European Commission
Mrs. Nathalie de Basaldúa
Head of the Audit Policy Unit
DG Internal Market and Services
B-1049 Brussels
Belgium

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Dear Mrs. De Basaldúa,

We are grateful for the opportunity to comment on the European Commission’s Green Paper ‘Audit Policy: Lessons from the Crisis’ (hereafter: Green Paper). By way of background, and to put our comments in context, Eumedion is the Dutch based corporate governance forum for institutional investors in listed companies. Our 70 Dutch and non-Dutch participants - with a long term return focus - have in total more than EUR 1 trillion assets under management.

Over the last years, Eumedion has been vocal on audit policy – at national and international level. Together with other institutional investors and representative organisations, we expressed our concerns vis-à-vis the current functioning of the audit market. It is our strong belief that the present organisation of the audit function is not optimal, with its inherent conflicts of interest. It serves the interests of management boards and auditors more than the interests of what should be the main beneficiaries of the audit function, investors. Eumedion believes that the way the audit function is organised requires significant changes. We therefore support the European Commission’s brave and open reflection on main elements of the audit function.
1. General

A high quality audit is a key vector for good governance and an efficient economy. The auditor is viewed as the expert on accounting and financial reporting. Furthermore, the auditor is well-positioned to objectively judge the company’s approach to risk and control. If need be, the auditor can challenge management’s judgement on accounting and assessment of risk. And it is the auditor who has the statutory duty to report to shareholders and other users of annual accounts on whether the company is presenting a true and fair view of the business. In order to facilitate optimal asset allocation, the investor’s analysis will build on this audit opinion – and hence, on the tip of the iceberg of the actual work conducted by an auditor. In terms of navigation, we know that this is not always sufficient to guarantee a safe journey.

The accounting scandals in the beginning of this millennium and the financial crisis at the end of this decennium has led to a loss of investor’s confidence in the value of the auditor’s opinion and the independence of the auditor. There has been criticism that banks’ annual accounts received unqualified auditor opinions shortly before the same financial institutions failed, leading to questions about the value of auditor opinions. Another point of criticism is that the auditor is too much aligned with the interests of the management board in stead of the users of the annual accounts and that the audit process is too much a mechanistic way of checking whether the IFRS and IAS are applied without applying sufficient professional judgement. In the changeover from accounting for historic costs to fair value, the auditor seems to have continue to apply audit mechanics of the past; looking backwards and ignoring operational, strategic and compliance risks linked to the business model of the audited company. Both management and auditors failed to install the countervailing powers in a fair value model.

Eumedion, therefore, broadly supports the Green Paper as a welcome starting point for the future of the auditor profession, with the objective of improving the relevance of the auditor’s work and changing the auditor’s behaviour.

Below is the summary of our views and main proposals to achieve these objectives.

- Reinforcing professional scepticism is key. To achieve real professional scepticism it is important that audit firm’s partners and employees commit themselves to high quality work and serving the public interest. Some of the factors influencing auditor’s scepticism are controlled by the auditor, such as a sceptical mindset, appropriate level and quantity of staffing, the knowledge of the relevant business and sector and the effectiveness of the audit process. Audit firms should constantly aim to improve these aspects. The amount of junior staff per audit partners must be reduced. High level permanent education must be a top priority. Other factors, such as
knowledge (and scepticism) about the audited companies’ corporate governance structure and the effectiveness of the audit committee are key as well. All these factors should fall under the scope of future Commission initiatives.

- To resolve conflicts of interests and ensure independent appointments, the responsibility to decide on the auditor’s (re)appointment should no longer, formally, or in practice, be with the management board. It should be the responsibility of the audit committee, composed only of independent supervisory board members or non-executive directors, to decide on the nomination, engagement and fee of the auditor. In doing so, the audit committee must carefully weigh all interests, including those of shareholders. The General Meeting of Shareholders should subsequently have the right to approve the audit committee’s nomination. It also should be the sole responsibility for the audit committee to decide on commissioning any non-audit services by audit firms – on a case-by-case basis. We strongly reject the Commission’s suggestion that an independent third party, such as the regulator, should be involved in the appointment process of the auditor.

- We believe there is a need to reassess the entire revenue model in order to ensure that auditors actually perform high quality work. We have the impression that today’s partner salary level is more dependent on commercial incentives (number of clients, turnover, cross selling, etc.) than on audit quality. The actual audit work is largely performed by rather inexperienced staff-members, redoing the work of internal auditors and controllers within the audited company. The larger the span of control of an audit partner, the higher his remuneration level. Under all circumstances, a partner and his team should have sufficient time and resources available to optimally conduct the audit. Introduction of independent public supervision on the remuneration structures of audit firms – in parallel with the financial sector – is an area worth considering.

