

Comments by the

***Institut des Réviseurs d'Entreprises (Institut royal) /
Instituut van de Bedrijfsrevisoren (Koninklijk Instituut)***
(Belgium)

on

**European Commission Green Paper
“Audit Policy – Lessons from the crisis”
(13.10.2010)**

About the «*Institut des Réviseurs d'Entreprises (Institut royal) - Instituut van de Bedrijfsrevisoren (Koninklijk Instituut)*» (IRE-IBR) - Belgium

The Belgian Institute of Registered Auditors (Royal Institute), a professional organization with legal personality, was created by the law of 22 July 1953. In 2007, the profession was thoroughly reformed in Belgium pursuant to the implementation of the Directive 2006/43/EC of the European Parliament and of the Council of 17th May 2006 on statutory audits of annual and consolidated accounts (hereafter the “Statutory Audit Directive”).

The purpose of the Institute is the coordination of the training and the ongoing organization of a body of specialists capable of performing the function of registered auditor with every guarantee of competence, independence and professional integrity.

Approximately 1,050 auditors are registered in the public register of the Institute. 420 trainees are also registered. Employment within audit firms represents 3.200 full-time equivalent positions in Belgium.

www.ibr-ire.be

About the process relating to the preparation and the adoption of the answers to the Green Paper and their representativeness

The answers have been prepared after a consultation of all members of the profession in Belgium, invited to contribute orally through meetings or in writing. Several commissions, especially the one on small and medium enterprises and small and medium practices, have been fully involved.

The answers have been adopted unanimously by the Board of the Institute. This Board is composed of 14 members, among which 6 members coming from the big four and 8 members coming from other kind of practices (mid-tier and smaller). The Board members have been elected individually in April 2010 with an average majority of 80 % of the votes.

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

Public interest

The Belgian audit profession is aware of its role acting in the public interest. The profession therefore shares the EC general objective to clarify the auditor's role, to extend the audit engagement for example to going-concern issues, and to take into account the size of the audited entities.

The profession welcomes the idea to have a larger role but stakeholders should first decide upon the additional information and certification requirements. Each time new requirements are defined, an adequate framework needs to be developed. In case of new responsibilities in the area of review of prospective information and risk management information, the audit profession should be safeguarded by an appropriate liability regime defined at European level.

The profession is also aware of the high quality requirements of the audit and the need to attract competent professionals.

General approach of the Green Paper

The IBR-IRE is ready to contribute to the efforts made by the European Commission to increase financial stability. However, the profession does not share the general approach of the Green Paper as far as it isolates the role of the auditor from that of the audited entities and from the accounting framework. Statutory audit is only a part of the financial chain. In Europe, there are no indications that failures in the performance of or in the reporting on audits or independence issues have caused or contributed to the financial crisis. But we understand that there are expectations that, in the future, our role will further evolve.

The management is first responsible for managing the company and for having internal control and risk management systems. Also regarding forecasts, it is management and directors that disposes of the relevant internal information and that is responsible for underlying management assumptions and for continuous monitoring and corrective actions as well as the communication thereon. If required, the audit profession could provide some level of assurance in the area of internal control, risk management information and systems as well as prospective information.

As the Statutory Audit directive of 2006 has not yet been fully implemented in all other Member States, the Belgian profession believes that it is premature to introduce fundamental changes in the short term. Nevertheless, we welcome every dialogue and action that can reduce the so-called expectation gap.

Some questions raised in the Green Paper could be reconsidered by taking into account the international context, for example the IESBA Code of Ethics that inspires most jurisdictions and practices worldwide.

Proportionality test

In any case, new measures should be proportionate to the objectives of financial transparency and competition as required by the European Commission from its Member States.

Competition is an important EU principle. EC Communications of 2004 and 2005 prohibit Member States to adopt national legislations that restrict competition in liberal professions if these restrictions are not proportionate in the public interest (health, solidity of building, financial transparency, *etc.*).

For example, the appointment of auditors by a regulator or another third party (which would replace the negotiation between the audited entity and the auditor and therefore reduce the competition), the prohibition of non-audit services (where auditors are in competition with other professions) and a mandatory external rotation of the audit firm (which excludes the auditor in place from the tender) seem to be disproportionate to the overall objective of financial transparency. Regulations that are disproportionate and would restrict the competition between auditors in favour of other regulated professions providing non-audit services should be avoided both at national and European level.

Another fundamental aspect is the fact that many companies and financial markets operate globally. A different regulation for our profession in Europe compared to Asia and America will make it very difficult for international audit networks to organize the audit at worldwide group level. In particular, independence rules are already harmonized at international level and broadly applied and monitored. Any proposed change in the European Union should take the international context into account and ensure that EU companies and their auditors are not subject to more burdensome requirements than their non-EU competitors.

Moreover, European regulations should remain compliant not only with the worldwide best practices, but also with the subsidiarity principle.

The cost/benefit ratio of any proposed change should be assessed to ensure that the benefits derived from it exceed the costs for the companies and the capital markets.

Public oversight

With respect to public oversight, the Belgian Institute is concerned that, in some countries, the same oversight body is responsible for making or endorsing the auditing standards, for investigating the possible infringements to these standards and for punishing the non-compliant auditors. This is a situation that is in contradiction to the basic principles of good governance, democracy, separation of powers and human rights, that apply to public authorities such as oversight bodies having the ultimate responsibility to adopt binding legal provisions (standards on auditing) and to control the application thereof by auditors (quality assurance reviews; investigations and disciplinary sanctions). The European Commission has a duty to contribute to the application by the Member States of the Convention on Human Rights endorsed under the Treaty of Lisbon.

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 Belgian profession welcomes the fact that the European Commission acknowledges the societal role of the auditor.

