



8 December 2010

GREEN PAPER ON AUDIT POLICY

General remarks

BUSINESSEUROPE welcomes the Commission launching a public debate on Audit Policy in general, and on whether there are any lessons to be learnt from the crisis.

Having said this, a general discussion, as well as the adoption of the International Standards on Auditing could have been carried out at the same time. Considerable time and effort has been invested, both by the EU and the IAASB, in clarifying and revising the standards on auditing in order to meet the expectations that were earlier expressed by the EU.

The green paper raises a lot of relevant issues and questions. What is lacking though is a thorough deliberation of the issues leading to the questions, including more in-depth documentation. For instance, a lot of questions concern the issue of the “expectations gap”, which has been debated for a number of years, without discussing the topic as such.

Moreover, the role of the regulators seems to be underestimated as the regulators have a significant impact on the performance of an audit. In this context, BUSINESSEUROPE would like to point out that a very formalistic approach from regulators could both deteriorate the audit and the financial statements themselves considering that such an approach shifts the focus from a true and fair view to immaterial details. Consequently, if the regulators do not strike the right balance they may endanger the whole reporting process. BUSINESSEUROPE would therefore suggest that further studies are carried out on the impact on regulators.

In 2006, the Directive on Statutory Audit was adopted and it entered into force at the end of June 2008. A number of the questions of the green paper touch on initiatives already addressed in this directive. For instance, the directive introduced more formal audit inspections and audit regulators as well as a rotation requirement. BUSINESSEUROPE would prefer an evaluation of this directive to take place before embarking on new legislative initiatives. We are of the opinion that once we have seen the 8th directive in force for a period of time, a lot of concerns will either be resolved or there will be good reasons which provide a proper basis for further decisions. It is thus important that an evaluation of the 8th Directive takes place in the near future.



The concerns raised by the green paper regarding the independence of the auditors are in our view also addressed in the 8th Directive. The result has been a strengthening of the role of the Audit Committee, the Board and the shareholders. It is important that current initiatives have already resulted in a strengthening of the appointment procedures. The nomination and appointment of auditors are in fact based on a thorough and real evaluation by the company. Therefore, regarding the election of auditors, we would like to strongly emphasize, that the shareholders currently elect the auditor and that we do not see any reason to change this.

The background of the green paper

The green paper states in the introduction on page 3: *"The fact that numerous banks revealed huge losses from 2007 to 2009 on the positions they had held both on and off balance sheet raises not only the question of how auditors could give clean audit reports to their clients for those periods but also about the suitability and adequacy of the current legislative framework."*

BUSINESSEUROPE would like to emphasise the importance of a thorough and comprehensive discussion and analysis of the causes of the alleged problems. It is important to understand the background of the green paper in order to be able to give a qualified and specific response to the main question. A key issue is whether some of the findings are only related to the financial sector or whether they are of a more general nature. Other key questions are whether the problem is linked to an audit issue only, whether the problem is of a regulatory nature, or whether the problem is linked to the financial reporting standards (in this case the IFRSs) being the standard to be audited.

The green paper touches to some extent on this question on page 6, where it is stated that "The banking crisis has shown that audit opinions should focus on "substance over form"etc."

It is not clear whether the problem relates to the audit opinion or whether the problem in reality relates to the application of the underlying accounting framework. We note that the Commission observes that "It is important to note that the International Financial Reporting Standards (IFRS) are based on the premise of the principles of true and fair view and substance over form."

From our point of view, there is growing concern about and criticism of the functioning of auditors. Criticism that mainly comes from listed companies and the financial sector in some countries and related to the application of IFRS. The criticism is fuelled by the perception that the IFRSs - the standard to be audited - has developed into a 'rules based' system, because of – among others – the convergence with US-GAAP and because of the risk of abuse. However, the criticism is also fuelled by a perceived degeneration of audits into a review on IFRS compliance (ticking off the check lists) instead of providing a professional judgement of a true and fair view of the financial reporting based on economic reality. This perceived degeneration is also caused by some regulators focussing on checklists and the fact that some regulators view the entire list of disclosures to be material (form over substance). In fact, it seems that some auditors have the perception that once an IFRS is established this reflects best



economic reality for the period it remains in force. The fact that this perception is not the right one is illustrated by the failure of fair value rules during the financial crisis. Therefore, the observation on “substance over form” should not be focussed on audit opinions, but rather on the development of IFRSs and the regulatory focus on the implementation of IFRSs. In this context, we would like to express our concerns on the governance of the IASB which should be improved.

Remarks relating to the specific questions

Part 1 – Introduction

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

We refer to our general comments.

BUSINESSEUROPE welcomes any debate relating to the reduction of the cost of capital and the enhancement of the internal market. Having said this, BUSINESSEUROPE also finds that regulation of auditors and mandatory use of auditors should focus on the core service provided, namely the audit of the financial statements, and not broaden the scope of audits to other areas.

On the green paper itself, BUSINESSEUROPE would have expected that the analysis would have taken account of the initiatives already taken in the audit area. The Directive on Statutory Audit (2006/43/EC) was adopted in 2006 and entered into force at the end of June 2008. Therefore, this directive has not been in force during the time leading up to the financial crisis. Consequently, an assessment on whether the initiatives already taken by means of this directive would have had an impact on the issues raised in the green paper would have been appropriate. This should have been included in the introduction. Also, other initiatives and legal acts, such as the Service Directive, should have been considered more thoroughly when discussing the creation of a European Market.

