GENERAL REMARKS on APPROACH and PURPOSES of GREEN PAPER on AUDIT

1. Introduction

As board of OvRAN, a Dutch private association of accountants, we appreciate very much your wish to assume leadership in an international discussion on the role and scope of audit as part of financial market regulatory reform. From experience we believe to qualify to judge on shortcomings of the existing situation at least in the Netherlands. To fully understand the existing audit situation, a short historical overview is in order.

Since the "4th Council Directive" on audit (78/660/EEC of 25 July 1978) ruled that larger company accounts should be audited, the world and the audit profession has changed a lot. In those years many small local accounting firms existed, auditing mostly local companies with some activities outside the national borders. Audit professionals were proud of their largely personal service to the public that company accounts were solid, without fraud and could be relied upon. A lot of paper to check, business software unavailable.

But the world has changed. Companies went global and increased in size. Every company uses mostly comprehensive business software for almost all details. Regulations and multiple oversight bodies cover almost all company activities in all countries, thus increasing complexity in the running of companies. Most accounting firms felt thus obliged to support its clients by specialized advice. First as a simple extension of audit, later as independent profit centers. Nowadays, larger accounting firms sell quite a lot of services that have nothing to do with audit or accounting. These developments enabled and forced smaller accounting firms to consolidate in much larger global firms. A virtual Big Four accounting oligopoly is the result. In the Netherlands for example it is estimated that only 20-30% of turnover of Big Four firms is related to auditing and accounting thereby serving > 80% of all audit clients. Partners of those firms earn many times the salary of the best paid public servants. These larger accounting firms act now as a virtual accounting oligopoly and have a strong interest regulating the profession and influencing lawmakers in all possible ways. This way a legal audit obligation has turned into an effective protection, not to the public as intended, but to an oligopoly of insiders.

In the meantime audit itself became compromised. Audit became viewed by insiders as a poorly paid, risky but vital service to get a foothold into a company to sell other better paid services. This threat to independence of auditors was inadequately covered by law. The "8th Council Directive"(84/253/EEC of 10 April 1984) just mentioned the words "integrity and independence". After many accounting scandals[1] Directive 2006/43/EC went further but took regretfully the view on independence that: "*this should not lead to a situation where Member States have a general duty to prevent statutory auditors or audit firms from providing non-audit services to their audit clients.*" Not every EU-member took notice of the fact that auditors are just as greedy as normal people. When they tried to prevent non-audit services of auditors, such as in France, easy escape routes are allowed in practice. In most other countries many fine words on independence just cover the fact that the auditor himself is allowed to give his own opinion on his own independence. So a variety of calibrated measures are vital to escape human greed.

In developing these measures it is essential to be fully aware that the existing accounting oligopoly influences law making heavily by creating barriers to entry of national markets. From own experience we saw for example that the Dutch government prevents virtually the creation of new associations of accountants. The pretext is that freedom of association as prescribed in art. 11 of the Convention of Fundamental Rights, does not apply to publicly regulated accounting bodies such as Nivra. This despite ample EU case law proving the contrary. Even your own unit MARKTD4 avoided handling complaints about infractions of EU-law and directives, by taking among others the view on these barriers that "*accounting is not a regulated profession within the meaning of Directive 2005/36*"[2] and maintained even, in spite of the principle of "home regulation" in Directive 2006/43/EC, "*it is normal that the auditors from other Member States performing audits of subsidiaries in the Netherlands are subject to the Dutch oversight and the rules of ethics applicable in the Netherlands.*" As you yourself quite rightly pointed out on page 18, the Directive 2006/43/EC allows only for approval, registration and aptitude test and these requirements act already as barriers to cross-boarder audit. These very recent examples show that even law makers and oversight bodies engage actively in preventing cross-boarder competition and strengthen protection of local markets.

Question 1: From the foregoing you may conclude that we agree with your approach and purposes. We stress the point that audit independence and free competition are vital in law making and public oversight.
Question 2: We agree also that there is a need to better set out the societal role of audit
Question 3: We believe also that "audit quality" should be further enhanced. Not necessarily by further regulation and oversight but by increased free competition and decreasing the expectation gap.