We agree that the role of the auditor needs to be better defined (see response 1). The auditor is only one component of the financial reporting chain within the capital markets and any substantial reform aimed at improving the functioning of the capital markets should contemplate ways to improve the effectiveness and contribution of each component of this chain. The financial crisis has been a crisis of confidence. It is the confidence in the system as a whole that has to be safeguarded, and not only the confidence in the audit.

Many questions with respect to the role of the auditor were raised as a result of the financial crisis. This indicates a need for a better understanding of the role and limitations of the work of the auditor, although the profession should continuously question its own functioning and monitoring.

The European Union should avoid regulating the profession in a way that would deter the auditor from applying principles and exercising professional judgment. It should be taken into account that the requirements of the recently clarified ISAs as to procedures and documentation in the audit are already very well developed and challenging.

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

The general level of “audit quality” is constantly enhanced and the audit profession is committed to further improve “audit quality” in the future, i.e. through:

- a) investing in training, permanent education,
- b) developing practical audit tools,
- c) contributing to the standard setting process, under public oversight,
- d) contributing to quality assurance reviews and, where necessary, disciplinary investigations under the ultimate responsibility of the competent public oversight body.

Harmonization of auditing standards by endorsing the ISAs, harmonization based on *International Standards on Quality Control (ISQCs)* and harmonization of the accounting standards at a high level of quality based on the IFRS, including for SMEs, can also play an important role in order to enhance the quality of the financial information that the auditor has to report on.

External quality assurance control activities increase the audit quality. It has to be implemented with inspectors having, or having had, sufficient experience as statutory auditor, under the ultimate responsibility of the public oversight.

The level of the audit quality is already fairly high as demonstrated by the lack of significant issues identified with respect to audits performed before, during and after the 2008 financial crisis. Based on the statistics of the insurance companies covering the audit profession, there have been almost no audit failures in Belgium.

However the level of audit quality may differ between practitioners in Europe partially due to:

- use of different auditing standards;
- difference in the effectiveness of the supervision put in place;
- markets / countries / boards / audit committees having different maturity levels.

While audit quality is of paramount importance, at one point increasing requirements will however have an unfavourable cost/benefit ratio.

Audit fees should be sufficient to ensure the application by the auditor of the standards on auditing. Sufficient audit fees contribute to the quality of the audit. Today, the increasing competition over fees is driven by regular public tenders in a market that is already subject to a very high competition. Academic research demonstrates that higher audit fees increase the audit quality¹.

However, as in any activity, zero risk does not exist and a legislator should not create the false expectation that increasing requirements in the audit profession will annihilate any financial risks. The auditor provides reasonable assurance but no insurance.

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

The profession is ready to provide higher comfort on the financial health, going concern and on the disclosures of key risks associated with the company's longer term business model, if this is expected by the users of financial statements and other stakeholders, and provided that proper frameworks are developed and appropriate liability caps are enforced.

Notwithstanding all the issues associated with determining the financial health of a company and taking into account the forward looking information already embedded in financial reporting, as discussed above, those charged with governance of a company could potentially:

- report on the assumptions related to the ability of the company to continue as a going concern, as they are used in the preparation of financial statements, where they are supposed to be valid at least for the next 12 months. This could include cash flow projections, assessment of critical accounting and other estimates as well as other risks, etc. Currently, management already assesses such assumptions and

¹ Pr. Dr M. WILLEKENS, *De toegevoegde waarde van de audit – la valeur ajoutée de l'audit – the added value of audit*, ICCI, Bruges, die Keure, 2008, 128 p.; Pr. Dr. M. WILLEKENS & A. GAEREMYNCK, *Prijzetting in de Belgische auditmarkt*, IBR, 2005, 111 p.

reports on them internally or privately to the company's (supervisory) board and audit committee;

- disclose key risks associated with the company's longer term sustainability of the business model (longer than 12 months) addressed in financial and non-financial terms. This is also already considered internally within the company. Such disclosures should be proportionate to the nature, size and complexity of the company.

If stakeholders, particularly shareholders and other investors, are interested in receiving such information, it could be described in the management or director's report and included in the annual report of the company. But for management to extend the current private reporting of such information to public reporting, a reporting benchmark or framework would be needed.

In addition, when such information is publicly reported by companies and when stakeholders, particularly shareholders and other investors, are interested in receiving such assurance,:

- the auditor could provide assurance on the statements made by those charged with governance in the annual report of the company. This would be in addition to the current auditor's role on the financial statements and annual report;
- this auditor's involvement could take different forms, being a reasonable assurance engagement or a limited assurance engagement⁽²⁾;
- this would require a benchmark or standards based on which such assurance could be provided.

The current criteria based on the capital maintenance can be supplemented with solvability and liquidity ratios.

The Belgian company law requires that the Board of directors of companies encountering financial difficulties justifies the going concern assumptions in its annual report to the shareholders. The statutory auditor has to consider this statement in his report on the directors' report.

The starting point of the auditors' opinion is the going concern of the audited entity at least for the coming 12 months. The auditor cannot certify the long term survival of the entity as risks and uncertainties evolve over time: long term future is not predictable. However, the

⁽²⁾ <http://www.fee.be/fileupload/upload/DP%20Assurance%20on%20Corporate%20Governance%20Statements%200911%20Colour20112009541533.pdf>

Belgian Institute shares the vision of the European Commission that stakeholders should be well informed of potential risks and uncertainties when they invest in companies.

Professor M. WILLEKENS (KULeuven) documented in the study about the added value of audit ⁽³⁾ that *“a firm’s survival score is higher in companies that are audited as compared to unaudited companies.(...) Overall, the evidence provided in this study suggests that the quality of financial reporting is significantly higher for private companies that appoint a financial statement auditor, and that financial reporting quality also increases in audit intensity. Furthermore, it appears that small firms that adopt a limited disclosure schedule of financial reporting are financially healthier when they appoint an auditor.”*

In this section of the Green paper, the Commission seems to suggest that auditors have to follow a substantive approach instead of a risk-based approach. The risk-based approach is the fundament of any high quality auditing standards. In many instances a balanced combination for testing internal controls and performing substantive procedures can provide appropriate audit evidence in the most qualitative and cost effective way. In addition, understanding and testing internal controls is important in particular to conclude on the completeness of transactions. Finally, understanding and testing internal controls provides the auditor the opportunity to identify internal control deficiencies that could result in significant financial statement misstatements in future accounting periods. The implementation of Section 404 of the US Sarbanes-Oxley Act has clearly led to a decrease in the number and magnitude of restatements of financial statements among US SEC registrants.

