INT/551
Audit Policy

Brussels, 16 June 2011

OPINION

of the

European Economic and Social Committee

on the

Green Paper - Audit Policy: Lessons from the Crisis

COM(2010) 561 final

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Rapporteur: **Mr Morgan**

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On 13 October 2010 the European Commission decided to consult the European Economic and Social Committee, under Article 304 of the Treaty on the Functioning of the EU, on the

Green Paper - Audit Policy: Lessons from the Crisis
COM(2010) 561 final.

The Section for the Single Market, Production and Consumption, which was responsible for preparing the Committee's work on the subject, adopted its opinion on 26 May 2011.

At its 472nd plenary session, held on 15 and 16 June 2011 (meeting of 16 June), the European Economic and Social Committee adopted the following opinion by 153 votes to 1 with 7 abstentions.

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1. Conclusions and recommendations

1.1 Overview

1.1.1 The Green Paper is entitled "Audit Policy – Lessons from the Crisis". The EESC believes the scale of the crisis was due to the fact that none of the parties involved performed as they should have, least of all the boards of many banks. Given the failure of bank boards, regulators, supervisors and statutory auditors (SA) should have detected the problems which caused the crisis. This they failed to do. The EU has already addressed the issues of regulation and supervision. A review of the role of SA is clearly necessary – indeed, the EESC called for just such a review in its 2009 opinion on the De Larosiere Report[1]. The Green Paper goes beyond the role of audit to consider matters such as governance, supervision and concentration. The EESC agrees that these issues do have a bearing on the performance of auditors during the crisis.

1.1.2 The Green Paper asks 38 questions. Three questions deal with very contentious issues: question 18, mandatory tendering, question 28, joint audit and question 32, reversing big four consolidation. In each case, whatever policy the Commission is minded to adopt, the EESC urges that a rigorous impact assessment is conducted before arriving at any decision.

1 OJ C 318, 23.12.2009, p. 57.

1.2 Role of the auditor

1.2.1 The role of the SA as presently defined and practiced is not fit for purpose. The Audit or Supervisory committee is the essential counterpart to the SA.
Greater independence for the SA and a reformation of the audit or supervisory committee are central to the proposals in this opinion.

1.2.2 The EESC proposes that the 2006 Audit Directive be amended in order to enhance the role of the audit or supervisory committee:

- A majority of committee members and the committee chairman must be independent.
- The competence of some Committee members must be relevant to the sectoral characteristics of the company involved, especially in the banking sector.
- The audit or supervisory committee should not only monitor, but actually take responsibility for the integrity of the audit process.

1.2.3 In respect of dual management systems which have both a management board and a supervisory board, the EESC favours strengthening the link between the SA and the supervisory board.

1.2.4 In general, the EESC sees a need for the following improvements:

- clarification of the SA's remit and corresponding responsibility;
- greater clarity and intelligibility in the SA's reporting, especially in respect of existing risks;
- making the audit more of a company health check by a commentary on the analysis prepared by the main or supervisory board of the viability of the business model, its financial strength and the visibility of and approach to business risks;
- better communication between the SA and the company's supervisory bodies during the year, while the audit is still ongoing.

1.3 Governance and independence

The EESC does not support the mandatory rotation of SA engagements but it agrees that the continuous engagement of SA firms should be limited by mandatory re-tendering the audit contract every six to eight years. The provision of non audit services by SA to their clients should be strictly controlled by the express approval of the audit or supervisory committee while for larger companies the provision by the SA of risk advice and internal audit services should be banned because of the conflict of interest involved. Provision of tax advice should be curtailed whenever a material SA conflict of interest could be involved.

1.4 Supervision

There should be a statutory obligation for SA and supervisors to meet regularly. This is particularly necessary in the case of systemically important banks.

1.5 Concentration

The concentration of most of the large company audit market in the hands of the Big Four firms is an oligopoly. There were five firms until Arthur Anderson failed. Another failure would be unthinkable. The EESC recommends short term action via living wills to mitigate the effect of a possible firm failure. For the longer term, the Committee considers that a reconfiguration of the market will be necessary. To this end it recommends referral of the oligopoly to Member State competition authorities starting with Germany, the Netherlands and the UK.

1.6 European market

The creation of an effective European market for statutory audit is a desirable goal, but differences in tax, law and language remain formidable obstacles. Some rationalisation is possible.

1.7 Simplification for SMEs

SMEs come in all shapes and sizes. If there are external investments and or important bank facilities and or major customers and suppliers concerned about the integrity of their value chains, it is difficult to envisage many short cuts.

