8 December 2010

Re: Green Paper on Audit Policy: Lessons from the Crisis (‘the Paper’)

Dear Sir/Madam

The Office of the Director of Corporate Enforcement (ODCE) in Ireland is pleased to respond to the Commission Green Paper on Audit Policy. Our comments on the questions in the Green Paper are contained in the attachment to this letter.

About the ODCE
The ODCE was established in 2001 with a remit to encourage, and where necessary enforce, compliance with Irish Companies legislation which of course comprises European Union Company Law Directives. Integral to our work is the receipt of reports on the performance of companies and company officers in complying with company law and duty. Our evaluation of these reports offers us a unique perspective on the performance of company auditors in contributing to the attainment of high standards of corporate governance, and we believe therefore that the insights which we have gathered from our work can inform the Commission in its current deliberations.

In 2010, we will receive about 2,000 reports as follows:

- 210 from auditors who have reported the detection during their audit of a suspected serious breach of company law by the company or its officers;
- 1,350 from the liquidators of insolvent companies in liquidation. The liquidator’s report includes an assessment of the extent to which the directors behaved honestly and responsibly in conducting the affairs of the company immediately prior to its liquidation;
- 450 from members of the public and other parties. The public complaints are often made by the company’s customers, suppliers, competitors, employees and occasionally by company directors with suspicions about the conduct of their fellow board members. A number of reports are made annually by regulatory authorities, including the Central Bank of Ireland and the Irish Auditing and Accounting Supervisory Authority (IAASA).
A further 250 cases will be examined in 2010 on the Office’s own initiative. These cases primarily involve insolvent companies which have not been put into liquidation. We seek to identify in these cases if the circumstances of the company’s failure warrants a legal sanction being sought against the directors in the public interest.

In a typical year, we successfully prosecute about 30 charges against companies and company directors for offences such as the failure to keep proper accounting records and against other individuals for acting, for example, as company auditors while not qualified to do so.

While we deal with all types and sizes of companies, the majority of companies are small or medium sized companies (SMEs). However, a minority are significant economic entities and include listed companies. By way of example, the ODCE has been undertaking since late 2008 an extensive criminal investigation of certain events at Anglo Irish Bank, a former listed company. The Bank is suspected to have breached a number of provisions of the Irish Companies Acts. The European Commission will be aware that the Bank is now nationalised having reported catastrophic losses on its business lending particularly to the property sector.

Every year, we also undertake extensive compliance work including preparing publications on company law duties and promoting the importance of good corporate governance in discussions with business and professional interests. It is relevant to report in this context that independent market research undertaken on behalf of the ODCE in 2007 reported that:

- 85% of company directors and professional people believed that compliance with the Companies Acts in Ireland had improved in the preceding five years and
- 75% of company directors and professional people rated the Office as effective or very effective in discharging its role.

**Conclusion**
The ODCE would be pleased to assist the Commission in clarifying any aspect of its submission. For that purpose, please contact me at paul_appleby@odce.ie or my colleague, Kevin Prendergast, at kevin_prendergast@odce.ie. Alternatively, our office number is +353-1-8585800.

Yours sincerely

Paul Appleby
Director of Corporate Enforcement
ODCE RESPONSE TO THE EUROPEAN COMMISSION GREEN PAPER ON

“AUDIT POLICY: LESSONS FROM THE CRISIS”

The Office of the Director of Corporate Enforcement (ODCE), Ireland, is pleased to have the opportunity to respond to the EC Green Paper on future audit policy. Our responses to the questions contained in the Paper are outlined below.

(1) Do you have general remarks on the approach and purposes of this Green Paper?
The ODCE welcomes the Green Paper and believes that a debate on audit policy in the light of the financial crisis is timely.

(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?
We are unsure of the persons to whom precisely such clarification should be addressed. The professional investor is (or should be at this stage) very well aware of the important but fundamentally limited role that the auditor plays in determining the accuracy of the financial statements. With regard to the non-professional user, while we would agree that it would be to everyone’s benefit if there was a better understanding of the role of audit, the truth is that despite numerous redrafts of the audit report template and a continuous attempt by the profession to explain their role, it would appear that the non-professional user of financial statements seems unable or unwilling to comprehend the precise nature of the auditor’s role.

