

By email to:

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Our reference: EN/AM/NJ/1210

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Dear Sirs

### **European Commission Green Paper - Audit Policy: Lessons from the Crisis**

Grant Thornton welcomes the debate which has been opened by the Green Paper.

We believe that it represents a timely and significant opportunity for change.

Appendix I to this letter contains responses to the questions in the Green Paper.

Grant Thornton makes three critical recommendations:

- expand the role of the auditor to ensure better information for investors
- reduce audit market concentration, and
- encourage growth of private companies by easing access to capital and reducing their administrative burden.

#### **Better information for investors**

Audit firms have to play a part in rebuilding confidence in capital markets.

Auditors should have a more valuable role in supporting the markets and wider society.

The EC's project on Audit Policy represents a welcome opportunity to assess what investors now need and what reporting model would answer that need. Investors should receive more meaningful information about companies with the aim of demonstrating how management has acted in their interests and how auditors have exercised appropriate professional scepticism.

Auditors should provide better communication to investors. We need to be more transparent about how we reach audit opinions and, likewise, there should be greater transparency about management's decisions in preparing the financial statements. In addition to issuing an audit report on financial statements, audit firms must provide new services to meet the changing needs of investors.

Auditors could also provide investors with:

- enhanced communication from the auditor to investors
- assurance opinions on increased narrative disclosures in audit committee reports, and

- assurance opinions on other information provided by the company.

### **Concentration and market structure**

Investors and regulators have consistently identified the risks associated with concentration in the large corporate audit market. They seek a larger pool of quality audit providers with meaningful share of the large corporate audit market to address the issues of concentration risk, market stability and innovation in audit practice. We are willing participants in that evolution.

The solution to excess market concentration identified by the Green Paper is a sustainable net increase in the number of audit firms with meaningful market share. We believe that across Europe this could best be achieved by:

1. greater investor and other stakeholder involvement in the auditor selection decision
2. companies' use of more than one firm to provide their audit and non audit services, and
3. removal by regulators of market practices and misperceptions which bias audit firm appointment and serve to direct large corporate audits towards a few large firms<sup>1</sup>.

The powers and communication channels are already in place for these suggestions to be implemented. However, those powers and communication channels are not currently being used by investors or regulators. If the market participants alone fail to deliver an acceptable solution in terms of market stability, resilience and choice then it likely falls to the regulators to act on the market's behalf. European regulators could, for example, guide investors to apply restrictions over time on market share, measured by number of audits, in concentrated sectors of the market.

The aim of any measures to reduce concentration should always be to enhance audit quality, furnish appropriate information flows about auditor appointment to investors and other interested parties and improve market confidence and stability. Grant Thornton already operates in the large corporate audit market and acknowledges a degree of self interest in that initiatives to reduce concentration will bring additional opportunities for us.

While we support the operation of market forces those forces left unfettered have brought the large company audit market to its present state. Audit market concentration is a problem because the potential failure of a major audit firm poses a threat to market confidence. If a major audit firm did fail it would mean

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<sup>1</sup> Market practices which direct the flow of large corporate audits towards a few firms include unwarranted restrictions on appointment of the auditor (restrictive covenants - see appendix II), unwarranted bias towards a few firms, and unlimited liability where the audit buyer views the volume of the auditor's resources as a form of insurance against loss in investment value. Regulators could help to eliminate this bias by fostering greater understanding of firms' commitment to audit quality by publishing results of independent audit inspections on individual audit firms.

significant disruption, with thousands of companies needing to find a replacement audit firm. This would leave the European market consisting of too few major firms with the attendant long term hazards of reduced price competition and reduced incentives to maintain audit quality. If this is accepted as a premise then the solution is to drive change in market structure as a medium term contingency plan.

If some form of stakeholder intervention is required to redirect market forces and build a more sustainable market structure then the focus should be on developing a greater number of firms with meaningful market share. Dramatic moves such as the breakup of the largest audit firms should be avoided as this risks unintended consequences which would be self-defeating.

#### **Facilitate growth of private companies**

Private companies are a driving force behind the European economy and they will be one of the key sectors which leads the economy towards sustained growth. To finance growth, companies need ready access to capital at a reasonable cost and obtaining appropriate assurance on financial information makes a vital contribution to the financing process. Grant Thornton supports a framework for assurance in the European Union (EU) which is tailored for companies' assurance needs, comprising:

- audits in accordance with international standards (ISAs), together with independent oversight, for those companies that need an audit
- a different form of assurance for small and medium entities (SMEs), and
- a compilation report for micro entities.

Such a framework would enable accounting firms to use their skills to provide business advice to SMEs and thereby encourage growth. A mandatory EU framework is unlikely to be appropriate given the diversity of maturity of EU economies and we recommend that EU law retains flexibility to allow Member States to tailor EU law to local needs.

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Grant Thornton will continue to contribute to development of audit policy. We have consulted widely within our organisation, particularly in Europe, and have received vital contributions in helping to construct this response. This is a critical project for the capital markets and we must ensure that recent momentum is maintained to build sustainable structures for the benefit of the European Union and beyond.

More detailed responses follow in appendices to this letter. If you have any questions on this letter, please contact our Global Head of Public Policy and External Affairs, April Mackenzie (phone: +1 212 542 9789; email: [April.Mackenzie@gt.com](mailto:April.Mackenzie@gt.com)).

Yours faithfully



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## **Appendix I - responses to questions in the Green Paper**

Unless otherwise stated, we respond to the questions in the context of public company audits.

### **1. Introduction**

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

*Question 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?*

Grant Thornton response: All market participants, including auditors, should reflect on the financial crisis and consider ways to improve market practices, including the financial statement audit. When reflecting on market practices it is important to give due prominence to processes that remained effective throughout, as well as processes that could be changed for the better.

The Green Paper addresses issues of a global nature. We therefore agree that, where applicable, the European Commission (EC) should cooperate with the Financial Stability Board and its G20 partners.

The Green Paper is a good starting place but we suggest going forward that the Audit Policy project be split into separate projects such as (i) the role of the auditor and (ii) concentration and market structure. Each project could utilize expert advisory groups to assist the EC and Grant Thornton would be willing to participate where appropriate.

The EC's project on Audit Policy represents a welcome opportunity to assess what investors now need and what reporting model would best answer that need. We welcome changes to the reporting framework which improve alignment of the scope of assurance with investor needs. If all parties are able to agree on the reporting framework going forward then we hope that there will be a new mutual understanding by market participants of each others perspectives and responsibilities. In this way we expect that a clearer understanding of the societal roles of the audit, investors, companies, directors and regulators will emerge.

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

The quality of any service can be enhanced. Audit quality should be considered in the context of stakeholder needs. There is a balance between the costs of an audit and the corresponding benefits to shareholders, investors and other stakeholders. The net benefit to user needs will not be enhanced by the performance of work where the related costs exceed the benefits.

Grant Thornton is always looking for ways to enhance and sustain audit quality. We are helped in this regard by regular dialogue with investors and regulators. The drive for audit quality is a process of continuous improvement. Independent

oversight has benefited the firms and the audit inspection results could be used more proactively to enhance user understanding of individual audit firm quality.

## **2. Role of the Auditor**

In the context of providing better information to investors and enhancing the role of auditors we support:

- improvements to the relevance of narrative disclosures in audit committee reports
- enhanced communication between the auditor and the audit committee
- constructive dialogue between financial institution supervisors and the large audit firms, and
- the work of the International Integrated Reporting Committee (IIRC) on integrated reporting.

Also, in addition to issuing an audit report on financial statements, audit firms must provide new services to meet the changing needs of investors. Auditors could also provide investors with:

- enhanced communication from the auditor to investors
- assurance opinions on increased narrative disclosures in audit committee reports, and
- assurance opinions on other information provided by the company.