Further, BUSINESSEUROPE believes that the reference to international trends is rather vague. If the aim of the Commission is to assume leadership at the international level, then BUSINESSEUROPE would have expected a more thorough analysis of international developments compared to the European development in order for the green paper to better facilitate the debate that the Commission would like to start on a number of issues. For instance, IFAC (the International Federation of Accountants) has launched several initiatives regarding auditor communication, ethics (independence), etc., that could have been mentioned and discussed in the green paper.

Finally, the green paper only briefly touches on and discusses key topics such as “expectations gap” and “audit quality”. The expectations gap is one of the fundamental discussions regarding the role and work of the auditor and the expectations of the work performed by the auditor. BUSINESSEUROPE would have welcomed both a definition and a more thorough discussion of the expectations gap followed by the related questions. The same goes for “audit quality”.

**Question 2 Do you believe that there is a need to better set out the societal role of the audit with regard to the veracity of financial statements?**

The responsibility of the auditor in relationship to the general public is different in the member states, often reflecting differences in legal systems.

In some jurisdictions, such as Denmark, the auditor has a predetermined role as being a “representative of the public”. This includes among other things an increased obligation in the audit report to include certain breaches of company law, for instance the bookkeeping act and shareholder loans, even if the breaches are immaterial. Further, certain public authorities require the company to forward a copy of the special Danish long form audit report¹.

In France, auditors’ role is mainly determined by the legal system and therefore cannot be fixed contractually. According to the legal system, auditors have to comply with various obligations, which may be difficult to understand for non specialists readers of financial statement regarding their effective mission.

In other member states, the auditors’ primary obligation is to the shareholders.

The discussions about the societal role of audit should first of all lead to search for a better understanding of the auditors’ work. It may appear necessary to explain the work performed and give more details on the opinion as proposed in Q5.

Thus, BUSINESSEUROPE considers that discussions about a societal role of the audit with regard to the veracity of financial statements should first of all be based on the present obligations in the member states. Secondly, on the public expectations taking into account the expectations gap filtering unreasonable expectations away, and thirdly, on the cost issue. BUSINESSEUROPE would thus advise the Commission to perform a more thorough study before embarking on any initiatives that changes the societal role of the audit.

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

The Green Paper does not define “audit quality”. It is in fact very difficult to define “audit quality”. It is therefore difficult to answer the question raised. BUSINESSEUROPE would however like to note that more audit procedures do not necessarily increase audit quality, rather, from our perspective, audit quality is a question about doing the right job, once “audit quality” is defined.

¹ The Danish long form audit report is based on a the Danish Auditors Act and the content is specified in a Danish standard on auditing and requires the auditor to formally issue a report on the audit performed as well as a description on significant audit procedures. In the report the auditor must also include matters of interest for those charged with governance, including material or significant audit- and accounting issues and the auditors opinion on those topics. The long form audit report is sent directly to those charged with governance. The auditor has to ensure that each and every member of the board (or those charged with governance) by signature acknowledge the receipt of the long form audit report.



In our opinion, initiatives have already been taken that are specifically aimed at increasing the “audit quality”. For instance, at European level, in the 8th Directive. Thus, the initiatives taken in respect of audit supervisory (including the initiatives outlined in the green paper section 4 in regard to supervision) are supposedly aimed at increasing the audit quality. These were reactions to earlier incidents that took place prior to the financial crisis. There was thus already a strong focus on audit quality when entering the financial crisis, and efforts were being made to restore confidence in audits.

Therefore, BUSINESSEUROPE would suggest to first try to define “audit quality”, and then report on efforts already implemented in Europe. This would give a better platform for stakeholders to discuss potential new initiatives.

Furthermore, we are aware of initiatives taken by IFAC in respect of audit quality. BUSINESSEUROPE would suggest that the Commission takes an active role in this project. This would also support the Commission in taking global leadership in this context.

On a general level, BUSINESSEUROPE is concerned by the fact that many auditors have increased their focus on checklists in order to meet the demand of audit inspection units. This essentially distorts “audit quality”, because a key feature of any audit is the ability to conduct an audit with a “professional scepticism” and to use “professional judgement” in performing an audit. BUSINESSEUROPE therefore welcomes initiatives made by audit regulators to refocus their inspections. The joint paper issued by FSA and FRC (referred to in the green paper on page 7) is seen as such an initiative.

Part 2 - Role of the Auditor

Part 2.1 - Communication by auditors to stakeholders

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

No. Audits should not be considered to provide comfort on the financial health of companies. Audits give assurance on the financial statements. Based on the financial statements, the user will and should form their own opinion on the financial health of the company. They may be guided by rating agencies or other professionals in this assessment.

Regarding the focus of the audit, BUSINESSEUROPE would support a change in focus (stronger focus on substantive verification of the balance sheet) in relation to the audit of small entities, as a system-based approach does not make sense due to the limited number of employees in small entities. For medium-sized and larger entities that have systems in place, the risk based approach is more efficient and should be maintained. However, even with a risk based approach it might be useful to maintain the focus of the audit on the financial data, and not broaden the scope to auxiliary areas and reports.