The alternative to moving understanding of audit closer to the reality of audit is of course to bring audit closer to the general (currently misplaced) understanding of what it is. Such a move would greatly increase the work of auditors, perhaps to an unmanageable extent. It could, we believe, be cogently argued that auditors can never in fact appease the demands of users with regard to what they are genuinely capable of achieving.

On this basis while we support any efforts to better inform users of the societal role of audit, we fear that this will continue to be an uphill battle.

(3) Do you believe that the general level of “audit quality” could be better enhanced?
Our experience with auditors in the context of their legislative reporting obligations and our other engagements with their work does suggest that there are grounds for questioning the consistency and quality of audit work within the profession. As we have no direct supervisory role with respect to auditors and their work, we are not in a
position to comment authoritatively on that work. We also acknowledge that the obligation in Irish company law which is placed on auditors to report a suspected serious breach of that law to the ODCE is a consequence (rather than the purpose) of that audit work. Nevertheless, we feel that the following observations will be of assistance to the Commission.

It has been our experience that:

- auditors report surprisingly few types of company law offence to us. Typically, over 75% of the 200 reports made to us annually relate to just one offence, namely directors illegally borrowing from their companies above the prescribed limits. A second offence (the failure to keep proper accounting records) usually comprises about 12% of reports. The balance comprises a handful of other offences. Yet, there are more than 100 reportable offences under the Companies Acts. In an effort to diversify the range of reported offences, we have published guidance in conjunction with the relevant accountancy bodies identifying some 13 types of offences which should be capable of being readily detected by auditors as part of their audit of a company’s financial statements. To date, this guidance has not served to materially alter the reporting patterns of auditors to the ODCE;

- some audit firms appear to discharge their reporting obligations to us more frequently than other comparable audit firms. Having regard to the focus of the Green Paper, it will be of interest to the Commission to know that ‘Big Four’ firms submit surprisingly few reports. In 2010 to date, the number of reports received from ‘Big Four’ firms is ten approximately, representing about 5% of all reports received;

- in our evaluation of the reports submitted by liquidators on insolvent companies, it is not uncommon that the most recent audit report on the company is unqualified, notwithstanding what appears to be a lack of disclosure of or accounting for obvious business difficulties. Similarly, we have reason to doubt at times that auditors are sufficiently robust in challenging the appropriateness of the ‘going concern’ concept in the financial statements of companies which are clearly in financial difficulty.

Moreover, in the course of our general investigative work, we have on numerous occasions taken issue with the quality of audit work and audit reports issued by members of the profession. Occasionally, this has resulted in admissions of lapses, and where appropriate, in revised audit reports being issued. Where we have uncovered evidence of poor audit quality, our approach has been to inform the relevant recognised accountancy body, as well as the Irish Auditing and Accounting Supervisory Authority, of our concerns.

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

We are wary of generalist type statements such as “financial health”. A company’s financial statements are essentially historic in nature, and an organisation’s ongoing financial health may be affected by many more influences than just those that are reflected in historic financial statements. For example, changes in the company’s
main markets, activities by competitors and political and macroeconomic factors may all influence a company’s economic health. The financial statements, and associated audit report, are one contributory element to a full understanding of a company’s financial health, but there is a risk of overselling what financial statements (and by extension audits) can actually provide by suggesting that they provide comfort on the financial health of a company.

(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?**

More information on what issues have been examined in the audit would, we believe, be useful to users of financial statements. In particular, we wonder whether the current approach of a standard audit report template is appropriate where other narrative elements of the annual report of a company are required to be more expressive. While certain elements of the report, for example the final opinion and other statutory disclosure requirements, should be retained, consideration should be given to the report being more discursive in nature, perhaps specifying the type of work done, the particular issues that arose and were dealt with and the auditors’ overall level of comfort with their work. Audit reports currently are viewed as “black or white”, that is, either clean or qualified. A narrative on the matters examined and the issues arising, even if subsequently resolved, would add more value to the report.

(6) **Should “professional scepticism” be reinforced? How could this be achieved?**

Professional scepticism is of course fundamental to an effective audit. It requires a mixture of professional expertise, experience and also qualities of character. As such, improvements in professional scepticism could be achieved by better training, enhanced requirements for experience, better trainee selection and recruitment or a mixture of all three.

