on audit methodology, there is a risk that such language could become too generic (or "boiler-plate") over time.

20. However, we see potential in developing the role of audit committees, and, in particular, enhancing reporting by audit committees¹ to shareholders. This could help shareholders to understand the aspects of the financial statements that have caused most concern to the audit committee, as well as

¹ CEBS is currently consulting on its internal governance guidebook (CP 44), which contains guidelines on audit committees. This consultation paper can be accessed at <http://www.cebs.org/Publications/Consultation-Papers/Open-to-responses.aspx>.

their views on other aspects of governance (e.g. more detail on their decisions regarding the provision of non-audit services). Such audit committee reporting may benefit from a stronger legal basis. We also believe that steps to facilitate an effective dialogue between an external auditor and qualified audit committees would be fruitful, and that ISA 260 contains useful guidance on communications between auditors and those charged with governance.

21. CEBS notes that the time that elapses between the accounting period end and the publication of the audit opinion is driven by deadlines within legislation for companies to prepare and publish their financial statements, rather than by the audit itself. Any proposals to amend the timing of the publication of financial statements should be subject to a robust impact assessment.

22. To enhance the value of audit, CEBS sees particular merit in considering the audit of disclosures within financial statements. Though there are current requirements in ISAs which cover the audit of disclosures, we believe this is an area where there is scope to clarify auditors' responsibility for the audit of disclosures. This would emphasise the requirement on auditors, as covered in ISA 700, to stand back and consider whether the financial statements as a whole (as well as each individual note or disclosure) present a true and fair view of the entity, with appropriate focus on the areas that have presented the most challenges during the audit process. Such emphasis could yield particular benefits for users in the area of accounting estimates, which was a particular area of concern in the financial crisis. We note that both the IASB and FASB are considering developing a framework for disclosures and that the IAASB is looking further into the audit of disclosures.

International Standards on Auditing (Q13-15)

23. As noted in its letter of October 2009, CEBS supports the adoption of ISAs at EU level. We believe that acceptance of ISAs at the international level has been sufficiently demonstrated. This opinion is based on the current state of convergence towards ISAs in some jurisdictions in the world, the adoption of ISAs in other jurisdictions, the application of ISAs by the largest networks of audit firms (through the incorporation of the clarified ISAs in their audit methodology and ISQC 1 into their firm's quality control policies) and the wide recognition of ISAs in the world by public authorities (e.g. the recent IOSCO statement² encourages securities regulators to accept audits performed in accordance with the clarified ISAs for cross-border offerings and listings).

24. We believe the EU would maximize the benefit of adopting a globally accepted set of standards without amendment. Moreover, amending the standards would not be consistent with the objective of having a single set of internationally accepted audit standards. In addition, ISAs form a closely integrated set of standards, established after strict due process and consultation. Piecemeal changes to them by the European Commission over time could damage their coherence and consistency.

25. CEBS assumes that ISAs would become legally binding in full via a comitology process and remains ready to play a role in an endorsement

² IOSCO Statement on International Auditing Standards published on 11 June 2009.

process. We believe that add-ons would be acceptable to the extent that they stem from specific national legal requirements relating to the scope of statutory audits, but that carve-outs should be avoided except in rare circumstances, where an ISA is not conducive to the European public good.

Governance and Independence of Audit Firms (Q16-24)

26. CEBS notes the Commission's concern that auditors being appointed and remunerated effectively by the audited entity may conflict with the auditor's independence. Though third party appointment of auditors may improve the *perceived* independence of auditors, CEBS does not believe that such an appointment mechanism would necessarily be effective in improving audit quality (nor address some of the issues highlighted in recent audit inspection reports). We question whether third parties would have sufficient expertise and knowledge of a firm's business model to routinely make better appointments than the firm's own management. Also, were auditors to be routinely appointed by a regulator, such an appointment mechanism would also change the nature of the relationship between the regulator and regulated entities.

27. Even if a third party appointment process were implemented, we do not believe that such a process would lead to an increase in the number of audit firms able to perform the audits of the very largest institutions, particularly in sectors where the audit market is concentrated (such as within the banking sector). For many large organisations, the provision of non-audit services by other audit firms could also create conflicts of interest which reduce the potential (already small) pool.

28. We believe that it would be more effective to ensure that the current system, where audit committees appoint the external auditors, works better. There could be scope for providing guidance to audit committees to support them in the appointments process.

29. In particular, greater transparency from the inspection units of auditor oversight bodies, as well as the audit firms themselves, could help audit committees make more informed decisions based on the quality of audit services provided.

30. Nonetheless, we believe that banking regulators should have some role in the appointment of auditors for credit institutions. CEBS' members rely on audited financial information when supervising banks, and recognise that high quality external audit contributes to a sound banking system and financial stability. Thus banking regulators will be concerned about situations where a bank's auditor does not demonstrate sufficient expertise or independence to conduct the audit to a high standard. At the least, banking regulators should be informed in advance of any new auditor appointment.

31. CEBS notes that audit partner rotation has only recently become mandatory. It may be useful for the Commission to first consider the effect that this has had on audit quality and auditor independence before moving to a system of mandatory audit firm rotation.

32. However, CEBS would support a more thorough debate of the risks and benefits of requiring mandatory rotation of audit firms as well as audit

partners. On one hand, periodic mandatory auditor rotation could lead to greater perceived independence of auditors and increase audit quality as a new firm could use different methods and set other priorities. On the other hand, having a hard limit on the tenure of an audit firm could lead to unintended consequences. For instance, it could be very disruptive to change the audit firm if there is, simultaneously, an unexpected change in the company's circumstances.

