
**Our point of view**

Ernst & Young believes that in the wake of the financial crisis there is an opportunity to take a fresh look at whether auditors could do more to contribute to investor confidence and enhance financial stability. We therefore welcome the recent European Commission (EC) Green Paper on audit policy, and encourage the EC to make audit quality the benchmark against which any future proposals are assessed.

**Context**


In the Green Paper, the EC is seeking, among other things, to address three broad questions:

i. What is the current role of the audit profession and whether it should change

ii. Whether the profession is sufficiently independent from the companies that we audit

iii. Whether the audit market is excessively concentrated.

These questions have important implications, not just for the audit profession but also for investors and companies in Europe and around the world. Some of the ideas discussed in the Green Paper, even if they were confined to the European Union (EU), would nevertheless have a global impact as many businesses have operations in Europe that would be affected if they were to be implemented. Moreover, the EC has made it clear that it intends to lead a global discussion of the issues raised in the Green Paper. Thus, interest in the Green Paper is not limited to Europe.

The EC will hold a conference in February 2011 to continue the dialogue on these issues. The Green Paper could potentially culminate in new legislation to be considered by the European Parliament some time in 2011.

While all of the issues addressed in the Green Paper warrant careful consideration, a few are of particular concern due to their potential to impair audit quality. Several of the measures discussed could weaken the role of audit committees – and thus disenfranchise shareholders – in overseeing the appointment of and working relationship with a company’s external auditor. We discuss these and other key issues below.

---

1 The Ernst & Young comment letter is available on ey.com
Key points

Role of the profession

► As policy makers take a fresh look at the role of the auditor and the relevance of the audit, it is important to distinguish between a company’s responsibility to report its results to the market and the responsibility of the auditor to provide assurance on that information.

We support efforts to enhance the understanding and value of the auditor’s work. The crisis has prompted questions about whether there should be additional disclosures about what auditors do and how they do it, as well as whether they could do more to contribute to investor confidence and enhance financial stability. We agree with the EC that measures to improve communication about the audit process could be helpful to users and engender greater confidence in audited financial statements.

From what we hear from investors, there is a desire for more insight into certain discussions among management, the audit committee and the external auditor. Therefore, consideration should be given to strengthening the role of the audit committee to include a report to investors providing greater transparency into key financial statement risks and critical judgments and estimates discussed with management and the auditors. The auditor could then be asked to attest to the disclosures made in such an audit committee report, based on globally consistent standards that would need to be developed.

Questions also have been raised about whether corporate reporting itself should be improved to enhance users’ understanding of an entity. Consideration should be given to whether corporate reporting could be enhanced to include improved and more relevant disclosures in areas such as the business model, risks, controls, management estimates and judgments, and sustainability. With an increasing amount of information relevant to the market coming outside the financial statements, the importance of internal controls is likely to grow in order to build trust in the reliability of that information. Therefore, we believe it would be valuable to have a broad global discussion with all stakeholders – investors, preparers, audit committees and regulators – about the importance of internal controls, not just over financial reporting but also over other operational aspects of an enterprise.

The EC suggests that consideration also could be given to expanding the role of auditors to provide assurance on non-financial statement information. We agree. For example, auditors could potentially be required to provide some level of assurance or attestation – or have other involvement with – certain information outside of the financial statements, including, for example, on a company’s narrative reporting (e.g., MD&A), as well as any enhanced business reporting that may evolve. If this were to move forward, consistent standards would need to be developed.

Independence of the profession

► To address independence concerns raised in the EC Green Paper, we believe that policy makers should take actions to promote strong and robust audit committees and avoid measures that reduce an audit committee’s responsibility or role in a company’s corporate governance framework.

In our view, independence is the cornerstone on which confidence in the audit profession is built and audit committees are crucial to the oversight of auditor independence. As the EC considers proposals relating to the audit process and audit profession, it should consider the implications for audit committee oversight, specifically how companies and audit committees manage the audit and auditor relationships. Some of the measures discussed in the Green Paper would remove audit committee oversight and responsibility, which are critical to our effectiveness as auditors. We would not support proposals that would remove important decisions from the
We recommend that the following measures be considered as possible responses to the questions raised by the EC about independence:

- Enhancing the role and responsibility of audit committees in all aspects of financial reporting and audit processes
- Giving audit committees clear responsibility for appointing the auditor and negotiating the audit fees on behalf of the company’s shareholders
- Requiring audit committees to be independent of management, with highly qualified, competent members who are actively engaged in all aspects of the financial reporting and audit process and able to challenge management and auditor judgments as appropriate
- Encouraging audit committees to conduct periodic evaluations of audit quality in determining whether there is a need to re-tender the audit, and to explain why they have not re-tendered the audit after more than a set period of years
- Encouraging audit committees to pre-approve significant permissible non-audit services and to disclose the nature and amount of such services provided to the company by the audit firm

control of boards and audit committees, who are responsible to shareholders and best situated to assess the needs of the audit. In particular, we believe the decision to appoint an auditor should remain with the audit committee. Appointment of the auditor by a third party such as a regulator would disenfranchise shareholders – the owners of the company.

