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Confédération Européenne des Associations d'Administrateurs
European Confederation of Directors' Associations

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ecoDa- The European Confederation of Directors' Associations

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ecoDa reaction to the

'GREEN PAPER on Audit Policy: Lessons from the Crisis'

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Questions

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

ecoDa, as the European Confederation of Director Associations, welcomes the leadership taken by the EU-commission to launch the debate on such an important topic as audit. The lessons from the financial crisis are very relevant to reflect on necessary adaptations of governance, including the audit approach for financial institutions. Moreover such adaptations can also be relevant for non-financial institutions, certainly the listed ones.

However, ecoDa would like to stress that the financial crisis was caused by a complex set,of factors, some of them being related to governance and governance actors. This does however not imply that governance actors, such as directors or auditor,. were the root cause of the financial crisis (see also ecoDa's reaction to the previous Green Paper on financial institutions and executive remuneration). Translating higher requirements and standards should therefore be proportionate to the problems and challenges at hand. Careful consideration of the costs and benefits of every new regulation is necessary, certainly when such requirements would also be applied to the audit of unlisted companies. ecoDa would not support changes that increase the regulatory burden beyond the current situation.

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?

Although the value of audit is indeed high in our modern economy, ecoDa wishes to stress that the auditors' role should not be overestimated; they are part of a monitoring puzzle composed of many pieces (with besides external audit also internal audit, risk management, internal control, the audit committee and the board). The monitoring of companies involves a combination of many parties which should effectively and efficiently interact and interplay. Managers and boards are

preliminary responsible for corporate monitoring. However, boards of directors can't perform their monitoring role properly without being able to rely on the expert analysis and independent opinion of the external auditor. But also investors and the capital market heavily rely on the assurance given by external auditors. The audit opinion is the trade mark of the quality of the financial statements and an indication of the trust a company merits. It is therefore of societal interest that the audit is legally obliged for quite a number of firms and that the profession is regulated and supervised.

However such trust is only feasible in as far as internal and external parties can fully rely on the auditor's opinion. It would therefore be in the interest of all parties involved that there should be a better view on what such 'clean audit reports' or 'unqualified opinions' really cover and to what extent the assurance given is limited by the audit methodology and the audit scope. This would help to bridge the expectation gap that is certainly present in many boards and society at large.

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

We may not confuse the problems observed in the financial sector with the overall quality of the audit. Overall, audit firms have played an important role in the external control of financial statements and its underlying elements. In light of the increased responsibilities of boards as to risk management and internal control the demands for extra support services have drastically increased. Moreover the growth in non-financial indicators for purposes of corporate social responsibility reporting and performance-related executive remuneration has augmented the demand for still more external audit work. Also the compliance with governance codes has raised the question to what extent external auditors could play a role in assuring the accuracy of such reporting.

Notwithstanding the expertise of external auditors it is more than reasonable to investigate further to what extent external auditors can secure the necessary quality in this vastly expanding domain of audit support.

The focus of external audit on the oversight of the financial reporting deserves special attention. Many investors attach much more importance to forward looking information than to historical overviews of past performance. This is not to state that the audit of financial reporting is not important. On the contrary, it gives to all stakeholders an insight in the fair and true view of such reports. But it is not sufficient for active investors, who are more interested in the forward looking perspectives, the growth perspectives and the eventual risks these may imply. Auditors should be more sceptical about the information with which they are provided by management, and provide less of a "black and white" opinion. They may wish to present financial information in a way that exposes the assumptions that have been made, e.g. in respect of asset valuations But there is also a need to go beyond the analysis of the past to assess the future and to go beyond the financial statements. Companies have to help investors to build their expectations by presenting their views on the future on what are relevant key value drivers and the strength and weaknesses of the company's business model. Companies should publish all these elements under the review of auditors. It is undoubting that external auditors have an important role to play as they have access to internal information which distinguishes them from other parties. However and although auditors play an important role in the financial system, we should not seek to excessively expand their role too far beyond that of substantive verification of financial data.

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

Such comfort is up till today the first and foremost important role to be played by audit firms. If audit firms are not fit for such purpose, priority should be given to increase the assurance quality and the reliability of their advice and opinion.