While recognising the need for change, we are proud of the role that audit plays in capital markets by providing investors with confidence in the reported performance of public companies. We recognise the risk of the perception gap: the difference between investor understanding of what an audit delivers compared to what is actually delivered. We observe that perceived shortcomings in auditing in relation to the financial crisis appear to derive from misunderstanding about the current scope of an audit as opposed to failures to perform certain tasks that are required as part of an audit. Therefore we welcome a debate on the role of the auditor to better align assurance services with investor needs and, in the process, raise understanding of those services.

As user needs for company information change, user needs for assurance will also change. We believe that the debate on the role of the auditor should address two main issues:

- communication of the result of the financial statement audit, and
- consensus on the other forms of information from the company that are required by investors (and others) and the appropriate forms of assurance on that information to meet investor needs.

Accounting firms are able to harness structures, cultures, ethos and technical skill sets. Audit firms are subject to regulatory oversight, invest heavily in recruiting and training some of the brightest people available and, with substantial international infrastructures, can play a valuable role in supporting the markets

and wider society. However, in reshaping the reporting framework the challenge is to avoid regulation, restrictions and administration which encourage a legalistic and therefore defensive model, as seen in highly litigious markets, to enable audit firms with the employment market's best people to deliver clarity and insight as demanded by the market.

The role of the auditor follows on from the role of company management. If reporting by management changes to provide enhanced disclosures to investors then the related assurance services should change too. We support working with the International Auditing and Assurance Standards Board (IAASB) to develop a framework for the provision of assurance reports on these enhanced disclosures. The audit firms, the wider profession, investors, regulators and other stakeholders all need to work together to identify user needs and the best way to service those needs.

### **2.1 Communication by auditors to stakeholders**

We hope that useful corollaries of the EC's project will be enhanced user understanding of the role of audit which will be to the benefit of all parties; improved dialogue by companies and their auditors with financial institution supervisors; and greater engagement by companies and their auditors with investors.

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

Grant Thornton response: We are unclear on the meaning of "financial health of companies".

The current purpose of auditing is to provide assurance on financial information prepared by the management of the company. Statutory audits could evolve to address the interests of all stakeholders and society at large by reporting on compliance with regulatory or market-based incentives, risk management, or internal controls to mitigate the risk of corruption and fraud.

Additional prospective financial information or risk information published by companies could be subject to some form of assurance by auditors, perhaps on the process for compiling the information. However, assurance given by the auditor should not replace the analyses by rating agencies and equity analysts which are based on their own expectations concerning the performance of a company.

*Question 5: To bridge the expectation gap and in order to clarify the role of audits, should the audit methodology employed be better explained to the user?*

Grant Thornton response: We understand this question to refer to generic disclosure in audit firm transparency reports about the firm's audit methodology, as opposed to disclosure by an auditor in an audit report about specific audit tests conducted on a specific audit.

We believe that the critical issue is enhanced user understanding of the role of the auditor, not how audits are conducted.

We support discussion about the role of the auditor and initiatives to enhance user understanding of the auditor's work. We agree that users would benefit from enhanced understanding about audit quality, which is most appropriately addressed in balanced and constructive reporting by independent auditor oversight bodies.

Users could derive benefit from enhanced disclosure by management of risks, judgments and estimates which typically are the topics of greatest discussion between auditors and audit committees and attract the highest degree of audit focus. The auditors' assurance role on these disclosures should respond to user needs but would likely include a positive opinion that the disclosures are consistent with the financial statements and the auditors' understanding of the business. Reporting on these topics would likely be more informative for users if there were safe harbours for diligent reporting by company management and auditors alike.

On the specific issue of explaining audit methodologies we are unclear on the information need which this proposal is seeking to address. Audit firms would have to make methodology disclosures to a granular level before readers could identify differences between firms. Accordingly, we believe that the critical need is to enhance users' understanding of the role of the auditor, not how audits are conducted. That said, European-wide use of ISAs would negate the need for detailed and potentially lengthy and confusing references to methodologies. Members of the Forum of Firms use ISAs to conduct transnational audits. As principles based standards, ISAs encourage the auditor to exercise professional judgment in a clearly defined framework.

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

Grant Thornton response: Professional scepticism is at the root of an audit and auditors need to maintain an attitude of professional scepticism throughout an audit. Audit standards, training programmes for auditors and audit processes and methodologies reflect the need for scepticism.

Professional scepticism is one of the key requirements of an audit under the ISAs, which define professional scepticism as "an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence"<sup>2</sup>. The auditor is required to consider the reliability of information and, in case of doubt or indications of possible fraud, to investigate further and to determine what additional audit procedures may be needed. We support this risk based approach. ISAs emphasise the importance of scepticism in key areas such as the presumed

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<sup>2</sup> ISA 200, 'Overall objectives of the independent auditor and the conduct of an audit in accordance with international standards on auditing'.

risk of management override, related party transactions, confirmations, management representation letters and auditing fair value estimates.

Some audit inspectors have observed that auditor scepticism needs to be reinforced and this has been noted by investors. Challenges to management might be evidenced in part by audit adjustments. However, due to the timing and nature of audit, oversight regulators typically do not observe the degree to which an auditor challenges management in key audit areas because such challenge happens in real time during the audit in a variety of ways and in a variety of settings. We believe that the gap in understanding of the level of professional scepticism being exercised could be addressed by increased communication, from the auditor to the audit committee, on challenges the auditor has made to management's assumptions; earlier communication by the auditor of significant risks and disclosures and more auditor focus on documentation. Guidance from regulators or auditor oversight bodies on areas of risk, whether in response to general economic conditions, or conditions specific to the audited entity or its business, could be useful aides for the auditor.

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

Grant Thornton response: A qualified audit report or an emphasis of matter paragraph (hereafter referred to collectively as modified audit reports) sends a clear and important message to the marketplace. We believe that dialogue between users, companies, auditors and regulators will help address the perception issue. However, while a modified audit report does result in negative perceptions, such a clear and important message is necessary and its function should not be changed.

In situations which require a modified audit report the issue is primarily one of communication by the company. Ideally, a modified audit report for a public company should not be a surprise to the market because users should already be in possession of information from the company. A modified audit report, for example on "going concern", should only summarise and draw the reader's attention to disclosure made by the company (unless the company has refused to make appropriate disclosure).

Whether or not the circumstances facing the company warrant an amended audit report would generally be a matter for auditor judgment. However, management will always need to make appropriate disclosure to the company's owners. We welcome discussion about how users can better understand the nature of the evidence which informed management judgments in reaching a particular conclusion.

It is said that an audit report modified for a going concern reference can become a self-fulfilling prophecy, particularly if it results in a company breaching a loan covenant. However this is a communication matter between the company and its

lenders and should not in itself discourage the auditor from making appropriate reference to going concern in the audit report.

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

*Question 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?*

Grant Thornton response: We believe that additional information should be provided to external stakeholders but any additional requirements should only be applied to audits of listed companies and public interest entities because that is the sector of the market where there is the greatest user need for enhanced information flows. However, we acknowledge that shareholders and lenders to private companies may also benefit from enhanced information flows. Therefore we advocate that enhancements in communication should be permitted and encouraged for other companies, but not mandated, because it is our perception that benefits of additional information would not be as widespread for private companies as public companies.

These issues are already the subject of thorough discussion with audit committees, for example judgments relating to the financial statements and risk of their misstatement. These discussions conventionally are of a private nature and held in confidence between the audit committee and the auditors. The discussions generally address the risks faced by the company and the judgments made by its management in preparing the financial statements. We have heard calls from some stakeholders for auditors to publish the content of these discussions, but such a requirement has the potential to harm the prevailing spirit of openness and disclosure by management to the auditors. Therefore, in our view, the solution in Europe lies somewhere between the French "justifications" and the publication of the dialogue between the audit committee and the auditor.