1.8 International cooperation

The EESC considers this to be mandatory. This requires initiatives with the FSB and the G20 but the most immediate efforts should be with the USA via the G8

1.9 Corporate Governance

The EESC regrets that the Audit Policy Green Paper does not include a chapter on corporate governance. A new Green Paper on Corporate Governance (COM (2011) 164 final) has just been published. It is imperative that the Commission integrates its proposals on corporate governance with its proposals on audit policy. These issues are inextricably linked in so far as the veracity of company accounts is concerned.

2. Introduction

2.1 Under existing legislation, it is the responsibility of the board of directors to keep the accounts of the company and to present a true and fair view of a company's affairs. Large companies are obliged to use the IFRS accounting convention. It is the responsibility of the SA to give an opinion as to whether a true and fair view has been presented by the board and as to whether the IFRS convention has been followed. The report of the directors and the opinion of the SA are both published in the Annual Report and Accounts of companies. Pre-crisis annual reports prepared by bank directors gave no warning of the coming crisis while SA continued to give those reports a clean bill of health. The main lesson from the crisis is that this state of affairs needs to change. It is the view of the EESC that the focus of that change should be on the audit or supervisory committee and safeguarding the independence of the SA.

2.2 The status quo is reflected in the statements by directors and SA published in Annual Reports. The Committee has also examined statutory audit reports from France, Germany, Spain and the UK. In all Member States, the focus of the SA is on procedure and process. Reference to IFRS conformance is repeated by SA throughout the EU. Concerns are now being expressed that box ticking IFRS conformity is removing judgement from some aspects of accounting and auditing.

2.3 An examination of audit opinions in Germany by one of the Big 4 firms on the 2009 accounts of Deutsche Bank, Munich Re and BMW inter alia reveals, in the English translation, almost identical wording, although the three businesses are very different. This tendency to use stylised text hides the substance of the audit from the user. The SA confirms that appropriate procedures have been followed, but there is no evidence of the richness of the audit. The EESC believes that changes are needed to ensure that audit reports put substance ahead of form.

2.4 External auditors largely rely on the internal control systems of their clients, with a great part of the audit focus being on the integrity of these systems. Larger companies have formal internal audit functions which are independent of the finance function and report directly to the audit committee. Internal audit is responsible for verifying the integrity of internal control systems. Some companies sub-contract internal audit to a third party. Where this is the case, the sub-contract services should never be provided by the appointed SA firm. It is the responsibility of the audit or supervisory committee to ensure the independence of the internal audit function and, by extension, the integrity of the system of internal controls.

2.5 While the audit will provide assurance of the financial information contained in the annual accounts, currently no specific opinion is given on the business decisions taken by the Company. One of the lessons from this crisis is that directors should identify in their reports the underlying state of affairs, including an assessment of the "risks", and that that SA should provide a level of assurance on these statements. For this reason, SA should not advise their clients on risk assessment and risk management[2].

2.6 After considering the deficiencies and failures of the present system of reporting to shareholders and stakeholders and especially in the light of the fate of certain banks during the crisis, there has been widespread support for expanding the role of the audit or supervisory committee. For example, the UK Financial Reporting Council has proposed the following principles as a basis for the reform of reporting:

– *higher quality narrative reporting, particularly on business strategy and risk management;*
– *more widespread recognition of the importance of Audit Committees and, therefore, greater emphasis on their contribution to the integrity of financial reporting;*
– *greater transparency of the way that Audit Committees discharge their responsibilities in relation to the integrity of the Annual Report, including oversight of the external auditors;*
– *more information about the audit process, both for Audit Committees and for investors and a broadening of the scope of the auditor's responsibilities; and*
– *more accessible Annual Reports through the use of technology.*

2.7 The EESC endorses these principles. The implications are as follows:

1. *Directors* will need to describe in more detail the steps that they take to ensure both the reliability of the information on which both the management of a company and the directors' stewardship of the company is based; and provide more transparency about the activities of the business and any associated risks.

2. *Statutory Auditors* will need to provide reports that includes a section on the completeness and reasonableness of the Audit Committee report and identifies any matters in the Annual Report that the SA believe are incorrect or inconsistent with the information contained in the financial statements or obtained in the course of their audit.