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?

The external auditor should clearly define what 'reasonable' assurance really means or implies in each specific firm. Moreover an approach where substance reigns over formalities would be more than welcome (no boilerplate language that is copied and pasted from one firm to another or from one year to another).

It would also be good that each audit committee would revisit on a regular basis the audit methodology and assure the board that this methodology is proportionate to the needs and challenges the firm is facing. The board and the audit committee's role would be enhanced if the auditor would clearly point to the relevant changes in methodology, valuation principles and clearly state all fields where the opinions of auditors and management differ.

New directors could get an induction course by the external audit firm before joining the audit committee.

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

As is the case with independent directors, it is important that persons responsible for monitoring and controlling the business demonstrate a sufficient level of scepticism and constructive dissent. This is critical to fulfilling such function effectively. But this is more a personal attitude issue which is, according to ecoDa, hard to regulate. Independence is a first requisite and on top of that professional education and evaluation of the performance of external auditors (by the audit committee) are probably better suited to achieve the goal of professional scepticism.

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

In general terms, the external information in the auditor's report is very limited: it is either good (unqualified) or bad (qualifications) and there is no way in-between. The bad option is seldom used because of the negative perception associated with it. The solution might be to add much more nuances to the opinion and step down from the black-or-white approach.

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

The burden on companies to comply with an ever increasing set of public transparency requirements has considerably grown over the last couple of years. The financial reporting for

listed companies is already very detailed and has recently been complemented with a substantive disclosure on corporate governance.

From the companies' statements it is already possible to gain an insight in the corporate social responsibility of the company. Additional information should therefore either be integrated in the financial report or in the corporate governance report. This does not mean that many companies can and do not invest in a separate reporting on corporate social responsibility. The GRI (Global Reporting Initiative) guidelines form a very useful framework for such stakeholder reporting. These developments prove that without regulation, serious efforts are made to report towards stakeholders.

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?

From board practice as well as board research it becomes clear that boards have invested considerable time in developing a regular dialogue with external as well as internal auditors. Whereas in former times it was only once a year that the audit committee met with the auditors, it is more and more common practice that the auditors are present at nearly all audit committee meetings. Normally there is at least once a year a session between the audit committee and the auditors with management not being present. Moreover auditors are also available for questions and reflections from the main board, at least on a yearly basis (annual accounts).

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

In line with our reaction to question 8, ecoDa wants to stress the need to leave such audit of stakeholder and CSR reporting to the decision of each company and its board.

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?

First of all the annual report contains the report of the external auditor or at least his opinion on the financial statements. Moreover in most countries, external auditors are present at the annual shareholders' meeting where they are available to answer questions from the shareholders. In some countries external auditors are also available to the workers' council when they should have questions on the annual accounts. It does not seem necessary to foresee additional communication formats.

As to the timing of the audit opinion, pressure on companies, audit committees and boards has grown over the years to speed up the accounting and auditing process. Especially investors have been pushing for shortening the time gap between the end of the quarter/half-year/year-end closing and the publication of the results, eventually audit. It does not seem reasonable to go much further on this time squeeze, certainly not if one wants to have a reliable and in-depth audit.

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

Auditors should put the information they have more to value. The focus should not only be on the accounting and audit methodology, the valuation principles etc. Special feedback on issues where interpretation margins exist, or where opinions could diverge, is of special relevance to board oversight (such as the need for impairment testing, the scope of provisions for fiscal claims, court disputes, etc.).

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

See answer to previous questions.

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

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

It would be advisable to investigate further to what extent the accounting methodology and structure is not disproportionate (too detailed, too costly) for smaller and medium sized companies. But it is also important to signal to companies what quality and insight external audit brings and to promote that auditors are chosen more on the base of their intrinsic quality and relevance for the company than focusing on price alone.

