



Audit Committee Institute

European Commission questions the role of auditor and audit committee

Sponsored by KPMG

The EC Green Paper *'Audit Policy: Lessons from the Crisis'* has initiated a wide-ranging consultation process that questions the role of both auditors and audit committees.

The EC Green Paper *'Audit Policy: Lessons from the Crisis'* – released in October 2010 – recognises that audit is a key contributor to financial stability and to re-establishing trust and market confidence, and that auditors have an important “societal role” in offering an opinion on whether the financial statements give a true and fair view.

However, the Green Paper identifies a number of areas where the EC believes there is cause for concern including the role of the auditor; the governance and independence of audit firms; and the structure of the audit profession, particularly the concentration of major audit firms. The Green Paper also identifies ways of strengthening cross-border audit firm supervision and the possibility of creating a single European market for audit firms. And finally it considers the specific case of Small and Medium sized Enterprises (SMEs).

Of particular concern to audit committees, the proposals appear to start with the presumption that the auditor / audit committee relationship is broken and that directors cannot be trusted to play a meaningful role in the appointment of auditors or control their use in the provision of non-audit services.

The Green Paper is clearly the first stage of a long consultation process before any legislation might be proposed. Our experience has taught us that the volume of submissions can have a significant impact on the final

outcome of a consultation process. We therefore encourage our clients to participate in the consultation by ensuring that your corporate views are made known to relevant trade bodies (CBI, 100 Group) and by corporately responding to the European Commission before the 8th December deadline.

Role of the auditor

The Commission looks at the role of the audit beyond the financial statements. Whilst it recognises the importance of forward looking information it states that, given the coverage by equity analysts and credit rating agencies, the role of the auditor should be “extended in this direction only if there is real value added to the stakeholders”. The Commission is also consulting on whether audits should extend to the financial health of the company or CSR.

The Commission acknowledges that an audit only provides “reasonable assurance” that financial statements are free from material misstatement and that audit work has evolved from a substantive verification of transactions and balances to a risk-based controls approach – but goes on to question whether this creates an expectation gap and whether a “back to basics approach” would be desirable, with compliance and systems work covered by internal audit and external audit being focussed on substantive testing.

The information provided by auditors to stakeholders is considered important,

both in terms of revisiting the audit report but also considering additional communication on audit methodology (for example, explaining the extent of substantive verification of the balance sheet).

The importance of regular dialogue between the Audit Committee, the external auditor and the internal auditor is highlighted in the Green Paper and the Commission is consulting regarding the adequacy of current dialogue and whether this could be improved.

The European Commission therefore is consulting on:

- whether audit methodology should be explained better to users;
- the need for reinforcing professional scepticism;
- what (and how) additional information should be provided to external stakeholders;
- the need for more regular communication by the auditor to stakeholders and the need to shorten the gap between the year end and the audit opinion dates; and
- whether, and how, to reconsider the negative perception attached to qualified audit reports.

Governance and the independence of audit firms

In the context of auditor independence being the “unshakeable bedrock” of

the audit environment, the Commission states that it would like to reinforce the independence of auditors and address the conflicts of interest which it asserts are inherent in the current framework.

The Commission identifies the appointment and remuneration of the auditor being made by the company being audited, the low levels of audit firm rotation, and audit firms providing non-audit services as potential issues.

Among the possible changes identified by the Commission are:

- auditors being appointed by some form of national/European regulator rather than by shareholders;
- limiting the maximum length of an audit appointment; and
- introducing a prohibition on non-audit services either for all companies, or just certain types such as systemic financial institutions, or limiting the maximum level of fees that can be earned from a single client.

Concentration and market structure

The Commission highlights the market share of listed company audits held by the Big 4 and questions whether this represents “systemic risk” – with the

Big 4 being “systemic firms” that require particular attention.

It also expresses the view that entry into the top-tier section of the audit market is difficult and that the reputation of those firms auditing large listed companies helps perpetuate market concentration.

The Commission is considering various ideas including:

- joint audits/audit consortia;
- mandatory rotation and re-tendering;
- the introduction of contingency plans such as “living wills”; and
- whether the recent consolidation of audit firms should be reversed.

Creation of a European market, supervision and international co-operation

The Commission notes that there are many barriers to integration of the European audit market and that cross-border mobility of audit professionals remains low. It therefore asks for views on the best way of enhancing cross-border mobility of audit professionals and whether concepts of “maximum harmonisation” and a “European passport” for auditors are supported.

The Green Paper notes that, at present, whilst supervision at a national level exists there is no coverage of cross-border management entities that cover an audit network’s operations across the member states and requests views on measures that might improve the integration and co-operation on audit firm supervision at EU level.

The Commission recognises that knowledge obtained by auditors through their work may be useful to supervisors and the desirability of improved communication between auditors and supervisors, but not if this blurs responsibilities between the two parties, and therefore also seeks views on how increased communication between the auditor of large listed companies and the regulator might be achieved.

The KPMG View

Some of the proposals in the Green Paper ‘*Audit Policy: Lessons from the Crisis*’ are worthy of further consideration, but we have a fundamental concern with the apparent lack of confidence in the ability of audit committees and / or supervisory boards to exercise their stewardship role effectively. This seems to be at the heart of a number of the suggestions which would restrict your ability to choose the best people for the job such as using a regulator to choose the audit firm, requiring mandatory audit firm rotation, requiring joint audits (or audit consortia – although it is less clear how this would work in practice) and prohibiting all non-audit services (potentially to the extent of creating “pure” audit firms). Whilst there are always exceptions to good corporate governance, we do not believe that the market has failed to the extent which would merit such an extreme level of regulatory intervention.

We are also far from convinced that such measures will improve audit quality – in fact we believe they may well have the opposite effect. We are also firmly of the view that having non-auditors within the same professional services firm enhances our ability to bring specialist skills and insights to our audit work. It is perhaps interesting to note that in its most recent consultation on non-audit services the UK Auditing Practices Boards stated “The message from the review undertaken by the APB is that commentators (irrespective of the constituency involved) were overwhelmingly of the view that there should not be an outright prohibition” on the provision of non-audit services by the auditor.

On the other hand, proposals to look at the scope of the audit, communication with shareholders and regulators and harmonisation of the audit market within Europe are likely to be much more fruitful areas of debate in enhancing the role and effectiveness of audits.