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.

Developing a general financial literacy at school, specialized auditing education within the universities, effective guidelines and brochures by professional bodies that explains the audit methodology and the level of assurance in function of the different categories of opinions (qualified, unqualified, etc.)⁽⁴⁾, as well as individual communication of auditors towards stakeholders (e.g. at shareholder’s meetings, workers councils, etc.), could surely help to reduce the expectation gap.

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

Yes.

Skepticism can only be encouraged by ensuring competence of the auditors and knowledge of the audited entity. Professional skepticism can only be effective to the extent adequate competences are present in the audit team. Therefore, the multidisciplinary character of audit firms should be encouraged.

⁽³⁾ Pr. Dr. M. WILLEKENS, *De toegevoegde waarde van de audit – la valeur ajoutée de l’audit – the added value of audit*, ICCI, Bruges, die Keure, 2008, 128 p.

⁽⁴⁾ *Het commissarisverslag – Le rapport du commissaire*, ICCI, die Keure, 2007, 238 p.

In Belgium, the education program (3 years minimum and more than 25 exams) in order to obtain the title ends with a jury examination during which professional skepticism is tested thoroughly.

The learning of « professional skepticism » is a progressive process that can be achieved through a permanent education of the auditors and a full knowledge of the audited entity. But skepticism should also be enhanced at the level of the Board and the Audit Committee where a healthy challenge of management's decisions and accounting estimates should take place.

The clarified ISAs provide clear guidelines with respect to the use of professional skepticism by the auditor (see in particular ISA 200). Legislators should avoid the pitfall of creating additional rules that could lead to a “check-the-box” attitude to the detriment of the sound exercise of professional judgment and skepticism in performing audits.

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

No. A qualification indicates that the auditor has identified some issues as a result of his audit activities. It is important that such issues are reported transparently to the stakeholders.

We think that today's system (with qualified and unqualified reports) provides clarity and comparability to the users of the audit reports. There is no need in our view to change this system, which does not lead to a systematical clean opinion on the financial statements by the auditor (see the following statistics regarding the audit reports in Belgium). The problem, if any, comes from the lack of understanding of the auditor's work (see question 5 – expectation gap).

	2006	%	2007	%	2008	%
Unqualified	12,776	78.6 %	12,461	79.2 %	11,958	81.6 %
Unqualified with emphasis of a matter	2,598	16.0 %	2,429	15.4 %	2,100	14.3 %
Qualified	670	4.1 %	636	4.0 %	468	3.2 %
Disclaimer	185	1.1 %	180	1.1 %	116	0.8 %
Adverse	16	0.1 %	18	0.1 %	8	0.1 %
	16,245		15,724		14,650	

Source: Graydon.

We believe that the current types of audit opinions (qualified, unqualified reports, etc.), while binary for their main cases of implementation, provide clarity and comparability to the users of the audit reports. In our view, there is no need to change this system.

The limited number of qualified opinion appears to reflect the continuous dialogue that usually takes place between the auditor and the board of directors in order to resolve most significant issues, thus avoiding that they lead to a qualification. The negative perception

attached to a qualified opinion is shows that stakeholders value the auditor's opinion and usually penalize companies that fail to address financial statement deficiencies.

However, the understanding of the audit report could be further enhanced by stimulating the auditor to intervene at the general meetings of shareholders, in order to explain the meaning of its report and to answer to questions raised by the shareholders.

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

In the first place, additional added-value information requirements should be defined by the stakeholders themselves.

As an example, in Belgium, the management has to provide additional information to the employees' representatives within the workers' council. The statutory auditor issues an opinion on this additional financial information.

In Belgium, there is also a lot of information publicly available for the stakeholders through the annual report. A better quality of the information can be achieved through developing frameworks aiming at helping the board of directors to prepare this information (for example: framework to report on the main risks). Additional information could be provided to the stakeholders by management based on its usefulness and relevance for the users of the financial statement. Additional information could be provided on:

- internal controls;
- robustness of risk management process;
- quality of accounting principles;
- key estimates and assumptions;
- quality of earnings (impact of out of period adjustments to the financial statements);
- explanation of the entity's business model and risk assessment;
- management's discussion and analysis;
- bank covenants;
- working capital.

The auditor's contribution would then involve providing assurance on the fact that this information is not misleading.

The Belgian Institute agrees with the European Commission that transparency is a key condition for financial stability. In Belgium, the financial statements are publicly available. Since 1978, as required by law, the National Bank of Belgium has been collecting and publishing the annual accounts of legal persons established under Belgian law (or under foreign law that are active in Belgium through a branch). More than 350,000 legal entities in Belgium are required to publish their annual accounts. These annual accounts are accessible to the public through the internet, free of charge for the users, and are very broadly consulted by all stakeholders (3,900,000 consultations a year). This system should be promoted at European level because it contributes to administrative simplification: the information included in this single set of statutory financial statements is used by the management, the

shareholders, the employees, the tax administration, the banks, the clients and suppliers, the national institute of statistics, etc...

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 Statutory Audit Directive has been implemented in Belgian Law. The Belgian Law requires a minimum of communication between the statutory auditor and the audit committee.

The Belgian Institute is in favour of further strengthening and formalizing dialogue and reporting between the statutory auditor, the board of directors, the audit committee, the internal auditors and the shareholders.