During the past decade measures have been put in place to mitigate the potential conflict in an auditor being appointed and remunerated by the same audited entity. For example, potential conflicts are addressed by the strict independence requirements that now apply to auditors and audit firms. The independence requirements are further reinforced in many countries through oversight by independent audit regulators. In our view, the EC should emphasize the key role that audit committees play in fostering auditor independence.

Empowered and independent audit committees play a vital role on behalf of shareholders in protecting independence and preventing conflicts of interest. While their specific responsibilities vary across jurisdictions, audit committees generally are responsible for appointing the auditor and in many places also for negotiating the audit fees on behalf of the company’s shareholders. We believe that this should be the case everywhere, and that consideration should be given to enhancing the role and responsibility of audit committees in all aspects of financial reporting and audit processes.

Audit committees need to be strong and robust, with highly qualified and competent members who are independent of management. They should be appropriately resourced so they can be actively engaged in all aspects of the financial reporting and audit process, and able to challenge management and auditor judgments as appropriate. Consideration could be given to requiring audit committees to conduct periodic evaluations of audit quality in determining whether there is a need to re-tender the audit, and to explain why they have not re-tendered the audit after more than a set period of years.

Audit quality

- Audit quality must be the priority as revisions to the audit framework are considered. Proposals that threaten audit quality should be rejected.

The Green Paper recognizes that continuity in the provision of high-quality audits to large companies is critical to financial stability. However, a number of the ideas the EC discusses would have far-reaching consequences for the structure of the audit market, threaten audit quality, and be highly disruptive to companies and investors. For example, the EC asks the following questions:

Should the largest audit firms be broken up?

No. While we agree that there are only a few audit firms of sufficient global scale to serve the upper end of the public company audit market, it must be recognized that large audit networks have grown to their current size over a significant period of time due to natural evolution and consolidation in order to be able to perform audits of large, complex multi-jurisdictional companies. The huge investment needed to perform these audits to a consistently high standard world wide – in technology, intellectual property, infrastructure, training methodology, independence monitoring and compliance – has required larger firms to grow and merge their practices both to fund this investment and to maximize possible economies of scale. Thus, breaking up the largest firms would diminish rather than enhance audit quality for companies whose audits require the depth and breadth of resources offered by the largest audit firms. For Ernst & Young in particular, we believe our highly integrated global organization strengthens the ability of Ernst & Young firms to deliver seamless, consistent, high quality service worldwide. A breakup, or “reverse consolidation” as the EC terms it, would in our view go in the wrong direction, increasing risk and reducing audit quality, to the detriment of investors and companies.
Should the provision of non-audit services be prohibited?

No. In our view, delivering the most complete range of permissible services increases a firm's knowledge of the company and its risks and processes, all of which contribute to audit quality. Moreover, an “audit-only” firm could be detrimental to audit quality as such firms would encounter difficulty in hiring qualified specialists (e.g., in tax and valuations) that are fundamental for a quality audit. The objectivity of the auditor is not compromised by providing permissible non-audit services to audit clients, provided that auditors and companies comply with the existing robust independence standards. In addition, audit firms and the networks with which they are affiliated have a strong system of quality control and are subject to significant independent oversight by audit regulators.

It may be worth considering whether audit committees in all countries should be required to pre-approve significant permissible non-audit services, and to disclose the nature and amount of permissible non-audit services provided by the auditor. This could provide an additional level of oversight and transparency.

Should there be mandatory audit firm rotation?

No. Audit committees and boards, representing the interests of shareholders, should be free to appoint the audit firm that best meets their needs at the time they believe appropriate. It does not need to be mandated by law. These decisions should remain in the hands of the audit committee. Mandatory firm rotation can threaten audit quality because it erases the cumulative knowledge an audit firm builds up over time about an audit client. While audit firms obviously can and do manage transitions effectively, this is not without cost or risk. Many countries (including the majority of those in the EU) have decided not to adopt mandatory firm rotation.

The concerns underlying the EC’s discussion of mandatory firm rotation are better addressed by audit partner rotation, coupled with robust independence requirements and effective regulatory oversight. The natural turnover of client personnel also keeps relationships between the audit firm and the audit client fresh. The CEOs and CFOs in large listed companies tend to rotate more frequently on average than the audit partner rotation requirements. In addition, as noted above, audit committees could be asked to perform a periodic assessment of the quality of service provided by their statutory auditor and explain in their audit committee report how they assessed audit quality and why they have not re-tendered the audit after more than a set period of years.