3. The growing strength of *Audit or Supervisory Committees* in holding management and SA to account should be reinforced by greater transparency through fuller reports by these committees explaining, in particular, how they discharged their responsibilities for the integrity of the Annual Report and other aspects of their remit such as their oversight of the external audit process and appointment of SA.

2 Risk management involves the identification, assessment, and prioritization of risks (defined in ISO 31000 as the effect of uncertainty on objectives, whether positive or negative) followed by coordinated and economical application of resources to minimize, monitor, and control the probability and/or impact of unfortunate events or to maximize the realization of opportunities. The strategies to manage risk include transferring the risk to another party, avoiding the risk, reducing the negative effect of the risk, and accepting some or all of the consequences of a particular risk; source: Wikipedia.org.

2.8 The 2006 EU Directive on Statutory Audit contains the following instructions in respect of audit committees:

Each public-interest entity shall have an audit committee. The Member State shall determine whether audit committees are to be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity. At least one member of the audit committee shall be independent and shall have competence in accounting and/or auditing.

Without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity, the audit committee shall, inter alia, monitor:

1. *the financial reporting process;*
2. *the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;*
3. *the statutory audit of the annual and consolidated accounts.*

2.8.1 In order to give effect to the principles and precepts detailed in paragraphs 2.6 and 2.7 above, the EESC believes that this instruction must be modified while the existing rules on co-determination are retained, to require that a majority of committee members and the committee chairman should be independent.

2.8.2 A simple requirement of competence in accounting and/or auditing is insufficient. The competence of some Committee members must be relevant to the sectoral characteristics of the company involved, especially in the banking sector.

2.8.3 The EESC believes that the audit or supervisory committee should not just monitor, but actually take responsibility for the integrity of these processes, in line with the principles and precepts detailed in paragraphs 2.6 and 2.7 above.

2.9 If it is given that the directors are responsible for the accounts, consideration should be given to the roles and responsibilities of directors in respect of the veracity of the accounts. For example, directors certify that they have made all the necessary enquiries to enable them to stand behind the accounts with good conscience. Can we believe that banking boards were making the necessary enquiries in the pre-crisis period? Did they have any comprehension of their liquidity risks, the poor quality of their mortgage related assets and of the risks embedded in their loan books? In future, banks and other companies will need to ensure that the independent directors appointed to the board come with an appropriate skill set and a better understanding of their role and responsibilities.

2.10 The principles detailed in paragraph 2.6 above will require a more general review of corporate governance if they are to be successfully implemented. It is essential that the conclusions from both Corporate Governance and Audit Policy Green Papers are integrated so that there are no gaps between them.

2.11 In summary, while directors are responsible for presenting a true and fair view of the business, the SA have to be sure that a true and fair view has been presented. Limitation of liability is an extraordinary privilege enjoyed by public limited companies. The statutory audit is designed to ensure that privilege is not abused. Shareholders, bondholders, bankers and other creditors have a direct financial exposure. They depend directly on the veracity of financial statements. The livelihood of other stakeholders – whether employees, customers or suppliers - depends on the company continuing as a going concern. In the banking crisis statutory auditors failed, as did all the other responsible parties. Audit cannot be immune from the reform and supervision being introduced elsewhere in the financial system. The *status quo* is not an option.

3. Questions

3.1 *Introduction*

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

Please refer to section 1 of this opinion.

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 veracity of financial statements is the *sine qua non* of a society which depends largely on the performance of public limited liability companies in a market economy. The public interest requires that companies survive and thrive. There is a complex multiplicity of dependent interests: shareholders, bondholders, banks and other creditors who depend on the statements to judge the safety of their investments and loans; employees who depend on the statements to judge the safety of their jobs and wages; other stakeholders who depend on the statements to judge the security of the company as an employer, supplier or customer; local communities and local and national governments which rely on the accounts as a measure of the company’s contribution to society, as well as its taxpaying capacity.

Apart from these considerations, banks and other credit institutions play a fundamental role in the operation of the market economy. During the financial crisis banks failed to fulfil their role of moving money around the economy. As a result, the veracity of their financial statements prior to the crisis has been rightly called into question. True and fair financial statements are the bedrock of EU political, social and economic organisation. Firms which undertake statutory audits are responsible for protecting the public interest.

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

Yes, audit reports are not meaningful. They do not reflect the work of the SA. With the advent of IFRS, the audited accounts may also be less meaningful, particularly in the case of the banks.