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

BUSINESSEUROPE would like to stress that before answering this question, one has to first identify the users and then clarify the expectations from the users and identify the reasonable expectations.

Regardless of whom the users are, BUSINESSEUROPE clearly finds that the audit methodology should be better explained to the public and the users. However, this explanation should not be included in the audit opinion. Instead the Commission and the auditors should focus on explaining the concept of an audit, for instance by providing explanations on the Commission website, or have more in depth explanations elsewhere on the internet. Local audit bodies should be more active in explaining what an audit actually implies, and what the user can expect, on national websites. Similarly, IFAC could play a significant role in this matter. There could be a reference to the appropriate website in, or in connection with, the audit opinion.

Comments regarding the audit opinion

The language in the audit opinion should also be revisited, as the present phrasing is very defensive and difficult to understand. The opinion should clearly state the responsibility of the auditor and the work performed.

The paragraph relating to the responsibility of the management should be deleted from the audit opinion, as this information is already given by the management in the financial statements.

Regarding the work performed, BUSINESSEUROPE is aware of the fact that in 2003 a justification of opinion was introduced and implemented in France, as a mandatory development and was aimed to providing more interesting information in the audit report. As we understand, the result is rather disappointing, and it seems that during the general meeting, nobody shows any specific interest on that part of the report.

BUSINESSEUROPE could support further studies in this area, but would like to highlight that it is important that the general outline of the audit opinion is identical (same headings etc.) and that the descriptions focus on the auditors work and deliberations.

Concerning qualified audit opinions, BUSINESSEUROPE is generally of the opinion that the explanations given are satisfactory. However, it might be beneficial to look into whether further explanations are necessary in the audit opinion, especially related to the work performed, if there is a general concern relating to qualified audit opinions.

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

As stated earlier under Q3 regarding the use of "checklists", the "professional scepticism" is critical for an auditor. BUSINESSEUROPE finds that regulators in the audit inspection should focus on the "professional scepticism" to a much higher extent and decrease the focus on whether all checklists have been completed.



Further, BUSINESSEUROPE would like to stress that professional scepticism combined with professional judgement are key to any audit. BUSINESSEUROPE would like to point out that ISA 200 on the Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing describes in great detail what is implied by having and maintaining a critical mind and the points to which the auditor must pay attention.

Until such time as the European Union decides to refer to ISA standards in connection with the duties performed by the auditor, the issue of a critical mind seems sufficiently well described in ISA 200.

Reinforcing “professional scepticism” is by nature difficult due to the fact, that it is a “state of mind”. However, professional scepticism should be reflected in the audit file and an audit inspector with knowledge of audit procedures should be able to judge whether “professional scepticism” has been applied, and if not, whether that has had an impact on the audit opinion. To reinforce “professional scepticism” audit regulators should be able to refer the auditor to a disciplinary tribunal.

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

BUSINESSEUROPE is in general satisfied with the present regime. We acknowledge that difficult discussions may arise when it is not crystal clear whether the auditor should issue a qualified opinion or not. However, BUSINESSEUROPE would assume that there are procedures in place to ensure that the auditor maintains the independence. These procedures consist of both the audit regulators and audit inspection units as well as the risk of either law suits or disciplinary sanctions if the auditor fails to qualify an opinion that should have been qualified.

If the regime is changed, the value of the audit opinion might decrease due to the fact, that the opinion expressed by the auditor would send mixed signals. For instance, if the auditor “nearly qualify” an audit opinion due to going concern, does the auditor then believe that the business is going concern or not?

Finally, BUSINESSEUROPE would like to note, that the “emphasis of matter”-paragraph is also a tool that the auditor can use when for instance the auditor is concerned about “going concern”, but agrees with management on their assessment, and these assessments are clearly described in the financial statements.

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

BUSINESSEUROPE would like to reiterate the overall remarks regarding the expectations gap. As stated in Q5, BUSINESSEUROPE finds the audit opinion to be very difficult to understand. In fact, we understand that most people do not read the audit opinion, but only focus on “qualifications” or “emphasis of matter”-paragraphs. However, BUSINESSEUROPE is not in favour of longer audit opinions describing for instance business risks etc. If business risks or risks related to intellectual property are material, then management will provide this information in the financial statements. If



the auditor finds that information should have been included, then the auditor has to consider whether to qualify the opinion or include an “emphasis of matter” paragraph.

The only relevant information the auditor should provide relates to how the auditor has planned and conducted the audit.

Question 9 Is there adequate and regular dialogue between the external auditors, internal auditors and the Audit Committee? If not, how can this communication be improved?

The internal communication has been improved over the last years. With the introduction of Audit Committees into European legislation, this communication has been further improved for large and listed companies. Finally, the auditing standards have had an increased focus on communication with management and those charged with governance. It is our understanding that according to the ISAs auditors must report material or significant issues on a timely basis to management and those charged with governance. Thus, the general level of communication is already high and adequate.