Frequent and effective dialogue between those charged with governance, including the board of directors and the audit committee, and the internal auditor and the statutory auditor, is essential in the wider context of good corporate governance as well as in the direct cooperation between the parties involved in public interest entities. Communication in the form of an open and direct dialogue based on a two-way communication will contribute to this ultimate goal.

The responsibilities of the audit committee in the appointment of the auditor could be reconsidered: the audit committee primary responsibility would be to evaluate the quality of the work performed by the statutory auditor and in case of a negative evaluation, the board of directors should be in charge of selecting a new auditor to be proposed to the shareholders' meeting, without prejudice to the veto right of the workers' council in Belgium.

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. Auditors can provide assurance on CSR reports using ISAE 3000. This would enhance the quality of the report and provide the readers with additional comfort with respect to the true and fair view provided by these reports. It is necessary for these frameworks to be based on a generally (i.e. widely) accepted reporting framework. In general, the Belgian audit profession is in favour of certified CSR reports for large companies (including certified non-financial information), provided that there is a clear reference framework.

In Belgium, the auditor already provides assurance on non-financial information to the workers' council. An update of the information, such as corporate, prospective and operational information (as referred to in articles 4 to 14 of the Royal Decree of 27 November 1973 *regarding the regulation of economic and financial information to be provided to the workers' councils*) has to be provided to the workers' council.

In order to implement the European Accounting Directive, as amended on 14th June 2006, the Belgian legislator has introduced by the law of 6th April 2010 the requirement for the board of directors of listed companies to publish a corporate governance statement, which mainly

contains non-financial information⁽⁵⁾. The corporate governance statement is also subject to certain procedures to be performed by the statutory auditor.

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?

Stakeholders should determine the level of communication that is required.

For example, in Belgium, a company that employs more than 100 persons needs to have a workers' council, composed of representatives of the employer and the employees. The representatives of the employees are elected every 4 years. The auditor has several obligations towards the workers' council i.e.:

- to attest in a specific written report on the completeness and fairness of the economical and financial information that management gives to the workers council, as far as this information derives from the books and the annual accounts of the company or other verifiable sources;
- to explain and analyze, especially for the members appointed by the employees, the meaning of the economical and financial information in relation to the financial structure and the evolution of the financial situation of the entity. This can be done orally or through specific long form reports.

This reporting to the workers' council is an example of good governance, financial transparency and reduction of the expectation gap. According to an academic study conducted by the universities KUL and UCL, the vast majority of the respondents within workers' councils are clearly positive about the educational role of the auditor. In this regard, two thirds of the respondents give a score of 7.5 or more on a scale of 10⁽⁶⁾.

Already today, important post-closing events have to be mentioned in the annual report and are subject to external audit.

Regarding the time gap between the year end and the date of the audit opinion, we do think that the decision remains with the stakeholders and that the current system applicable in Belgium (annual accounts should in principle be filed within 7 months maximum after accounting closing date depending on the date of the shareholders' meeting) is a good compromise and sufficiently flexible in order to take into account the various situations existing within the audited entity and among the various stakeholders. Reducing the time gap would increase the work load of auditors on a short period of time and reduce the audit quality.

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

⁽⁵⁾ ICCI, *De bedrijfsrevisor en de niet-financiële informatie – Le réviseur d'entreprises et l'information non financière*, nr. 2010-3, Antwerp, Maklu, 2010, 281 p.

⁽⁶⁾ *De rol van de bedrijfsrevisor ten opzichte van de ondernemingsraad – Le rôle du réviseur d'entreprises à l'égard du conseil d'entreprise*, ICCI, Maklu, 2010, 315 p.

We refer to the answers to questions 3 and 4.

Additional value is only possible with sufficient level of audit fees.

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

The ISA's should be adopted at European level. The European Commission should proceed with measures to ensure that the ISA's are adopted for all audits in all Member States.

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)?

ISAs should be made legally binding throughout the European Union. A similar endorsement approach (but ISAs as a whole and not standard by standard) should be adopted in line with the endorsement of International Financial reporting Standards (IFRS). The use of non-binding legal instruments (recommendation, code of conduct) would not be appropriate because it would harm the comparability of audit reports in Europe.

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

Today, ISAs already take into account the size of the audited entities (ISAs are scalable). At international level, there are practical tools and guidance for SMPs to implement the ISAs in SMEs. In Belgium, our Institute does provide support to the SMP's in the implementation of ISA's. Specific practical education on ISAs for SMEs has been developed and audit softwares have been presented to the profession by specialized software providers. In addition, the Belgian Institute has invested in the preparation of SME tailored made ISA's documentation templates.

The profession supports the view that "an audit is an audit" and that auditing standards can be applied to entities of all sizes. However, the audit of a SME will have different areas of focus to those identified in the audit of a large public interest entity. The audit of a SME is likely to focus on risks that arise due to their relatively small size and evolving management structures. The audit of a SME is unlikely to be affected by complex accounting issues. In contrast, the audit of a large listed entity is more likely to focus on areas of risk arising from diversity in operations and complex transactions, which in turn raise more complex accounting issues.

The profession supports the fact that the International Federation of Accountants (IFAC) issued relevant and useful Guidance, which clearly demonstrates how auditing standards can be applied to very small entities (see i.e. the Guide on "Using International Standards on Auditing in the Audits of Small- and Medium-sized Entities" issued by the Small and Medium Practices Committee of IFAC), and consequently shares the view that the same principle can be applied to the audit of SMEs. Relevant guidance also already exists in some countries

[such as the “Practice Note 26” (Guidance on smaller entity audit documentation) issued by the UK and Ireland Auditing Practices Board].

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?

Auditors consider their independence as essential. In Belgium, significant safeguards are already in place in response to the possible threats to the auditor’s independence in relation to appointment and remuneration. Accordingly, there is no need for additional requirements in this field, except maybe in public interest entities as further explained below.

The Belgian Company Code has already provided numerous extra safeguards including prohibition of seven non-audit services that can create a threat to independence.