If publication of additional information for investors is required then it is important that the audit committee make such communication through an enhanced audit committee report. Accounting policies and internal controls are other areas to be considered. Auditors can then provide assurance on management assertions on these disclosures where investors perceive the benefits of the disclosure and assurance exceed the cost of the provision of same.

A positive development in meeting investor needs will be enhanced external communication of audit results. We believe that the French system of "justifications"<sup>3</sup> has merit but perhaps does not, in its current form, go far enough to meet investor needs. We understand that investors want to know more about

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<sup>3</sup> The French system of "justifications" requires that the auditor brings certain information in the financial statements to the attention of the reader and explains how the auditor reached their opinion on that element of the financial statements.

financial reporting issues such as risk assessment, judgments and estimates, accounting policy choices and controls.

We are aware that a number of standard setters are considering the content of the audit report, including the IAASB. Some of the 21 items for inclusion in an audit report in India could also be of interest to European users.

We support regular dialogue between the audit committee and the auditor. On formal internal communication between the external auditor and the audit committee the German system of auditor communication to the supervisory board has merit. There is similar practice in Denmark, Belgium, UK and France, all of which go further than the minimum requirements in ISAs to communicate with those charged with governance. We have three additional suggestions with respect to auditor communications:

1) *Audit committees*

We note that the benefits derived from enhanced dialogue between the auditor and the audit committee, and from enhanced communication from the audit committee to users, are dependent on the quality of audit committees. We understand that robust audit committees are not necessarily prevalent in every Member State.

2) *Reporting by someone other than the statutory auditor*

The framework for provision of assurance reports on company disclosures located outside the financial statements, such as CSR information, could be designed where appropriate to permit the involvement of a firm other than the statutory auditor. This is a possible method for delivering the benefits of multiple auditors to stakeholders, companies and audit firms which are seeking a foothold in the large listed audit market.

3) *Safe harbour provisions*

As an implementation issue we urge the regulators to consider safe harbour provisions for diligent preparers and auditors who publish information outside the financial statements and give related assurance statements. By safe harbour we mean granting immunity from liability where there has been diligent, good faith reporting in accordance with applicable standards. We believe that this will encourage more meaningful disclosures and thereby maximize benefits to users.

*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?*

Grant Thornton response: Yes. Management disclosure, and assurance thereon, should match user needs.

To the extent that information, such as that pertaining to CSR, is included in the financial statements then it falls within the scope of the financial statement audit. Where such information is provided by management outside the financial statements then additional assurance may be appropriate if the investor community would find this of value. The scope of that assurance, the nature of

the assurance opinion, and respective liability of company management and assurance providers would be implementation issues to address.

The IIRC was launched in August 2010 to create a globally accepted framework regarding accounting for sustainability: a framework which brings together financial, environmental, social and governance information in a clear, concise, consistent and comparable format - put briefly, in an "integrated" format. We support this initiative and believe that regulation in the field of CSR in EU law is now appropriate, as disparity is harmful. At this stage, we suggest that the EC stands ready to act on IIRC recommendations as its work moves forward in 2011.

*Question 11: Should there be more regular communication by the auditor to stakeholders? Also, should the time gap between the year end and the date of the audit opinion be reduced?*

Grant Thornton response: We believe that current minimum requirements for regular communication by the auditor to stakeholders are sufficient, and we note that more regular communication can be requested by the company and shareholders.

The maximum period for audit reporting should not be reduced from its current levels.

As a general principle, it is primarily the responsibility of company management to communicate with stakeholders. Auditor communications need to be an integral part of the wider corporate governance process. The auditor concludes its work following provision of information by the company.

Currently auditors are required to report on the company's annual financial statements and may be engaged by the company, or required by national regulation or local listing requirements, to review interim reports or other communications. The company's owners are also generally able to instruct the company to obtain additional assurance.

The timing of auditors' opinions is in general driven by the deadlines for corporate reporting imposed by securities markets and other regulation. Any acceleration of such requirements should be subject to consultation and give due consideration to the time and cost burden this would place on the companies affected. Care will be needed if applying accelerated reporting timetables across the EU. If a company has good financial reporting processes and systems then you can place greater reliance on the information it publishes. Given the need to consult on difficult audit issues in a measured manner, accelerated reporting deadlines may have a detrimental impact on audit quality.

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

Grant Thornton response: Enhanced communication, referred to above, is critical to maximizing user value derived from the financial statements and the audit. A firm could provide comment to users on the quality of management's disclosures, which would be broader in remit than just reporting on the financial statements, and could comment on issues such as clarity of disclosure, appropriateness of management emphasis, management's sensitivity analysis, and whether risk disclosures are sufficiently broad to address the size and nature of the business.

The auditor's role could be expanded outside the financial statement audit, perhaps to address aspects of risks and controls to mitigate those risks, being careful to weigh likely costs and benefits. Auditors could take a greater role in relation to the narrative reporting which accompanies the audited financial statements. Other possibilities include reporting on specific disclosures around a company's business model and risk information and providing assurance on objective measures such as Key Performance Indicators (KPIs).

We observe that in documents accompanying Initial Public Offerings there is often a report on disclosures about the risks and fundamentals of a business. It seems reasonable that a similar report could accompany the financial statements, accompanied by an assurance report which supplements, but does not replace, the audit of historical financial statements. Such a report would not be dependent on access to a large volume of resources but would require only high quality business analysis.

We support developments to promote better interaction between auditors of regulated entities and prudential regulators. Among the key proposals for audits of financial institutions are:

- more frequent bilateral meetings between the prudential supervisor and audit firms, and separate meetings involving companies, on both generic pressure points within the sector and entity specific matters
- specific, targeted reports to the supervisor by financial institution auditors on regulatory returns, control activities and governance
- a coherent framework which would enable financial institutions to provide high quality disclosures on matters such as more detailed explanation of their business model, identification of key risks, a detailed going concern statement, a capital statement and benchmarking. These disclosures would be reported on by an auditor.

To the extent that company management is required to make greater disclosures, particularly around risk information, some form of safe harbour will encourage more meaningful disclosure to users. To the extent that auditors provide assurance on this expanded information, safe harbours would by necessity need to apply to auditors as well. Other implementation issues will include the form of the report including the wording of the opinion, respective responsibilities of management and the auditor, and the need for international standards describing the work required to form such an opinion.

## 2.2 International Standards on Auditing (ISAs)

The Green Paper raises important issues about qualified reports, professional scepticism, and going concern. The Green Paper's discussion of "higher levels of assurance" infers a possible increase in substantive testing and reduced reliance by the auditor on controls testing. However, substantive tests typically give low levels of assurance on a population with high numbers of transactions in which case increased cost to the user may not generate sufficient benefits. Financial reporting has developed largely in reaction to faster and more complicated business practices so that it is now inappropriate in many audits to place too much reliance on substantive testing.

It is our understanding that a return to greater reliance on substantive testing would not be welcomed by investors who we believe supported the IAASB in developing the fraud and risk ISAs to significantly improve the ISA framework. While we welcome the Green Paper's discussion of user needs for assurance, the work required to conduct a financial statement audit should remain the responsibility of audit standard setters, who undertake appropriate consultation and due process in delivering high quality standards of auditing.

Question 11 asks whether reporting timelines could be reduced. Current or shorter reporting timelines would not be possible without supportable reliance on internal controls as opposed to substantive testing.

*Question 13: What are your views on the introduction of ISAs in the EU?*

*Question 14: Should ISAs be made legally binding throughout the EU? 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)? and*

Grant Thornton response: ISAs should be mandatory for all **audits** (emphasis added) in the EU. ISAs should be made legally binding throughout the EU.

