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CEIOPS[1] response to European Commission Green Paper on Audit Policy: Lessons from the Crisis

1. CEIOPS welcomes the opportunity to comment on the Commission's Green Paper "Audit Policy: Lessons from the Crisis". The financial crisis and its spread over to the global financial system have revealed the critical importance of enhancing financial stability in the EU and improving the existing arrangements for European financial regulation and supervision.

2. The Green Paper is an important step in the right direction, providing a sound analysis of the challenges facing audit. Therefore we would like to express our support for the EC's project to analyse and discuss the role and scope of audit. CEIOPS looks forward to contributing further to this important area of work.

3. In CEIOPS' view stakeholders' confidence in audited financial statements is an important element of the proper functioning of the financial markets.

4. The proposed initiatives will have an impact not only on cross sectoral and sectoral regulation, but also on the domestic legal arrangements of each Member State and CEIOPS thereby acknowledges the complexity of the issues discussed.

5. Furthermore, insurance supervisors use the audited financial statements – and in several jurisdictions also the audited supervisory reports – as an essential source of information in the supervision of undertakings.

6. Besides, CEIOPS considers that the specificities of the insurance business need to be taken into account: within the Solvency II Directive, a

[1] The Czech National Bank, that is member of CEIOPS, does not agree with the CEIOPS contribution.

specific framework for valuation of the prudential balance sheet is being developed, and this will be used not only by supervisors, but also by other users since it provides a risk-based view of the financial and solvency position of the undertaking. Therefore, CEIOPS believes that there is a role for an external audit in Solvency II public disclosure and supervisory reporting. The rationale for this view is further developed below in the "Scope of audit" section.

7. CEIOPS agrees that there is a need to better set out the societal role of the audit with regard to the veracity of financial statements. We fully recognize the existence of a gap between the society's expectation of the role of the auditor and the tasks actually performed. CEIOPS believe that better communication by auditors can help to bridge this gap: communication of the current task and responsibilities when performing an audit should be improved. Furthermore, CEIOPS welcomes a debate how the tasks and products of auditors can be better matched to the expectations of society.

8. In general we think that improvement in communication and transparency by the audit firm towards stakeholders would enhance audit quality. CEIOPS sees two perspectives: entity-specific communication (between the auditor and the undertaking and between the auditor and other stakeholders) and communication on an industry level or even on a cross-industry level. Via this kind of "macro-communication" the auditors can have a valuable role in identifying developments and risks and communicate these on an aggregated level. In this way, they may contribute to a timely debate on national and international developments e.g. in the financial sector and the way auditors, supervisors and industry can deal with these risks.

9. The introduction of the "clarified ISAs" will also contribute to audit quality.

10. Large institutional investors could take the lead and have a more extensive role in challenging the financial statements at stakeholder meetings. Also, it should remain clear that the Board of the undertaking bears the ultimate responsibility to ensure that its financial statements provide a true and fair view of its financial position and performance.

11. Next to that, auditors could work more on continuous assurance, by which we mean that auditors could focus more on the reporting process of the company during the course of the year, instead of only at year-end reporting, in order to form an opinion on the quality of the reporting process in an earlier stage. This way, corrective measures can also be taken in an earlier stage if necessary.

12. More specifically, we would like to mention the following items.

Role of the auditor/ Scope of audit

13. We agree with the principle of "substance over form", but this principle needs to be embedded in all European and local accounting regulations if it is to be implemented (i.e. it is in IFRS, but not in European directive on insurance accounts, nor necessarily in local GAAP).

14. Following ISA 200, the purpose of an audit is to enhance the degree of confidence of intended users of financial statements. To do so, the objective of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. Furthermore, the objective of an auditor is to express an opinion on whether the financial statements are prepared in accordance with an applicable financial reporting framework. One of the most fundamental assumptions of general purpose financial statements is that financial statements are prepared on a going concern basis. It is the auditor's responsibility to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements and to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern (ISA 570).

15. Hence, auditors provide assurance that financial statements are free from material misstatements and that the management's use of a going concern assumption is appropriate. We do not think the role of the auditor in this process should be extended. Audit firms should not become some sort of credit rating agencies predicting or assessing the future solvency of companies. It is the responsibility of the management to analyse the going concern assumption and to communicate the conclusions via the financial statements. However, we support improving the communication of the auditor towards stakeholders on this issue. Even if auditors agree with the institution's management assumptions and conclusions about the financial health of a company, the auditor should communicate its assessment of the management's analysis. Further discussion on improving the explanatory notes to the going concern assessment would be welcomed.