Independence is demonstrated by clean opinions that are delivered *after* accounting adjustments imposed as a result of the audit. In Belgium, after these adjustments nearly one fifth (18.4 %) of all audit reports are still *not* “unqualified without emphasis on a matter”. The important percentage of non “clean opinions” demonstrates the independence of the statutory auditor (see answer to question 7) and that the independence is not impaired by the fact that the auditor is appointed and remunerated by the audited entity.

In Belgium, other stakeholders than the directors participate in the appointment of the statutory auditor. For example, the workers’ council has a veto right on the auditor nomination proposal made by the board of directors to the general assembly. If there is no agreement between the workers’ council and the board of directors, the President of the Commercial Court appoints the statutory auditor. Audit committees also participate in the proposal for appointing the statutory auditor (in public interest entities).

The role of the audit committee in the selection of the statutory auditor may create future conflicts of interests within the audit committee (when it will have to work in the future with the selected auditor), and should focus on its key functions (monitoring the internal control and the preparation of the financial statements).

In some large and complex audited entities, an alternative to the proposal by the audit committee may be reduced to an opinion (evaluation) on the audit performed by the statutory auditor in place. An alternative could be to consult about the proposal of appointment a committee composed with shareholders instead of the audit committee, without prejudice to the veto right of the workers’ council as it exists in Belgium.

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

No, unless in very exceptional circumstances (see here-under).

Being appointed by only one client (this very third party), the auditor would no longer be a liberal profession, but would become a public servant appointed and remunerated by a sole entity.

A general appointment by a third party is non-existent within the European Union. If this third party is a public authority, this authority would be subject to the European Directive regarding public tenders.

In Belgium, under an amendment of 1980 of the Royal Decree number 185 of 19th July 1935, a special registered bank auditor was appointed and remunerated by the Banking Commission (regulator). This system has proven to be ineffective and inefficient and it has been abolished by the Law of 22 March 1993.

In Belgium today, there are sufficient safeguards and prohibitions (including a list of non-audit services that can create a self-review threat and that are considered as not compliant with the statutory auditors' independence) to ensure the independence of the statutory auditor is not impaired. These rules are applied and, in case of non-compliance, subject to disciplinary sanctions and other sanctions.

The appointment of an auditor by a third party is in contradiction to the rules generally accepted at international level. It would create an economic dependence to this third party, i.e. the appointment by regulators or another third party is obviously in contradiction to the requirement of being economically independent from a client or group of clients, because the source of income of the auditor for audit engagements would entirely depend of this regulator or another third party. With this regard, attention should be paid to Section 290 of the IESBA Code of Ethics for all statutory audits and in particular to paragraphs 290.220 to 222, which limit the fee proportion to be received from a single audit client. When the total fees from an audit client represent a large proportion of the total fees of the firm, the dependence on that client because of a concern about losing this client, creates a self-interest or intimidation threat. For public interest entity audits, specified safeguards of independent review and discussion with those charged with governance are required where the proportion exceeds 15%. In this context, one could assume that the person or entity that appoints the auditor would be the single client and such a situation would therefore give rise to threats to independence.

An economic research demonstrates that the board of directors is interested in appointing the auditor with the highest quality ⁽⁷⁾.

Appointment by a regulator would increase, in certain jurisdictions, the risk of undue influence.

To increase the independence of the statutory auditor towards the board of directors, other stakeholders than the directors or the management may be involved in the appointment of the statutory auditor.

⁽⁷⁾ Consult different studies mentioned by FEE, Study Mandatory Rotation of Audit Firms, October 2004, 25 p.

For example, in Belgium, the workers' council has a veto right on the appointment of the statutory auditor, who therefore must gain the confidence not only from the management, the board of directors and the shareholders, but also from the employees' representatives.

In financial institutions, the auditor is appointed by the institution, but the Banking Commission has a veto right.

It should also be taken into account that the volume of the work and therefore the cost of an audit is also largely dependent on the quality of the information within the entity, the quality of cooperation to the audit, the quality of the internal organization, and unpredicted decisions, events and circumstances that would make it almost impossible to monitor the work and the fees of the audit by a third party.

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?

This issue has already been addressed in the Statutory Audit Directive, which considers that the partner's rotation within the audit firm every seven years in public interest entities (listed companies, credit institutions, insurance companies) is sufficient to reduce the familiarity threat. This rule is compliant with worldwide generally accepted ethical rules, including the IESBA Code of Ethics. Any other measures seem disproportionate to the objective and, therefore, in contradiction to the European Internal Market and competition rules.

If it would be considered to modify the system implemented by the Statutory Audit Directive, an impact assessment process should be undertaken prior such a decision.

Firm rotation instead of partner's rotation increases the audit fees as well as the risk of audit failures, without increasing the audit quality. The key problems of mandatory audit firm rotation are amongst others:

- the significant loss of audit quality as to understanding the business ;
- an increase of switching costs (i.e. the start-up costs incurred by the client for a new audit engagement) and total costs of audit;
- an increase of risks during the first years of each audit engagement.

With respect to independence, it should be noted that according to best international practices (ISQC 1), the audit firms are requested to regularly verify the continuous acceptance of a client, taking independence rules into account.

Audit quality is enhanced by a sufficient (not too short) period of service of the auditor. In Belgium, auditors are appointed for a three-year term. A mandate between three to six years does appear to be a good safeguard for the statutory auditor's independence.

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.

Many safeguards and even prohibitions are in place in Belgium, taking into account European rules and international guidelines. There is a list of seven non-audit services that are supposed to create a self-review threat and that therefore are not compatible with the independence of the statutory auditor (valuation services, litigation services, accounting services, recruiting services, internal audit services, etc.). These prohibitions apply to the auditor and his network, in Belgium or abroad, and to all related companies (including foreign daughter companies) to the company for which the auditor provides audit services. This system is considered by most stakeholders and supervisors as satisfactory.

