

## **Statement by the Wirtschaftsprüferkammer on the**

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

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Netzwerk Europäische Bewegung

*[Network European Movement]*

European Financial Reporting Advisory Group

European Group of International Accounting Networks and Associations

Fédération des Experts Comptables Européens

International Federation of Accountants

IFRS Foundation

International Organization of Securities Commission

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## **Germany**

Deutscher Bundestag – Wirtschafts-, Finanz-, Rechts- und Europaausschuss

*[German Bundestag – Economic, Financial, Legal Affairs and European Affairs Committee]*

Bundesministerium für Wirtschaft und Technologie

*[Federal Ministry of Economics and Technology]*

Bundesministerium der Justiz

*[Federal Ministry of Justice]*

Bundesministerium der Finanzen

*[Federal Ministry of Finance]*

Bayerisches Staatsministerium für Wirtschaft, Infrastruktur, Verkehr und Technologie

*[Bavarian Ministry of Economic Affairs, Infrastructure, Transport and Technology]*

Bundesrechtsanwaltskammer

*[The German Federal Bar]*

Bundessteuerberaterkammer

*[Federal Chamber of Tax Advisors]*

Bundesnotarkammer

*[German Civil Law Notaries]*

Patentanwaltskammer

*[German Chamber of Patent Attorneys]*

Bundesverband der freien Berufe

*[Federal Association of Liberal Professions]*

Institut der Wirtschaftsprüfer in Deutschland e. V.

*[Institute of Public Auditors (Public Accountants/Wirtschaftsprüfer) in Germany, Incorporated Association]*

Deutscher Buchprüferverband e. V.

*[German Association of Buchprüfer (Auditors), Incorporated Association]*

wp.net e. V. Verband für die mittelständische Wirtschaftsprüfung

*[wp-net e.V., Association of Wirtschaftsprüfer (Public Accountants) for Small and Medium-Sized Enterprises, Incorporated Association]*

Deutscher Wirtschaftsprüferverein e. V.

*[German Association of Wirtschaftsprüfer (Public Accountants), Incorporated Association]*

Deutscher Genossenschafts- und Raiffeisenverband e. V.

*[German Cooperative and Raiffeisen Confederation, Incorporated Association]*

Deutscher Sparkassen- und Giroverband (Prüfungsstellen)

*[The German Savings Banks Association (Auditing Agencies)]*

Deutscher Steuerberaterverband

*[German Association of Tax Advisers]*

Deutscher Anwaltverein

*[German Bar Association]*

Deutscher Notarverein

*[German Notaries' Association]*

Parlamentarischer Mittelstand der CDU/CSU-Fraktion im Deutschen Bundestag

*[German SME Circle (PKM) of the CDU/CSU parliamentary group in the German Bundestag]*

## **A. Executive Summary**

### **Introduction**

- Against the backdrop of the financial and economic crisis, the Wirtschaftsprüferkammer welcomes the EU Commission's initiative, in a comprehensive approach, to put forth for discussion the content and environment surrounding the audit, and is delighted to join in on considerations that may lead to improvement in the value of financial accounting and audits along with their ability to be understood by their users.
- The transference of various basic principles and requirements that have been intrinsic elements to the banking system and other stakeholders in the financial system (e.g. system relevance of auditors, appointment and remuneration of the auditor compared to common practice and operating environment for rating agencies) is, however, only partly warranted. Decisive to the effectiveness and efficiency of the auditor is his independence, the quality of his work, the public oversight and his communication with the environment, not to mention the basis on which the companies to be audited are to prepare their financial statements. Without high-quality, comprehensible and clear accounting rules, which provide a yardstick for measuring the subject matter at hand, the utility of the audit for the users of financial statements also becomes questionable. This is where unequivocal guidelines of accounting purposes would be helpful.
- For all topics addressed by the Green Paper, it must be considered whether rules should be established for all kinds of audit, for the area of statutory audits thus falling within the scope of application of the Directive on Statutory Audit or selectively for audits of public-interest companies. Due to the significance of capital markets, it would seem obvious to establish special rules for public-interest companies and their auditors where appropriate.

### **Role of the Auditor**

- The public conception of the role of the auditor is also influenced by the so-called expectation gap. The Wirtschaftsprüferkammer supports every definition concerning the audit that leads to a reduction of an expectation gap. Important influencing factors in this regard are also the quality of the accounting rules, the phrasing of the auditor opinion, as well as the scope and users of the auditor's reporting duty. The auditor opinion (the findings of the auditor for the general public) in combination with the management report additionally required in Germany, along with the audit report (a statement by the auditor for the control body, the supervisory board, that goes above and beyond the auditor opinion and takes the management report into account) has proven itself in terms of the auditor's reporting duty. An EU-wide introduction of a reporting format modelled after the German management report as

well as the design of the German "long form report" as a comprehensive instrument for communicating with the control body should therefore be taking into consideration. In this respect, the company's management report could be expanded to include details about the business model and the associated opportunities and risks. These details would in turn be checked by the auditor for their plausibility.