The formal reporting known in Germany and Denmark could be an enhancement, especially for SME’s, as this requires the auditor to explain the work performed in a little more detail. However, BUSINESSEUROPE would assume that the ISAs already ensure that significant information is reported. Thus, in order to change the internal communication we would suggest that the Commission first of all identifies the flaws under the present system.

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

No. BUSINESSEUROPE is not in favour of broadening the scope of audits. Narrative reporting such as CSR should be the sole responsibility of the company. In the offset, CSR reporting is a voluntary reporting adapted to the specific entity on the areas that are important to the business. The objective must be to encourage companies to take on board social and environmental responsibility, not to open up a new market for auditors.

It is critically important to maintain a proactive approach in this matter and to leave it up to companies to decide whether they want to opt for certification of the information provided. If the company voluntarily want to include external assurance on the complete report or part of the report (for instance due to market pressure or signalling effect), then the company should be free to choose both which parts of the report they would like to be covered by the assurance service, and which service provider that should give this assurance. It should not be a mandatory requirement, as this could distort competition in the assurance market (by excluding non-auditors from this assurance service) and reduce the competitiveness of business (by imposing mandatory assurance requirements without a corresponding benefit for the business).

Further, it should be noted that even though auditors might have a certain methodology in the area of assurance, they often don’t have the skills necessary to understand the



details of reports such as CSR-reports. Therefore, companies might often use specific experts if they choose to get some sort of assurance on a CSR-reporting.

Question 11 Should there be more regular communication by the auditor to stakeholders? Also, should the time gap between the year end and the date of the audit opinion be reduced?

At present the communication by the auditor to the stakeholders correspond with the publication of the financial statements. BUSINESSEUROPE cannot see any reason to increase the external communication as this would imply that the auditor would have to issue an audit opinion without referring to any specific communication from the company. BUSINESSEUROPE finds it difficult to envisage how this could be achieved and what information the auditor can communicate to the stakeholders without publishing company specific information and thus being responsible for those facts.

BUSINESSEUROPE finds that the audit opinion should be published at the same time the financial statements are published. If the information is not perceived to be timely it is rather the financial statements themselves that are not timely. If so, this issue should be solved in the accounting directives.

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

Auditors should not give assurance on forward looking information, as they cannot control for instance management decisions, new strategic initiatives, mergers etc. Thus it is nearly impossible to gather sufficient audit evidence to issue any form assurance on forward looking information. The problems around gathering sufficient audit evidence were one of the key reasons for lifting the audit requirement of the management report in Denmark.

Assessing the forward looking information provided by management is one of the core businesses (if not the core business) of credit rating agencies and analysts. When they apply their methodology to give external estimates on the value or prospect of a business, this is based on the information at hand both from the company and from the other sources.

By asking the auditor to provide forward looking information there will be an extra layer of uncertainty added and it could endanger the independence of the auditor (the auditor would have the incentive to meet the estimates expressed earlier by choosing appropriate accounting treatment). Further, the management generate a track record in their ability to be accurate with their forward looking information. Finally, it should be noted, that the auditor cannot knowingly be associated with misleading information due to the ethical standards. Thus, even without any requirements in place, the auditor would still have to reflect on the forward looking information provided in the management report.



Part 2.2 - International Standards on Auditing (ISAs)

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

BUSINESSEUROPE would like to refer to our comments on the 2009 consultation. The answers to this consultation is attached.

BUSINESSEUROPE supports the introduction of ISAs in Europe for medium, large and listed entities as early as possible. For other entities BUSINESSEUROPE finds that further work needs to be done in order to make these auditing standards appropriate for companies with few employees, as outlined in our answer to question 4.

Question 14 Should ISAs be made legally binding throughout the EU? If so, should a similar endorsement approach be chosen to the one existing for the endorsement of International Financial reporting Standards (IFRS)? Alternatively, and given the current widespread use of ISAs in the EU, should the use of ISAs be further encouraged through non-binding legal instruments (Recommendation, Code of Conduct)?

Yes, the ISAs should be legally binding for auditors throughout Europe, when auditing medium, large or listed entities. BUSINESSEUROPE would welcome an endorsement procedure similar to the procedure in place in the area of accounting.

However, the application material should only be issued as recommendations or other non-binding legal instruments.

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

Please refer to question 4 and 13 above.

Part 3 – Governance and independence of audit firms

Question 16 Is there a conflict in the auditor being appointed and remunerated by the audited entity? What alternative arrangements would you recommend in this context?

The primary (and original) focus for the auditors is to provide assurance to the shareholders and other stakeholders. The shareholders elect the auditors on the general assembly, and the auditors have their responsibilities towards the shareholders, the Audit Committee and the non-executive directors. At present, management cannot elect the auditors. Therefore, the problem should in principle be non-existing.

BUSINESSEUROPE finds that the steps taken to ensure that other consultative services do not endanger the independence of the auditors should solve the bulk of the concerns raised. Thus in our opinion the existing internal governance measures of companies and measures of partner rotation and current practices of tenders are perfectly adapted to avoid any conflicts.



As an extra precaution it is possible for minority shareholders to bring in a second auditor, if they for instance feel that the current auditor is not truly independent or they are not comfortable with the auditor for other reasons.