3.2 *Role of the Auditor*

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

As they stand, audits are not fit for such a purpose. The on-going financial health of a company is a function of the resilience of its business model. Testing the model is mainly the role of institutions and analysts, not the SA. Even so, changes must be made. In their reports, directors need to be more transparent about the actual health of the company. Providing external assurance on these disclosures should then be a function for the SA. To do this, SA will need sector specific understanding of inherent risks which appears to have been lacking as the complexity of banking assets increased. In this context, there should also be an explanation of the judgements made to confirm the going concern.

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?**

Yes. SAs make brief statements in the Report and Accounts but these are process oriented and reveal nothing of their findings, concerns or judgements. It is not just a question of explaining methodology. The directors must explain their judgements and decisions and then the SA should explain the process by which they conclude that the accounts do give a true and fair view. In doing this, it will be important to ensure that SA do not once again revert to boiler plate language.

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

Professional scepticism can be reinforced by training, non-audit experience, peer review of audit findings and the leadership of audit partners. In addition, the greater transparency required of the auditors under the proposals in section 2 will require SA to exercise professional scepticism more rigorously than heretofore. The establishment of a professional disciplinary body in each Member State would reinforce scepticism.

It is likely that professional scepticism would be further enhanced by economic independence. The scale of non-audit services supplied to audit clients should be reviewed and critically assessed by the audit or supervisory committee so as to restrict any conflict of interest between the exercise of professional scepticism and the retention of important client revenues. It is also possible that scepticism would be reinforced if mandatory tendering (question 18) reduced the probability of extended tenure by the incumbent audit firm.

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

No. Shareholders and stakeholders should be concerned if the report of the directors needs to be qualified by the SA. However, greater transparency in the reporting by the Directors and/or the Audit or Supervisory Committee may provide greater clarity to shareholders as to the reasons why an SA has qualified an audit report.

In the case of banks, a qualification can create a crisis of confidence with potential systemic implications. Therefore any SA concerns should be reported as soon as possible to regulators and supervisors so that potential issues are speedily addressed.

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

SA have a responsibility to shareholders and by extension to employees and other stakeholders. They do not report separately to stakeholders. The company is responsible for information provided to stakeholders. As proposed in section 2, more information should be provided to the company's supervisory bodies, shareholders employees and other stakeholders by both directors and SA , and with greater transparency.

In addition, the EESC urges that in those audit reports made to main and supervisory board, the SA comments clearly on risks ascertained. The SA should be a source of information that brings to light potential risks to the company's viability. This information should provide a commentary on possible risk scenarios, potential damage levels and their probability. The effects of accounting policies on the company's assets, finances and profits should be assessed in a more transparent way.

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 banking crisis would suggest regular and adequate dialogue did not take place in all cases, but in many cases it will have. An enhanced role for the audit committee would result in improved communications .

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

Possibly, but not before there is EU agreement on what the reporting standards might be.

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?**

Stakeholders are covered at Q8 above. Timing is not an issue.

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

The Commission should review of the impact of the introduction of IFRS, particularly in respect of their application to banks. There is a concern that critical concepts like prudence and accounting conservatism have been superseded in IFRS by process and compliance to standards. There is evidence that, by limiting auditors' scope to exercise prudent judgment, IFRS offers less assurance. IFRS also has specific defects, such as its inability to account for expected losses.

Oral evidence given to the UK House of Lords enquiry into audit market concentration showed that the weaknesses of IFRS are especially serious in relation to bank audits[3].

International Standards on Auditing (ISAs)

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

Supportive. However strict neutrality vis-à-vis the respective national legal systems must be respected.

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, possibly by regulation.

3 House of Lords report published on 15 March 2011, "Auditors: Market concentration and their role", volume 1, page 32. http://www.parliament.uk/hleconomicaffairs.

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

Not necessary.

3.3 *Governance and Independence of Audit Firms*

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?**

There is a potential conflict, but it is manageable. Greater transparency in relation to the appointment and re-appointment of SA is needed, and this is included in the proposals outlined in section 2. Appointment by the Company (Audit or Supervisory Committee and shareholders) allows for an SA to be appointed that is best able to meet the particular requirements of that company, for example knowledge of the business sector and requisite international reach.

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

Not in normal circumstances. However, the question might arise in relation to systemically significant (SS) institutions such as large banks. If supervisors are in regular contact with the SA of SS institutions, and they are dissatisfied by their performance or their independence, the supervisor should have the power to require the institution to make a change. This need only be a reserve power, since a company aware of supervisory concern would be likely to make the change itself.

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?**

In responding to this question, the EESC first of all expresses a caveat: any proposed change to the status quo should be subject to a rigorous impact assessment.