A prohibition of any non-audit service seems disproportionate to the objective and, therefore, contrary to the European Internal Market and competition rules. The possible prohibition, for instance, of tax services clearly restricts competition. As there is no monopoly for tax services, the auditor is in direct competition with tax lawyers. Any general prohibition would be questionable compared to the proportionality test and the principle of subsidiarity.

Auditors should be allowed to provide non-audit services to large companies and SME's under the condition that the independence principles are safeguarded. SME leaders expect from auditors to act as independent control experts but also that they provide:

- constructive management comments and recommendations as a result of their procedures; and
- additional value through tax, VAT and other regulatory advice.

For SMEs, it is important to principally rely on one independent expert, this to avoid higher costs that would be the consequence of using several experts.

The Green Paper does not only envisage the prohibition of all non-audit services by audit firms with one particular audit client, but also envisages to exclude all non-audit services with non-audit clients. The audit does however not only cover accounting issues but also tax, IT, environmental, etc... areas. The auditor should be supported by competent experts to realize high quality audits. Only multidisciplinary firms can host high quality experts.

Undertakings benefit from management letters and from some other non-audit services that do not impair the auditor's independence. As a principle, the same independence rules should apply to the statutory auditors in large undertakings and in SMEs. Moreover, if non audit services would be forbidden in SMEs, most of them will not have the means in order to benefit of any alternative services rendered by other advisers at the same level of fees for similar services.

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

The excessive reliance on one audit client is a potential threat to the auditor's independence. The IESBA Code of Ethics sets a limit at 15% (see our answer to question 17). The adoption of the relevant part of the IESBA Code could therefore address this concern (paragraphs 290.220 to 290.222 - Fees – relative size).

21. Should new rules be introduced regarding the transparency of the financial statements of audit firms?

In Belgium, almost all financial statements of audit firms are publicly available with the National Bank. This system should be promoted at European level. See answer to question 8.

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

The provisions of the Statutory Audit Directive are sufficient.

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

The Statutory Audit Directive already introduced in 2006 the possibility to raise capital from external sources by requiring that only the majority of the voting rights have to be held by auditors.

However, from an independence point of view, it is not appropriate for audit firms to raise capital from external sources. The participation to the capital of audit firms should be limited to auditors, accountants, tax advisers and other related professionals.

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

To address this issue, only the rules resulting from ISA 600 are an adequate response and should be mandatory. It requires amongst others that the group auditor checks the competence and the independence of the statutory auditor of any significant subsidiary.

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

Member States should first fully apply the Statutory Audit Directive, including cooperation and harmonized rules on professional secrecy.

Harmonized standards on auditing and ethics should also be endorsed at European level.

Belgium has appropriately implemented the Statutory Audit Directive. An oversight body is in charge of endorsing draft standards on auditing submitted by the professional body after public consultation, and another oversight body has the ultimate responsibility of inspection and quality assurance – this inspection and quality assurance being performed by inspectors

having a strong audit experience. Only this system seems to be compliant with the fundamental democratic principles on separation of powers.

This system has produced effective results, including disciplinary sanctions, as mentioned in the annual report of the Belgian public oversight authority⁸.

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

Before increasing consultation and communication, there should be increased effective harmonization between regulators of the EU Member States.

Under the subsidiarity principle, this should be determined by the Member States according to their jurisdictions.

Other authorities than a regulator, such as judicial authorities, may be involved. An example of regular communication with a judicial authority in case of severe going concern issues is provided by the “alert procedure”. This alert procedure provided for in the Belgian law requires the statutory auditor in certain circumstances to seize the President of the Commercial Court in case of going-concern issues (art. 138 Companies Code).

The Ministry is currently examining a draft Belgian auditing standard relating to the cooperation between the auditor and the regulator. This draft standard requires the auditor to report certain issues to the Banking regulator. This cooperation implies:

- a specific opinion issued by the auditor on the interim financial statements;
- an opinion on specific aspects in internal control and the findings thereon (this audit should be performed following ISA’s);
- specific reports on the organization, procedures, financial structure and compliance with regulations. The auditor is also required to immediately communicate to the regulator decisions, events or developments that may have an effect on the financial position of the financial institution. The standard provides for a dialogue between the regulator, the auditors and the internal auditors on the audit program.

The Banking, Finance and Insurance Commission (CBFA) may also require specific reports.

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

The Belgian legislation defines a cap on liability to an amount that can be covered by an insurance company (12,000,000 euros for listed companies and 3,000,000 euros for other entities, except for intentional fault). This cap reduces a potential systemic risk.

⁸ <http://oversight-audit-belgium.eu>

Legislation is the only way to address this issue. Contractual clauses between the auditor and the audited entity are not binding for third parties, such as employees, shareholders, clients and other stakeholders.

Unlimited liability creates the false impression that there are no limits to compensation, thus creating an expectation gap. Unlimited liability also reduces the attractiveness for the audit profession, because the financial risks (also for individuals) are out of proportion with the work performed (and with the audit fees).

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?

Strongly different views exist within the Belgian profession on this matter.

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?

Rotation

The Belgian audit profession is not in favour of a mandatory rotation.

Several studies examined the impact of audit firm rotation on audit quality, independence, accounting conservatism and audit cost. Often quoted disadvantages are the loss of appropriate knowledge of the client and of the industry, and switching costs. Under mandatory audit firm rotation, auditors lose client specific knowledge and expertise. The conclusions of the papers⁽⁹⁾ are very clear with regard to audit quality and accounting conservatism:

- *audit quality*: all papers conclude that mandatory audit firm rotation has an overall negative impact on audit quality. Most notably, a study⁽¹⁰⁾ points to an immediate threat to audit quality resulting from accelerated rotation as partners report a two-to-three year client familiarization period, and a preference to learn a new industry rather than relocate⁽¹¹⁾. Another study shows that the statutory auditors' rotation policy does not improve the audit quality of audit partners⁽¹²⁾. Furthermore, a study using German data finds evidence of more earnings management and

⁽⁹⁾ Papers presented at the 33rd Annual Congress of European Accounting Association at Istanbul (May 19 - 21, 2010)

⁽¹⁰⁾ Audit Partner Rotation: An Analysis of Benefits and Costs (Brian DAUGHERTY, Denise DICKINS, Julia HIGGS).