In addition to this, in general BUSINESSEUROPE finds that the audit organisations themselves and the regulators as part of their regulatory tasks should ensure that independence requirements are met.

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

No, the appointment of the auditor is the responsibility of the company. Appointment by the company is the better way to obtain the adequate quality of audit: the company is the sole to be able to determine which auditor has the necessary knowledge of the industry and the adequate international network. The company must remain responsible for that choice.

It should be noted, that during audit inspections, the regulator may conclude, that an auditor (or an audit company) should not be able to perform any audits. If the legal procedures are met, then this would require the company to elect a new auditor (but the regulator should not be able to appoint the auditor)

Question 18 Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?

BUSINESSEUROPE does not share the concerns raised in the green paper. BUSINESSEUROPE finds that the rules set out by the directive strike the right balance and that it is too early to change the directive, as it has only been effective for 2 years. In fact 2010 is the first year, when we will see auditors rotating due to the new directive. Therefore, a number of member states have seen an increase in audits exposed to tendering.

We have noted that the Commission raises concerns as to the tendering process as they stress a requirement of “full transparency as regards the criteria according to which the auditor will be appointed.” Further, the green paper indicates that quality and independence should be drivers in selecting the new auditors. BUSINESSEUROPE would like to stress that if independence is an issue then we would assume the audit inspection units to have a number of cases already. Similarly, even though it goes without saying that preparers expect audit companies to deliver high quality, BUSINESSEUROPE would expect the audit regulators to first of present a number of cases where the audit quality where not in order, secondly to relate that to the tendering process and thirdly explain why the audit inspection units do not have the appropriate tools at hand under the 8th directive to ensure that audits are in fact performed at a satisfactory level of quality. BUSINESSEUROPE would like to underline that a significantly lower audit fee after a tendering process does not imply that independence will be violated or that the audit quality will not be at an appropriate level. There may be very valid explanations to low bids ranging from temporary excess of staff in an audit company, where it is better to sell their services at cost than to lay them off if the audit company expect growth in the near future to cases where the level



of documentation and internal controls at the preparer in fact reduces the workload of the auditor.

A mandatory rotation of audit firms would in our opinion not open the audit market for new entrants as companies already today expose the audit contract to the public. Therefore, mandatory rotation would only increase the costs, as there would be one audit firm less to make the bid.

Finally, BUSINESSEUROPE supports the view, that there is a loss of knowledge with a mandatory rotation.

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

BUSINESSEUROPE acknowledges that the implementation of art 22 has not been uniform across Europe. BUSINESSEUROPE is aware of the fact that in some member states the legislation prohibits non-audit services to be provided to audit clients, except for a list of specific services permitted because they are closely linked to the audit. In other member states the approach is more principle based.

BUSINESSEUROPE cannot support a EU-wide ban prohibiting auditors from delivering non audit services. Certain services are more or less an integrated part of the audit service.

However, BUSINESSEUROPE would welcome a thorough investigation of the implementation of article 22 across Europe, thus being able to revisit the topic on a more informed basis. BUSINESSEUROPE would like to stress that when evaluating whether non audit services can be provided, one should take into consideration the size of the audit client. For small entities, the auditor may often both compile and audit the financial statements, where this should not be allowed for listed entities.

In any case, it is crucial that audit firms – with respect to the implementation of article 22 - go on providing non-audit services. It is essential for the audit quality in general as it is the most efficient way for auditors to maintain all the necessary. Analyses of international activities of the companies are ever more complex and it is of the utmost importance to maintain the diversity of skills in the audit firms to adapt to this growing technical nature. “Pure audit firms” as it is proposed by the Commission would lead to a poorer quality of audits.

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

To BUSINESSEUROPE's knowledge, limitations on the total fees (audit and non audit) arising from one client is already in place. For instance in Denmark, the audit and non-audit fees arising from one client may not exceed 20 percent of the turnover.



In France, there is a general principle stating that the audit and non-audit fees arising from one client should not compromise the independence considering the proportion it represents of the total revenues.

BUSINESSEUROPE would find it useful to have a common threshold throughout Europe. However, by setting a threshold on for instance the fees arising from one client, it may create another entry barrier to the audit market. Therefore, the threshold should not be set too low. BUSINESSEUROPE could support a threshold around 15 percent of the turnover.

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

BUSINESSEUROPE could support efforts taken to increase the transparency of audit firms, especially global networks. These efforts should build on the steps already taken with the 8th Directive where the publication of transparency reports is mandated. BUSINESSEUROPE has observed that a number of the networks is changing their legal structure, and as a result they have to publish audited financial statements. However, the special legal structure around certain networks should be considered. Therefore the answer might be a customized transparency report for those structures, rather than imposing financial statements on structures not required to issue consolidated accounts.

It would be natural to require these reports to be audited. Already today, audit firms issue audited financial statements, where an external auditor issues an audit opinion. Due to the fact, that an auditor cannot share information about their clients, BUSINESSEUROPE does not share the concerns raised.

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

BUSINESSEUROPE finds it difficult to comment on the governance of audit firms based on the short paragraph in the green paper. In order to be able to have an informed debate on this topic, the issues should be more clearly fleshed out, and our brief suggestions could be part of this discussion.