- The development of a "best practice" in conjunction with regular consultation within the scope of the audit could foster better communication between the auditor and the control body.
- To the extent that companies are obliged to prepare interim reports, the requirement of audit review would also contribute to greater communication.
- The introduction of the ISA would, in our view, lead to a European-wide harmonisation of the quality of the audit at a high level. Scalability requires special attention in this regard.

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

- The independence of the auditor contributes significantly to the trust of the public in the audit and hence the annual financial statements being audited. The practice of the auditor's being appointed and remunerated by the company to be audited has proven itself in Germany. Not the management but rather the General Assembly selects the auditor and the control body of the company (supervisory board, meeting of the shareholders) handles the appointment and negotiation of remuneration. The appointment by a third party (for example by an oversight agency) would represent a massive encroachment upon the decision-making freedom of the General Assembly / the supervisory board or shareholders' meeting and thus upon the property rights of the company's owners, quite aside from the colossal bureaucratic effort and lack of company-specific expertise of such a third party.
- Mandatory external rotation of the auditor in our view does not necessarily strengthen independence. In fact, in this case we see the danger of reducing the quality of the audit based on the subsequent auditor's lack of knowledge about the company to be audited, along with increased costs and time commitment. Experience in various European member states has proven this. From our perspective, internal rotation, on the other hand (change of the responsible auditor within the audit firm), has been proven to strengthen the independence of the auditor.
- We take a critical view towards a complete prohibition on the provision of non-audit services or indeed the creation of exclusive auditing practices. Consulting activities contribute integrally to the creation and retention of special expertise, which is indispensable to conducting

an audit. Self-audit by the auditor in areas in which he has been actively involved must, of course, be excluded and the other reasons for exclusion specified in the Directive on Statutory Audit must be preserved. Additionally one might consider having consulting engagements of an auditing client contracted, or at least approved, by the supervisory board.

- As regards the auditor's fees on the whole, it could be reasonable to expand to the entire EU Germany's limit on remuneration from an audit client to particular maximum proportionate amounts (dependency on revenues).
- We also take a critical stance towards ownership participation of return-orientated investors in audit practices, which can only be detrimental to the quality of the auditor's work. This type of ownership participation will not serve to cover liability risks. For this, however, there are other instruments such as the German liability regime. The EU-wide introduction of rules for limiting liability therefore ought to be included in further considerations.

### **Oversight**

- Already in 2005, in implementing Article 32 of the Directory on Audit, Germany established with the Auditor Oversight Commission (AOC) an oversight body independent of the profession above the Wirtschaftsprüferkammer and thus above the auditors.
- The structures of audit practice oversight must fulfil their mission in an effective way. For auditors of EU-wide engagements, it is therefore recommended that the coordination of the existing oversight bodies be strengthened within the scope of the European Group of Auditors' Oversight Bodies (EAOB) by setting up a Lamfalussy Level 3 Committee. The decisive factor for structuring professional oversight is that the strict principle of subsidiarity should apply. Additionally, professional expertise, irrespective of the unrestricted decision-making authority of persons or institutions from outside the profession, should sufficiently enter into the judgement of the subject matter.

## **Concentration and Market Structure**

- A systemic relevance of audit practices is called into question, because these are personnel-intensive but not capital-intensive and tend to be of lesser significance to the functioning of the economy – compared to the banking sector. The experiences even following the failure of Arthur Andersen have shown that the audit market is capable of absorbing corresponding human resources and making them available to those in demand of audit services. This may lead to further market concentration.
- The risk of failure of an audit practice as the result of liability to pay compensation to clients, at least from the perspective of the German liability regime, is very limited. We are not aware of any ramifications of limited liability on audit quality compared to countries without limited liability. Also in reference to the topic of "concentration and market structure", we would once again like to put forth for consideration the idea of European-wide introduction of basic principles of limited liability.
- As for the question of the ramification of joint audits on the market structure, one should rely on the experiences of other EU member states. Joint audits may make sense in certain cases, but they do involve a greater need for coordination and communication and thus presumably also lead to higher audit costs to the client.
- Companies operating internationally in turn place demands on their auditor with respect to size and internationality. The creation of international networks in our view serves to meet the demands of the market.