16. We note that increased focus on the director's report and discussion of risks and other non-GAAP measures has led to questions about whether there needs to be a corresponding change in assurance provided by auditors. In our view, much of the extra information frequently requested by investors (and cited by the Commission) on e.g. potential risks and sector evolution would be best provided by management. CEIOPS welcomes a debate on the appropriateness for an additional assurance requirement for this type of information. However, there is a risk that

adding further material to the auditor's report would only generate "boiler-plate" language rather than significant specific tailored information on the performance of a particular entity. We also question whether auditors would be able to provide reasonable assurance on forward looking information.

17. Nevertheless, CEIOPS believes that Solvency II figures (such as the Solvency II Balance Sheet) should be submitted to an external audit, as this information provided in addition to financial statements will be extensively used, not only by supervisors but also by users as it will give a risk-based view of the financial and solvency position of the undertaking. In particular, CEIOPS fully agrees with the statement from the Commission in its Green Paper on the Corporate governance of financial institutions that "it could be envisaged for the external auditor to validate a greater range of information which is relevant to shareholders than it does at present in order to improve investor confidence in this type of information" (p. 14).

18. The situation of insurance supervisory requirements from Solvency II is specific and should not be compared to the situation in the banking sector with regards to the CRD, insofar as Solvency II defines a specific valuation framework, which differs from financial statements. This is why additional assurance is necessary on Solvency II figures, as this assurance will not be provided through audit of financial statements of insurers. Also, we consider that such external audit will not "blur" the respective responsibilities of auditors and supervisors, as audit assurance enables supervisors to focus on their effective tasks, i.e. risk assessment and supervision of the solvency & financial position of undertakings.

19. An important area where we can see improvements is the explanation to stakeholders on the work actually carried out as part of the audit, and how they have dealt with issues of judgement. A very prescriptive explanation of the audit work programme would not decrease the information gap. The information should be tailored to the specific entity.

20. One way this could be implemented is via more requirements for the audit committee about their role, how they interact with the different stakeholders and about disclosure of their work and their interactions with the external auditor. Furthermore, this could be undertaken is by developing the auditor's report to the audit committee. There could also be public disclosure of some aspects of the report by the auditors to the audit committee. For example, we do see some potential merits in the disclosure of the type of audit approach (risk-based approach or data driven), disclosure of the materiality thresholds and sample selection procedures applied by the auditor. Further discussion is needed to determine what information would be of interest to stakeholders.

21. Professional scepticism and the audit of disclosures are the most important areas where we believe that audit quality could be improved. We particularly believe that auditors should look at disclosures as a whole, and consider whether they give a fair representation of the issues that have proved the most difficult during the audit work. Professional scepticism should have considerable attention during the auditor's education. Professional scepticism may be enhanced by more extensive communication among auditors themselves and with different stakeholders. More debate leads to a broader spectrum of views. There should be no unnecessary legal restrictions for the exchange of views on auditing and accounting issues with other stakeholders, such as the prudential supervisor. Especially, for institutions that are under supervision of prudential supervisors, there should be no legal restriction for audit firms to share client-specific information with the prudential supervisor.

22. CEIOPS would encourage experts to start a debate whether different categories of qualifications in audit reports could be feasible. Qualified opinions are a warning to investors and in this way, the negative perception is logical and appropriate. Qualified opinions are rare, as in most circumstances institutions will adjust their financial statements on request of the auditor in order to prevent a (negative) market reaction. This mechanism puts considerable pressure on the auditor to give a non-qualified opinion, even when the qualification is just marginally defensible. As a minimum, improved communication (and explanation) about the audit report, even when it is a non-qualifying opinion, would be useful.

23. CEIOPS does not fully understand the following statement (p.7) that "the Commission wishes to explore the case for "going back to basics" with a strong focus on substantive verification of the balance sheet and less reliance on compliance and systems work i.e. tasks that should primarily remain the responsibility of the client and in the main be covered by internal audit". Even if we agree that substantive verification is essential, focus on internal controls is an important part of the external audit work, especially in financial institutions.