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

BUSINESSEUROPE welcomes any initiative, that gives audit firms increased access to capital. However, models other than the current model would probably involve risk:

- (i) in relation to the independence of auditors (if third parties acquired a capital stake in a firm, there is a risk of non independence depending on the relations between said third party and the audited companies);
- (ii) but also alteration of actual audit services. Some new players might consider the latter to be less profitable than the advisory services; this may unbalance the audit market (audit service & advice services). The development of spin-off activities within the big audit firms (focusing on information systems and their deployment) is evidence thereof.



Moreover, we consider that alternative models could involve a risk of weakening the liability of auditors being in relation to what prevails in the matter in the current model. We also point out other risks – inherent in the adoption of these models – of conflicts in terms of the allocation of resources between audit “practicians” and capital “holders” are to be taken into account.

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

BUSINESSEUROPE finds it difficult to comment on an undocumented “shared concern” as BUSINESSEUROPE does not have in depth knowledge of the nature of the concerns. If such concerns are raised and are valid the concerns ought to be properly fleshed out in order to receive a meaningful response. Therefore, BUSINESSEUROPE would like the Commission to document their concerns in order to have a proper debate on this key question.

Having said this, BUSINESSEUROPE would have liked to refer to the revised ISA 600 on Group Audits which is about to enter into force. In this standard the responsibility as well as the access to documentation has been addressed. In the study prepared by the Commission on the costs of introducing the ISAs this standard actually ended up contributing to a significant increase in administrative burdens. Therefore, BUSINESSEUROPE would like to ask the Commission to carefully consider this question and to take into account the changes already made in both the Directive and the revised ISA 600, and to reflect on whether these changes have had sufficient time to function in order to evaluate the effects.

Finally, BUSINESSEUROPE is intrigued to know whether the problems relate to information within the EU or whether it relates to jurisdictions outside the EU. BUSINESSEUROPE is aware of companies (and auditors) experiencing problems in jurisdictions outside the EU. Therefore, if the problems relate to jurisdictions outside the EU, the Commission should reflect on how this could be reinforced outside Europe, especially whether this is an issue to be taken to an international body.

Part 4 – Supervision

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

BUSINESSEUROPE agrees that audit inspections of the management of multinational audit network should take place. However, whether this is the responsibility of a pan-European inspection unit or the jurisdiction where this management resides should be debated. Further, BUSINESSEUROPE supports a more formalized integration of the European audit inspection units in order to achieve more identical practices etc.

In principle, BUSINESSEUROPE does not see a need to further European institutions so therefore BUSINESSEUROPE would favor a model where a centralized audit inspection unit is integrated into an existing framework. On the other side there is an independence concern relating to integrated inspection units conducting audit



inspections, overseeing financial reporting and issuing interpretation or mandatory regulation. Therefore, BUSINESSEUROPE would like to have a more in-depth knowledge on the differences between the indicated models, before issuing support to any model.

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

First of all it should be documented that there are problems in this area. The supervisory bodies have just recently found their footing and the work performed by CESR and the local regulators are showing signs of progress. Therefore, BUSINESSEUROPE are rather hesitant to increase mandatory communication or consultation with regulators. Apparently, the stringent reporting and consultation requirements in the financial sector did not resolve the issue. Therefore, would rather like the regulators to have a more open and transparent debate with both auditors and preparers. This debate or communication should be informal and should be decided on a member state level.

At present, BUSINESSEUROPE does therefore not support increased formal consultation between auditors and regulators. Focus should be on transparent communication between regulators, auditors and preparers on a member state level.

Part 5 – Concentration and market structure

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

Even though the data might suggest a “systemic risk” BUSINESSEUROPE finds that the current configuration does not present a systemic risk that cannot be handled. Recently, we have seen contingency plans being in place ensuring that if an office in a country “collapses” then this can be contained within the jurisdiction. Further, BUSINESSEUROPE is not aware of companies that were not audited because of the collapse of Arthur Anderson.

The emergence of new entrants on the audit market is certainly desirable but should not be used as a pretext to take bad measures. However, in the event one of the Big 4 collapses; this would lead the individual auditors (or local audit offices) to join other networks. In this case BUSINESSEUROPE would foresee that one or more of the present second-tier networks would merge with a number of the offices thus gaining true global strength. It could be appropriate to implement contingency plans supporting the emergence of one or two new actors in the event of a “Big 4”-collapse, as 3 global actors is not enough to ensure both the proper conduct of certification as well as meeting the demand for non-audit services.

BUSINESSEUROPE would also like to reiterate the concerns expressed with ISA 600. In this standard it is more or less required that subsidiaries are audited by the group auditor’s network. BUSINESSEUROPE finds this to be a hindrance for mid tier companies. Further, BUSINESSEUROPE cannot understand why an auditing standard is not first of all based on trust in an audit opinion issued by a subsidiary auditor but



requires a group auditor to perform extra work in forming his or hers own opinion. If this mistrust exists in an auditing standard, then how can the user trust the group auditors audit opinion?