We believe that a single set of global auditing standards is one of the key cornerstones in providing investors and lenders with high quality financial information to make investing and lending decisions across capital markets. The benefits of a single set of global auditing standards include:

- enhanced user understanding regarding the nature and level of assurance being provided by using similar standards, which in turn enhances confidence in the reliability of financial reporting
- enhanced harmonisation of EU auditing not only throughout the EU but also within Member States
- reduced complexity and therefore cost of EU auditor oversight
- greater comparability and transparency of audited financial information
- clearer understanding of auditors' responsibilities and work

- greater cross-border investment
- increased credibility of financial information published by EU companies
- lower cost of capital for investors in EU companies
- a basis for mutual recognition of audits by regulators, and
- reduced cost of complying with multiple or different standards.

Based on responses to the EC's own consultation on ISA adoption there is clear evidence of broad international acceptance of ISAs. ISAs are accepted for audits of foreign listed entities by many of the world's capital markets.

An ISA endorsement process is needed because ISAs are set by a private sector body, the IAASB, and yet are likely to be implemented into EU law through a Regulation. The appropriate point for discussion of the content of a standard should be during the IAASB standard setting process, including the consultation phase. Thereafter the focus of ISA endorsement should be whether the IAASB has followed due process.

The endorsement process should:

- request national audit standard setters and auditor oversight bodies to identify any additional requirements to the extent these are specified by local law
- permit additional requirements at a Member State level providing separate disclosure is made of these in the auditor's report
- include "sunset provisions" that limit the application of a Member State requirement to a defined period of time, and
- prohibit Member State carve-outs.

The Auditing Regulatory Committee is the likely body to approve any proposed Regulation before it is passed to the European Parliament and European Council.

*Question 15: Should ISAs be further adapted to meet the needs of SMEs and SMPs?*

An audit is an audit so ISAs should not be adapted for SMEs and SMPs. However, research into a lower level of assurance conducted to a set of review standards would be beneficial and we describe this in more detail in our response to question 35.

As principles based standards, ISAs allow for the audit to be scaled appropriately for both small and large entities through the exercise of professional judgment by the auditor. Therefore audits conducted in accordance with ISAs give the same effective level of assurance whatever the size of the audited entity. However, oversight bodies will likewise need to scale their inspection approach to the application of these professional judgments. The IAASB has recognised the unique characteristics of small and medium entities by including guidance on how specific requirements can be applied in the circumstances of an SME audit.

Further, a number of the ISAs are unlikely to apply to a small company audit with no cross-border aspects.

Concerns have been expressed by smaller audit firms that adoption of ISAs will increase the amount of audit work that must be done on audits of SMEs. We believe that these concerns are unfounded. The IAASB staff has also issued a document entitled “*Applying ISAs proportionately in the audits of SMEs*”. In addition, the IFAC Small and Medium Practices Committee issued the “*Guide to using ISAs in the audit of SMEs*” which provides comprehensive guidance to SMPs with respect to the application of ISAs.

Adoption of ISAs for all statutory audits across the EU will improve the quality and consistency of audit without a disproportionate cost for the SME/SMP sector. This will be a significant benefit not just to investors in the capital markets but also to a wider group of stakeholders including banks and fiscal authorities as well as entities being subjected to an ISA compliant audit.

### **3 Governance and Independence of Audit Firms**

*Question 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?*

Grant Thornton response: Having auditors appointed by the companies they audit appears to represent a conflict of interest. However we believe that this independence threat is adequately mitigated where the audit committee, consisting of suitably qualified independent non executive board members, has responsibility for the auditor appointment decision. In addition, for all audits independence controls include ethical standards, often enforced by external oversight.

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

In general we do not believe that the auditor appointment decision should be made by any party other than the company with adequate input from shareholders.

In our experience shareholders are rarely involved in the auditor appointment decision prior to the annual general meeting resolution to approve appointment. As we explain in the section on audit market concentration, there are reasons other than independence to require shareholders to be consulted and involved in the auditor appointment process, including consultation on the appointment decision.

*Question 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?*

In the context of independence we do not believe that an audit firm tenure should be limited in time.

We believe that the checks and balances contained in the International Ethics Standards Board for Accountants (IESBA) Code of Ethics for Professional Accountants are sufficient, in particular the requirement for rotation every seven years of the audit partner and rotation every seven years for other senior audit team members. However, initiatives to reduce audit market concentration will be impaired where there is infrequent tendering. We believe that infrequent tendering would best be addressed by investor engagement and influence on directors making the auditor appointment decision.

In this regard it is our understanding that investors would welcome greater transparency and consultation on appointment for audit and non audit services, and fees for those services. We have heard concerns expressed by various stakeholders that downward pressure on audit fees could adversely affect audit quality. Audit regulators need to monitor how pricing impacts audit quality, and how market power is used to maintain and grow market share. Investors and regulators could establish criteria for audit committees to consider when selecting and compensating an auditor. The regulator could monitor implementation of those criteria.

*Question 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?*

Grant Thornton response: In the context of independence, the provision of non audit services by audit firms should not be prohibited.

The IESBA has recently revised its Code of Ethics for Professional Accountants which includes strengthened independence requirements. These changes come into effect on 1 January 2011 and will apply to all statutory audits, not just those of listed companies or public interest entities.

Whilst the provision of some non audit services to audit clients can pose a risk, the objectivity of auditors is not compromised by providing non audit services to audit clients provided that auditors comply with independence standards. Certain non audit services would impair independence by, for example, creating a risk of self-review and would either be prohibited or would require specific measures. In addition, audit firms and the networks with which they are affiliated have a strong system of quality control and are subject to significant independent oversight. Disciplinary sanctions should be available where a firm has provided services which are proven to conflict with independence standards.

Additional transparency regarding non audit services to audit clients could be achieved by better disclosure in the reports or accounts, by improving disclosure of audit committee pre-approval processes, or by additional written guidance for

boards and audit committees. There is a strong argument in favour of audit committees in larger companies pre-approving the provision of all non audit services to audit clients (subject to de minimus provisions).

The provision of services to a non audit client has no impact on the statutory audit of a totally unrelated entity. The ability to provide a wide range of non audit services to non audit clients enhances an audit firm's overall range of skills, many of which are essential in performing a high quality audit. The range and depth of skills offered by multi-disciplinary firms enhances the quality and efficiency of both audit and non audit services and meets the needs of clients with complex and cross-border businesses. The provision of a wide range of services helps an audit firm attract and retain the brightest staff seeking a stimulating, varied and rewarding career which thereby contributes to audit quality.

Prohibiting an audit firm from providing non audit services to non audit clients would increase a firm's economic independence on its audit clients, and it would undermine the financial strength of an audit firm by limiting the opportunity to spread infrastructure and compliance costs over a larger network. It is our opinion that the business model of an audit only firm would be unsustainable.

The onus is on the audit committee to ensure that fees for non audit services do not contain a hidden subsidy for a low audit fee. We understand that shareholders would welcome greater transparency from the audit committee on fees and on appointment decisions.

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

Grant Thornton response: The maximum level of fees from a single client should be regulated by reference to the IESBA Code of Ethics for Professional Accountants.

Too large an economic dependency on a single audit client makes it very difficult to identify counterbalancing safeguards to maintain auditor independence. We support limits on the maximum level of audit and non audit fees that an audit firm can receive from any one audit client and related entities expressed as a percentage of **total firm revenues** (emphasis added) from all clients. The Green Paper refers to total audit revenues which represents a stricter definition than total firm revenues and would present a problem for even the largest firms taking on large assignments in smaller countries. We support the IESBA Code of Ethics for Professional Accountants which provides that if the total fees from any one public interest entity audit exceed 15% of the total fees (all firm revenues) of the audit firm for two consecutive years, then an external independent quality control review of the second year's audit is needed.

*Question 21: Should new rules be introduced regarding the transparency of the financial statements of audit firms?*

Grant Thornton response: No.

