CENTER FOR AUDIT QUALITY
Serving Investors, Public Company Auditors & the Markets

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Green Paper on *Audit Policy: Lessons from the Crisis*

Dear Ms. De Basaldua:

The Center for Audit Quality (CAQ) is an autonomous public policy organization representing a membership of approximately 700 public company auditing firms that is dedicated to enhancing investor confidence and public trust in the capital markets. The CAQ fosters high quality performance by public company auditors, convenes and collaborates with other stakeholders to advance the discussion of critical issues, and advocates policies and standards that promote public company auditors' objectivity, effectiveness and responsiveness to dynamic market conditions.[1] The CAQ is entirely funded by membership dues. Membership in the CAQ is open to U.S. accounting firms registered with the Public Company Accounting Oversight Board (PCAOB) and others.[2]

We appreciate the opportunity to comment on certain topics raised in the European Commission's (Commission) green paper on *Audit Policy: Lessons from the Crisis*. Our comments represent the observations of the CAQ, but not necessarily the views of any specific member firm, individual or CAQ Governing Board member.

[1] The CAQ receives strategic guidance from a 12-person Governing Board that includes three members from outside the public company auditing profession.

[2] Associate membership is available for U.S. accounting firms not registered with the PCAOB. We also offer international firm subscriptions. For more information about the CAQ and its Governing Board, please visit its website at http://www.thecaq.org.

As the green paper notes, auditors have not been cited as a cause of the recent financial crisis. We believe that auditors generally carried out their role effectively during the crisis and appropriately reached audit opinions within the context of the applicable accounting and auditing frameworks. Nevertheless, the CAQ agrees that there are lessons to be learned from the crisis pertinent to the role of the auditor and the relevance of the auditor's report. We also acknowledge that the information needs of the marketplace continue to evolve as markets become more global and intertwined.

The green paper raises a wide range of topics that could dramatically alter the structure and role of the audit profession and have the unintended consequence of undermining audit quality to the detriment of investors. Given the important role auditors play in contributing to confidence in markets, it is of great importance that before statutory or regulatory changes are effected, there be an explicit acknowledgement of the importance of the auditor's *current* role in providing an opinion on the fairness of a company's financial statements. If auditors are to continue to meet their obligations in a responsible manner, which serves to promote market confidence, the profession must be sustained and permitted to evolve in a manner that facilitates its ability to meet the needs of domestic and global markets and investors.

The public company auditing profession has an important role to play in the capital markets and firsthand experiences to share in related discussions. Therefore, we welcome a thorough consideration of the costs, benefits and consequences of the various proposals to change the current reporting model and audit market structure discussed in the green paper.

Instilling Confidence in Markets (Qs. 1, 2, 3)

The CAQ strongly believes that along with corporate governance and governmental oversight, a robust audit is a necessary element for sustaining confidence in markets. We further believe that audit quality is a process of continuous improvement and requires significant focus on the part of firm management. It is particularly striking that confidence in audited financial statements of U.S. publicly-traded companies has remained high despite the financial crisis. For the last two years, 70 percent of U.S. individual investors expressed confidence in audited financial information released by publicly-traded companies.[3] This suggests that, even in the midst of the largest financial crisis in memory, the fact that a company receives an unqualified audit opinion from its independent auditor engenders confidence in the majority of individual investors.

We note that implementation of oversight programs takes time: the investor protection programs implemented in the U.S. under the U.S. Sarbanes Oxley Act of 2002 (Act or Sarbanes Oxley Act), including independent oversight of public accounting firms, is now only eight years old and still maturing.[4] European Union (EU) nations are implementing independent auditor oversight

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[3] The Center for Audit Quality. The CAQ "Main Street Investor Survey." September 2010. http://www.thecaq.org/newsroom/pdfs/2010SummaryInvestorSurvey.pdf. The survey has a sampling error of only +/- 3 percentage points of what they would be if the entire population of investors had been polled with complete accuracy.

[4] The Sarbanes Oxley Act of 2002 aimed at regaining market confidence by defining clear duties and requirements for preparers, boards of directors (and specifically audit committees), auditors, and regulators – all designed to broaden investor protection. Among other things, it closed regulatory gaps by giving the SEC broader rulemaking mandates, and importantly, created the PCAOB, a regulator independent of the profession with full authorities including inspections and enforcement authority. CEOs and CFOs who have primary responsibility for financial reporting must now certify the effectiveness of their internal controls over financial reporting and the accuracy of

programs under the Commission's Company Law Directive 2006/43/EC on Statutory Audit (audit directive of 2006). The regimes vary and some countries are still in their first year of inspections. Adoption of ISAs and the IESBA Code of Ethics throughout the EU would encourage consistently high quality audit practices across nations and help the Commission's efforts to enhance audit quality. These regulatory requirements should be given time to impact the audit profession and studied to see if modifications are necessary.