However, the ODCE also suggests that evidence of the exercise of professional scepticism would help to provide public assurance that independent and robust audits are being undertaken. One means of achieving this would be to extend the content of the annual transparency reports of each audit firm required to produce such a report in order to give statistical information on:

- the number of audits completed;
- the number of audit reports which were unqualified;
- the number of audit reports which were qualified;
- the number of audit reports which were the subject of adverse opinions;
- the number of mandatory reports made to the police adverting to a detected potential breach of law and
- the number of mandatory reports made to national regulators adverting to a detected potential breach of law or conduct.

Such information would be of assistance to company shareholders in considering the respective merits of audit firms. If, for instance, a particular audit firm issued few qualified reports relative to their peers, shareholders might well question if the audit should be undertaken by another firm which had demonstrated a more frequent exercise of professional scepticism in its audits.
(7) Should the negative perception attached to qualifications in audit reports be reconsidered? If so, how?
It is a natural consequence of a qualified or adverse audit opinion that the company’s standing is diminished in some respect. Such a negative consequence is a necessary market stimulus to the company to present a more accurate set of financial statements on the next occasion.

As noted in answer to question 5 above, we think that there is merit in providing in audit reports further explanations of the issues that have arisen in the audit and of the extent to which they have been addressed or remain outstanding. If a more discursive audit report were the norm, then greater clarity would be available of the basis for the resultant audit report, whether clean or qualified.

(8) What additional information should be provided to stakeholders, and how?
See the answers to questions 5 and 7.

(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?
The ODCE is not in a position to know if there is inadequate dialogue between the external auditors, internal auditors and Audit Committee at present. Accordingly, we cannot respond authoritatively to this question.

(10) Do you think auditors should play a role in ensuring the reliability of the information companies are reporting in the field of CSR?
No. In general, CSR is not an area in which many auditors have competence. The further auditors move away from their core skills (i.e., the assessment of the adequacy of a company’s financial statements), the less value we believe can ultimately be placed on the opinions they express. The priority should be the improvement of the audit of a company’s financial standing.

(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. Firstly, not all director communications to stakeholders need to be audited. Directors must continue to take primary responsibility for the accuracy and completeness of their own communications. The priority, in the ODCE’s view, is to improve the effectiveness of, and public confidence in, auditor reporting of the matters which should be subject to audit before embarking on any increase in auditor reporting frequency.

On reducing the gap for reporting, there is a risk that this may harm the quality of the audit. This would particularly the case if more substantive audit testing were to be introduced.

(12) What other measures could be envisaged to enhance the value of audits?
It needs to be made clear what audit can and cannot do. In the ODCE’s view, audit needs to consolidate its focus on providing assurance that past events and some present and future risks have been accurately represented in company financial
statements. Similarly, auditors need to be equally clear in communicating the role of audit and, just as importantly, the limits of that role.

We note the suggestion in the Paper of a renewed focus on substantive audit testing rather than on validating compliance and control systems. The danger, as we perceive it, with substantive audit testing is that for many of the larger companies, the amount of time that would be needed to substantively test the requisite number of year-end balances would inevitably increase the audit burden in terms of cost and duration. In particular, this could prove problematic for timely financial reporting. Moreover, a focus on substantively testing balances at the year end increases the risk of missing what is not included in year end balances, precisely the sort of issues that a risk-based approach is designed to uncover.

In summary, we would not favour altering or extending the current focus of the audit.

(13) What are your views on the introduction of ISAs in the EU? These are already mandatory in Ireland, and we support their wider application 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)? The ODCE considers that it would be beneficial for ISAs to be made legally binding throughout the EU. The current IFRS endorsement process offers a satisfactory model for doing so. In the absence of ISAs being legally applied, a Recommendation could be considered.

(15) Should ISAs be further adapted to meet the needs of SMEs and SMPs? While the ODCE is not in a position to respond authoritatively to this question, it is our understanding that they may already be capable of adaptation to the needs of SMEs and SMPs.

(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? At the SME level, we feel that the current system which is based on shareholder approval remains appropriate.

Where public interest entities and regulated firms are the subject of audit, we acknowledge that there is potentially a conflict in having the auditor appointed and remunerated by the audited entity. However, the question to be asked in this context is: can that potential conflict be adequately mitigated by appropriate measures?