We are unclear on the user need which would be met by enhanced understanding of audit firm financial information. Audit firms currently disclose significant information to independent oversight bodies – including financial information – and if such oversight bodies believe that these disclosures contain information that poses a risk to audit quality, then they can address their concerns with the audit firm in question and publicise their findings as appropriate. Regulators are also party to sufficient information to enable them to identify whether an audit firm is under-capitalised and requires corrective action.

In most Member States audit firms that are incorporated as limited liability partnerships already prepare financial statements that are filed with a public registrar. In the majority of these Member States the financial statements are also subjected to an external audit. In addition, Grant Thornton International Ltd is a company incorporated in the UK and therefore its financial statements are audited.

We welcomed the requirement for auditors of public interest entities to prepare Transparency Reports under Article 40 of the Statutory Audit Directive. At a global level, we have for a number of years adopted the Article 40 requirements on a voluntary basis<sup>4</sup>. In the Grant Thornton International Transparency Report we provide information about funding of Grant Thornton International and worldwide member firm fee income. When considering additional network disclosures at an international level, it is important to address two questions – firstly, what is the purpose of these financial disclosures and secondly, to whom should the disclosures be made?

On another issue linked to transparency of audit firms, regulators and other stakeholders have expressed an interest in using metrics that facilitate an assessment and public reporting of audit quality. We would support the development of a suitable framework to assess audit quality. In addition we support publication by independent oversight bodies of named firm audit quality reports that are prepared in a constructive and balanced manner.

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

Grant Thornton response: EU level provisions on audit firm governance could help to reinforce confidence in the audit process.

However, care needs to be taken not to impose a burden on audit firms that is out of proportion to the benefits that might be realised. The various recommendations of the recently introduced UK Audit Firm Governance Code (the UK Code) should be considered. The UK Code covers general principles and includes sections on accountable management, professionalism, integrity and objectivity.

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<sup>4</sup> Grant Thornton International Transparency Report: <http://www.gti.org/Transparency-report/index.asp>

The requirement for larger audit firms to appoint Independent Non-Executive Directors (NEDs) could have a positive influence on auditor independence both in appearance and in fact. Grant Thornton UK was the first UK audit firm to appoint NEDs to its governing body and the appointment of NEDs is under consideration at Grant Thornton Ireland.

NEDs can help reassure the wider public on an audit firm's commitment to deliver high quality audit services. Some flexibility should be allowed in how the appointment of NEDs might be applied across the EU. Audit firms should be allowed to choose the governance structures that best meet stakeholder needs at local, regional or international level. For example, the benefits of NED appointments could be obtained without a requirement to appoint NEDs in every Member State.

Concerns about independence arising from NED appointments to audit firm managing boards must be addressed but they are surmountable.

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

Grant Thornton response: We welcome proposals to explore alternative audit firm control structures and allow audit firms to raise capital from sources external to the firm.

The current rules on audit firm ownership have served their purpose but now unnecessarily restrict the options available to national audit firms and to international audit organisations. We believe that relaxation of the rules relating to control structures of audit firms, which is an initiative focused on the strategy of audit firms and the supply of audits, might help to reduce the excessive market concentration over the long term by providing alternative sources of funding to finance growth. As the world's capital markets expand, and as national boundaries become increasingly irrelevant to market participants, audit firms should be able to seek outside capital to finance growth. If audit firm growth is impeded by rules which have no reference to audit quality then ultimately the capital markets will suffer.

A more immediate benefit of a change in audit firm ownership rules would be to enhance cross border integration of audit firms. All large audit organisations strive for greater global consistency in delivering audits, and to deliver a more cohesive client service. In addition to liability concerns, global audit firm integration is artificially impeded by national barriers such as those related to firm ownership.

However, changes to ownership rules will have no short term impact on the key issue of excessive concentration. If the unsustainable market concentration is to be reduced in an orderly manner then there must be changes to audit buying patterns by companies and audit committees.

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

Grant Thornton response: All barriers to access by the group auditor to working papers and reports of third country subsidiary auditors which derive from local law should be removed.

On occasion access might be restricted by the local auditor or by management. ISA 600, *Special Considerations - Audits of Group Financial Statements (Including the Work of Component Auditors)* contains important guidance for auditors in the event that the group engagement team's access to information of a component of the group is restricted by circumstances that cannot be overcome and alternative sufficient appropriate audit evidence is not available.

We agree that the group auditor should take responsibility for the audit of the group financial statements, as required by ISA 600. ISA 600 does not require the parent company to appoint audit firms from the same network throughout the group. Where there are challenges with other firms, it is up to the group auditor to determine what work the group auditor does on all aspects of the group.

#### **4 Supervision**

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

Grant Thornton response: We believe that the current EGAOB should be upgraded to a "level 3" committee and, ideally, become a statutory authority in the European legal framework.

The EU needs a strong, well resourced, pan-European Auditor Oversight Body in order to engage on an equal footing with its non-EU counterparts, notably the US PCAOB. This will further reinforce cooperation both between Member States and with third countries. Over time this should lead to the alignment of national oversight systems and a consistent approach to both cross-border supervision of audit firms as well as local supervision of audit firms whose activities are primarily domestic.

There should be alignment of inspection procedures concerning EU supervision of non-EU audit firms. The work of the European auditor oversight institution should be coordinated with the work of the International Forum of Independent Audit Regulators (IFIAR).

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

Grant Thornton response: We agree that there is a need to reinforce the dialogue between regulators and auditors. We also agree that this dialogue should be a two way process so that regulators also alert auditors regarding particular areas of

concern. Trilateral discussions between the regulator, the regulated entity and the auditor would also benefit audit quality.

In Germany, regulators are invited to attend periodic meetings of a listed company's Audit Committee together with the external auditor. This has had the advantage of exposing the regulator in Germany to current audit issues before they are resolved, rather than have them only perform inspections and identify potential issues after the audit has been completed. This concept could be explored at EU level. Industry fora could also be encouraged where firms and the local professional body could engage with regulators to discuss industry specific concerns.

In answering question 12 we outline positive developments in the specific case of discussions between financial institutions, their auditors and their regulators.

### **5 Concentration and market structure**

Investors and regulators have consistently identified the risks associated with concentration in the large corporate audit market. They seek a larger pool of quality audit providers with meaningful share of the large corporate audit market to address the issues of concentration risk, market stability and innovation. We are willing participants in that evolution.

The solution to the concerns of investors and regulators of excess market concentration is for more audit firms to have meaningful market share. Grant Thornton recommends three specific actions to dilute concentration in Europe:

1. greater investor and other stakeholder involvement in the auditor selection decision
2. companies use of more than one firm to provide their audit and non audit services, and
3. removal by regulators of market practices and misperceptions which bias audit firm appointment and serve to direct large corporate audits towards a few large firms.

The powers and communication channels are already in place for these suggestions to be implemented. However, those powers and communication channels are not currently being used by investors or regulators. If the market participants alone fail to deliver an acceptable solution in terms of market stability, resilience and choice then it likely falls to the regulators to act on the market's behalf. European regulators could, for example, guide investors to apply restrictions on market share, measured by number of audits, over time in concentrated sectors of the market.

While we support the operation of market forces, those forces left unfettered have brought the large company audit market to its present state. Audit market concentration is a problem because the potential failure of a major audit firm (warranted or not) poses a threat to market confidence. If a major audit firm did fail it would mean significant disruption, with thousands of companies needing to

find a replacement audit firm, and would leave the European market consisting of too few major firms with the attendant long term hazards of reduced price competition and reduced incentives to maintain audit quality. If this is accepted as a premise then the only viable solution is to forcibly drive change in market structure as a medium term contingency plan.