In addition, we understand that the Commission plans to publish a green paper on corporate governance in the coming months. Yet, many of the ideas discussed in this green paper could have a significant impact on corporate governance (including the role of the board and audit committee), and on current reporting models for companies and auditors. Accordingly, we respectfully recommend that the Commission consider comments received on the corporate governance paper in connection with its consideration whether to take further action regarding audit policy.

Role of the Auditor

Expectation Gap (Qs. 5, 12). Auditors of U.S. publicly-traded companies are required to plan and perform audits to obtain reasonable assurance whether the financial statements, taken as a whole, are free of material misstatement and, for companies with $75 million or more of market capital, whether effective internal control over financial reporting was maintained in all material respects. Given the complexities of performing an external audit, auditors perform a very considerable amount of work in assessing the risk that a material misstatement exists (including assessing the risk of fraud), and performing appropriate tests and verifications to obtain sufficient evidence on which to form an opinion on a company's financial statements. Regulators, auditors and companies recognize that reasonable assurance is a high level of assurance, although not a guarantee. Yet investors and other stakeholders do not always understand the work that underlies the audit opinion.

The CAQ has been concerned about what we see as an expectation gap for some time and has taken steps to help address misperceptions about the auditor's role and the scope of work involved in an audit of financial statements. We believe that a more concerted effort by the profession, academics, investor groups, preparers and regulators to educate stakeholders through dissemination of expanded information about the nature and extent of the audit would be very effective in educating investors about the extensive work underlying the auditor's report, would narrow the expectation gap and increase the perceived value of the audit. This in turn would engender an even higher level of confidence in audited financial statements.

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their financial statements (companies with market capitalization over $75 million are required to have their auditors attest to the effectiveness of the controls). Audit committees of public companies were required to be composed of independent directors. In addition, audit committees, rather than management, were given responsibility to hire, fire and oversee auditors, and to ensure the auditor's independence from management. Audit committees also are required to pre-approve any non-audit services by the auditor even if permitted under the Act and PCAOB rules. The law requires disclosure of audit and non-audit fees paid to auditors in annual company proxy statements. Auditors also are subject to independent oversight by the PCAOB and specific independence and ethics standards (under the Act, SEC rules and PCAOB rules), including rotation requirements for lead and second review partners.

Audit Report and Other Assurance (Qs. 4, 5, 10). Despite the fact that a large majority of U.S. investors are confident about audited financial statements, we recognize that there is a desire to make audit reports themselves more relevant to today's business environment. We believe that the strong confidence investors, analysts, regulators and other stakeholders have in the work of the auditor underlies the suggestions from some of them that the auditor's report could provide more information about the audit, and that the role of the auditor might be expanded to provide assurance on, or otherwise have some involvement with, certain nonfinancial disclosures presented by a company.

In the United States, the PCAOB has embarked on an assessment of the form and content of the auditor's report and a consideration whether there are additional user needs. The PCAOB already has identified changes that would clarify the auditor's report to provide more transparency around the scope of an audit underlying the audit opinion and thereby help to narrow the expectation gap. We understand it is in the process of conducting research and outreach on the auditor's reporting model. Others, such as the Financial Reporting Council, the International Auditing and Assurance Standards Board, also are considering these issues.

We strongly encourage regulators to coordinate closely before adopting any new requirements on the form of the auditor's report to avoid divergent and potentially confusing communication models. In addition, regulators should consider whether an expansion of the auditor's role could inadvertently serve to increase the expectation gap or downplay the company's responsibilities in these areas. We also recommend that if regulators do encourage or require auditors to provide these services, applicable professional standards must be carefully delineated so as not to be confused with an audit.

For example, the green paper identifies the conundrum that can result when an auditor concludes that a company's financial results are fairly and accurately presented, even though the "health" of the company might be questionable when viewed more broadly. But audits in their current form are designed to give assurance on financial information provided by management of a company as of a point in time.[5] The audit is not designed to provide an opinion on a company's business model or likely earnings; that role is filled by analysts, rating agencies and the company itself.

