

Audit policy: lessons from the crisis

2011/2037(INI) - 13/10/2010 - Non-legislative basic document

PURPOSE: to present a Green Paper on international audit policy following the 2008 crisis.

BACKGROUND: the measures adopted both in Europe and elsewhere in the direct aftermath of the financial crisis have focussed on the urgent need to stabilise the financial system. While the role played by banks, hedge funds, rating agencies, supervisors or central banks has been questioned and analysed in depth in many instances, limited attention has been given so far to how the audit function could be enhanced in order to contribute to increased financial stability. 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**. It seems thus appropriate that both the role of the audit as well as the scope of audit are further discussed and scrutinised in the general context of financial market regulatory reform.

The Commission is keen to assume leadership at the international level on this debate and will seek close co-operation from its global partners within the Financial Stability Board and the G20.

Against this background, the Commission presents this Green Paper which aims to open a debate on the role of the auditor, the governance and the independence of audit firms, the supervision of auditors, the configuration of the audit market, the creation of a single market for the provision of audit services, the simplification of rules for Small and Medium Sized Enterprises (SMEs) and Practitioners (SMPs) and the international co-operation for the supervision of global audit networks.

The Commission is launching this Green Paper as part of its holistic approach that includes other initiatives within the context of financial stability. This Green Paper also builds on the results of earlier studies and consultations carried out by the Commission on these matters. In particular, the [Green Paper](#) of 2nd June 2010 on Corporate Governance in financial institutions and remuneration policies addresses a number of concerns regarding the audit of financial institutions.

CONTENT: audit, alongside supervision and corporate governance, should be a key contributor to financial stability as it provides assurance on the veracity of the financial health of all companies. This assurance should reduce the risks of misstatement, and in doing so, reduce the costs of failure that would otherwise be suffered by the company's stakeholders as well as by the broader society.

Robust audit is key to re-establishing trust and **market confidence**; it contributes to **investor protection** and reduces the cost of capital for companies.

In this context, it is important to stress that auditors have an important role to play and are entrusted by law to conduct statutory audits. This entrustment responds to the fulfilment of a societal role in offering an opinion on the truth and fairness of the financial statements of audited entities. **The independence of auditors should thus be the bedrock of the audit environment**. It is time to probe into the true fulfilment of this societal mandate.

Certain stakeholders have expressed concerns with regard to the relevance of audits in today's business environment. For other stakeholders it may be difficult to understand that an institution's financial statements may suggest "reasonableness" and "material soundness" even if the same institution was, in fact, distressed financially. Given that these stakeholders may be unaware of the limitations of an audit (materiality, sampling techniques, role of the auditor in the detection of fraud and the responsibility of

management), this engenders an expectation gap. **The Commission therefore advocates the need for a comprehensive debate on what needs to be done to ensure that both audits of financial statements and auditor reports are "fit for purpose".**

The Green Paper focuses on the following themes:

- a **limited offer of international audit firms**: after the demise of Arthur Andersen there are now a handful of such large, global firms, with an even lower number of firms being able to perform audits of large, complex institutions. The potential collapse of one of these firms could not only disrupt the availability of audited financial information on major companies, it would also be likely to damage investor trust and confidence and could impact the stability of the financial system as a whole. There is a need to explore further the ways to mitigate this risk;
- options such as the ramping up of the capacities of non systemic firms and exploring the pros and cons of "downsizing" or "restructuring" systemic firms should be further examined;
- the possibilities to **reduce existing barriers to entry into the audit market**, including a debate on existing ownership rules and the partnership model employed by most audit firms;
- a **genuine single market for the provision of audit services** based on enhanced harmonisation of rules and the creation of a "**European passport**" for auditors which would allow them to provide services on an EU wide basis.

The Commission stresses the need for a differentiated and calibrated approach which is adapted and proportionate to the size and characteristics of both the audited company and its auditor and will seek, in the case of any potential proposal that may emerge as a result of this Green Paper, to modulate any such proposals to take this into account. Any measures which the Commission would propose as a follow-up to the present consultation would be subject to better regulation principles, including cost-benefit analyses and impact assessments.

The Commission will be proactive in seeking comments from the broadest possible base of stakeholders such as investors, lenders, management, employees, government authorities, auditors, tax authorities, credit rating agencies, equity analysts, regulators, business counter-parties and SMEs.

A broad consultation will allow the Commission to assess the interplay of different policy options while maintaining a commitment to financial stability. This consultation will also assist the Commission in **calibrating the intensity of any future measures in a manner that is appropriate to the size and nature of the entities in question.**

Other issues dealt with in the Green Paper are as follows:

- the **role of the auditor**: in particular as regards the definition of what sort of information should be provided to stakeholders by the auditor as part of its opinion and findings;
- the governance and the **independence of audit firms**: in particular the question of possible conflicts of interest and the rules to be respected on the matter;
- the **supervision of auditors**: the Green Paper proposes that the supervision of audit firms in Europe must be performed on a more integrated basis, with closer cooperation between the national audit oversight systems
- the **configuration of the audit market**: the market for audits of listed companies is, in the main, covered by the so called Big Four audit firms (Deloitte & Touche, Ernest & Young, PricewaterhouseCoopers and KPMG). The market appears to be too concentrated in certain segments and deny clients sufficient choice when deciding on their auditors. Such concentration might entail an accumulation of systemic risk and the collapse of a "systemic firm" or a firm that has reached "systemic proportions"⁵ could disrupt the whole market;
- the **creation of a single market for the provision of audit services**: a single European market for the provision of audit services could be based on enhanced ("maximum") harmonisation and a

"European passport for auditors". This would imply creating a European-wide registration with common professional qualification requirements and common governance, ownership and independence rules applicable across the European Union;

- the **simplification of rules for Small and Medium Sized Enterprises (SMEs) and Practitioners (SMPs)**;
- the **international co-operation** for the supervision of global audit networks.

Next steps: this Green Paper will be open for public consultation until the 8th of December 2010. The Commission will host a high level Conference on 10th February 2011 which will aim at discussing the present Green Paper and the main findings of this consultation with all stakeholders and explore possible ways forward. Once this consultation phase is closed the **Commission will announce any appropriate follow up measures and proposals in 2011.**