1 *See http://en.wikipedia.org/wiki/Accounting_scandals#Notable_accounting_scandals*

2 *On the recognition of professional qualifications*

2.1 Role of the auditor and communication

Your remark that "*statutory audit evolved from substantial verification of income, expenditure, assets and liabilities to a risk based audit approach*", is more then true regretfully. The same holds for your remark that this "*risk based approach is less targeted to give 'reasonable assurance' and more geared to ensure that the financial statements are prepared in accordance with the applicable financial reporting framework.*" These two remarks are part of the same basic picture: avoiding auditing risks. Substance over form are nice words but put yourself in the place of an auditor.

Human beings continually balance risks and opportunities. Auditors therefore balance between the risk to lose an important client or being caught by oversight bodies and/or legal actions for mistakes made. So, there is a natural tendency to show as much verifiable clerical check points as possible within the financial reporting framework. This extensive framework has been developed over the years by IASB and FASB to very complicated and confusing structures with inconsistencies between US-Gaap and IFRS and interpretation difficulties. Maybe its application leads to sufficient insight into the companies affairs. In any case this framework does not pretend to reveal the ultimate real cause of company bankruptcies: lack of liquidity or lack of trust of liquidity providers be it banks or financial markets refusing to offer cash. These real threats on liquidity are very difficult to verify or to predict and develop often very fast. An auditor drawing public attention to these real threats irritates management of an audited company and increases the very liquidity risks management wants to avoid at any price[3]. So, practical human beings such as auditors tend to avoid this dilemma until it is too late. Therefore, the cost/benefit relation of public audit is questioned in many arena's. In our opinion there is no easy solution for this dilemma on the auditors role. However, the underlined policies below enforced by law would help:

1. Audit and substantial other services with the same client having also a large percentage of total turnover, should be avoided at all costs by automatic protection limits against dependency. We at OvRAN apply a 10% as a maximum for other than pure audit services. These limits should be part of EU law. Tools should exist to combat avoiding structures.
2. Actually audit reports, management letters, long form reports and so on are not available to the public. Normally the public just sees an unqualified audit opinion as a black/white picture. The real world at the contrary contains all shades of gray. Audit opinions tends to maximize the use of legal wordings to avoid any liability and material details. EU-law should make audit opinions reveal more material detail a. what kind and amount of audit work has actually been done, b. give a hint about current discussions with management or the audit committee, c. contain a qualified and quantified opinion on the probability of various liquidity threats. This way all audit opinions will always contain shades of gray and some qualifications to lessen the expectation gap.
3. The cost/benefit relation of public audit work is under question. Larger companies have no way to resist the regulation and audit framework created by the Big Four oligopoly regulation. Changing auditors is difficult, audit processes remain hidden to management, material criticism by management of audit processes are near impossible. Real competition on audit quality is failing. To enable competition on audit quality a number of measures should be put in place by EU-law: a. companies should be allowed to gain insight into audit processes and costs, b. they should be authorized to limit audit work they deem to be not worthwhile resulting in qualified opinions, c. with permission of the shareholders they should be authorized to be relieved of all public audit after discussion on viable alternatives such as internal audit, specialized audit on certain regions or business aspects etc., d. free competition on public audit work should be encouraged to enable smaller specialized audit firms to gain part of the cake. The threshold for public audit obligation should be much higher.

Our answers to your questions 4-12 are the following:

Question 4: Audits should provide comfort on the financial health of companies but actually audits are not fit for such a purpose. Its very value, at least the cost/benefit relation, is seriously questioned nowadays.
Question 5: The expectation gap should be closed by allowing and stimulating internal and external criticism and viable alternatives under terms of free competition between fully independent auditors.
Question 6: 'Professional criticism' can only be reinforced by the same measures as proposed under points 1-3 and summarized with our answer to question 5.
Question 7: Negative perceptions on qualified opinions should be reconsidered by making all opinions qualified as proposed under points 1-3.
Question 8: Additional information should be available as proposed with points 1-3.
Question 9: Dialogue between external, internal auditors and the Audit Committee will be improved with the measures as proposed under points 1-3 are turned into law.
Question 10: Auditors should play no role in CSR reporting.
Question 11: Communication between auditors and stakeholders should increase as proposed with point 1-3.
Question 12: The value of audits will increase by implementing the measures as proposed under points 1-3.