International Standards on Auditing (ISAs)

24. CEIOPS welcomes the introduction of ISA's in the EU and feels this is a good step forward in the harmonisation of auditing practices in the Community. CEIOPS supports the idea that ISA's should be legally binding for all financial institutions – also the smaller ones - throughout the EU. A similar approach to the existing procedure for the endorsement of IFRS can be chosen.

25. Further improvement on the consistent application of auditing standards within the Community and the implementation of the Clarified

ISA’s (e.g. ISA 260 and 265 regarding the requirements for the auditor to report possible serious matters) could be helpful.

Governance and Independence of Audit Firms

- **Auditors independence- appointment and remuneration**

26. CEIOPS believes that audit committees should be in the best position to judge which auditor is most appropriate for their firm, and that it would be most helpful to look at how audit committees could be better able/equipped/prepared to perform this role effectively. We also believe that audit quality could be better enhanced by improvements in the role that auditors actually carry out, rather than by changes to the appointments process.

27. On remuneration, CEIOPS acknowledge the risk that independency may be influenced negatively by commercial reasons. However, considering costs, bureaucracy and issues on practical implementation (on a global level?), we don’t yet see the possibilities for a good alternative. We see more merits in other solutions to improve independence: for example, by requiring a more extensive dialogue with other stakeholders, stricter enforcement by supervisors and requiring partners to involve other partners or their “technical departments” in cases where pressure from the undertakings is expected.

- **Mandatory Rotation**

28. Mandatory rotation and third party appointments are proposed by the Commission as possible measures to improve auditor independence. CEIOPS support the current mandatory rotation of partners within an audit firm. However, we are not convinced that the rotation of only the audit partner could assure the independence of auditors. There is a threat that even after an individual ceases to be the key chartered auditor, such a person can still influence the audit work provided by the same audit company.

29. CEIOPS agrees that mandatory rotation of firms or third party appointments could enhance independence, and should make it less likely that audit partners will feel constrained from challenging the management of the undertaking for fear of losing the audit.

30. Moreover, cyclical rotation of audit firm may enhance the audit quality, because the new audit firm has different experience and knowledge compared to the previous firm and can suggest improved

solutions which may not have been considered under the previous audit approach. From the audit company side, changing clients means gathering more knowledge and experience from wider perspective, which it would never get by auditing only a limited number of the same companies.

31. However, CEIOPS is also aware that the rotation of audit firms could create potential downsides. In order to deliver high audit quality, an audit firm needs incentives to invest in developing their knowledge of the business, especially in large and complex undertakings. The maximum permitted audit engagement period must be chosen carefully, because when an audit engagement period is set too short, the audit firm may not have the chance to recover these costs. An audit firm may then choose to focus more on the efficiency of the audit to keep costs low, especially in the last year.

32. CEIOPS would welcome a more thorough debate on the costs and benefits. An element of this consideration should be the situation of international groups – where the head office – may be outside the EU - often decides about the appointment of the auditor.

33. Within the EU a number of countries have already set audit firm rotation requirements as a legal obligation. It would be useful to evaluate their experiences.

- **Non audit services**

34. A "side effect" of providing non-audit services by audit firms, is the investment in keeping up to date with the latest developments and developing their knowledge. This also enhances the audit activities. We are not in favour of prohibiting non-audit services in general. However, we would favour a solution where the combination of audit and non-audit services for a single client (group) is clarified, in order to prevent conflicts of interest and too much dependency of the auditor on the client. This should not impede the ability of supervisors to ask auditors to provide additional work on specific items.

35. Specifically, in clarifying, the scope of non-audit services, most non-audit services such as consulting services should clearly be prohibited along audit services for a given client; however, some non-audit services may go hand-in-hand with auditing services. Such services and decisions made about using such services should clearly be disclosed by the audit committee in order to enhance transparency. Besides, it should be made clear that an audit firm cannot also provide its audit client with an external opinion on valuation of certain balance sheet items (as this would lead to a threat to independence from self-review).

36. CEIOPS believes that these principles should be applicable to all financial institutions, whatever their size, meaning that the proposal for SMEs to give "consideration to providing for a safe harbour which, subject to appropriate safeguards being in place, would allow the auditor of an SME to continue providing certain non audit services to that company – e.g. assistance in their access to credit, in tax returns, payrolls, or even accounting" (p. 20) should clearly not be applicable to financial institutions.