With respect to providing assurance on the reliability of corporate social and environmental responsibility reports, reporting frameworks are still in the development stage and there is no agreement on definitions or on how to integrate nonfinancial information with financial information. Some of the global audit networks are involved in these initiatives; for example, the International Integrated Reporting Committee that was launched in August includes regulators,

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[5] Under PCAOB standards, the auditor has a responsibility to evaluate whether there is a substantial doubt about a company's ability to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements being audited. This evaluation is based on his or her knowledge of relevant conditions and events that exist at or have occurred prior to the date of the auditor's report and information from management how the conditions are to be mitigated. If, the auditor still concludes there is substantial doubt, he or she should consider the possible effects on the financial statements and the adequacy of the company's disclosure about its inability to continue as a going concern for a reasonable period of time, and include an explanatory paragraph in the audit report. If the auditor concludes that substantial doubt is alleviated, the auditor still should consider the need for disclosure of the principal conditions and events that caused the auditor to believe initially that there was substantial doubt.

standard setters, preparers, auditors and users of financial statements. As these initiatives evolve, the audit profession can provide considerable input by helping to identify processes for establishing consistent and informative reporting formats and assurance processes. Where appropriate, auditors might provide assurance, although this would require a clearer understanding of the liabilities of the assurance provider.

Communication and Professional Skepticism (Qs. 6, 8, 9, 10, 11). The CAQ believes that regular dialogue between the audit committee and the auditor should be the norm if audit committees are to fulfill their responsibilities for the company's financial reporting processes. In the United States, the audit committee is a hub for coordinating many financial reporting communications because it has primary reporting lines from management and the external auditor. While we believe there is regular dialogue between the audit committee and external auditors, there may be opportunities to expand communication across all those involved in the financial reporting process (management, audit committee, internal audit and external auditors). Opportunities to expand communication include the auditor and audit committee identifying the information the committee needs to effectively evaluate the company's critical accounting estimates and assumptions, and the auditor employing increased sensitivity to external factors (e.g., general economic conditions or conditions specific to the audited entity or its business sector) that could inform the auditor's risk assessment and be shared with the audit committee. In addition, audit committees might consider private sessions with the above parties. We recommend that before acting on these suggestions, the Commission consider the need for additional research and outreach to auditors and audit committee members aimed at identifying the nature and extent of information that could be provided to the audit committee to facilitate oversight of the financial reporting process in an effective and efficient manner.

Effective communication between the auditors and preparers and auditors and audit committees is key for exercising professional skepticism, which is a fundamental element of a successful audit. The CAQ strongly supports efforts to continually enhance the application of professional skepticism by auditors. Just as important, skepticism should be employed more consciously by audit committees, boards, and management, which have primary responsibility for financial reporting. To make this happen, the CAQ has entered into a collaborative partnership with Financial Executives International, The Institute of Internal Auditors, and the National Association of Corporate Directors. The partnership plans to improve the capabilities of all those responsible for financial reporting to detect and deter financial reporting fraud. One of our key initiatives will be aimed at developing techniques to enhance the application of skepticism.[6]

With respect to whether auditors should have regular communications to external stakeholders, we recommend looking first at ways to improve the communications and reporting provided by companies to external stakeholders, including the possibility of expanded reporting by audit committees. As noted earlier, discussions around the content of the auditor's report and consideration whether auditors might provide assurance or other forms of reporting around additional, non-financial disclosures would, if adopted, expand the auditor's communications with external stakeholders, but care should be taken to assure that these new roles do not jeopardize their independence or confuse their roles with those of analysts, rating agencies and company management.

[6] http://www.thecaq.org/newsroom/pdfs/CAQPressRelease_10062010.pdf

Auditor Independence (Qs. 16, 17, 19, 22)

For auditors to fulfill their role in providing reasonable assurance that financial statements, taken as a whole, are free of material misstatement, they must be independent of management and able to perform their task with an objective perspective. The green paper suggests a number of measures that might be implemented to further reinforce this independence, some of which (e.g., appointment of the auditor by third party, mandatory firm rotation, and a blanket prohibition of non-audit services) would go far beyond what is needed to accomplish this goal. We believe that the conflict of interest that exists when an auditor is appointed and remunerated by the entity can be mitigated through independence rules, ethics requirements and, importantly, placing responsibility on audit committees to oversee the auditor. We do not support a third party appointing the auditor as that would completely undermine the role of the audit committee and investor choice and would implicate the government in private corporate matters.

Similarly, mandatory firm rotation is likely to undermine audit quality by reducing the responsibility of the audit committee (or shareholders) to select the auditors. It also is costly for companies, and increases the burdens on audit committees to oversee the work of the auditor. We also note that private and public sector studies consistently have recommended against mandatory firm rotation because of cost and other inefficiencies for companies and their shareholders.[7]

One unintended consequence of prohibiting audit firms from providing non-audit services to their audit clients is that clients may lose access to the range and depth of skills offered by multi-disciplinary firms. Auditing can require special expertise that is developed through audit, tax, advisory and other non-audit services. If an audit firm does not have sufficient experts on complex issues, it may not be able to provide the quality of audit service expected. Moreover, without the variety of rich work experience offered by a multi-disciplinary environment, firms would not be able to attract and retain the highest caliber professional staff. The competitive environment must allow – and incentivize – firms to maintain resources necessary to address a wide range of complex audit issues, particularly for a large multinational company.