3 *Systematic public denial of any liquidity risk by auditors, bank supervisors and management is amply shown by Lehman, Fortis and a long list of other less well known company disasters.*

2.2 Role of the auditor and International Standards of Auditing(ISA's)

Your recommendation to introduce ISA's by binding or non binding legal instruments, should be judged on its effects. Although ISA's are clarified, there remains quite a lot of space for interpretation. ISA's are written with large company structures and large auditing units in mind. On paper, room is allowed for smaller accounting and audit firms. However, especially interpretations how to apply ISA's to smaller accounting and audit firms, allow for space to regulate the profession by dominant parties for other purposes than the public good. Strong barriers to competition may be the result as is the case in the Netherlands.

Almost all accounting organizations in the EU are member of or adhere to Ifac standards. So new community law instruments would have little effect in any case. If nevertheless community law instruments on top of Ifac standards are developed to introduce ISA's in the EU, complimentary legislation is needed to prevent that one dominant group of accountants applies her interpretation of ISA's on all accountants in the same country. In most countries there is often only one association of accountants allowed to set accounting regulations for all its members over the entire country. This might create strong barriers to competition if this association is in effect managed by one dominant group of accountants such as the Big Four oligopoly.

In the UK and Belgium there are more associations of accountants and accounting bodies allowed. However, also in these countries remain legal or practical obstacles to create other associations of accountants or accounting bodies. This despite the fundamental right of freedom of association.

So if you decide to introduce ISA's by binding or non binding legal EU instruments, than all national barriers to create associations of accountants should be abolished by these same instruments. If not so, ISA's might just lead to limited competition as a result not of the ISA's itself but of the resulting binding interpretations under influence of oligopoly members.

Question 13: The introduction of ISA's in the EU might be useful but is of little effect because almost all EU accounting bodies and associations already adhere to all Ifac standards. To prevent that specific interpretations of ISA's leads to barriers to entry and limited competition, all national barriers to create associations of accountants should be abolished.
Question 14: The same answer holds for your question whether legal instruments or endorsements are applied to introduce ISA's in the EU.
Question 15: There is no need to adapt the ISA's further to the needs of SME's and SMP's. The ISA's give on paper enough room to the needs of SME's and SMP's. The only problem is a matter of definition and interpretation and that might lead to barriers to competition under certain circumstances.

3. Governance and Independence of audit firms

As you will have noticed we more than fully agree with your remark that "*Independence should be the unshakeable bedrock of the audit environment.*" You will also have concluded that we fully agree that in the current audit landscape existing measures as appointment, remuneration, rotation and selling non audit services, need to be reinforced. Reinforcing these measures is not enough in our opinion, the current landscape itself should change fundamentally in order to reduce the expectation gap and restore confidence in financial statements.

Your proposal to introduce third party appointments and remuneration of auditors might be considered if other measures prove to be politically not viable. The same holds to your proposal to reinforce mandatory rotation of audit firms and partners. We prefer the indirect scenario set out in points 1-3 on the role of the auditor. Free competition and the use of market forces, stimulated by law, is a much better and less bureaucratic way to ensure independence as the unshakable bedrock of the audit environment. The pro's and contra's of rotation can better be decided upon by management, audit committee or shareholders. In this context we recommend that shareholders not only approve nominations but gain the right to disapprove and appoint other auditors. The qualified audit opinions we recommend will furnish a solid base to judge on the necessity of change.