- **Ownership rules**

37. We disagree with the view to revisit the partnership model. Introducing external owners raises huge challenges in terms of independence, while the benefits in terms of additional capital are limited. In terms of incentives, the threat of a direct financial impact for partners in case of a lack of audit quality is useful, and this would disappear if there was a distinction between owners and partners.

Supervision of auditors and external auditor/supervisory dialogue

- **European oversight body**

38. CEIOPS supports strengthening the role of the EGAOB so that it could provide technical advice to the Commission and strengthen convergence of practices in the supervision of audit firms across the EU. Creation of an European Supervisory Authority for auditor oversight would be a possibility, and such harmonized oversight could lead to the development of a European passport.

39. We do not believe that auditor oversight should be part of, or report to, any of the existing ESAs as situating auditor oversight in a separate authority would be a better way of bringing together all the relevant expertise in a way that would make it a robust authority. Also, such a solution potentially ignores the fact that oversight on audit firms needs to cover the activities of auditors performed in all industries, not just in (a specific part of) the financial sector.

40. However, we would note that improved co-operation at the regional/EU level would only address one part of the global networks operated by the major audit firms, so we believe global auditor oversight structures should also be strengthened.

- **External auditor/ supervisor dialogue**

41. CEIOPS favours a stronger dialogue between prudential supervisors and external auditors. With respect to the duty to report to the audit committee and to supervisors, CEIOPS pleads for better enforcement of existing regulations.

42. Next to that, it is very useful to have so called "tripartite meetings" between the auditor, the supervisor and the financial institution. In this meetings the undertaking, auditors and supervisors can have a dialogue on the undertaking's risk profile - all from their own perspectives and based on their separate (legal) responsibilities. This will assist the supervisors to identify significant issues and contribute to the supervisory review process. For auditors this may contribute to their planning and focus of the auditor's work. CEIOPS would encourage a debate on the benefits of extending the EU requirements by giving the tripartite meetings a legal grounding for this possibility in every member state. CEIOPS believes there should not be a general duty of alert for supervisors toward auditors, but it should be made sure that the external auditor has access to the information transmitted by prudential supervisors to undertakings, in order to have a view of the supervisory dialogue with the undertaking.

43. In this field the consistent application of auditing standards within the Community and the implementation of the Clarified ISA's (e.g. ISA 260 and 265 regarding the requirements for the auditor to report possible serious matters) could be helpful. We note that IFAC is considering enhancing the current provisions in the International Code of Ethics in the area of reporting to securities regulators.

- **Concentration and market structure**

44. CEIOPS agrees that the over reliance on a small number of audit firms brings additional risk to the market. We would not see this risk as systemic (in the form identified by banks during the credit crisis) but would see the risk more in the form of potentially adding significant disruption in the capital markets, should one of the large audit firms exit the auditing market. We believe that further debate on this issue can be useful and work could be done on contingency planning, both at sector level and also by individual audit firms and companies (where they might lose their auditor), to try to mitigate this risk.

45. CEIOPS sees merits in an approach where barriers making it challenging for smaller audit firms to develop to become closer to the size of one of the bigger accountancy firms are diminished. We believe that increasing the number of large audit firms within the audit services market could reduce the negative effects of the possible collapse of one of the big auditing firms. In general, this could be promoted by enhancing transparency of the quality of audit firms, e.g. by disclosures by the audit oversight authority. A more specific possibility to achieve this goal could be the proposed European quality certificates for audit firms, which would formally recognise their aptitude to perform audits of large listed companies. This would increase confidence in audit companies from outside the "big four", who obtained such certificate and would allow them to compete with the "big four" companies on the large listed companies market. However, the requirements to obtain such certificates should be designed very carefully. More demanding constraints, together with procedures to get such a certificate may also heighten the entry barriers for smaller firms.

46. Joint audits should not be considered as a means of dealing with audit market concentration. In particular, CEIOPS disagrees with the proposed mandatory formation of an audit firm consortium with the inclusion of at least one smaller audit firm for the audits of large companies: in fact, this will only lead to the audit work being performed by the big audit firm, which can rely on its network and workforce to look at the firm as a whole, especially for cross-border activities; in such circumstances, this would reduce the benefit of having a joint audit. Furthermore, the possible collapse of the big company from the consortium could automatically result in following collapse of its smaller partner(s).