In market sectors around the world concentration is getting worse as large company audits gravitate towards a few firms. Audit firm appointment is often biased by market practices or misperceptions which serve to direct large corporate audits towards a few large firms. Removing these influences is a critical first step in addressing market structure. Market practices which direct the flow of large corporate audits towards a few firms include unwarranted restrictions on appointment of the auditor<sup>5</sup>, unwarranted bias towards a few firms, and unlimited liability where the audit buyer views the volume of the auditor's resources as a form of insurance against loss in investment value. Regulators could foster greater understanding of firms' commitment to audit quality by publishing results of independent audit inspections on individual audit firms.

We propose two solutions to remove the unwarranted effects of restrictive covenants:

- the European Commission, securities regulators and audit regulators should support the OECD position and prohibit or discourage unwarranted restrictions, and
- if restrictions are not prohibited then restrictions on appointment must be in the public domain (we recommend on a national database, such as EDGAR which is used in the US).

However, while removing influences unrelated to audit quality on the audit buying decision may help to slow the current trend of audits gravitating to a few firms, it is unlikely to reverse that trend. If the current trend of audits gravitating to a few firms is to be halted and then reversed in an orderly manner then there must be a change in audit buying patterns by companies and audit committees. The nature of the intervention to bring about change in audit buying patterns will derive from the rate of change in market structure that is needed by investors and regulators. We believe that improvement in market structure will require some form of intervention led by investors, and possibly including other stakeholders, in the auditor selection decision.

*Our suggestions for gradual improvement in market structure*

A gradual improvement in European market structure might be achieved by an investor group having influence over the company's auditor selection decision and encouraging greater use of consortia (more than one firm to provide the service, including non big four firms) in the provision of audit and non audit services. This would make large companies less prone to disruption in the event of unplanned exit from the audit market by their auditor.

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<sup>5</sup> Appendix II summarises Grant Thornton's evidence of restrictive covenants.

*Greater investor influence on company auditor selection decisions*

There should be a regulatory code of conduct or an unequivocal statement from investors promoting the wider use of firms outside the four largest firms. In the first instance the statement might be to appoint other firms as auditors of subsidiaries of large public companies. The allotment of more services to more firms will help to dilute concentration. Involvement of owners in the selection process should encourage greater use of more than one audit network in a group situation, and could help to ensure that audit fees are commensurate with the level of resources required to conduct a high quality audit. Shareholder involvement in the process is critical because the current practice of seeking shareholder approval at the AGM is usually too late to have sufficient influence on the decision.

*Consortia and the provision of audit and non audit services*

The main benefit of consortia is that more firms are able to directly demonstrate high quality in a range of services to a wider range of companies which in turn bolsters the firms' credibility. Greater understanding of more firms delivering high quality services becomes a virtuous circle leading over time to more firms with a meaningful share of the large company audit market.

A specific form of audit consortium is joint audit. In France it has been mandatory for public companies to have joint audits for more than 40 years. In Denmark joint audit was compulsory for public companies but this requirement was lifted five years ago. Nevertheless 16 of Denmark's 64 largest public companies still use joint audit voluntarily. Both joint audit positions are held by the largest four firms at 22% of companies.<sup>6</sup>

Supporters of joint audits assert that a wider range of audit firms are consequently engaged by public companies than elsewhere. Grant Thornton in France has increased its share of public company audits to 19 SBF 250 assignments (2009: 16) of which 6 are on the SBF 120. Grant Thornton member firms in France, Denmark, Cyprus and Belgium have gained important joint audit assignments where they believe they would otherwise have had limited chance of winning the sole audit. We believe that there could be benefit in encouraging wider use of joint audit on a permissive basis in certain sectors of the public company audit market. There would need to be attendant features such as involvement of firms like Grant Thornton to ensure that joint audits address the problem of concentration. However, we do not believe that mandatory joint audit would enjoy widespread support from investors or companies elsewhere in Europe.

*A sector-based approach to concentration*

In the UK there are helpful lessons on auditor appointment processes which could be learned from the public sector audit market, where there is less institutional prejudice, audit quality is high and there is a widespread view that audited entities receive value for money. In this market, independent appointment bodies

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<sup>6</sup> Source: Hemscott as at 1 July 2010: There were 407 public companies in France and Denmark which used joint audits and had market capitalisation in excess of €60m. Both joint audit positions were held by the largest four firms at 90 of those 407 companies.

representing the "owners" monitor audit appointments, audit quality, value for money and tenders.

When taking the discussion forward, the EC and investors should clarify the sectors of the market where they wish to reduce concentration and the timescale for achieving that goal. Once an appropriate market structure is built in some sectors, then successful policies could be applied to other sectors of the market. Sectors might be defined by reference to one or more factors such as geography, industry, and company size/market capitalisation. For example Grant Thornton UK, in its September 2010 submission to the House of Lords Select Committee on Economic Affairs, raised the possibility of short term intervention in certain sectors of the UK market and, in giving evidence to the House of Lords enquiry, suggested that initiatives to reduce concentration could be targeted at FTSE 250 companies (companies ranked 101-350 measured by market capitalization). Similar sectors could be studied elsewhere in Europe.

*Our suggestions for faster improvement in market structure*

A faster improvement in market structure would need greater intervention in the company's auditor appointment process, which in turn may bring greater risk of unintended consequences such as increasing rather than reducing concentration. However, it may be that the risk of unintended consequences is mitigated when major interventions are applied over time and only to certain sectors of the public company market. Therefore it is likely that an analysis will be required of the benefits of faster improvement versus the greater risk of unintended consequences.

A form of greater intervention could be to mandate (rather than encourage) use of consortia requiring that at most one of the consortium members is one of the largest four firms.

A major intervention could be to impose restrictions on market share, by number of audits, over time in concentrated sectors of the European market. A monitoring group comprised primarily of investors, and possibly regulators, could place tapered limits on the absolute number of audits that any one firm can carry out for defined sectors of the market over say a five year period. The sectors would be defined by reference to market capitalisation, and limits could be flexed for each sector. Market shares would be monitored by a panel of representatives from regulators and investors. The market share monitoring panel might also work over time towards aggregate limits for the largest four firms in certain sectors such as 80% (by number) of the largest 100 companies ranked by market capitalisation, 60% (by number) of the largest 300 and no more than 50% (by number) of the largest 500.

*Question 27: Could the current configuration of the audit market present a systemic risk?*

Grant Thornton response: As stated by the London Economics study for the European Commission, the failure of one or more of the largest audit firms could cause disruption in the global capital markets.

Companies in certain jurisdictions and/or market sectors already face a concentrated market and the potential failure of a major audit firm (warranted or not) poses a threat to market confidence. If a major audit firm did fail it would mean significant short term disruption and leave the European market consisting of too few major firms with the attendant long term hazards of reduced price competition and reduced incentives to maintain audit quality.

If this is accepted as a premise then the solution is to drive change in market structure as a medium term contingency plan. It is widely acknowledged by investors, regulators and companies that the solution to excess market concentration is a sustainable net increase in the number of audit firms with meaningful market share.

While there would be significant disruption for companies if a major audit firm failed, no firm is too big to fail. Migration to another audit firm would be manageable and, in economic terms, failure of one firm would be unlikely to trigger cascading audit firm failures or an economic crisis requiring government intervention to preserve confidence in the markets. For these reasons the largest four audit firms should not be viewed as being as systemically important as multi-national financial institutions, and do not warrant protective measures which would benefit only those firms.

*Question 28: Do you believe that the mandatory formation of an audit firm consortium with the inclusion of at least one smaller, non systemic audit firm could act as a catalyst for dynamising the audit market and allowing small and medium-sized firms to participate more substantially in the segment of larger audits?*

Grant Thornton response: There should be a regulatory code of conduct or an unequivocal statement from investors promoting the wider use of firms outside the four largest firms. However we do not believe that, at this time, mandatory consortia would enjoy widespread support from investors or companies in countries other than France.

