Position
of the Ministry of Finance of the Slovak Republic on the Green Paper

3 December 2010

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

We welcome the initiative of the European Commission and its interest in increasing the quality of the audit profession, which is one of the pillars of the stability of financial markets.

However, we consider it necessary to note that Directive 2006/43/EC, which fundamentally influences the regulation of the audit profession, entered into force only in June 2006 and has been applied in the legislation of the Slovak Republic since 1 January 2008, when Act No. 540/2007 Coll. of 25 October 2007 on Auditors, Audit and Oversight of Audit entered into force. Less than three years of the validity of this Act may be characterized as a transition period (formation of oversight bodies, their financing and staffing, a change in the role of the Slovak Chamber of Auditors, the beginnings of the oversight of audit), which, moreover, was largely affected by the global financial crisis, which still reverberates in the Slovak economy. We believe that it would be beneficial to first analyze the impact of such a systemic change as the adoption of the aforementioned directive and answer the questions raised by the Green Paper in the light of the results of such an analysis and to consider further fundamental changes only then.

2. Do you believe that there is a need to better set out the societal role of the audit with regard to the veracity of financial statements?

The current role of an auditor is to improve the veracity of the financial statements of a company by providing an opinion with which the auditor states in an auditor's report whether the financial statements give a true and fair view of the financial position and the financial result in accordance with the relevant accounting legislation.

A more detailed definition of the role of audit, the way in which it is performed and how its results are published may, of course, be subject to further discussion with all stakeholders. However, audit is only one of the elements in the entire process of financial reporting, and primary responsibility for providing true and fair financial (and nonfinancial) information is (and must remain) with the company management and those charged with governance.

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

Yes.

It is possible and necessary to continuously enhance the level of audit quality, which should be at the center of attention of both large international audit networks and small audit firms.
We are convinced that audit quality has improved in recent years, thanks to the adoption of Directive 2006/43/EC, which allows active oversight by the regulator (in the Slovak Republic, it is the Auditing Oversight Authority) and active control of audit quality by the professional organization (Slovak Chamber of Auditors, SKAU). Another benefit was the mandatory adoption of the ISAs for all statutory audits in the Slovak Republic in 2004 and retraining of the audit profession to apply the ISAs in practice.

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

The current role of an auditor is to improve the veracity of financial statements of a company by providing an opinion with which the auditor states in an auditor's report whether the financial statements give a true and fair view of the financial position and the financial result in accordance with the relevant accounting legislation. This means that it is an assurance concerning historical information.

A change in this role of audit requires a comprehensive discussion with all stakeholders. Audit should not replace the role of rating agencies and analysts, nor must it not replace the role of company management and those charged with governance.

On the assumption that shareholders and investors are truly interested in more detailed information (the going concern assumption, key risks, and so forth), it is up to company management to disclose such information in financial statements and/or an annual report. The role of an auditor may be to provide a certain form of assurance. In this case, it will probably be necessary to reassess and extend the financial reporting framework, as well as the standards that would make it possible for auditors to provide such form of assurance (only ISAE 3400 exists at the present time).

However, we would like to point out that even the most comprehensive standards on presenting information and its "audit" cannot totally eliminate risks and uncertainties that business and investing bring about. At the same time, it needs to be realized that an extension of an auditor's obligations will also be accompanied by an increased number of tasks, which is likely to be reflected in a price increase for auditing.

5. To bridge the expectation gap and in order to clarify the role of audits, should the audit methodology employed be better explained to users?

Yes.

We agree that not all users of auditor's reports are actually aware of the limitations of an audit (for example, the principles of materiality, sampling, and so forth). Therefore, we welcome any initiatives that will clarify the role of an auditor and the audit methodology and, if "public demand" arises, make it possible to discuss the extended wording of auditor's reports.

One of the required steps is the adoption of unified standards on auditing (ISAs), which would become a reference document and are, after all, available to all users.
Another "awareness-raising" role should be played by the communication of an auditor of listed companies in particular and public interest companies with their audit committees. This communication requirement is directly imposed by Slovak legislation (Article 19a of Act No. 431/2002 Coll. on Accounting as amended).

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

Professional skepticism is the foundation of audit activities and the key concept of audit in accordance with the ISAs. A significant step forward is represented by the clarified ISAs, which began to be applied to audits in 2010. Any new ideas that lead to the reinforcement of this concept in practice are more than welcome. Some measures to reinforce professional skepticism may include:

- consistent audit oversight
- communication between an auditor and a audited entity
- audit focused on real risks (risk-based audit).