- We would like to underline that the management board, under supervision of the supervisory board or non-executives, is responsible for the quality and completeness of the annual accounts and other disclosed (non-)financial information. The board should provide a fair view of the risks (not only financial risks, but also strategic, operational, governance, sustainability and compliance risks and a combination of risks) that are material for the continuity of the business in the Management Discussion & Analysis (MD&A). If the management board fails to do so, the auditor should have the possibility to ‘alert’ shareholders and other users of the annual report and annual accounts on the risk profile in his own capacity, based on his professional judgement. This could be included in a special section in the auditor’s report. An Auditor’s Discussion and Analysis (AD&A) section or a “Letter to the Shareholders” as part of the filing to provide investors with the auditor’s perspective on key risks and key assumptions could also be considered.

- To provide investors with more information about possible risks, it should be mandatory for the company or for the auditor to disclose the reasons for a change in the auditor. We advise the
Commission to propose a revision of the Directive 2006/43/EC on statutory audit in order to introduce this ‘noisy withdrawal’ obligation.

- We would not support a complete ban on auditors and audit firms providing non-audit services to their listed audit clients. Some services are naturally closely related to audit (governance, risk, sustainability) and do not necessarily give rise to additional conflicts of interest. The advantage the audit firm has in terms of knowledge about the business and the specific company brings quality and efficiency benefits that companies and their investors would preferably not like to lose. At the same time the provision of other services which have no natural connection with the audit must be discouraged or even be legally forbidden as these type of service contracts are a main cause for conflicts of interest and provide the audit firm with a competitive advantage which is unwanted.

- We would encourage changes in the governance structure of audit firms, including the introduction of mandatory audit firm (supervisory) board composition requirements. A requirement such that the board also includes independent third parties might lead to a more independent mindset and might create safeguards to protect auditor’s quality - professionally and ethically.

- In our view, audit quality is key. The current Big Four services are essential to perform high quality audits on firms operating globally. The issue of the dominance of the Big Four should in our view be dealt with by the market itself under the existing legal (market competition) framework. Many institutional investors are using Big Four services as a result of a demand of audit quality on a global scale. One can not expect investors to voluntarily opt to do business with an audit firm outside those with global presence. Institutional investors invest globally and they have a fiduciary duty to see to it that all our global investments are well-managed. We would however welcome if DG Competition keeps a close eye at this oligopoly. The impact of possible suboptimal competition limits necessary developments and innovation in the market.

- We support the current system of at least partner rotation. However, such a partner rotation should be ‘proven’ to the outside world. If it appears to be only formally a partner rotation, it might in fact be just a continuation of the status quo. More research is needed whether this is reality. Only if such research leads to the conclusion that partner rotation is not effective, mandatory firm rotation should be considered.

- We see no merit in the introduction of mandatory audit firm consortiums for the audits of large companies in order to encourage the emergence of other players. The supporting evidence is weak. In our view, this would be a costly and inefficient way of conducting audits.

Below, we will mainly focus on the role or external auditors, in line with the focus in the Green Paper. In our view, the role of internal auditors – and their independence - must however not be forgotten or minimized as it is a critical component of a high quality audit.
2. Role of the auditors

The number one objective and priority of an independent auditor is, and should be, to provide investors and other users with an independent opinion as to whether the financial statements and disclosures therein, are materially accurate and complete, and offer a true and fair view. In our opinion, we should adhere to a continuous improvement audit profession model to ensure independent, high quality audits by auditors and audit firms. Auditors should serve as independent gatekeepers that instill public confidence via high quality audits in public companies seeking capital from investors.

**Auditor’s behaviour**

There is a case to reinforce auditor’s profession scepticism. Companies are increasingly complex and global in nature, which in turn affects the skills and staffing requirements needed to conduct a high quality audit. Today, the majority of audit work is still being performed by staff that on average approximately has less than six years of experience. In some cases, the auditor’s approaches have focused too much on gathering and accepting evidence to support management’s assertions. Assessing whether the input, judgements and assumptions by the management board on financial statements, governance and risk are appropriate, requires a high degree of professional scepticism as well as effective cooperation with a well established internal audit function. And we share the Commission’s opinion that professional scepticism may also play an important role in the detection and prevention of fraud. To achieve real professional scepticism it is important that audit firm’s partners and employees commit themselves to high quality work and serving the public interest. Audit firm partners should realise that although they work for private firms, they have a public duty. Some of the factors influencing auditor’s scepticism are controlled by the auditor, such as a sceptical mindset, appropriate level and quantity of staffing, the knowledge of the relevant business and sector and the effectiveness of the audit process. Audit firms should constantly aim to improve these aspects. The amount of junior staff per audit partners must be reduced. High level permanent education must be a top priority. Other factors, such as the knowledge (and skepticism) about audited companies’ corporate governance structure and the effectiveness of the audit committee are key as well. And audit firms should rethink the “up or out model”. All these factors should fall under the scope of future Commission initiatives.