As already provided for in Directive 2006/43/EC, the relationship between the auditor and the audited entity must be managed and overseen by the audit committee led by non-executive directors. In particular, the audit committee now has the primary legal role in the recommending the appointment of the auditor to the company’s
shareholders. We believe that this is the appropriate approach and that time should be given to allow this regime to work effectively.

It would be of assistance in this connection if there were a more active shareholder base which sought to involve themselves in influencing the appointment of the company auditor. Perhaps the audit committee should consult more frequently with the company’s major stakeholders in developing its recommendation on the auditor’s appointment.

(17) Would the appointment by a third party be justified in certain cases?
At this time, we do not favour regulated entities having their auditors either appointed, or even subject to review and/or veto, by a regulator. In particular, the suggestion that the remuneration of the auditor would become the responsibility of the regulator seems a suggestion that would be extremely difficult to implement in practice, even if it were ostensibly funded by industry.

We understand that in some cases at least, it is open to the regulator to appoint a person to perform the task of audit in any case where it is not happy with the audit. While this fall-back option should be available for use by the regulator in particular circumstances, we believe that it would not be appropriate to overturn the present arrangement whereby shareholders have the responsibility to appoint the auditor on an annual basis.

(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?
Yes. Lengthy terms of continuous audit engagement (of, say, longer than 10 years) do not inspire public confidence in the independence and robustness of a public interest entity’s audit. Accordingly, we believe that having regard to the recent financial crisis, a limit should now be placed on the time which an auditor should hold a particular audit engagement. Such a limit should in particular improve auditors’ willingness to challenge their clients knowing that their audit engagement is time-bound.

At the same time, we recognise that in a substantial and complex business, it may take some time for a new auditor to become fully familiar with its operations at the start. However, this disadvantage may be offset in two ways:

- the new auditor may bring fresh insights to the engagement as a result of acquiring greater experience in auditing other similar entities consequential on the introduction of an auditor rotation regime;

- there would be merit in the new auditor monitoring the last year of the retiring auditor’s audit of the entity before assuming responsibility for the audit. Such a transitional handover period would help to mitigate any associated disadvantage.

While it may be argued that the longer the auditor is in situ, the better will be the quality of the audit, we do not see that this should prevent the introduction of a limit to the audit engagement. In particular, we believe that the value of this argument is substantially diminished where public confidence in that (arguably better) long-term
audit is lacking. Moreover, we note that auditors are regularly replaced after public doubt is cast on the credibility of an audit notwithstanding the argument that there is benefit in a long-term audit engagement.

We recognise too that the introduction of a limit on the audit term may also give rise to planning issues for the company and its audit committee. In advance of any formal appointment of a new auditor, the company may have to ensure that the new audit firm is not providing any non-audit services which could conflict with the audit assignment. However, we believe that these difficulties are manageable given proper planning.

As to the maximum length of audit assignments, we feel that client familiarity after about eight years may start compromising the auditor’s professional scepticism which is critical to a good audit. Accordingly, we propose a maximum period of eight years for the audit of most public interest entities. We suggest that this could be extended to ten years for very large public interest entities in recognition of the additional time which may be required for a new auditor to become familiar with the complexity of the business. We also propose a general requirement for audit partner rotation at least every five years. Any rule in this area would also need to preclude a partner from taking an audit client with them should they move firms at the end of the relevant five year period.

We believe that if any time limit for the audit engagement were introduced, an exemption should be given for SME clients. In a system where exemption from audit is an option for the majority of such companies, we feel that those who decide voluntarily to subject themselves to the discipline of an audit should not be inconvenienced by doing so.

(19) Should the provision of non-audit services by audit firms be prohibited? Should any such provision be applied to all firms and their client or should this be the case for certain types of institutions, such as systemic financial institutions?
We do not feel that the provision of non-audit work by audit firms in all companies should be prohibited. However, certain types of work that could give rise to the risk of self-audit or could financially or otherwise compromise the auditor’s independence should not be allowed. Moreover, an outright ban on non-audit work may hamper audit firms’ ability to hire, train and retain key staff and ensure that staff have sufficient experience and expertise to carry out the audit function successfully.

(20) Should the maximum level of fees an audit firm can receive from a single client be regulated?
Yes. There should be limits on the financial dependence of an audit firm on a single client or client group such that the potential risk to independence is substantially diminished.