In the context of the entire EU, we believe that the first fundamental step should be the mandatory implementation of the ISAs in all EU member states.

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

No.

A qualified opinion expressed in an auditor's report is more an exception than a rule and points to an error/problem (of course, from the perspective of an independent auditor) in financial statements, which the company management is unable or unwilling (no matter the reason) to correct. Most inaccuracies in financial statements are corrected during the course of an audit after the opinions of the auditor and the management are clarified. This means that, in its substance, a qualified opinion is not a really "positive" signal for the users, but if the required information is adequately disclosed in financial statements and annual reports by the management and, in general, if communication between the company and users (analysts, stock exchanges, banks, and so forth) is appropriate, a qualified opinion should not come as a surprise.

On the other hand, a qualified opinion is proof of the independence and quality of an audit, thanks to being perceived negatively.

We would, of course, welcome a broader discussion on how auditors should inform users in the best possible way of the reasons leading to qualified opinions, but the negative perception of qualified opinions of an auditor by users cannot be changed via a legislative amendment.
8. What additional information should be provided to external stakeholders and how?

In our opinion, any possible further disclosures should only concern public interest companies and should not increase the administrative burden for small and medium-sized companies.

As has been stated to a certain extent in the replies to questions No. 5 and No. 7, a broader discussion is needed on the extent to which the auditor should provide additional information. Primary responsibility for providing financial and nonfinancial information, assumptions, and assessing various risks must remain with the company management and those charged with governance. The role of an auditor is to improve the veracity of financial statements by performing an audit and disclosing its conclusions in the form of an auditor's report.

9. Is there adequate and regular dialogue between the external auditors, internal auditors and the Audit Committee? If not, how can this communication be improved?

In essence, there is always room for an improvement in any communication.

Slovak legislation makes it binding for an auditor to communicate with the audit committee, and communication between external and internal auditors is regulated by ISA 610.

If there is doubt about the adequacy and regularity of such communication, it is possible, based on a discussion between the regulator, the professional organization, companies, and other stakeholders, to arrive at the need to formalize this communication and thus monitor its existence. At the same time, we do not think that the quality of communication can be improved by merely adding the legal obligations to communicate.

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

Yes.

If the stakeholders are interested in assurance services regarding CSR information, auditors should, of course, play the main role in this process.

"Public demand" for this type of services will apparently rise in the near future; this issue is already being worked on (the International Integrated Reporting Committee is currently addressing issues related to the establishment of a unified platform for reporting this information). We are of the opinion that, at the present time, it is only necessary to be prepared for the application of the IIRC recommendations in practice.

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?

No.
As stated in the reply to question No. 9, Slovak legislation directly regulates communication between an auditor and an audited entity. In view of the undeveloped (inactive) capital market in the Slovak Republic, we are of the opinion that this area does not need to be further regulated by law.

The frequency of communication by the auditor to stakeholders should be primarily influenced by the requirements of these stakeholders (shareholders, regulators, stock exchanges and so forth). If there is no "demand" for more frequent communication or communication in another form, we consider the current legal regulation sufficient.

The time gap between the year end and the date of the audit opinion is regulated by Slovak legislation in Article 19 of Act No. 431/2002 Coll. on Accounting as amended. Any shortening of this time gap depends on an agreement between the auditor and the audited entity and results from the needs of stakeholders (the parent company, foreign stock exchanges, banks, and so forth). In most cases, this time gap is considerably shorter than allowed by the legislation. In our opinion, an across-the-board reduction of this period would be self-serving and could lead to a reduction in the quality of information provided.

A change in the current state of affairs should result from a consensus among auditors, companies, and other stakeholders after a careful consideration of the benefits and costs of accelerating the entire financial reporting process.

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

We are not convinced that it is necessary to adopt any further measures. The audit market in the conditions of the Slovak Republic uses the instruments contained in the current legislative framework (audit committees, oversight by the Auditing Oversight Authority, quality review by the Slovak Chamber of Auditors, the right of veto of the National Bank of Slovakia – see the replies to questions No. 16 and No. 18, etc.). The quality of audit has improved since the implementation of Directive 2006/43/EC, but, given the short time from its transposition in the national legislations of member states, its influence has not yet been assessed. Without such an assessment, any further measures may be unsystematic, increase administrative and financial demands for auditing, and lead to the negative perception of audit as such.

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

We support the mandatory implementation of ISAs in the EU.