The main benefit of consortia is that more firms are able to directly demonstrate high quality in a range of services to a wider range of companies which in turn bolsters the firms' credibility. Greater understanding of more firms delivering high quality services becomes a virtuous circle leading over time to more firms with a meaningful share of the large company audit market. Greater use of audit consortia would make large companies less prone to disruption in the event of unplanned exit from the audit market by their auditor.

There should be a regulatory code of conduct or an unequivocal statement from investors promoting the wider use of firms outside the four largest firms. In the

first instance the statement might be to appoint other firms as auditors of subsidiaries of large public companies. The allotment of more services to more firms will help to dilute concentration. Involvement of owners in the selection process should encourage greater use of more than one audit network in a group situation, and could help to ensure that audit fees are commensurate with the level of resources required to conduct a high quality audit. Shareholder involvement in the auditor appointment process is critical, because the current practice of seeking shareholder approval at the AGM occurs too late to have sufficient influence in the decision.

We believe that there could be benefit in encouraging wider use of consortia on a permissive basis in certain sectors of the public company audit market. There would need to be attendant features to ensure that consortia address the problem of concentration.

*Question 29: From the viewpoint of enhancing the structure of audit markets, do you agree to mandatory rotation and tendering after a fixed period? What should be the length of such a period?*

Grant Thornton response: The timing and regularity of an audit tender should generally be a decision for the audit committee to evaluate, and for the audit committee to seek affirmation from the company's owners.

In some sectors of the market audits are put out to tender infrequently, which serves to restrict opportunities for other firms to gain market share. However mandatory rotation/tendering of itself will not reduce concentration and because of the bias towards the four largest firms there is a risk that it will increase concentration. Therefore we support more regular tendering but only at the behest of the company having taken advice from the company's owners.

Another barrier to a company changing its auditor is the complexity of the company's business operations, which means that the company is concerned about the disruption caused by a new auditor building its understanding of the business, systems and controls. We believe therefore that there could be a mechanism to make orderly transition to a new auditor easier. For example, the company could use joint audit or consortia in the transitional period.

*Question 30: How should the 'Big Four bias' be addressed?*

Grant Thornton response: The "big four bias" should be addressed by:

- a prohibition on restrictive covenants (see appendix II)
- greater investor influence over the auditor appointment decision which is subject to the bias
- implementing an appropriate liability limitation regime, to remove the bias of investors who treat the audit opinion as a form of insurance against loss in value of their investment, and

- auditor oversight bodies giving clear positive messages on audit quality, to remove the misperception that bigger firms provide better audits.

The bias towards the largest four firms derives from a number of sources, and influences the company's auditor selection decision. Investors need to have greater input to the audit tender process and the auditor selection decision. Investors should therefore have sound knowledge of audit firm capabilities, and understand the risks posed by the audit market structure in the relevant sector.

The incentive on company owners to appoint one of the largest four firms, where owners treat the audit opinion as a form of insurance against loss in value of their investment and the largest four firms have greater resources to settle larger claims, will be diluted by appropriate liability limitation regimes which are fair on all market participants.

We recognise and appreciate that the EC has not repeated accidental inferences in past consultation papers that firm size equates to audit quality. We encourage the EC to work with oversight bodies to ensure that clear positive messages on audit quality are given to the market. For example the UK independent audit inspection reports in November and December 2009 demonstrated that Grant Thornton and BDO were the only major firms with no audits requiring "significant improvement"<sup>7</sup>.

During the course of discussions with other parties about the Green Paper we have encountered unsubstantiated assertions that audit quality is lower when conducted by firms outside the largest firms. We have also encountered statements which infer that the bigger the firm the better the quality. Such statements are untrue, and they are damaging because they serve to reinforce the bias.

*Question 31: Do you agree that contingency plans, including living wills, could be key in addressing systemic risks of firm failure?*

Grant Thornton response: We support discussions with regulators on possible contingency plans, aimed at helping to prevent unwarranted failure of an audit firm or dealing with an unplanned demise of an audit firm, with a view to rapidly resolving any significant disruptions in the provision of audit services. Living wills will not prevent unwarranted failure of an audit firm.

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<sup>7</sup> 2008/9 Audit Inspection Unit reports for Baker Tilly, BDO Stoy Hayward, Deloitte, Ernst & Young, Grant Thornton, Horwarth Clark Whitehill, KPMG, PricewaterhouseCoopers. The AIU describes the meaning of significant improvement as follows: "Where an audit is assessed as requiring significant improvement, this may indicate that the AIU had significant concerns in relation to the sufficiency or quality of audit evidence or the appropriateness of judgments in relation to key aspects of an audit, either individually or collectively, or alternatively very significant concerns in relation to other aspects of an audit. This assessment however does not necessarily imply that an inappropriate audit opinion was issued."

We believe that lessons can be learned from the experience in Japan. In particular, all firms that wish to do so should be able to participate from the outset in arrangements for orderly migration of audit assignments from the failed firm.

It is essential that the process to be followed by a regulator in the event of failure of a large audit firm should be fully transparent to preserve trust and confidence of the capital markets. The process of changing auditor should be applicable to all audit firms that audit public interest entities. The contingency plans should be adaptable to the specific context, size and international impact of any disruption.

*Question 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?*

Grant Thornton response: We do not support a break up of the largest four firms, whether effected by reversal of past consolidations or by other means.

A tiny proportion of the very largest global public companies needs an audit on a scale provided by the four largest firms. However, sufficient resources to audit the very largest companies does not require dominant public company market share. France has some of the largest companies in the world, and audit quality is generally held to be high. The four largest firms in France provide audits to these companies from a base of approximately 50% collective share of the audit positions at France's 400 largest public companies. If at most 50% is sufficient collective market share in France then 80% and 90% and higher need not be necessary in other jurisdictions.

Therefore, meaningful growth in public company market share by other firms, which generally equates to minimal reduction in market share for the largest four firms, will not put at risk the ability of the largest four firms to audit the largest public companies.

All accounting organisations search for new members to enhance their service offering which reflects market forces. However, when one of the largest four networks acquires a firm from outside the four then this inevitably serves to increase concentration. These national firms may be small in the context of global revenues, but they are sometimes significant in terms of regional service offering in an environment where perception of insufficient geographical reach is often cited by companies as a reason for appointing a big firm over a smaller firm. Concentration is a cross-border issue and it requires regulatory coordination and cooperation to manage the problem. While we do not support reversal of past global consolidations, national regulators will need to cooperate and take account of the global impact on concentration before they approve large four acquisitions of a national firm. In the interests of preventing increased concentration we advocate a global requirement for prior approval of an acquisition by a large four firm by the relevant national body (competition authority or audit regulator) in consultation with their international counterparts.

## **6 Creation of a European market**

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

Grant Thornton response: We welcome Commissioner Barnier's new initiative to bring forward the internal market. More mobility of people is in the interest of internationally active audit firm networks. Increased mobility helps to engage auditors with specific expertise to work directly with clients in different EU countries and to give audit opinions if this reflects their role in the audit.

Greater mobility will be facilitated where there is: closer alignment of the syllabuses that underpin professional examinations; adoption of international standards (eg IFRS, ISA, IESBA Code of Ethics) which will remove national differences between the Member States; and harmonisation of company law across Member States.

Language will remain a barrier but we believe that facilitating greater mobility by embedding ISAs and allowing mobility of practitioners across borders will be extremely helpful, especially in specialist sectors.

*Question 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?*

Grant Thornton response: The "single passport" is one practical area where the EC could facilitate and accelerate closer integration and greater mobility. The single passport should be available to all firms, but it should not be mandatory because it will be of benefit only to those firms that wish to operate across borders.

We note that the 8th Audit Directive is a minimum harmonisation Directive and the challenge with any scheme such as this is to establish appropriate levels of minimum harmonisation on issues such as qualification and audit quality.