(21) Should new rules be introduced regarding the transparency of the financial statements of audit firms?
The ODCE is not in a position to give an authoritative answer to these questions.
(22) What further measures could be envisaged in the governance of audit firms to enhance the independence of auditors?
The ODCE is not in a position to respond authoritatively to this question. However to the extent that this measure does not yet operate, we suggest that there be a requirement that the boards of major audit firms include a reasonable number of independent non-executive directors and that those non-executive directors constitute a majority of the audit committee of the firm.

(23) Should alternative structures be explored to allow audit firms to raise capital from external sources?
The ODCE is not in a position to authoritatively comment on this other than to say if such structures were to be made available, then appropriate safeguards as to independence would need to be put in place.

(24) Do you support the suggestions regarding Group Auditors? Do you have any further ideas on the matter?
We believe that group auditors should have access to all of the reports and other documentation of all auditors reviewing sub-entities of the group.

(25) Which measures should be envisaged to improve further the integration and cooperation on audit firm supervision at EU level?
We recognise that there is a challenge for national audit firm regulators to supervise major audit networks. We are aware that there are existing cooperative fora (namely the European Group of Auditors’ Oversight Bodies and the International Forum of Independent Audit Regulators) which are already sharing information among national audit firm regulators. We are not in a position to comment authoritatively on the adequacy of these arrangements or on the likely merits of the alternative proposals put forward in the Paper.

(26) How could increased consultation and communication between the auditor of large listed companies and the regulator be achieved?
As explained earlier, there are legal reporting obligations for auditors in Ireland in respect of suspected breaches of company law and other legislation. In respect of larger listed entities, we believe a wider application of that reporting responsibility could be beneficial.

In particular, we believe that auditors should communicate directly and openly with regulators where the regulator may either be uninformed in relation to certain matters or to emphasise to the regulator the matters which the auditor considers need to be addressed in respect of the company. To the extent that the law does not already allow this, it should be possible to provide for such communications without the auditor’s ethical rules as to confidentiality being compromised.

(27) Could the present configuration of the audit market present a systemic risk?
We believe that it does present a systemic risk due to the over-concentration of major audit assignments within just four firms.

(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
We are not able to comment authoritatively on the practicality of this suggestion although it is certainly worth evaluating further. We wonder however if, in some jurisdictions at least, the gap between the four largest firms and the rest is too large for this alone to act as a sufficient catalyst for market change.

(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 the length of such a period?
We refer you to our answer to question 18.

(30) How should the “Big Four” bias be addressed?
The ODCE is not in a position to respond authoritatively to this question.

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

(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?
While we cannot comment authoritatively on these questions, we welcome that this matter is being discussed. Remedial action would be likely to need a global approach rather than merely being confined to the EU.

(33) What, in your view, is the best manner to enhance cross border mobility of audit professionals?
We note that the revised 8th Directive has introduced a number of measures to improve the recognition of auditor qualifications throughout the EU. We do not have any additional suggestions to offer at this time.

(34) Do you agree with “maximum harmonisation” combined with a single European passport for auditors and audit firms? Do you believe this should also apply for smaller firms?
The ODCE is not in a position to comment authoritatively on this question. However, maximum harmonisation would appear to be an overly bureaucratic approach for the great number of small and medium sized audit practices.

(35) Would you favour 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?
The ODCE has engaged in previous consultations at a national level on a similar proposal, and it was held on balance that a limited audit would not serve any productive purpose and would only increase the level of confusion about the role of audit generally.
(36) Should there be a “safe harbour” regarding any potential future prohibition of non-audit services when servicing SME clients?
As already noted, we are not convinced that an outright ban on the provision of non-audit services is practical or worthwhile. This would apply with even greater force with respect to SME clients. Accordingly to the extent such a prohibition may be introduced, an exemption should be provided for SME clients. In a system where exemption from audit is an option for the majority of such companies, we feel that those who decide voluntarily to subject themselves to the discipline of an audit should not be disadvantaged by doing so.

(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?
As already indicated, we do not support the concept of limited audits.

(38) What measures could in your view enhance the quality of the oversight of global players through international cooperation?
The ODCE is not in a position to comment authoritatively on this question.

Office of the Director of Corporate Enforcement
8 December 2010