⁽¹¹⁾ Audit Partner Rotation: An Analysis of Benefits and Costs (Brian DAUGHERTY, Denise DICKINS, Julia HIGGS).

⁽¹²⁾ Does a long-term audit partner tenure impair audit quality? A comparison between the Ordinary Least Squares and Linear Mixed Model (Yu-Shan CHANG, Min-Jeng SHIUE, Yu-Jr LIN).

manipulation when the audit review partner rotates⁽¹³⁾. A study investigating the extent to which mandatory statutory auditor rotation has an impact on audit quality (Italian, German and French data) confirms that systems of mandatory statutory auditor rotation are related to increased earnings management⁽¹⁴⁾. An Italian study testing the effectiveness of the rotation at both partner and firm level concludes that only mandatory partner rotations might have a beneficial effect on reporting quality⁽¹⁵⁾;

- *accounting conservatism*: rotations increase conservatism, but the conclusion of an Italian study is that conservatism is associated with both partner and firm rotation and partner rotations are as effective as firm rotations in enhancing conservative reporting⁽¹⁶⁾;
- *independence*: auditor independence may be compromised when auditors with short mandates receive high non-audit fees, but there is no significant association between non-audit fees and earnings management when the auditor's mandates are long⁽¹⁷⁾.

Furthermore, audit failures are more frequent if auditors have only limited experience with the client⁽¹⁸⁾ and the length of the auditor-client relation has a positive effect on observed independence and audit quality⁽¹⁹⁾.

The conclusion of the above mentioned studies support the path undertaken by different legislators around the world, who introduced the mandatory rotation rule only at partner level (internal rotation).

The profession stresses the fact that the measures should be proportionate to the objective of financial transparency. Competition is an important topic for the European Union. For example, EC Communications of 2004 and 2005 prohibit Member States to adopt national legislation that restrict competition in liberal professions if these restrictions are not proportionate to the objectives in the public interest (health, solidity of building, financial transparency, *etc.*). Regulations that are disproportionate and would restrict the competition between auditors in favor of other regulated professions providing non-audit services should be avoided both at national and European level. Mandatory external rotation of the firm is disproportionate to the overall objective of financial transparency.

Moreover, European regulations should remain compliant with the subsidiary principle.

⁽¹³⁾ The Effect of Audit Engagement and Review Partner Rotation on Audit Quality (Friederike LINDSCHEID, Christiane POTT, Christoph WATRIN).

⁽¹⁴⁾ The impact of auditor rotation on audit quality (Ignace DE BEELDE).

⁽¹⁵⁾ Mandatory auditor rotations and audit quality. Evidence from Italy (Angela PETTINICCHIO).

⁽¹⁶⁾ Mandatory Auditor Rotation, Adoption of IFRS and Accounting Conservatism (Gilad LIVNE, Angela PETTINICCHIO).

⁽¹⁷⁾ Auditor Tenure, Nonaudit Fees, And Earnings Management (WATRIN/POTT/LINDSCHEID).

⁽¹⁸⁾ Audit quality attributes: the perceptions of audit partners, preparers and financial statement users (CARCELLO, HERMANSON and MCGRATH).

⁽¹⁹⁾ Perceptions of auditor independence (SCHELLUCH, THORPE).

Public tender

The profession is not in favor of requiring public tenders, because it increases unnecessarily the (already very high) pressure on the audit fees and reduces therefore the quality of the audit.

The European Commission should focus on the quality of the audit and the necessary resources to perform an audit, including a sufficiently high level of audit fees instead of increasing the competition over fees by imposing public tenders in a market that is already subject to a very high competition. University studies demonstrate that higher audit fees increase the audit quality.

The level of audit fees should not be the main criteria to select the statutory auditor as it is the case today.

The executive directors are appointed by the general meeting of shareholders, and the same procedure applies to statutory auditors. The remuneration of directors is however determined according to the market, without any tender procedure.

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

Endorsing the ISAs, making them the common methodology for all auditors, developing external quality assurance reviews and effective oversight, increase the choice in the audit market.

If needed, the European Commission should use its powers to apply the European competition rules in this regard. The profession believes in free competition. Any clause that restricts competition should be banned. Third parties, whether banks or regulators, should be prevented from imposing clauses that recommend one auditor rather than another.

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

No, the key issue on addressing systemic risks is to introduce a cap on liability to reduce the risk of audit firm failures (see our answer to question 27).

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?

We believe that the rationale for the past consolidation of audit firms is still valid. We do not believe a reversal could be envisaged.

There is a high competition in the audit market, as shown by the pressure on the audit fees. The competition on fees, with unwanted consequences on the quality, is increased by the

compulsory publication of the audit fees required by the Statutory Audit Directive. The aforementioned Directive should be amended so that only the proportion (percentage) between audit fees and non-audit fees are published.

There is also a trend towards consolidation at other levels, i.e. SMP's, due to the high requirements in the fields of education, quality of the audit, specialization and due to the complexity of the laws and regulations.

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

Further mobility is possible in case of further harmonization of audit and accounting frameworks, for example by endorsing at European level IFRS including for SMEs as well as ISAs for all statutory audits.

In Belgium, the mutual recognition is focused on checking the knowledge of specific legal provisions, for example on the role of the auditor toward the workers' council.

Knowledge of the clients' languages and applicable regulations remain very important. From this point of view, the European Union and the USA are very different.

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?

Before harmonizing audit firms, the laws, including the company and the accounting laws, must be further harmonized.