As to your proposal to ban non-audit services we fully agree that independence is the unshakable bedrock of the audit environment. It should have been implemented long ago in every country. Maybe some practical space should be given. For example 10% of the total audit fee on a client as an automatic maximum of non-audit services to the same client fines on trespassing. Tools should exist to combat avoiding structures. Definitions of both client and audit network rely heavily on the network definition applied. Avoiding structures are easily created by clever structuring of the audit network(e.g. your wife or friend runs formally the advice business) or client network(splitting into formally independent groups). Greed takes many creative forms.

As to your recommendation to limit dependency on a single client an automatic limit should prevail, for example also 10% of total turnover of the firm, followed by automatic fines on trespassing. Your case to make exceptions for small audit firms sounds sympathetic but should be avoided. Also small firms may make the wrong decisions driven by greed. We recommend to change the audit environment as set out in points 1-3 on the role of the auditor notably point 3. Enabling companies to judge on the cost/benefit relation of certain public audit work and forgo or substitute elements of it, gives small audit firms a big chance.

As to your recommendation of full transparency of the audit firm, we fully agree including the possibility to have audit work on their own accounts done by non competing statutory audit bodies.

As to your recommendations on organizational requirements, owner- and partnership rules we fully agree. These measures however will have little effect compared with changing the audit environment itself as proposed in points 1-3 on the role of the auditor.

As to your recommendation on group audits we more than fully agree. This recommendation is vital to enable smaller audit firms to focus on larger companies together with a fundamental change of the audit environment as proposed in points 1-3 on the role of the auditor.

Question 16: There might indeed be a conflict between public interest and the auditor being appointed and remunerated by the audited entity? If a fundamental change of the audit environment as proposed in points 1-3 on the role of the auditor, proves to be impossible, then we would support the idea that nominations and remunerations are settled by a third party. The capacity and preferences of that third party does not work necessarily better than market forces and competition.
Question 17: In some cases the appointment by a third party might be justified if agreed by the share- or stakeholders of the company or organization.
Question 18: A time limit on the length of continuous engagement of an audit firm might be justified when the audit environment does not leave enough space for competition and market forces.
Question 19: Provision of non-audit services by audit firms should be limited in all cases, it undermines independence.
Question 20: The maximum level of fees an audit firm can receive from a single client should be limited.
Question 21: New rules about transparency of financial statements of audit firms are indeed required.
Question 22: New rules enabling the group auditor to have access to all information are essential and required.
Question 23: We support alternative structures of raising capital for audit firms provided not enforced by law.
Question 24: We strongly support the suggestion group auditors having unlimited access to all information.

4. Supervision

Your remarks that international supervision of audit firms should be more integrated, has our support. The same holds for your remark on the mismatch between pan European audit networks and national supervision. Reinforcing the dialogue between regulators and auditors, also sounds like a good idea. But, better supervision and more dialogue should also remain efficient and may not lead to close relationships. Stockholm syndromes take many forms and many directions as we noticed in the Netherlands.

Question 25: The European Group of Auditors' Oversight Bodies (EGAOB) should decide whether the additional costs of more international supervision of audit firms is worth the additional costs and risks.
Question 26: Decisions to reinforce the dialogue between regulators and auditors, should also better be left to the EGAOB considering the additional costs and risks.

5. Concentration and Market Structure

We more than fully support your remarks about the risks inherent in the actual oligopoly market structure. On top of the risks you already defined, we would like to draw your attention to the additional risk of undue influence by this oligopoly on regulators, be it national of international. In this respect we would like to recall the examples on page 1 where lawmakers create barriers to entry of national accounting markets. These examples exhibit the fact that regulators where either not fully aware of the subject or were heavily influenced.

As to your remark on joint audits / audit consortia we support your suggestion. There is a big risk that forced consortia might reinforce the actual oligopoly if the choice of a consortium partner is left to a Big Four company. When supervisors make that choice, bureaucracy might result. Therefore we would like to focus attention to the need to change the accounting environment fundamentally as we proposed in points 1-3 on the role of the auditor. These proposals offer a variety of possibilities, do not need to be enforced by law and should have preference above specific regulations on what is in effect just one possible solution out of a range of a solutions. Deciding among those solutions can better be left to market forces.