33. Careful consideration would also be needed to understand the effect that such a rotation regime could have on audit quality. Audit firms need to invest time and resources in building up expertise in a particular industry; too short a period could reduce incentives to invest in this knowledge and thus adversely affect audit quality. Alternatively, there may be benefits to a new audit firm looking at an audit client with a fresh pair of eyes or using a more innovative methodology.

34. Regarding audit fees, CEBS notes the IFAC Code of Ethics contains provisions both on the remuneration of the audit partner and on maximum levels of fees that an audit firm can receive from a single client. CEBS would expect these provisions to apply across the EU.

Supervision (Q25-26)

35. CEBS would support the EGAOB being given a stronger mandate to foster audit supervisory convergence within the EU and provide technical advice to the Commission.

36. In principle, a strengthened EGAOB could perform a role similar to that of the existing Lamfalussy Level 3 committees or become a European Supervisory Authority (ESA). However, auditor oversight practices currently vary significantly in EU Member States. The Statutory Audit Directive has only been implemented quite recently, so while auditor oversight bodies are beginning to work together, they do not have the same background of a shared rulebook as in other areas of financial services regulation. Creating an authority immediately from this base could be challenging and would take time to be completed effectively.

37. As noted above, CEBS believes that the adoption of ISAs could help foster convergence in auditor oversight practices, as oversight bodies would be assessing compliance against common standards. Also, a review by the Commission of how the Statutory Audit Directive and other relevant legislation has been implemented in different Member States could identify areas where convergence in practices is particularly important.

38. CEBS would not support responsibility for auditor oversight being transferred, either directly or indirectly, to any of the ESAs. A European auditor oversight body would need specialised knowledge of audit practices and methodology that does not naturally fit within the other ESAs, which focus on the supervision of specific parts of the financial services market. CEBS stands ready to collaborate with a strengthened EGAOB on matters of mutual interest.

39. CEBS also notes that the major audit firms operate global networks which extend beyond the EU. Any development in supervision arrangements at a

regional level will also have to be aware of the international nature of the audit market.

40. CEBS supports interaction between auditors and supervisors, and notes that auditors already have an obligation to provide information to banking supervisors as foreseen under EU law. CEBS' letter to the Commission on its Green Paper on Corporate Governance (September 2010) notes that additional guidance would be helpful in this area to further develop the relationship between auditors and supervisors. In particular, CEBS recommends that the Commission consider whether there are currently any legal barriers that would prevent deepening co-operation and whether there is a need to amend Article 53 in Directive 2006/48/EC to introduce a "right" (as well as a "duty") for auditors to report to supervisory authorities (so that, for example, auditors could also submit copies of reports to the management body directly to the supervisory authority if appropriate).

Concentration and Market Structure (Q27-32)

41. CEBS agrees with the Commission that the level of concentration within the current audit market structure could pose risks to financial markets. Were one of the largest audit firms to cease to provide audit services, this could cause severe disruption in EU markets. Furthermore, CEBS is aware that, in some countries, the choice of auditors for banks is limited to even fewer than four firms. However, CEBS does not believe that the risks posed are the same as those witnessed in the banking sector during the financial crisis.

42. The Commission suggests some actions which CEBS believes could have some merit, such as mandatory rotation (see also paragraph 31-33) and greater transparency of audit firms (which, alongside greater transparency from audit inspection units, would help users assess evidence of audit quality alongside a firm's reputation). We also support contingency planning. However, as CEBS' members do not have a remit over competition issues in this area, we do not express any views on an optimal market structure. The potential impact of any proposals affecting the structure of the audit market should be carefully assessed to ensure that neither the quality, the efficiency nor the availability of statutory audit work is reduced (if audit firms are no longer prepared to accept the risks of auditing very large and complex companies).

43. The largest audit firms are part of international networks and there is a risk that an audit firm may fail as a result of events outside the EU (thus also affecting the part of the audit firm within the EU). CEBS believes that an European solution to this issue would not be sufficient and should be accompanied by an international solution.

Creation of a European Market (Q33-34)

44. CEBS believes that a European market for auditors would require harmonised auditing and independence standards across the EU. As discussed above, CEBS supports the adoption of ISAs at EU level and believes that this would be a useful step towards developing a single market. Similarly, implementing a common code of ethics based on the international *Code of*

Ethics for Professional Accountants could support convergence in independence standards.

45. However, the role of statutory audit often encompasses reporting on compliance with aspects of national company law, as well as (for smaller entities) giving an opinion on compliance with local accounting standards. These factors would have to be taken into account when considering measures to facilitate greater cross-border mobility. Differences in legal systems could also make it hard to move to maximum harmonisation in the short term.

46. CEBS also questions whether a larger EU market would benefit small and medium-sized practitioners. At least in the short term, CEBS expects that most of the benefits of a more integrated European audit market would accrue to larger audit firms, which could help to consolidate their position and market share, rather than increasing competition.

Simplification: Small and Medium-Sized Enterprises and Practitioners (Q35-37)

47. With regard to limited audits proposed by the Commission for financial statements of SMEs, CEBS notes that audited financial statements are currently used by banks as part of the credit granting process. As such, there is a risk that any proposal to reduce the level of assurance given on SMEs' financial information could have unintended consequences for the availability of credit for such businesses. CEBS believes that a robust impact assessment would be beneficial, were the Commission to pursue any proposals in this area.

International Co-operation (Q38)

48. As noted above, the Statutory Audit Directive has only recently been implemented in the EU. Before considering strengthening this Directive, CEBS believes that the Commission should review current implementation with a view to identifying any gaps or areas where an enhanced EGAOB could work to foster stronger convergence and harmonisation in practices.

49. CEBS supports the Commission's intention to discuss audit policy with its international partners. The global nature of both the largest organisations and audit firms means that an international solution could be the most appropriate way to address many of the issues raised by the Commission in its paper.