Such a European-wide registration could therefore only be considered when IFRS and or IFRS for SMEs would be endorsed as the only accounting frameworks permitted in the European Union or to the extent such a European-wide registration would be limited for audits of financial statements drawn in accordance with IFRS and or IFRS for SMEs (such as audits of public interest entities, audits of groups, *etc*). But even then, we believe that taking responsibility in assessing compliance with laws and regulations remains very important. A higher mobility of auditors for purely competitive reasons should therefore be avoided.

In any case, the regulation of the auditors of smaller entities should continue to be at the Member State level (subsidiarity principle).

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?

Currently audited SMEs' representatives and Belgian auditors are not in favor of reduced assurance services instead of a statutory audit for currently audited SMEs²⁰.

There is no evidence that the cost of audit for such SMEs exceeds the benefits (cost of capital, etc.).

Suppressing audit in SMEs would only increase concentration in the audit market and increase the cost of capital for SMEs. There are other stakeholders than shareholders, such as employees, who are interested in high quality annual accounts. In fact, the presence of an auditor is sometimes more necessary in SMEs, where no other safeguards are put in place (e.g. for going-concern issues). Some SMEs present higher risks and complexity than some PIEs. Moreover, ISAs are scalable and therefore applicable to entities of all sizes.

Belgium is concerned by some European political messages asserting that audits of SMEs should be discouraged. Further, such a message seems to disregard national realities and the principle of subsidiarity.

While expectations for “good corporate governance” in public interest entities (listed companies; credit institutions and insurance companies) are clearly understood and upheld through strong regulatory oversight, the role of regulatory oversight of small and medium sized business is less clear. The objective of reducing ‘red tape’ and ‘regulatory burden’ is well founded when used to remove a ‘one-size-fits-all’ approach to regulation. However, in a growing economy it is important that certain checks and balances remain in place, so that growing businesses establish good management practices as they become economically significant. External audit can support good governance in SMEs.

The concept of “limited audit” is a new term that does not and should not exist because a “limited audit” contradicts the principle of “an audit is an audit”, and it confuses users' expectations and assumptions.

We believe that a statutory “review” is only relevant for entities below the current audit exemption thresholds. These thresholds should remain unchanged at European level, or even reduced. Promoting reliable accounts for all entities with limited liability is important for many stakeholders and for the public interest, as the financial crisis has proven. Indeed, non-audited companies were partially responsible of the sub-prime crisis in the USA.

36. Should there be a “safe harbour” regarding any potential future prohibition of non-audit services when servicing SME clients?

No.

Similar independence rules of statutory auditors should continue to apply to SMEs and other audited entities.

²⁰ Either more than 100 employees or two of the following criteria: 3,650,000 EUR balance sheet ; 7,300,000 EUR turnover or 50 employees.

In Belgium, we have a reasonable system of prohibition of *some* non-audit services (see answer to question 19).

Even in PIEs, the public interest is better served with the statutory auditor being involved in some non-audit services. For example, the statutory auditor can be involved in preparing a question to the tax authority (“ruling”), such as on transfer pricing. It will give that authority more comfort in the accuracy of the question.

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, the Belgian profession is not in favor of a « limited audit » or « statutory review » and therefore is not in favor of a “limited quality control”. However, as the ISAs are “scalable”, the quality control has to be “scalable” and adapted to the specificity of the audit of small entities.

Even if a form of “limited audit” is introduced, this does not involve that the quality of the professionals implementing this “limited audit” should be lower.

Where audit practices provide services such as reviews, the existing IAASB standard ISQC 1 *Quality control for firms that perform audits and reviews of historical financial information, and other assurance and related services engagements* sets down appropriate quality control standards. This standard is widely recognized as the basis for a sound system of quality control in an audit and assurance practice of any size. The standard needs to be applied appropriately and proportionately. Good guidance on the application of ISQC 1 to a SMP performing audits or reviews is available in the form of the Guide to Quality Control for SMP issued by the Small and Medium Practices Committee of the International Federation of Accountants. As ISQC 1 is a credible and appropriate standard, we do not see the need for reducing quality control standards for audit and other assurance engagements.

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

The Statutory Audit Directive should be fully implemented, which is not the case yet in all Member States. This Directive harmonises cooperation and professional secrecy rules between oversight authorities at European level.

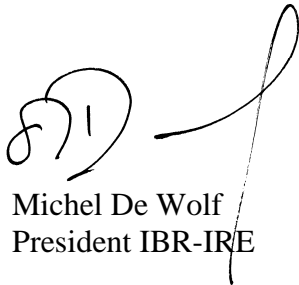
The objective of the oversight is to enhance the audit quality. In Belgium, the implementation of the Statutory Audit Directive involves that an oversight body is in charge of endorsing (or not) draft auditing standards submitted by the professional body after public consultation, and that another oversight body has the ultimate responsibility of inspection and quality assurance performed by delegation by inspectors showing an experience as a professional. Only this system seems compliant with democratic principles on separation of powers. This system has

produced effective disciplinary sanctions and conclusions of quality assurance (see our answer to question 25).

With respect to public oversight, we are concerned that in some countries, the same body is responsible for making or endorsing the standards on auditing, for investigating the possible infringements to these standards and for punishing the non-compliant auditors. This is a situation that is in contradiction to the basic principles of good governance, democracy, separation of powers and human rights that apply to public authorities such as oversight bodies. The European Commission has a duty to contribute to the application by the Member States of the Convention on Human Rights endorsed under the Treaty of Lisbon.

A European public oversight system should be compliant with the following principles:

- a) separation of normative powers (standards on auditing; code of ethics) and inspection/investigation powers (the European Union being now fully submitted to the European Convention on Human Rights);
- b) oversight on draft audit standards and inspections;
- c) cultural diversity;
- d) harmonisation of liability regimes, in order to avoid that European disciplinary sanctions have different consequences on liability issues.



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