On mandatory rotation of auditing firms and partners, enough has already been said on this subject under 3. governance and Independence of audit firms.

The "big Four is best" bias is best addressed by fundamental changes in the accounting environment as we proposed in points 1-3 on the role of the auditor. "Big Four only clauses" should be void and forbidden by law.

We fully support your suggestions on a contingency plan when larger audit firms fail. Such a contingency plan should also reinforce the meager insurance cover, the larger audit firms actually possess. One of our proposals under points 1-3 on the role of the auditor allows already formation of consortia. In the actual oligopoly market structure, forming consortia are next to impossible from a commercial point of view. When forming an accounting consortium is allowed as a company decision on his own audit as we propose, market forces will give consortia a much better chance.

About your doubts expressed on the rationale for consolidation into large audit firms, we deem it is time for a rethink. The audit obligation might be part of the rationale. If the consolidation of the past can be reversed, remains to be seen. In any case the current oligopoly market structure, has big disadvantages that should be addressed preferably by market forces and not by law. By changing the accounting environment as we proposed in points 1-3 on the role of the auditor, these market forces get a real chance.

Question 27: We support your belief that the current market configuration presents a systemic risk.
Question 28: We support your suggestion that mandatory formation of an audit firm consortium with the inclusion of at least one small audit firm might combat the existing oligopoly. A better way is a fundamental change to the accounting environment as proposed under points 1-3 on the role of the auditor.
Question 29: We support mandatory rotation and tendering if a more fundamental change to the accounting environment, proves to be not viable politically.
Question 30: The "big Four is best" bias is best addressed by fundamental changes in the accounting market.
Question 31: Contingency plans incl. living wills could help to address systemic risk.
Question 32: The current oligopoly should be reversed, competition should be restored. A reversal may be achieved using market forces as we suggested under points 1-3 on the role of the auditor.

6. Creation of a European market

Your remark that still many barriers to cross-boarder mobility remain, is more than true. The obstacles are much bigger than the ones you mentioned. The Dutch government for example refuses to implement Directive 2005/36 on recognition of professional qualifications as to accounting. It supports even discrimination between Dutch and non-Dutch accountants. Even your own unit MARKTD4 maintained that "*accounting is not a regulated profession within the meaning of Directive 2005/36*"[4]. Complaints on national discrimination were disregarded with the remark: "*Discrimination is forbidden by the Treaty where it affects non-nationals.*" Despite the principle of "home regulation" in Directive 2006/43/EC your own unit MARKTD4 stated: "*It is normal that the auditors from other Member States performing audits of subsidiaries in the Netherlands are subject to the Dutch oversight and the rules of ethics applicable in the Netherlands.*" Very expensive legal procedures and other actions are under way to change this state of mind of Dutch law makers and European supervisors. This state of mind makes the creation of a European accounting market virtually impossible. These examples are just part of a much larger picture in probably most EU countries.

As long as this state of mind persists, nothing can be reached. Simple but rigorous enforcement of existing directives on the accounting profession(2006/43/EC), recognition of professional qualifications (2005/36) and services (2006/123/EC) in all countries is the best way in the short run to go forward to a European market. This requires however intimate knowledge of national accounting habits and accounting regulations in your own units and a persistent pursuit of all violations.

A practical problem remains that language, tax and other regulations differ enormously between each country. This raises already an enormous natural barrier for an accounting practitioner.

Question 33: The best way to enforce cross-boarder mobility in the short run is rigorous enforcement of existing rules and directives on the accounting profession in all countries.
Question 34: Creation of a single European passport might make sense but only in the long run if natural barriers like language, tax and other regulations, do no longer prevail. This passport should of course also apply to smaller firms.

