Re: European Commission Green Paper on Audit Policy

The Financial Supervisory Authority in Finland (FIN-FSA) is pleased to provide the Commission with its comments on the European Commission Green Paper on Audit Policy. FIN-FSA presents its views from the perspective of audits of public interest entities. These entities are subject to supervision by FIN-FSA in Finland.

The Green Paper seeks views on significant legislative measures in the field of auditing in order to enhance the auditors’ contribution to the financial stability and the public interest. FIN-FSA thinks that the Commission has raised several important questions, which should be taken under closer consideration. The statutory auditors are subject to a wide range of expectations, some of which are difficult to meet. The lack of confidence in auditors’ work could, in turn, weaken the functioning of financial markets. FIN-FSA believes that there is room for improvement in areas like external communication, independence issues related to non-audit services, governance of audit firms, supervision as well as audit market concentration.1

The Green Paper introduces several new legislative measures. FIN-FSA thinks that remedial measures should not only focus on legislative actions, but they should be proportionate and well balanced with other alternative measures. Such measures could include the reinforcement of corporate governance practices, particularly regarding audit committees, and the strengthening of audit firm supervision and co-operation of supervisors.2

In addition, FIN-FSA would like to stress that the potential actions on the basis of the Green Paper require careful impact assessments, where the costs for listed companies and other financial sector institutions should be taken into account.3

Underneath, please find our detailed responses to other questions of the Green Paper.

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1 Answer to Question 1
2 Answer to Questions 1 and 3
3 Answer to Questions 1
ROLE OF THE AUDITOR

Question 6: Should "professional skepticism" be reinforced? How could this be achieved?

FIN-FSA considers it important that audits are carried out applying the methodology of ISAs. ISAs should be developed if it is found that their application does not lead to a desirable outcome. In our view, there is currently no indication that would suggest that the methodology should be profoundly changed. For example, FIN-FSA sees that the internal controls and their testing are still central to the audit.

Furthermore, the audit methodology under ISAs includes the requirement for auditors to work with professional skepticism. Some European audit oversight bodies have communicated in their reports that that the auditors do not necessarily apply these requirements as desired. Some supervisors believe that the financial crisis revealed weaknesses in audits of financial institutions. Therefore, FIN-FSA believes that the Commission has raised an important issue concerning professional skepticism, but that remedial measures should not focus on regulatory changes, but on auditors' training activities and the effective supervision of auditors in Europe, so that the rigorous application of ISAs could be enhanced.

Question 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? Question 8: What additional information should be provided to external stakeholders and how?

FIN-FSA would find beneficial to develop the external communication of auditors, since its current form, the audit report does not fully serve the need of global investors and other users of financial statements and audit reports. In our opinion, the expectation gap is large. To develop the external communication is, however, very challenging and it should take place within the framework of the ISAs.

When developing the external communication, for example, a more "narrative" report could be considered. This might help the users to better understand the nature of the audit, the audit methodology and its inherent limitations. It could be useful to users that the auditors would explain in their reports the use of judgment relating to the major issues that have required special attention during the audit. FIN-FSA sees that this could contribute to increased investor confidence in financial reports and auditors' work.

Nonetheless, FIN-FSA would like to point out that in its opinion companies have the primary responsibility to communicate with investors and other stakeholders and the roles of companies and auditors should be clearly separated in this respect.
Question 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?

FIN-FSA sees that the time spent to perform an audit does influence the audit quality. FIN-FSA is therefore critical to the possible shortening of time limits, as they are already tight in the financial markets. The time limits for auditors are also not independent, as they are closely linked to the time limits set for the companies’ reporting.

Question 12: What other measures could be envisaged to enhance the value of audits?

The Green paper suggests extending the work of the auditors to various areas, so as to be more useful to investors and other stakeholders.

FIN-FSA believes that the extension of the auditor's work and reporting should be treated with great reservation. As the extension of the auditor's work would directly increase companies' costs, there should be sufficiently accurate information about the benefits. However, the positive effects may be difficult to assess.

The auditor's work and reporting should not be extended, especially to areas that are not, in practice, effectively auditable, for example forward looking information. Such auditor's work, for which the auditor cannot provide a meaningful opinion, are likely not to strengthen the confidence in auditor's work.

Question 13: What are your views on the introduction of ISAs in the EU? Question 14: Should ISAs be made legally binding throughout the EU?

FIN-FSA supports the adoption of ISAs in the audits of public interest entities because we see significant benefits in the harmonization of auditing standards in the EU and globally.

In many European countries ISAs are to some extent implemented through legislative measures or through self-regulation. Making the ISAs part of the EU legislation would strengthen the role of the standards and would enhance their consistent application. In addition, for the effective supervision of auditors it is fundamental to have binding regulation. For these reasons, FIN-FSA's thinks that ISAs should be made legally binding.

GOVERNANCE AND INDEPENDENCE OF AUDIT FIRMS

Question 19: Should the provision of non-audit services by audit firms be prohibited?

In FIN-FSA's view auditor independence is one of the key pillars of the audit. If the confidence in the independence is weakened, this will affect
the credibility of auditor's work. However, the complete removal of the conflicts of interest is not possible in practice, without changing the basics of auditing. The measures to strengthen the independence should therefore seek to manage the conflicts of interest. To achieve such an objective may not be met through additional regulation alone.

Alternatively, consideration could be given to combining such regulation with developing the governance practices of audit firms and audited companies, as well as strengthening the supervision of auditors regarding independence issues.

Regarding the specific question on non-audit services, FIN-FSA is in favor of reinforcing the rules on the provision of non-audit services. FIN-FSA thinks that this is necessary due to the reasons described above and because of that differences in the implementation of the Directive in Europe have created inconsistencies in practices. Nonetheless, any additional restrictions should focus on the provisions of non-audit services to the same audit client. FIN-FSA does not see the need for such far-reaching measures that would create “pure” audit firms.