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?

ecoDa understands that the nomination and payment of auditors by the company, they have to control, can create the perception that their independence is hampered. Such practice may create conflicts of interests and can be the root cause of numerous problems observed with failing corporations (à la Enron). Opting for a centralized system, where independent supervisors organize the audit work, is probably a bridge too far. It may lead to much more bureaucracy and a higher cost. However, ecoDa is of the opinion that more efforts are needed to improve the independent position of the auditor, such as:

- The nomination cannot be done by management but must be done by the board, on the advice of its independent audit committee.*
- In its advice, the audit committee should especially pay attention to the independence and the professional scepticism of the external auditor. There are already substantive prescriptions to judge the independence (with limitations on non-audit functions and fees). More attention to the critical attitude and professional scepticism could be welcomed to complement their annual evaluation.*

- *Moreover it is or should be the general assembly that approves the nomination proposed by the board.*

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

With the suggestions outlined in point 16, we see no need for an appointment by third parties. It would only complicate the supervision task further.

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?

There are pros and cons as to limiting the term an audit firm can serve a company. At the one hand it gives rise to the loss of experience and insight into the corporate challenges and characteristics. On the other hand a long serving term could create the danger of losing the necessary degree of independence. But with the swift changes in top management the last couple of years the danger of a too cosy club between external auditor and CEO or CFO is less and less prevailing. ecoDa therefore suggest that if any limitations seem necessary it is about regular rotation of audit partners and limiting the time span the external auditor can serve under the same CFO/CEO. ecoDa, believes it is good practice to include information in the annual report about the tendering frequency, the tenure of the incumbent auditor, and any contractual obligations that acted to restrict the audit committee's choice of external auditors (as prescribed by the Guidance on Audit Committees, FRC). Shareholders should study this information carefully and challenge the company if necessary.

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?

To reply to this question, one has to weigh the pluses and the minuses of combining audit and non-audit services. It's not a black-or-white situation.

On the one hand, there is the question of efficiency. Audit firms have valuable expertise, insight and information on the companies they audit. Combining audit with non-audit services might mutually benefit both functions from an efficiency as well as an effectiveness perspective.

On the other hand, the independence of external audit is key. So all non-audit services should be limited or excluded if they might impair the independent position of the auditor. As the debacle with Andersen has shown, it is very important to limit the volume of non-audit services to guarantee that the audit fees are the most important source of income from the company in question. Fees for non-audit services should never be so important that they could jeopardize the independent position of auditors. Moreover it is advisable to foresee that certain types of non-audit services can be incompatible with audit services (generic types as well as specific combinations).

On top of that, there might either be a provision that non-audit services should be limited to "downstream" post audit functions (such as filing of tax return), or audit firms should have a clearer obligation to disclose their non-audit services in their audit letter.

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

In line with the previous question, it seems reasonable to limit the dependence on one firm in order to secure the independent position of the external auditor.

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

Notwithstanding the fact that most audit firms are partnerships or private companies, ecoDa considers it a sign of good governance that such firms are fully transparent to their partners (being also their shareholders; see next question).

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

Audit firms are to some extent comparable to listed companies. They have public responsibility and play an important role in the economy. Therefore, audit firms should have the right governance structure and transparency. For the larger companies (and certainly the Big 4) this would mean the highest level of governance whereas for the smaller audit firms it could be advised to apply a gradual approach (see ecoDa's guidance on CG for unlisted companies http://www.ecoda.org/docs/ECODA_WEB.pdf).

The European Commission could be inspired by the Audit Firm Governance Code, published by the FRC and the Institute of Chartered Accountants in England and Wales in January 2010, to release a European Audit Firm Governance Code to which the (big) audit firms should adhere.

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

According to ecoDa, alternative funding structures might compromise independence.

Moreover, the case for shifting from a partnership to a limited company structure for audit firms is not particularly convincing.

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

Having a single audit firm for a group makes a lot of sense to enhance control on group-wide risk management, as well as better prevention and communication. But it may also be said that allocating major group companies among distinct audit firms would create beneficial checks-and-balances and be a better guarantee to limit the internal conflict of interest. As all depends on particular situations, ecoDa would not recommend regulating on this.

The use of joint auditors could be a solution. It allows having a group audit opinion which increases confidence in the audit opinion and at the same time, it allows one of the joint auditors to be changed whilst maintaining continuity of knowledge and expertise on the audit.

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

Not relevant for ecoDa but for auditors and their supervisors.