Should there be compulsory joint audits?

No. Compulsory joint audits have significant disadvantages. Most importantly, mandating joint audits would mean that the board or audit committee, acting on behalf of the shareholders, would not be making the decision as to whether a joint audit is appropriate for a particular company. Companies in most countries today can opt for a joint audit if it suits their needs. However, this is rare, as joint audits present challenges in coordinating between two audit firms as well as additional costs from duplication and risks of gaps. Compulsory joint audits also would restrict choice by reducing the pool of audit firms from which a company can select its auditor as the number of non-conflicted firms that are able to compete in a tender situation would be lower.
We recommend consideration of the following approaches to increase choice of auditor:

- Implementing measures that would increase the visibility of firms outside the largest networks, giving them the incentive to make the investments necessary to serve larger and more globally complex companies
- Prohibiting contractual restrictions that prevent companies from appointing audit firms outside the largest networks
- Encouraging audit committees to reflect upon their audit needs, taking into account the necessary breadth and depth of audit resources, and to consider a wider universe of audit firms when re-tendering the audit

In addition, we recommend the following measures be considered to reduce the likelihood that a large firm will exit the market:

- Encouraging audit firms to work with their regulators to develop contingency plans
- Developing reasonable limitations on an auditor’s liability, which in many countries is the single largest threat to the sustainability of uninterrupted audit services to the market, due to the unlimited and uninsurable nature of the risk

**Concentration**

- Concern about concentration in the upper end of the public company audit market is understandable, and efforts to increase auditor choice should be considered. However, care must be taken not to erode the audit committees’ fundamental responsibility to select the auditor.

In the context of the public company audit market, the three issues of concentration, choice and competition are quite distinct though often confused. There is concentration in the upper end of the global public company audit market, and the number of audit firms from which to choose may be limited for the very largest companies where the global reach and capacity of the very largest audit firms are essential. Nevertheless, most companies around the world do not face this constraint because they are not as global or complex in scale. Importantly, even within the upper segment of the market, competition among accounting firms is intense, with firms competing fiercely based on accounting expertise, audit quality, industry knowledge, firm culture, geographic reach, and other factors. In other words, concentration has not led to an absence of competition. Nor does concentration in any way diminish audit quality.

We support efforts to increase the choice of auditor, provided that such measures would not impair audit quality or erode the responsibility of audit committees to appoint the auditor and oversee the audit process. For example, there could be measures to increase the visibility of firms outside the largest networks, giving them the incentive to make the investments necessary to serve larger and more complex companies. Policy makers should consider encouraging audit committees to reflect upon their audit needs, and consider a wider universe of audit firms when re-tendering the audit, taking into account the necessary breadth and depth of audit resources. In addition, contractual restrictions that prevent companies from appointing audit firms outside the largest networks should be prohibited.

Moreover, the EC is understandably concerned about the effects on markets and investors if a large audit firm were to fail. We believe it is important to reduce the likelihood that one of the large firms could be forced to exit the audit market. Encouraging audit firms to work with their regulators to develop contingency plans could help address this concern. In addition, the EC should continue to explore with its counterparts reasonable limitations on an auditor’s liability which, in many countries, is the single largest threat to the sustainability of uninterrupted audit services to the market due to the unlimited and uninsurable nature of the risk.

**Global coordination**

- Global coordination among policy makers and regulators is necessary, given the inter-connectedness across the global capital markets.

Many of the issues discussed in the Green Paper would, if implemented, affect companies outside of the EU. In addition, they could harm European competitiveness by, for example, increasing companies’ regulatory burden and the cost of audits. Therefore, when considering proposals that would fundamentally alter the structure of the profession, the role of the audit, or other key aspects of the audit, the EC should keep in mind the inter-connectedness of global markets and the need to adopt consistent regulatory approaches and avoid anti-competitive measures.

There is a need for consistent high quality regulatory standards across markets so that investors can have comparability between international companies and confidence in the information available. This is why we continue to call for a single set of high quality global financial reporting standards and support the global adoption of International Standards on Auditing (ISAs), including in the EU as the Green Paper proposes for consideration. Moreover, we encourage greater cooperation and information exchange among national audit regulators. To bring about more consistency and quality in oversight, audit regulators need to agree on common oversight.
frameworks. To this end, the International Forum of Independent Audit Regulators provides an important venue for regulators to share information and best practices and contributes to higher quality oversight.

In this context, we also agree with the EC that enhancing cross-border mobility for audit professionals within the EU, and creating a “single European passport” for auditors and audit firms are steps that could reduce barriers to entry, without posing harm to audit quality.