7. Simplification: Small and medium sized enterprises and practitioners

Your remark about discouraging statutory audit of SME, has our full support. The limits on statutory audit should therefore be raised substantially. Stakeholders of SME's know much better than auditors what is going on in their company. Stakeholders will continue to ask for assistance on accounting matters if they feel that need. Regardless of its form, any accounting and audit work helps SME's to convince banks, tax authorities and other third parties to better believe their financial statements. Thus, every assistance of a qualified accounting professional gives some sort of assurance. It may be left to national habits what form this might take. So as to SME's, statutory audit is more of a burden than support. Increasing limits on statutory audit, also helps to overcome transitional difficulties when non-audit services to an audit client become forbidden.

If the limits on statutory audit are substantially raised and non-audit services to an audited client are prohibited, nothing will change as to SME's where audits are no longer deemed necessary. The change will only affect larger firms under audit obligation as a result of the automatic limit on non-audit services as a guarantee for independence. Therefore we propose an automatic limit of 10% on non-audit services to the same client. After the introduction of such automatic limits on non-audit services, temporary measures should prevail in a transition period of 2 or 3 years.

Question 35: When there is no audit obligation, most companies will use some sort of "statutory review", "limited audit" or whatever the local name, to satisfy third parties. That is a natural process. Professional registers of accountants may help to that effect. Tying specific services to specific professional registers of accountants may be considered but is better left to local habits than formalized on a European level.
Question 36: If limits on statutory audit are substantially raised, a safe harbour regarding any future prohibition of non audit services is not necessary. If not so, there should be a longer transition period.
Question 37: A "statutory review", "limited audit" or whatever the local name, might indeed be accompanied by less burdensome internal control rules and oversight. This should remain up to the accountant to judge. Internal control rules however should be left to the company to decide and not be the result of putting names on some audit results.

4 *On the recognition of professional qualifications*

8. International Cooperation

As to your doubts on mutual reliance on auditors of third countries, it is our belief that a painstaking step by step, country by country, approach is in order. We see no standard method to choose between avoiding a duplication of efforts and risks resulting from trust not deserved. Basic element in this process is the judgment of the European group auditor. If all European group auditors rely heavily on third country audits, there is little reason not to trust the third country supervisor.

Question 38: We do not see any clear and practical way to enhance the quality of global audit players except by the use of market forces as suggested under points 1-3 on the role of the auditor.

CONCLUSION

We sincerely hope that some of the ideas and steps you recommend, will be implemented within a few years. This effort is worthwhile because actually the purpose of audit: to serve the public, has been undermined. Several developments turned audit from substance into form. You made that very clear with your basic points:

- ✓ "*statutory audit evolved from substantial verification of income, expenditure, assets and liabilities to a risk based audit approach*", and
- ✓ "*this risk based approach is less targeted to give 'reasonable assurance' and more geared to ensure that the financial statements are prepared in accordance with the applicable financial reporting framework.*"

There will be strong resistance of interested parties. You will have realized that those steps may result in making audit services much more expensive or totally unattractive because cross-selling is not longer allowed.

For both eventualities we remind you of our previous recommendations to change the accounting environment fundamentally as proposed under points 1-3 on the role of the auditor. The existing black/white unqualified accounting opinions have proven to be of little intrinsic value. The expectation gap should diminish by making all accounting opinions contain at least a qualified opinion on liquidity threats. The legal audit obligation should return into being an effective protection to the public as intended, and not to an oligopoly of insiders. Therefore founded criticism and viable alternatives should be allowed.

To counter critics on your and our proposals, all measures taken should be combined with a substantial increase of the threshold for public audit obligations and/or enabling management or the audit committee under certain conditions to abstain from certain audit procedures or public audit altogether.

This last proposal will be under severe attack by the suggestion that audited companies will unduly influence the audit outcome. It should be noted that this is already the case in other ways. We have confidence that national supervising bodies will know how to safeguard the veracity of the audit outcome. When necessary national supervising bodies should be authorized to request a previous consent of the conditions to abstain from certain audit procedures or public audit altogether.

Board of OvRAN
Contact Details
Mr. Drs. C.B.A. Spil RMC
Postal Address: Lage Driesstraat 25, 5268 BP Helvoirt
Phone: 00-31-411-641699 Fax: 00-31-411-6414008
Mail: bestuur@ovran.nl

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