**Level of assurance and audit reports**

The existing standards for audit reports are to some extent useful for institutional investors, since it offers investors with an impression of the auditor’s opinion on the correctness of financial
statements and the basis for that view. Nevertheless, we believe the auditor report could become much more relevant and useful for investors. An unqualified opinion is basically a snap-shot opinion that the financial statements at year-end properly reflect the financial conditions of the company at that moment. Especially since the introduction of IFRS, an unqualified opinion is no longer a guarantee for the company’s continuity in the year ahead.

For the purpose of investors’ investment decision making, further information on the audit process (what the auditor actually did) and the quality of the financial statements (level of conservatism in management accounting decisions, analyses of risks) should be considered to be included in the auditor report. This would make the auditor report a true report, instead of a statement with limited informational value and a maximum of disclaimers.

*External communication*

We would like to underline that the management board, under supervision of the supervisory board or non-executives, is responsible for the quality and completeness of the annual accounts and other disclosed (non-)financial information. The board should provide a fair view of the risks (not only financial risks, but also strategic, operational, governance, sustainability and compliance risks and a combination of risks) that are material for the continuity of the business in the Management Discussion & Analysis (MD&A), included in the financial report of the audited company. If the management fails to do so, the auditor should have the possibility to ‘alert’ shareholders and other users on the risk profile on his own initiative, based on his professional judgement. If such a requirement would appear to be difficult to implement, we would opt for a ‘level playing field’ in transparency requirements for auditors of listed companies. In that case we would encourage regulators to consider requiring an Auditor’s Discussion and Analysis (AD&A) section or a “Letter to the Shareholders” as part of the filing to provide investors with the auditor’s perspective on key risks, where necessary, in addition to the (MD&A). Such a requirement for an AD&A would help ensure that auditors are not missing anything significant, and it would incentivise auditors to show that they perform better audits. In this AD&A auditors could give information on:

- Key business and audit risks the auditor believes exist, and which the auditor has considered when conducting the audit.
- The auditor’s perspective on what are the key assumptions used in judgements that materially affect the financial statements, and whether those assumptions are at the low, most likely, or high end of the range of possible outcomes.
- Key audit issues and their resolution which the audit partner documents in a final, summary audit memo.
- Changes to accounting policies that have a significant impact.
Unusual transactions.
- Accounting applications and practices that are uncommon to the industry.
- Quality and effectiveness of the governance structure and risk management.

Furthermore, to provide investors with more information about possible risks, it should be mandatory for the company or for the auditor to disclose the reasons for a change in the auditor. We advise the Commission to propose a revision of the Directive 2006/43/EC on statutory audit in order to introduce this 'noisy withdrawal' obligation.

**Dialogue audit committee**

We are of opinion that it is important to have regular and open communication between the audit committee, the internal auditor and the external auditor, prior to, during and after the audit. In doing so, the external auditor must position himself as an independent expert on critical and complex issues. This will help to ensure that the audit is not purely compliance driven, with auditors adopting a de minimis checklist approach. The dialogue should not be limited to material audit findings, but also include key elements like governance, compliance and risk monitoring. If auditors were to exercise professional scepticism by challenging the management board and the audit committee from a user perspective during the dialogue, the independence of the auditor would not be compromised, and in fact would be strengthened.

Furthermore, it has appeared that audit committees have suffered from a lack of expertise and current knowledge on audit and accounting issues. To build a fruitful dialogue between the internal and external auditors and the audit committee, it is a key prerequisite that the audit committee has sufficient capacity on board.¹

**Corporate Social Responsibility**

Good quality non-financial information, including information on Corporate Social Responsibility (CSR), is of the same order of paramount importance as financial information. A company aiming to stay in business in 50 years from now, must incorporate a sustainable strategy today. An independent verification is needed to ensure the quality and credibility of reported sustainability information. The auditor is rightly placed for performing such a task – as are other service providers. There is a tendency towards integrated information, by developing an internationally applicable reporting framework that brings financial and sustainability information into one document. However if auditors fail to understand the reported sustainability information an important opportunity will be lost. An opportunity to truly develop credible sustainability

information, instead of those fancy brochures we still encounter today. Auditors need to build new skills on non financial levels while maintaining their technical accounting and auditing knowledge and skills.