14. Should ISAs be made legally binding throughout the EU? If so, should a similar endorsement approach be chosen to the one existing for the endorsement of International Financial Reporting Standards (IFRS)? Alternatively, and given the current widespread use of ISAs in the EU, should the use of ISAs be further encouraged through non-binding legal instruments (Recommendation, Code of Conduct)?

Yes.
In the Slovak Republic, ISAs were made mandatory in 2004 with respect to all audits. They replaced the hitherto Slovak Standards on Auditing. The quality of audit has also increased as a result of the use of ISAs.

The mandatory use of ISAs is determined by the Act on Auditors. ISAs have been implemented in the Slovak Republic "en bloc" without any carve-outs and add-ins, which we consider correct. Experiences with the process of endorsement of IFRS at the level of the EU have shown that this process is lengthy, impractical, and administratively demanding. In spite of this, if other member states were willing to use ISAs only on the condition that they will go through a similar endorsement process as IFRS, we will support this process.

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

Yes.

The Slovak economy is small, with a large proportion of small and medium-sized enterprises. It is therefore important for Slovak auditors to have an instrument for an audit of small and medium-sized enterprises. We expect audit quality to increase, thanks to the "Guide to using ISAs in the audit of SMEs," among other things.

16. Is there a conflict in the auditor being appointed and remunerated by the audited entity? What alternative arrangements would you recommend in this context?

No.

In our opinion, there is no conflict. It is proper if an auditor is appointed and removed by shareholders. In justified cases, a model may be implemented where the regulator or oversight body has the right of veto. In the Slovak Republic, this model has been implemented with regards to financial market entities where the auditor is appointed by shareholders, but the National Bank of Slovakia, as an institution overseeing the financial market, has the right of veto.

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

No.

A third party could have the right to appoint an auditor only in very isolated cases, for example, in the case of imposing forced receivership.

18. Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?

No.

See also our reply to question No. 29. We do not support such interventions by regulators as, for example, joint audits (question No. 28) or mandatory rotation of audit firms (question No. 29), because we believe that this would lead to an increase in audit costs and also reduce audit
quality in many cases, as it would take a new auditor several years to obtain the knowledge that the existing auditor has accumulated during the audit. Instead, we support the following:
- the role of audit committees
- the right of shareholders to select, appoint, and dismiss an auditor, including the reappointment of an auditor
- in the case of certain public interest entities (for example, the financial market), the right of the regulator to veto a decision of shareholders. We have the same situation in the Slovak Republic, with the National Bank of Slovakia, as an institution overseeing the financial market, having the right of veto in connection with the appointment of an auditor.

It is not guaranteed that rotation will be achieved to the required extent if the rotation obligation is introduced.

19. Should the provision of non-audit services by audit firms be prohibited? Should any such prohibition be applied to all firms and their clients or should this be the case for certain types of institutions, such as systemic financial institutions?

No.

In the Slovak Republic, auditors must observe the Code of Ethics for Auditors, which is based on the IFAC Code of Ethics. The provision of non-audit services is not prohibited, except for maintaining accounting books and providing certain advice on a merger, amalgamation into a separate accounting entity, and sale if the audit is performed in the same entity at the same time.

It is within the powers of shareholders and/or audit committees to allow or prohibit the provision of selected non-audit services.

We are of the opinion that a general ban on providing non-audit services, whether it would concern only audit clients or all clients, would not solve the problem that this Green Paper intends to solve – concentration in the audit market. A ban on providing non-audit services is not an appropriate instrument to solve the issue of concentration in the audit market.

According to the experiences of our auditors, audit clients expect an auditor to also provide non-audit services, whether it is in the area of tax advice, accounting advice, or other non-audit services. On the other hand, the provision of non-audit service increases the auditor's knowledge and thus also increases audit quality.

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

No.

We are of the opinion that the level of fees should be left to an agreement between the two entities involved and such cases should be assessed individually, in the context of the specific circumstances and situation of the respective auditor.
21. Should new rules be introduced regarding the transparency of the financial statements of audit firms?

No.

In the Slovak Republic, financial statements are prepared by all audit firms and all these financial statements must be published.

Financial statements of audit firms that exceed certain criteria of size must be audited by an auditor. These audit firms also prepare an annual report, whose consistency with the financial statements must be audited by an auditor. An auditor's report is published together with financial statements.

Therefore, we are of the opinion that these measures are sufficient. In addition, audit firms that carry out an audit in public interest entities must prepare and publish a transparency report.

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

N/A

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

No.

We are of the opinion that the current requirement that auditors should hold a majority of voting rights in an audit firm is correct and contributes to an increase in audit quality.