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

BUSINESSEUROPE does not support joint audits, audit firm consortiums or similar mandatory initiatives. BUSINESSEUROPE would have supposed that the use of joint audits were more widespread if this were to be considered as fruitful. On the contrary, BUSINESSEUROPE is aware of the fact that Denmark in 2001 (with effect for the financial year beginning on 1 January 2005) abolished the joint audit requirement. The main arguments for abolishing it were that it was outdated and a burden to Danish companies. For your information the Danish requirement for two auditors was introduced in 1930 at a time were auditing in Denmark was primarily a one-person business. In fact it was a second partner review of that time. At present auditors are members of larger firms and networks. Often two auditors sign the audit opinion and there are strict quality control systems in place. Therefore the Danish requirement was perceived as outdated. Today, only a minority of the Danish listed entities has retained two auditors.

It is correct that the French joint audit requirement has been helping to maintain at least two important audit firms in addition to the big 4. It should also be noted that the French companies see pros and cons for joint audits. The pros are that if the audit networks are of equal size it brings more independence and enhance audit quality, as a double look is provided on each important topic. The cons are the heaviness of the process, which cannot be denied, and the incidence on the limited choice of audit firms in a very concentrated market. As a conclusion, they consider that the benefits brought are more important than these difficulties and for that reason, they still support joint audit in France.

It should be noted that the Danish joint audit requirement did not specify how the work was shared between the two auditors. The majority of the audits had a relative share of 20 % : 80 %. We understand that under the French rule the audit firms have to divide their work following the requirements of the professional standards. We also understand that the auditor by law is appointed for a period of six years.

One of the experiences from France is that the joint audit has to be balanced to be profitable. The proposal of the commission of one big and one small audit firm does not correspond to the same idea. In that case the big one may have such a leadership in the audit that the possible benefits in terms of independence and double judgment may not be obtained.

To conclude, BUSINESSEUROPE does not support initiatives to introduce mandatory joint audits. Such a requirement will in our opinion not imply that the second tier



companies will grow significantly but rather the level of competition will be further reduced, because there will be fewer independent audit networks available (some of the big 4 would already provide other services and can therefore not bid on an audit).

Question 29 From the viewpoint of enhancing the structure of audit markets, do you agree to mandatory rotation and tendering after a fixed period? What should be the length of such a period?

As already noted in our answer to question 18, BUSINESSEUROPE cannot support a mandatory rotation of audit firms as this would lead to a decreased competition in the audit market. It is our understanding that such a requirement exists in Italy today. It is also our understanding that as a consequence the other audit networks are able to calculate when an audit network is going to rotate of. If it is only the partner that is going to rotate of then the competition will be stronger.

BUSINESSEUROPE would suggest that the Commission closely follows the effect of the 8th directive before introducing new requirements.

Regarding the issue about quality and independence as selection criteria in the tendering process, BUSINESSEUROPE would assume that it goes without saying that the independent auditor should be independent. They cannot bid if they are not independent. Further, BUSINESSEUROPE assumes that audit quality is always at a high level, as they would otherwise fail in the audit inspections. Instead BUSINESSEUROPE would like to stress that selection criteria includes a mix of parameters that are individually decided from company to company. These criteria include expertise in the particular industry or sector; communication; network presence in the countries where the MNE has subsidiaries; the qualifications and size of the specific audit team compared to the business and the audit fee. It should be noted that, audits are a cost that business need to maintain on a competitive level and that costs should decrease in a crisis where the supply of auditors exceeds the demand (basic economic theory would suggest that fees will decrease in a competitive environment when supply exceeds demand). Auditors can reduce their fees by either reducing the billing per hour or by increasing the efficiency through for instance deployment of new technology or audit methods.

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

BUSINESSEUROPE finds it disturbing if there is a use of Big 4 only clauses as these do in fact reduce the competition in the market and forms a barrier to entry. The use of such clauses indicates that not only the European Commission but also the users need to address this issue. It also suggests that the audit opinion in itself is without importance (as long as it is unqualified) and that the only driver in perceived audit quality is the network behind the opinion. This strengthens some of our remarks to the earlier questions as it makes it more important to define audit quality.

A creation of a European quality certification would in our perspective only be a "quick fix" as it would create a new entry barrier to the audit of large listed companies. We would rather suggest that the Commission focused on why such a Big Four perception



exists and then tries to solve that issue. In BUSINESSEUROPE's opinion one of the explanations is the use of the International Financial Reporting Standards (IFRS's) as only the Big Four audit firms today may be able to maintain a sufficient knowledge of these standards, and even in these networks the local offices struggle to maintain sufficient knowledge. This is not consistent with the Commission's search for new entrants. This could also trigger Big Four clauses if the market does not have knowledge of the second tier audit network's ability to ensure a consistent interpretation and application of the IFRSs. BUSINESSEUROPE would therefore urge the Commission to investigate where the roots to the (mis)perceptions are and how the problem can be dissolved without creating any "red tape".

The difference between the *big 4* and the other large firms is their widespread international presence and their particular reactivity on any topic, in almost any country. In principle, a company must freely decide who they appoint as their auditors. If a third party imposes an audit by a "big 4" it might be considered whether this should be disclosed.

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

BUSINESSEUROPE would like to support the use of contingency plans (we deliberately use the plural, as it should be a set of coordinated contingency plans). However, BUSINESSEUROPE does not share the observation regarding the importance of the formation of consortia. The demise of Arthur Anderson did not leave a larger number of businesses in the dark. Rather, a solution was found and new audit teams formed. It is true that these audit teams did have a shorter timeline than normal, but they did however manage the task.