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

ecoDa is not convinced about the need for greater dialogue between regulators and auditors outside of the financial sector, where there is much less of a problem of ultimate taxpayer liability and regulators are consequently not foreseen as is the case with financial institutions

. It is however relevant to have efficient whistle blowing mechanisms.

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

The big audit firms have reached a point where they are "too big to fail". As with banks, this can potentially lead to a problem of moral hazard: the big audit firms believe that they will be bailed out in the event of a collapse, and can therefore ignore their own risk profile.

Consequently, a resolution regime is needed that could manage the potential collapse of a large accounting firm. A governance code for larger auditing companies (which mandates the inclusion of non-executives on auditor's governing bodies) also makes sense (as it is e.g. being introduced in the UK).

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 dynamizing the audit market and allowing small and medium-sized firms to participate more substantially in the segment of larger audits?

Experience with this model shows that it works in practice, but it comes at a cost. It is to be questioned whether the additional cost allows smaller audit firms to get sufficient growth perspectives by teaming up with a Big 4 company. ecoDa is not convinced that making the formation of an audit firm consortium mandatory would be appropriate.

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?

See reply to question 18.

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

ecoDa is of the opinion that market forces should drive the market. When economies of scale prevail size will matter more. If lean and mean offers a competitive advantage also smaller companies will prosper.

Is there evidence that such a bias exists and if so, this is not necessarily a bad thing? It might provide a quality label. However, attention should also be given to the capability of other firms. It cannot be that e.g. banks impose conditions, effectively requiring the use of a Big 4 firm prior to issuing loans or as part of loan covenants.

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

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

There is a need to harmonise cross border audits to match the scale of the customer. Also the economies of scale are important given the increasing need for more specialists with higher skills.

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

The European Passport is probably the best route to reach that goal: it would entail a higher level of harmonization and would enhance supranational supervision.

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?

ecoDa will agree with a "maximum harmonisation" combined with a single European passport for auditors and audit firms, but will point out the fact that companies could limit themselves to local markets.

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?

ecoDa is of the opinion that the regime for listed companies and especially that for the financial sector should not be copied as such to the non-listed companies, certainly not to the SMEs. The audit regime for smaller companies should be light, and in certain circumstances entirely avoidable. In the UK for instance, it is

possible for small companies to avoid an audit under certain conditions, e.g. if it is not demanded by at least 10% of the shareholders or if it is not required by the articles of association.

ecoDa wants to stress the particular burden that audit often places on medium sized companies. Large companies have significant audit requirements, but they have the resources to manage them. Small companies may have relatively light audit requirements, or may be exempt from audit altogether. However, medium sized companies fall between these extremes. For them, audit may impose a significant burden, both in terms of financial and human resources.

Lighter audits for SMEs should not be viewed as a "race to the bottom", but rather as creating a situation in which audit requirements will be more determined by market forces, e.g. the demands of creditors, shareholders or other stakeholders.

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

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?

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

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About ecoDa:

The European Confederation of Directors' Associations (ecoDa) is a not-for-profit association founded in December 2004 under the laws of Belgium. Its objective is to represent the views of company directors from EU member states to corporate governance policy-makers at EU level. ecoDa, the European Confederation of Directors' Associations, is a not-for-profit association acting as the "European voice of board directors". The seat of ecoDa is in Brussels.

Through its 10 national institutes of directors¹, ecoDa represents around fifty-five thousand board members from across the EU, ensuring that their views on Corporate Governance are clearly communicated to policymakers in the EU institutions. ecoDa's member organisations represent board directors from the largest public companies to the smallest private firms, both listed and unlisted.

To perform its mission, ecoDa has undertaken:

- to promote the development of new national director institutes and attract new members in order to strengthen its European representativeness,
- to influence the European decision-making on corporate governance by reacting to pending issues in the European pipeline or by pro-actively taking own initiatives to generate European debate and reflection,
- to develop European governance standards by acting as a standing body where national experiences are shared and discussed in detail and
- to provide services to its members, mainly by providing information regarding relevant European issues.

¹ National institutes of directors from Belgium, Croatia, Czech Republic, Finland, France, Luxembourg, Poland, Slovenia, Spain UK,