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

FIN-FSA sees that the use of a third party would fundamentally change the auditors' and the audited companies' roles and relationships as well as giving rise to a number of new problems. It would be difficult for a third party to acquire enough knowledge about a company and its operations, which would be necessary for the selection of auditors, and the determination of a reasonable fee.

FIN-FSA's opinion is that the companies' audit committees are in the best position to assess the suitability of the auditor. Audit committees could from many points of views play an important role in relation to the auditors. Regulation and / or guidance should, however, be developed so that the activities of the audit committees would meet the expectations set on them.

FIN-FSA points out the fact that an approach that highlights the role of audit committees mainly reaches the large companies with audit committees genuinely functioning. This, however, corresponds with the starting point of the Green Paper, being that the measures set out would specifically target large companies.

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

FIN-FSA sees that high-quality corporate governance should apply to all participants in the financial markets. Therefore, FIN-FSA believes that it could be worthwhile exploring the opportunities to enhance the governance practices of audit firms. FIN-FSA's understanding is that the
factors that have created large expectation gaps among global investors include the issues relating to the governance of audit firms and the lack of transparency.

SUPERVISION

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

The Green Paper suggests to reinforce the current rules on the audit oversight with a view to ensuring the full independence of the public oversight systems of all Member States from the audit profession. FIN-FSA acknowledges that independence is usually seen as the most important feature of the oversight system. FIN-FSA is in favor of strengthening the current regulation.

Regarding the cooperation between national audit oversight bodies, FIN-FSA's view is that, for the credibility of the European oversight system, a significantly closer international cooperation than at present is necessary. For the oversight of auditors belonging to the large global networks, small national oversight bodies need international contacts in order to be genuine challengers. If the international consolidation of audit firms continues, the only effective form of oversight is cross-border cooperation with other oversight bodies.

FIN-FSA also draws the attention to the fact that the supervision of the application of the ISAs will require consistency of the oversight activities in the longer term. The consistency is achievable only through close cooperation between oversight bodies. Experience of such cooperation exists regarding the enforcement of the application of IFRSs.

In addition, FIN-FSA believes that the European level cooperation is of strategic importance because it would create a stronger common European base in relation to third-country supervisors. The target of mutual recognition of the oversight mechanisms is a goal difficult to achieve without a credible network of European oversight bodies.

The Commission presents three possible options to proceed with arranging cooperation in Europe. It is, however, difficult to perform a more in-depth analysis of the alternatives on the basis of the information in the Green Paper. For example, costs are one of the key factors influencing the decision. Taking into account this deficiency, FIN-FSA has preliminary concluded that the transformation of EGAOB into a Level 3 Committee could represent a first step. In any case, the cooperation should gradually evolve from the current system to closer cooperation between the supervisors. Arranging the cooperation in connection with the Commission does not correspond to the development of setting up other supervisory bodies on European level.
CONCENTRATION AND MARKET STRUCTURE

Question 27: Could the current configuration of the audit market present a systemic risk?
Question 31: Do you agree that contingency plans, including living wills, could be key in addressing systemic risks and the risks of firm failure?

FIN-FSA considers that the Commission's concern on the concentration of the audit market is warranted. The current level of audit market concentration poses risks on the functioning of financial markets. The measures considered to promote competition and reduce concentration could, however, have serious implications on audit quality particularly within smaller audit markets. Thus, a careful analysis of the planned measures and performing an impact assessment is of outmost importance. It is even possible that European-level measures are not effective because of the global nature of audit markets.

From the perspective of small audit markets, the concentration risk is very different in nature, as small national audit markets hardly have enough volume for the Big 4 firms. At the Finnish level the measures diminishing concentration risk can thus be artificial and, at worst, could only lead to increased audit costs without any benefits. Our understanding is that the same situation exists in some other small EU countries too.

In addition, FIN-FSA would like to state, that the systemic risk related to the audit market is not similar to the systemic risk related to e.g. the banking sector. One should be careful in drawing too many parallels and thus should not for example build a governmental rescue mechanism.

FIN-FSA supports a more detailed study of contingency plans as a means of risk mitigation.

Question 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?

FIN-FSA believes that the so called joint audit system is particularly unsuited for small audit markets. The purpose of the joint audit system would be that a large company would choose one small audit company alongside with the Big 4 firm having the same level of responsibility. In a small Member State there are not such mid-sized or small firms, which could realistically grow up to this task. The joint audit system would therefore not provide any additional benefits, but only additional costs for large companies.
Question 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?

In FIN-FSA’s view the rotation of audit firms could contribute to the independence of auditors and it could also help in dynamising markets. Regular rotation of audit firms could significantly change the relationship between auditors and their clients and the loss of a client would no longer be such a threat as in the current situation.

There are, however, also negative implications related to audit firm rotation such as, the new audit firm not being as familiar with the new client company in the beginning of the engagement as the previous auditor. This can lead to temporary deterioration in audit quality. Mandatory rotation may work, if the duration of the engagement is determined to be sufficiently long.

Other disadvantages include the fact that changing the audit firm is a costly and time-consuming process, especially for large international companies. Changing the audit firm means the change of the network worldwide in all parts of the group. On the other hand, the mandatory rotation can lead to lower prices because of tendering process.

The benefits and disadvantages of audit firm rotation are not clear enough, as described above, and should therefore in FIN-FSA’s view be considered very carefully. In FIN-FSA’s opinion also developing the activities of audit committees could be considered as an alternative to the mandatory rotation, among others by requiring audit committees to publish the criteria for changing and appointing the auditor.

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