On the contingency plans BUSINESSEUROPE especially supports the efforts made to retain or isolate a national office of a network in order to resolve the issues at an appropriate low level. According to our information these contingency plans has in fact already been tested and have passed this stress test.

Question 32 Is the broader rationale for consolidation of large audit firms over the past two decades (i.e. global offer, synergies) still valid? In which circumstances, could a reversal be envisaged?

One of the key drivers for creating the large global networks and thus creating a consolidation is the consolidation at the preparer side. The size of the largest, multinational entities requires large, global networks. If the network is not large enough, then independence will be endangered as the audit fee rises to and above for instance a 20 percent pointer.

Having said this it might be fruitful to look into the actual innovation in the audit firms. Such a study should include the impact from the audit inspection units and the impact from the ISAs. During the last 2 decades the approach of audits has changed which is reflected in the new audit methodology in the ISAs.



BUSINESSEUROPE would not like and cannot support a forced reversal of the consolidation that has taken place in the last years. BUSINESSEUROPE is confident that other measures taken or proposed will reduce the perceived problems to an acceptable low level.

Part 6 – Creation of a European Market

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

BUSINESSEUROPE notes the new regulation on credit rating agencies. However, article 3 and 14 were included in the 8th directive after a thorough consideration from both the Commission and the Member States. Therefore BUSINESSEUROPE would suggest that the Commission evaluates the application of the 8th Directive, in this case with the focus on art 3 and 14. Once this evaluation has been conducted BUSINESSEUROPE would suggest revisiting the question.

BUSINESSEUROPE would however like to note that it finds it difficult to remove the aptitude test (art 14) as this is focusing on national legislation. When issuing an audit opinion it is important to ensure that the auditor is familiar with national legislation. This was also one of the reasons for audit services to be excluded from the services directive.

Question 34 Do you agree with "maximum harmonisation" combined with a single European passport for auditors and audit firms? Do you believe this should also apply for smaller firms?

BUSINESSEUROPE finds it very difficult to talk about a "maximum harmonization" when we haven't even adopted the ISA's nor evaluated the application of the 8th directive. Further, even though there might be grounds for a "maximum harmonization" in some areas, BUSINESSEUROPE cannot see that a "maximum harmonization" could overcome the concerns around the aptitude test, and therefore we would find that an aptitude test would be needed anyhow.

Therefore, BUSINESSEUROPE finds it difficult at present to give an informed opinion on a "maximum harmonization" as we cannot foresee where there might be problems. Therefore, once an evaluation has been conducted, BUSINESSEUROPE would like to revisit this question.

Part 7 – Simplification: small and medium sized enterprises and practitioners

7.1. Small and Medium Sized Enterprises (SMEs)

Question 35 Would you favour a lower level of service than an audit, a so called "limited audit" or "statutory review" for the financial statements of SMEs instead of a statutory audit? Should such a service be conditional depending on whether a suitably qualified (internal or external) accountant prepared the accounts?



BUSINESSEUROPE supports the actual situation in the 4th Directive, where companies below the threshold in article 11 (small entities) according to article 51 can be relieved from the mandatory audit.

In the future BUSINESSEUROPE find that these small entities should be able to voluntarily opt for an alternative service as well as an audit, if they find it adds value to their business. Such a service could be named a SME audit, an SME assurance or similar. The important issue is that the procedures end up with an understandable, and positive phrased opinion. BUSINESSEUROPE would like to note that a system-based approach often does not make sense in small entities due to the limited number of employees, and therefore a change in focus (stronger focus on substantive verification of the balance sheet) could be the appropriate starting point for this service.

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

BUSINESSEUROPE does not support the suggested prohibition in question 19. Therefore any safe harbor rules would be obsolete, as BUSINESSEUROPE would not introduce the before-mentioned prohibition. Having said this, BUSINESSEUROPE would like to refer to our answer in question 19.

7.2. - Small and Medium Sized Practitioners (SMPs)

Question 37 Should a "limited audit" or "statutory review" be accompanied by less burdensome internal quality control rules and oversight by supervisors? Could you suggest examples of how this could be done in practice?

The internal control rules would be relieved automatically as the bulk of the costs relates to documenting the work in accordance with the requirements in the ISAs. On the quality control systems BUSINESSEUROPE would like to see a more streamlined process, but the basic principles in the quality control requirement should be maintained and it should be covered by audit inspections.

We would like to reiterate that the audit inspectors themselves has a huge responsibility in streamlining the audit process, as audit inspections only (or primarily) focusing on checklists deteriorate audits and may actually be harmful to the audit quality.

Part 8. – International co-operation

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

BUSINESSEUROPE supports initiatives that lead to international cooperation between audit regulators as this is the only efficient way to conduct audit inspections of large networks.

In the process BUSINESSEUROPE has however raised concerns about the flow of business sensitive data from one audit inspection unit to another unit.



BUSINESSEUROPE would like to underline, that even though international cooperation is the overarching goal, this must under no circumstance endanger the confidentiality of business sensitive information resting at the audit firm.

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