## **7 Simplification: Small and Medium Sized Enterprises and Practitioners**

Private companies are a driving force behind the European economy and they will be one of the key sectors which lead the economy towards sustained growth. To finance growth, companies need ready access to capital at a reasonable cost, and obtaining appropriate assurance on financial information makes a vital contribution to the finance process. Grant Thornton supports a framework for assurance in the EU which is tailored for companies assurance needs, comprising:

- audits in accordance with international standards (ISAs), together with independent oversight, for those companies that need an audit
- a different form of assurance for small and medium entities (SMEs), and
- a compilation report for micro entities.

Such a framework would enable accounting firms to use their skills to provide business advice to private companies and thereby encourage growth. A mandatory EU framework is unlikely to be appropriate given the diversity of maturity of EU economies and we recommend that EU law retain flexibility to allow Member States to implement EU law in accordance with local needs.

We support initiatives to reduce the administrative burden for companies which do not impair the efficient operation of the EU economy, but only where removal of those burdens would not increase costs or administrative burden for other sectors of the economy. All proposed changes to corporate law must be tested against user needs, which will almost certainly vary between Member States, not least because of the differing maturity of their respective economies.

Therefore conclusions in this area are best drawn after reference to a robust Regulatory Impact Assessment determined at a Member State level.

In considering the structure of European company law in the medium term, the debate would benefit from consideration of factors affecting corporate profile other than size. For example, breadth of ownership should be a factor when considering the appropriate levels and form of accountability of companies.

Throughout Europe, privately held companies are vital for economic growth and stability. The EC has a difficult task in seeking to balance appropriate EU-wide legislation for corporate Europe, while encouraging the growth of European business and the European economy.

There are many factors to consider in designing appropriate assurance requirements, especially in the current financial environment, where there are reports that credit insurance premiums are rising, lenders appear reluctant to enter into new facilities that are affordable to SMEs, and tax revenues are under pressure prompting fears of an increased number of inspections by tax authorities. Companies often use audited financial information to restrict these administrative costs. For example, a Danish tax return asks the company whether it has had an audit/review/nothing. In Finland and Sweden it has been reported that 85% of lost tax revenue derives from companies that do not have an audit. If a service which provides users with a lower level of assurance than an audit is accepted by these third parties then there is a chance of lower costs for SMEs.

*Question 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?*

Grant Thornton response: We believe that a limited assurance review service should be allowed provided it meets the assurance needs of users.

The amount of costs saved by a limited assurance review compared to a statutory audit would depend on the scope of the review work. Our initial view is that

potential cost savings would be maximised if the review procedures did not have to consider internal controls, such as controls to mitigate fraud, or be subject to external oversight.

As a first step we would support research into whether users in the EU would accept negative assurance opinions based on work conducted in accordance with International Standard on Review Engagements 2400: *engagements to review financial statements*. One of many implementation issues to consider is involvement of qualified accountants. A review in accordance with ISRE 2400 is conducted by a practitioner who complies with the IESBA Code of Ethics for Professional Accountants. The review is planned and performed with an attitude of professional scepticism and evidence is obtained primarily through inquiry and analytical procedures.

*Question 36: Should there be a "safe harbour" regarding any potential future prohibition of non-audit services when servicing SME clients?*

Grant Thornton response: Assurance opinions should be independent, but we agree that independence requirements should be more relaxed for auditors of SMEs than for auditors of public companies, as described in the IESBA Code of Ethics for Professional Accountants. The assurance provider working for SMEs is able to add value through provision of business advice that would be inappropriate (and largely unnecessary) for public companies.

As explained earlier, we would oppose a prohibition on provision of all non audit services by the auditor to companies, whether they are SMEs or public companies.

*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?*

Grant Thornton response: Oversight of auditors in this segment of the market could be performed by local professional bodies. A lighter approach to oversight is warranted because the degree of public interest in financial statements of private smaller companies is lower than in those of public companies.

Every company regardless of size should have a system of internal control but this should not be mandated by law. For private companies the active involvement of owners often reduces the need for elaborate internal control systems and the small number of personnel often renders such systems impractical. This comment applies equally to smaller audit firms.

## **8 International co-operation**

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

Grant Thornton response: The focus of improved international cooperation between regulators on oversight of global audit firms should concentrate on the audits of multi-national, public companies.

To bring about more consistency and quality in oversight, auditor oversight bodies need to agree common oversight frameworks to the fullest extent possible and with a particular view to mutual reliance. This concerns, inter alia:

- agreed sets of (updated) registration information
- common inspection mechanisms and reporting thereon, and
- adequate mechanisms for exchange of information, including in the event of cross-border audit failures.

Results of independent audit inspections should be reported publicly, for individual firms, in a balanced and constructive manner. Balanced public reporting on named firms will help to inform investor understanding of audit quality across a broad range of firms, and support investor confidence in the probity of published financial information.

## **Appendix II - evidence of restrictive covenants**

In the covering letter we highlight the existence of market practices which direct the flow of large corporate audits towards a few firms. Such market practices include unwarranted restrictions on appointment of the auditor, which are often referred to as restrictive covenants.

The European Commission is mandated to act as the EU's competition authority and its job is to ensure that competition in the Single Market is free and fair. Restrictive covenants contravene the EC's goal for a free market for services and impair a company's auditor selection decision, and thereby act to compound audit market concentration.

Grant Thornton member firms have obtained evidence of restrictive covenants:

- member firms in Finland, Germany, Ireland, Spain and the UK possess written evidence of restrictions
- member firms have encountered restrictions but have not had access to the restricting document in these five countries and in addition in Armenia, Belgium, Denmark, France, Georgia, Greece, Israel, Kazakhstan, Macedonia, Malta, Poland, Portugal, Russia, Turkey and Ukraine.

We know that restrictions cross borders. In the US we have identified that at least 10% of the Russell 2000 companies are subject to some form of restriction on appointment of auditor or accounting adviser. The US is one of the few jurisdictions which require documents such as lending agreements to be placed in the public domain, via the EDGAR database.

The Organisation for Economic Co-operation and Development (OECD) acknowledged that restrictions are undesirable and that unwarranted restrictions should be removed. The OECD Competition Committee report on competition and regulation in the auditing and related professions (the Report) was published in May 2010<sup>8</sup>.

The Report concluded that "Promoting entry of new international accountancy networks and expansion of existing... networks should be encouraged, by: preventing unnecessary restrictions being imposed on companies by third parties (such as lenders) regarding the choice of statutory audit firm..."

The Report stated that "If regulators and competition authorities take the lack of competition in the accountancy services market seriously, therefore, regulatory and market barriers impeding such expansion [should be] addressed." The Report also noted that "Where a company wishes to use a non-Big Four auditor certain market practices may prevent or discourage it from doing so. Market practice has emerged in some jurisdictions including the US, Germany and the UK, whereby third parties such as lenders, impose covenants on the company which restrict the

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<sup>8</sup> OECD Competition Committee Report: Competition and Regulation in the Auditing and Related Professions; <http://www.oecd.org/dataoecd/8/8/44762253.pdf>

company's choice of auditor to a Big Four firm or apply more punitive terms and conditions to loan finance where a non-Big Four firm is appointed. Such restrictions are not based on a qualitative assessment of the pool of audit firms available and prevent excluded audit firms from competing with the Big Four firms and thus entering or expanding further into the audit market for large or quoted companies. The positive impact of other initiatives which aim to increase the number of suppliers of large international audits is thus impaired by unnecessary buy-side restrictions."

We propose two solutions:

- the European Commission, securities regulators and audit regulators should support the OECD position and prohibit or discourage unwarranted restrictions, and
- if restrictions are not prohibited then restrictions on appointment must be in the public domain (we recommend on a national database, such as EDGAR which is used in the US).