3. Governance and independence of audit firms

Appointment and remuneration of auditors

We are of the opinion that there may be a potential conflict when the auditor is being appointed and remunerated by the management board, while serving the interests of investors, lenders and other parties related to that company. In a few countries - including the Netherlands - auditors are appointed by the General Meeting of Shareholders. But even in those countries, it usually is the CFO who remains in the driving seat for the process and in fact decide on auditor choice. As mentioned in the FSA-FRC Report, a reappointment of the auditor often hinges on the quality of their long-term relationship with the management board.²

To resolve conflicts of interests and ensure independent appointments, the responsibility to decide on the auditor’s (re)appointment should no longer, formally, or in practice, be with the management board. It should be the responsibility of the audit committee, composed only of independent non-executive directors, to decide on the nomination, engagement and fee of the auditor. In doing so, the Audit Committee must carefully weigh all interests, including those of investors. The General Meeting of Shareholders should subsequently have the right to approve the nomination. It also should be the sole responsibility for the audit committee to decide on commissioning any non-audit services by audit firms – on a case-by-case basis. We strongly reject the Commission’s suggestion that an independent third party, such as the regulator, should be involved in the appointment process of the auditor. Such a system would result in more bureaucracy and would create new governance and independence issues (f.e. the regulator would have the power to regulate the audit profession, would supervise the audit profession (and judge the auditor’s work) and would appoint and dismiss the auditor – this is not a system we prefer).

Another point of concern is the revenue model many audit firms have today. We believe there is a need to reassess the entire revenue model in order to ensure that auditors actually perform high quality work. We have the impression that today’s partner salary level is more dependent on commercial incentives (number of clients, turnover, cross selling, etc.) than on audit quality. In those structures auditors’ contributions to turnover and profit are important factors for determining career opportunities and remuneration differentials within audit firms. The actual audit work is in

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² Financial Services Authority & Financial Reporting Council, Enhancing the auditor’s contribution to prudential regulation, June 2010, p. 63.
practice largely performed by rather inexperienced staff-members. The remuneration of partners of audit firms should be more aligned with the quality of the auditor control. Under all circumstances, a partner and his team should have sufficient time and resources to optimally perform the conduct of the audit. Introduction of independent supervision on the remuneration structures of audit partners – in parallel with the financial sector – should be considered.

**Mandatory firm rotation**

We support the current system of at least partner rotation. However, such a partner rotation should be 'proven' to the outside world. If it appears to be only formally a partner rotation, it might in fact be just a continuation of the status quo. More research is needed for that. Only if such research leads to the conclusion that partner rotation is not really effective, mandatory firm rotation should be considered. Audit firm rotation is, however, not our first choice, as a lot of audit knowledge and history could be lost, in particular in case of a very large and complex multinational. Mandatory audit firm rotation could have adverse effects on audit quality, especially in the first years after the rotation. This would not be in the interest of the users of auditor opinions.

**Non audit services**

It is of relevance to raise the question whether the independence of auditors is compromised if they advise the same client over non audit matters, such as reducing their tax bill. There is a general perception that the provision of non-audit services may impair auditor's objectivity.

We would not support a complete ban on auditors and audit firms providing non-audit services to their listed audit clients. Some services are naturally closely related to audit (governance, risk, sustainability) and do not necessarily give rise to additional conflicts of interest. The advantage the audit firm has in terms of knowledge about the business and the specific company brings quality and efficiency benefits that companies and their investors would preferably not like to lose. At the same time the provision of other services which have no natural connection with the audit must be discouraged or even be legally forbidden as these type of service contracts are a main cause for conflicts of interest and provide the audit firm with a competitive advantage which is unwanted. We therefore believe that Article 22 of the Directive 2006/43/EC on statutory audit already provides the necessary framework to guide auditors through the decision making process on whether or not to provide non-audit services. Further restrictions can be included in the above Directive.
Publication of Transparency reports

We support the proposal to enhance transparency on audit firms’ financial statements. Transparency applied by audit firms contributes to an environment in which audit firms compete not solely on factors as reputation, size and audit fees. This is important, as competence and experience of auditors and firm’s governance (e.g. quality control systems, safeguards against conflicts of interests, and education programs) are other relevant factors for audit quality.