If audit firms were not controlled by auditors, we believe that this would excessively increase the risk that non-auditors would inappropriately intervene in the activities of the audit firm and prefer short-term goals and a short-term return on their investments.

What could accelerate growth of small and medium-sized audit firms and increase their participation in audits of riskier clients, for example, public interest entities, is, for example, a limitation of liability for damage. In the Slovak Republic from 2008, an auditor's liability is limited to 20 times the fees for audit of public interest entities and 10 times the fees with respect to other clients.

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

Yes.

We support the suggestions regarding Group Auditors. In the Slovak Republic, the use of ISAs has been mandatory for all audits since 2004, and we also support the implementation of ISAs at the EU level.
25. Which measures should be envisaged to improve further the integration and cooperation on audit firm supervision at the EU level?

When Directive No. 2006/43/EC was transposed into Slovak legislation in 2008, the Auditing Oversight Authority, UDVA, was established and began its activities in the Slovak Republic. UDVA oversees all auditors and audit firms, whether they are purely Slovak or international (European or global).

We recommend that the experiences with supervision at the national level be assessed first and the results of supervision, both positive and negative, be analyzed, and, after their assessment, the opportunities for improving cooperation at the EU level should be assessed.

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

An auditor of companies subject to oversight by the National Bank of Slovakia (NBS), as an institution overseeing the financial market, already has enough obligations toward the NBS, namely according to the Act on Banks, the Act on Insurance Companies, the Act on Securities, the Act on Collective Investments, and so forth. Among other things, an auditor is required to report to the NBS any violation of the legal regulations by the audited companies, problems with the going concern, considerations regarding the expression of an qualified opinion, and so forth.

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

No.

In our opinion, although a certain risk exists, we do not consider it systemic. We do not assume that a failure of any of the global audit networks would provoke a crisis in financial markets or even an economic crisis. In addition to the Big Four, there are a number of large audit firms in the world that would be able to create new, further global audit networks.

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?

No.

Although a "joint audit" could bring about certain positives in sharing know-how, we believe that the negatives prevail.

In our opinion, the concept of "joint audit" will increase audit costs and place an inappropriate burden on audited entities. Audit entities will have to devote substantially more time to coordination of work with auditors. Although this concept allows appointed auditors to share work and competencies, a large number of procedures will have to be carried out by both companies. The auditors will mutually control the quality of their work, which we believe will be more demanding in terms of time. In addition, when audit firms perform an audit at the
present time, they have various levels of technology, training, methodology, and audit quality. In the case of a joint audit, a person who would be clearly and ultimately responsible for the audit is missing (there are more of them). There may be divergent interpretations of the accounting policies applied by the client/audited entity. Consequently, possible legal disputes may be complicated as well. Even if "joint audits" were made mandatory, it would not be possible to legislatively prevent two companies from the Big Four from joining forces.

Current Slovak legislation does not prohibit the formation of consortia of audit firms, but shareholders nonetheless do not use this possibility when selecting an auditor.

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?

No.

The Slovak Republic already has some experience with mandatory rotation of audit firms. Rotation of audit firms was mandatory in 1996-1999; they had to rotate after three years and the cool-off period was at least one year. This mandatory rotation did not prove its worth in practice, because it did not lead to an increase in audit quality or structural changes in the audit market. Therefore, it was abolished in 1999.

In our opinion, mandatory rotation will lead to an increase in audit costs, both for the client and the auditor. Both the client and the auditor will need more time for an audit during the first years after the rotation, but these increased costs will not be reflected in the improved quality of an audit.

Legislation in the Slovak Republic has minimized the risk of familiarity by introducing mandatory rotation of a key audit partner instead of rotation of an audit firm. In the case of an audit of public interest entities, a key audit partner must be mandatorily rotated every five years. In addition, it is known from practical experience that the natural turnover of employees in audit firms is relatively high and a natural turnover of employees of a client exists as well. This reduces the potential risk of familiarity.

An auditor of public interest entities is proposed to shareholders by the audit committee and removed by the general meeting, that is, not the client management. This reduces the potential risk of familiarity.

Independent oversight of the audit profession was introduced in 2008 (Auditing Oversight Authority), which represents another element in ensuring audit quality and observing the principles of an auditor's independence.

In the case of audited entities from the financial sector (for example, banks, insurance companies), an auditor is appointed by shareholders, but the authority overseeing the financial market (National Bank of Slovakia) has the right of veto. This model has proven its worth in the Slovak Republic.
Therefore, we are of the opinion that sufficient systemic measures have been implemented to minimize the risk of familiarity.