The rotation of audit teams and leaders and normal life cycles of Chairmen, CEOs and CFOs mean that at an individual level there is a more than adequate sequence of revolving relationships. The issue is corporate to corporate: the SA need to keep its clients and the client's willingness to keep an auditor with which it feels comfortable. These long term relationships are a potential threat to independence and professional scepticism.

The EESC does not support the limitation of SA engagement through mandatory rotation but it does recommend that large companies carry out a mandatory tender of their statutory audit contract every six to eight years. The invitation to tender should be sent to at least one firm outside the big four. Such an exercise will not necessarily lead to a change of SA. Therefore the process needs to be transparent. The Audit Committee should explain the basis of its tender and of its decision. It should also hold a meeting with its principal shareholders in this context.

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?**

There should be no restriction on SA firms supplying non-audit services to companies other than their statutory audit clients but such services should only be provided to statutory audit clients with the express approval of the audit or supervisory committee. To enhance the independence of the statutory audit of large companies, the SA should not provide risk advice to the client, nor should it be the internal auditor. The provision of tax advice should be curtailed whenever a material conflict of interest could be involved. Broadly speaking, non-audit services involve either consulting or accountancy. Consultancy is less likely than accountancy to raise conflict of interest issues *vis a vis* the statutory audit. Audit committees should approve all non audit services provided by the SA and avoid conflicts of interest. Committees should also monitor the total value of these non audit services and this figure should be published in the Annual Report.

In the case of SMEs, a more relaxed regime may be envisaged. SMEs come in all shapes and sizes. In many cases, it would make sense for taxation and risk advice to be provided by the SA firm.

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

This can only be answered in the context of each audit firm’s total revenues at the national level. The current threshold of 15% of a national firm's fees resulting from one client, as contained in the IESBA Code of ethics, is sensible to recognise that audit fees are a function of the scale and complexity of the audited company. Clients are relentless in driving these fees down. Fees for non audit work paid to the audit firm should be reported separately.

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

Yes, but these rules need to recognise that Big Four networks comprise separate national firms rather than being one entity. Audit firms should publish their accounts, just like the companies they audit.

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

In some jurisdictions, auditors give a formal annual confirmation of independence. In one Member State they follow a governance code for audit firms. Where a conflict of interests arises, they must withdraw from one or other engagement. In addition, audit firms should employ independent directors and advisors.

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

The limited liability partnership is an attractive structure for audit firms. The comparator is the public company structure of credit rating agencies which undoubtedly had some bearing on the disastrous rating decisions which led to the financial crisis. If not faced with the threat of unlimited liability in Member State courts, the partnership arrangement should be sufficiently robust. Nevertheless, if other forms of incorporation help to widen the market, they should be encouraged. Limitation of liability could have the double benefit of encouraging the entry of new capital as well as incentivising mid range audit firms to bid aggressively for large company mandates.

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

Group auditors should certainly have the necessary authority and access to fully discharge their responsibilities towards group shareholders.

3.4 ***Supervision***

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

There is an international dimension relating to such issues as standards, passports and the international networks of audit firms. Nevertheless, SA firms operate through national units under Member State supervision. The EESC would support a college of national supervisors linked to the new EU framework for financial supervision.

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

There are already certain statutory requirements, although there is evidence that in the years prior to the crisis, SA / supervisor dialogue had broken down in certain Member States. The EESC recommends that the new European Banking Authority should define banking specific requirements. Furthermore, regulators should hold the chairman and the board responsible for communication with them, with sanctions available if the company fails to communicate key issues.

3.5 ***Concentration and Market Structure***

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

We consider that there is a real risk of disruption of the market. We do not believe that the failure of any one SA firm presents an immediate systemic risk to the market. However, from the point of view of independence and market, dominance by just three firms would be utterly unacceptable. The recent financial and economic crisis has highlighted the fact that in risk management, every eventuality should be covered.

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?**

The legal requirement that companies should be audited by a consortium of at least two firms exists in France. Similar provisions used to be in place in Denmark but were found to be no longer needed. In France this requirement has applied to listed companies since 1966. It was extended to companies obliged to publish consolidated accounts in 1984 at a time when the Anglo American audit firms were rapidly increasing their market share. To an extent, the policy has succeeded. In a 2006 study[4] of 468 French companies based on 2003 data, 54 were audited by two Big Four auditors, 241 (51.5%) by one Big Four and one French firm while the balance of 173 were covered by various combinations of large and small French firms.