With disclosed financial statements, including transparency reports, from audit firms, the audit committee and the shareholders of a listed company will have information available to make a proper comparison between audit firms in the process of (re)appointment of an auditor. This creates another incentive for audit firms to raise audit quality.

Organisational requirements

Proportional governance safeguards are needed to protect audit quality. An effective framework of codes of governance of audit firms could contribute to that. New structures in firms’ governance, for example a (supervisory) board of directors with a more independent mindset, might create such safeguards. Currently audit partners are supervised by audit partners of the same firm. This is a form of suboptimal supervision. The composition of such a board of directors must be a fair reflection of the interest of the true constituents, including the users of audit services. The personalities that serve on those boards, must be carefully selected.

Revisiting Ownership Rules and the Partnership Model

Many large public companies have business activities in international markets and the complexity of their industries impacts their financial reporting. Those companies simply require audit firms with international coverage.

Currently, due to legal ownership restrictions almost all firms are organised as private partnerships and do not raise capital through public markets. The existing restrictions on ownership of audit firms can avoid firms from accessing non-private capital that could be used to develop firms in order to be able to audit large public companies.

Opening up the audit market for large public companies could have several advantages. The most important ones are swift access of investors to new emerging markets and the entrance of new audit market players. Reducing ownership barriers may contribute to the availability of choice of audit services for large public companies. Allowing for non-practitioner ownership may create more alternatives and safeguards for large public companies and their investors, in case one of the Big Four unexpectedly gets involved in an Arthur Andersen scenario.
We recognise the potential risks associated with changes in ownership rules on auditors’ independence, professionalism and long term public interest focus. However, we believe that these risks can be reduced by implementation of practical solutions. Under the current ownership rules, risks to auditor independence and quality exist as well. We would particularly welcome further study on the effects of the lifting of the current legal ownership restrictions. Simply as a facility, not to force a revision of the current ownership structure within audit firms.

4. Supervision

The internal governance of audit firms is first and foremost the responsibility of the firm itself. As mentioned above, there is a need to strengthen the governance of audit firms by establishing a more independent board of directors. The executive board and the independent board of directors should take action when difficulties in the governance practices may arise including potential conflicts of interest as well as remuneration and ethical dilemmas. Public supervisory authorities should check whether this is done properly.

Given this context, we strongly encourage initiatives to enhance the cross-border cooperation between audit oversight systems. Pan-European audit networks, as part of global firms, should preferably be supervised at European level.

5. Concentration and Market Structure

Systemic risk

In our view audit quality is key. And quality is more important than the availability of a multitude of different firms. As a comparison, we like to refer to the supervisory model in Europe where it is advantageous for a financial institution to just have one supervisor with international experience. It is important that supervisors adhere to international standards of high quality and not have a national bias. The same is true for audit firms.

The current Big Four services are essential to perform high quality audits on firms operating globally. Concerning the current market structure, including the dominance of the Big Four, it should be taken into account that the existing oligopoly was created by the market itself. For instance, the fact that the +2 (BDO, Grant Thornton) have not grown fast enough to a ‘Big Six firm’ was partly the result of their own strategy. In our view, the issue should be dealt with by the market itself under the existing legal (market competition) framework.

Some may argue in this respect that institutional investors should do more business with smaller audit firms. This appears to be difficult in practice. The coverage of offices and the expertise and experience in smaller firms are not always sufficient enough to meet the requirements of globally operating institutional investors. Institutional investors can simply not afford to take unnecessary
risks in their worldwide portfolios as a result of accepting a degree of audit quality which might potentially be suboptimal.

We would however welcome if DG Competition keeps a close eye at this oligopoly. The impact thereof limits competition and necessary developments and innovation in the market. The impact of possible suboptimal competition limits necessary developments and innovation in the market. The development of fees and profits in the audit profession over the years is an indication that this market might not be competitive.

Joint audits
Eumedion clearly opposes the introduction of mandatory audit firm consortiums for the audits of large companies in order to encourage the emergence of other players. The practical experience in France is not convincing. It would be a rather costly and inefficient way of conducting audits. As already set out above, potential issues on getting competition and choice in the market for audit firms should be addressed by the market itself in accordance with the legal (market competition) framework.

If you would like to discuss our views in further detail, please do not hesitate to contact us. Our contact persons are Gerben Everts (email: gerben.everts@apg.nl, tel. +31 45 579.2249) and Wouter Kuijpers (wouter.kuijpers@eumedion; tel. +31 20 708.5882).

Yours sincerely,

Rients Abma
Executive Director