30. How should the "Big Four bias" be addressed?

A decision on the selection of an auditor is made by shareholders, who, in our opinion, decide in accordance with their possibilities, taking the situation in the market into account.

In our opinion, shareholders of an accounting entity have an opportunity to choose from various audit firms that offer them adequate quality for an adequate price. They are not required to select an audit firm that does not correspond to their ideas. Shareholders should have the opportunity to choose an audit firm on the basis of a contractual relationship, but, on the other hand, any requirements by the state or regulators that the Big Four should be selected should be eliminated or prohibited.

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

It will apparently be problematic in practice to determine the limit as to which audit firms should have such a contingency plan and which should not. This requires a broader discussion. On the other hand, the demise of the audit firm Arthur Andersen did not cause any crisis on the financial markets or the audit market.

32. Is the broader rationale for consolidation of large audit firms over the past two decades (i.e., global offer, synergies) still valid? In which circumstances, could a reversal be envisaged?

Yes.

In our opinion, the current situation has resulted from the natural development of the market, rather than artificial interventions by regulators or other authorities. Globalization of clients required, and still requires, globalization of audit firms. This is also related to the strengthening of the responsibility of a group auditor for the audit of group financial statements.

We assume that such consolidation of large audit firms cannot be abolished retroactively in a state ruled by law.

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

In our opinion, the existing system, where an auditor who wants to perform an audit in another member state must first successfully pass an aptitude test, is suitable. An auditor then receives an authorization to perform audits in all types of accounting entities.
In order to ensure the required quality of this audit, the auditor must prove that, in addition to the language of the other member state, they also know the legal regulations of that state, which are relevant for the audit of financial statements, for example, local accounting regulations, tax regulations, the Commercial Code, the Labor Code, and so forth. It is not sufficient if they only have knowledge of ISAs and IFRS. Approximation of regulations at the EU level is carried out only for trading companies, which is why it is necessary to review the knowledge of other areas, for example, financial management and accounting of municipalities, public institutions, tax law, and so forth.

34. Do you agree with "maximum harmonization" combined with a single European passport for auditors and audit firms? Do you believe this should also apply for smaller firms?

No.

See our reply to question No. 33. Legal regulations of individual member states relevant to financial statements and their audit are so specific that it is not possible to consider a single European passport for auditors and audit firms. In our opinion, this would considerably reduce audit quality and decrease the trust of users in financial statements.

35. Would you favor a lower level of service than an audit, a so-called "limited audit" or "statutory review" for the financial statements of SMEs instead of a statutory audit? Should such a service be conditional depending on whether a suitably qualified (internal or external) accountant prepared the accounts?

No.

On the one hand, there is the need to remove administrative barriers for businesses; on the other hand, it is necessary to strengthen the veracity of their financial statements. A large number of users, such as shareholders, creditors, employees, investors, and state institutions (e.g., tax authorities), rely on the accuracy of financial statements.

In our opinion, regarding any change to the current situation, it is necessary to consistently consider all positives and negatives. For example, the removal of administrative barriers for businesses by abolishing the obligation to have financial statements audited by an auditor may lead to a decrease in the users' trust in these financial statements, but, at the same time, it may be an opportunity for small and medium-sized audit firms to grow and gradually catch up with the large audit firms.

We assume that, if the number of statutory audits of small and medium-sized enterprises shrank, the number of small and medium-sized audit firms would also decrease, which would also reduce potential future competition for large audit firms.

We do not view a "limited audit" or "statutory review" as a realistic alternative to the existing state of affairs, even if the financial statements were prepared by a suitably qualified accountant. The purpose of an audit of financial statements is to detect material misstatements in financial statements, and not only those caused by error, but also fraud. Auditors also have an irreplaceable role in the fight against money laundering.
36. Should there be a "safe harbor" regarding any potential future prohibition of non-audit services when servicing SME clients?

No.

See also our reply to question No. 35. In our opinion, imposing less stringent ethical requirements on auditors of the financial statements of certain clients would lead to a situation where these auditors would begin to be viewed as auditors providing a lower quality of audit than other auditors, which would also reduce the veracity of the financial statements audited by them.

37. Should a "limited audit" or "statutory review" be accompanied by less burdensome internal quality control rules and oversight by supervisors? Could you suggest examples of how this could be done in practice?

No.

See our replies to questions No. 35 and No. 36. In our opinion, less burdensome internal quality control rules and oversight by supervisors would lead to a decrease in audit quality.

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

See our reply to question No. 25.