The shape of the audit market in France is not just a function of legislative intervention. Company ownership in France is much more concentrated than in Anglo-Saxon countries and this affects the audit requirement. Using the same sample, the single largest investor owns 25% or more of 73% of French companies. The largest ownership groups are other companies (34%), family ownership (25%) and the general public (21%) while international investors hold just 8.5%.

The study found that *"In particular, the use of Big 4 auditors increases when the ownership structure is less concentrated by a single large block holder, and has more international and public investors; while the use of Big 4 auditors is less likely when there is large family ownership. In addition, a Big 4 auditor is more likely as institutional ownership (banks and pension funds) increases. Importantly, there is evidence that some*

4 Assessing France's Joint Audit Requirement: Are Two Heads Better than One? by Jere R. Francis, University of Missouri-Columbia and Chrystelle Richard, Université Paris Dauphine and Ann Vanstraelen, Universiteit Antwerpen and Universiteit Maastricht.

of these ownership characteristics are also associated with the use of two rather than one Big 4 auditor".

Given this linkage between ownership and audit, these findings suggest that it is unsafe to conclude that the French legal environment is the sole determinant of the audit market structure in France. However, in this regard, it should be noted that contrary to what the Commission is proposing, under French law there is no obligation to involve a "smaller" firm alongside a "larger" one in the joint audit. As the Commission has acknowledged, the responses to the Green Paper consultation on this question were mixed, particularly as regards whether joint audits would deliver better accounts or add bureaucracy and cost.

In answer to the question, joint audit would increase the involvement of smaller firms in the large company market. As to whether this would actually reduce concentration, and over what timescale the EESC urges the Commission to undertake a profound impact assessment before coming to any conclusion on this point. The EESC believes that competition law can provide an additional way of dealing with the oligopoly.

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?**

The EESC does not support mandatory rotation. As regards mandatory tendering please refer to our response to Question 18.

30) **How should the "Big Four bias" be addressed?**

The EESC supports the abolition of any artificial bias towards the "Big four" firms, such as banking covenants. Mandatory assignment of tasks only to the Big Four should be prohibited. The Commission may consider introducing a scheme to certify the large company audit competence of the next rank of audit firms.

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

There should be contingency plans for both Audit firms and national regulators. Audit firms are international networks. The best strategy would be to focus on containing any failure at the Member State level while maintaining the integrity of the rest of the network. Living wills would be the key to any containment strategy. Early warning of potential problems would facilitate the implementation of contingency plans.

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?**

As in our response to Q 18, the EESC is adamant that any action contemplated in this area be subject to a profound impact assessment. As the future Asian superpowers expand worldwide, it is likely that their audit firms will follow their clients. Any government mandated action to force a change in the market for audit should be considered in a 20 year time frame. In addition, the potential impact of the law of unintended consequences should be seriously considered.

It is difficult to envisage a reversal, but the important thing is to enforce competition law in the audit market. The EESC would favour references to Member State competition authorities starting in Germany, the Netherlands and the UK. Competition authorities should also carefully scrutinise any proposed acquisitions by Big Four firms.

3.6 *Creation of a European market*

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

Harmonisation of regulations and applicable laws would be a starting point. Introduction of ISA would also help. The variety of the tax, law and language in the 27 Member States is undoubtedly a barrier to full scale cross border mobility.

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?**

Yes, but we should not underestimate the difficulties involved. It would be conceivable to have a European auditor passport for the area of statutory IFRS financial reporting. The decision as to which auditor or SA firm could receive such a passport must therefore be based on whether the auditing practice can or will carry out audits of IFRS financial statements.

3.7 ***Simplification: Small and Medium Sized Enterprises and Practitioners***

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?**

SMEs come in all shapes and sizes. If there are external investments and or important bank facilities and or major customers and suppliers concerned about the integrity of their value chains, it is difficult to envisage many short cuts. The work of a certified accountant could be adequate for a self financed micro enterprise.

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

Yes, but the case for prohibition is not made.

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?**

See question 35. Small companies have small simple audits anyway.

3.8 ***International cooperation***

38) **What measures could in your view enhance the quality of the oversight of global audit players through international cooperation?**

Involvement with the G20 and the FSB but, to start with, the most important measure would be cooperation at the G8 level, with particular focus on close links with regulatory bodies in the USA.

Brussels, 16 June 2011.

The President
of the
European Economic and Social Committee

Staffan Nilsson