The EU audit directive of 2006 addresses auditor independence by, among other things, giving audit committees a central role in monitoring the independence of auditors and audit firms, requiring partner rotation and mandating independent auditor oversight bodies. The Commission's independence concerns can be mitigated by staying the course set forth by the EU Recommendations on Auditor Independence, which are generally as robust as international standards under the IESBA Code of Ethics. These provisions (and similar requirements in the

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[7] For Example: The International Chamber of Commerce, *Policy Statement: The Adverse Effects of Compulsory Audit Firm Rotation*, 2005; The European-American Business Council, *EABC Policy Paper: EABC Opposes Mandatory Audit Firm Rotation*, 2007; The Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Fraudulent Financial Reporting 1998 – 2007: An Analysis of U.S. Public Companies*, 2010, http://www.coso.org/documents/COSOFRAUDSTUDY2010.pdf; and Cameran, M., Prencipe, A., Trombetta, M., *Auditor Tenure and Auditor Change: Does Mandatory Auditor Rotation Really Improve Audit Quality*?, working paper, Bocconi University (Milan- Italy) and IE Business School (Madrid- Spain), 2010. See also Carcello, Joseph V., and Albert L. Nagy. Audit Firm Tenure and Fraudulent Financial Reporting. *Auditing: A Journal of Practice & Theory. Vol. 23, No. 2, September 2004, pp. 55 – 69;* United States General Accounting Office. *Mandatory Audit Firm Rotation Study: Report to the Senate Committee on Banking, Housing and Urban Affairs and the House Committee on Financial Services*. February 2004. *http://www.gao.gov/new.items/d04217.pdf*.

U.S. system) place a general prohibition against auditors providing non-audit services that (i) create a mutual or conflicting interest with the audit client; (ii) place auditor in the position of self review; (iii) result in auditor acting as management/employee of the audit client; or (iv) place auditor in position of being an advocate for the client. These principles might be further reinforced by requiring audit committees to pre-approve non-audit services and disclose such pre-approvals along with fees paid for non-audit services in the company's reports.

Systemic Risk and Financial Stability (Q. 27)

The green paper asks whether the present configuration of the audit market itself presents a systemic risk. In our opinion, the loss of a member firm (however large) in one jurisdiction would not present systemic risk in the traditional sense (i.e., likely to disrupt the greater economy within the jurisdiction and/or other countries). Audit networks do not present the transactional risk that systemically important financial institutions present to financial stability.

Audits of Small and Medium Sized Enterprises (Qs. 35, 37)

Audit standards in the United States and, we believe under ISAs, already provide for and expect audits to be risk-focused and scaled to the complexity of the company. This is preferable to legislating "less burdensome" internal quality control rules and oversight by supervisors, as suggested in the green paper. In addition, we do not support allowing internal accountants to provide assurance on financial statements they have prepared due to independence concerns. While we are not expressing a view on requirements for companies that are not publicly-traded, if any reductions to the current statutory regime for small and medium sized enterprises were to be adopted, it would be important that they be fully explained to the public so that they may appropriately adjust their level of reliance on the financial reports of those companies. For example the term "limited audit" could mislead stakeholders if in fact the procedures performed by the auditor are less than a full audit. Similarly, the provision of non-audit services should be governed by independence and ethical consideration rather than the size of the organization.

International Cooperation (Q. 38)

It is important that all regulators be permitted to satisfy their statutory remits but in a manner that eliminates regulatory burdens associated with having multiple regulators to the fullest extent. Accordingly, the CAQ strongly supports cross border cooperation and information sharing by regulators. We also support better consistency and quality of oversight and encourage regulators to strive toward common oversight frameworks. We hope that through cooperation, regulators will build trusted relationships that allow for greater reliance on the work of the home country regulator.

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In closing the CAQ believes that certain the topics raised in the green paper deserve further focused discussion and vetting. Consideration of the role of the auditor should take into consideration the appropriate and legally-required roles of management and boards and we recommend that the Commission consider comments received on the upcoming corporate governance paper in connection with its consideration whether to take further action regarding audit policy. Finally, the Commission's actions may have an impact outside of the EU;

accordingly, we strongly encourage the Commission to collaborate with regulators and policymakers around the globe in order to avoid creating requirements in the EU that diverge from other major markets. The CAQ appreciates the opportunity to comment on the green paper. We look forward to participating in the Commission's continuing study of these important issues.

Sincerely,

Cynthia M. Fornelli

Executive Director
Center for Audit Quality

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