## **Creation of a European Market**

- In assembling a team of auditors – especially in large audit firms – cross-border mobility is already a reality today. Problems with regard to a European audit market derive from the authorisation to issue or sign auditor opinions. The responsible auditor must be appointed as an auditor, pursuant to the Directive of Statutory Audit, based on the regulations prevailing in the receiving country. There are mitigating factors here through the aptitude test. Maximum harmonisation or complete standardisation of the European audit market would be desirable, but this can only be the outcome of a medium- to long-term development.

## **Simplification: small to medium-sized audit firms**

- We reject the introduction of a "limited statutory audit" or a general "statutory review" in lieu of the statutory audit. Audit quality and the reliability of the audit opinion must remain uni-

form. Of all things, a "limited auditor's opinion" would cause the expectation gap to widen from the perspective of the users of the financial statements.

- Safe harbours for the provision of non-audit services by small to medium-sized audit practices ought to be considered. However, this must not be allowed to affect the auditor's impartiality.

## **B. Recommendations of the Wirtschaftsprüferkammer at a Glance**

For all recommendations, it should be considered on an individual basis whether rules should be established for all kinds of audit or for statutory audits thus falling within the scope of application of the Directive on Statutory Audit or only for audits of public-interest companies:

- Examination of the contents and complexity of current rules for accounting as well as unequivocal guidelines of accounting purposes where appropriate (on Question 1)
- An EU-wide introduction of a reporting format modelled after the German management report as well its expansion to include details on the business model and the associated opportunities and risks. The auditor is to evaluate these in terms of their plausibility (on Question 4)
- EU-wide use of the design of the German "long form report" as a comprehensive instrument for communicating with the company's control body (on Questions 5, 8, and 12)
- Improved communication between the auditor and the control body (development of a "best practice" flanked by a regular exchange) (on Question 9)
- Duty of audit review of interim financial statements, to the extent that they are to be prepared (on Question 11)
- Approval or contracting of audit engagements by the supervisory board (on Question 19)
- EU-wide introduction of rules limiting liability (on Questions 23, 27)

### **C. Statement**

The Wirtschaftsprüferkammer [Chamber of Public Accountants] is pleased to take the opportunity to participate in consultation on the green paper.

The Wirtschaftsprüferkammer is a corporation under public law, whose members are all Wirtschaftsprüfer [German public accountants], vereidigte Buchprüfer [German sworn auditors], Wirtschaftsprüfungsgesellschaften [German public audit firms] and Buchprüfungsgesellschaften [German firms of sworn auditors], in Germany. The Wirtschaftsprüferkammer is headquartered in Berlin and is competent for its more than 20,000 members throughout Germany.

The more than 20,000 members of the Wirtschaftsprüferkammer comprise 13,619 Wirtschaftsprüfer, 3,688 vereidigte Buchprüfer, 2,540 Wirtschaftsprüfungsgesellschaften, 121 Buchprüfungsgesellschaften and 828 additional members. Of the 17,307 Wirtschaftsprüfer and vereidigte Buchprüfer, some 23 % (3,909) practice in the five biggest Wirtschaftsprüfungsgesellschaften and some 77 % (13,398) in other audit practices. 4,322 audit practices are authorised to carry out statutory audits; including 119 audit practices that audit the annual financial statements of public-interest companies (all figures as at 31 December 2009). The Wirtschaftsprüferkammer thus represents all groups belonging to the profession, regardless of size or legal form.

Against the backdrop of representing the entire profession of auditors in Germany and given that the Wirtschaftsprüferkammer is obliged to remain neutral with regard to the various commercial interests of its members, we would like to point out that we refrain from making remarks on Chapter 5, "Concentration and Market Structure" to the extent that the business interests of groups of members of the Wirtschaftsprüferkammer are affected.

For all topics addressed by the Green Paper, it must be considered whether rules should be established for all kinds of audit, for the area of statutory audits thus falling within the scope of application of the Directive on Statutory Audit or selectively for audits of public-interest companies. Due to the significance of capital markets, it would seem obvious to establish special rules for public-interest companies and their auditors where appropriate.

## 1. Introduction

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

The Wirtschaftsprüferkammer supports the initiative of the EU Commission to put forth for discussion, in a comprehensive approach, the content and environment surrounding the audit. However, the regulatory purpose being pursued by the initiative is not sufficiently clear. For example, market issues (improvement of competition, breaking through the market supremacy of the Big Four) are mixed with quality issues ("very high level of assurance", substantive audit procedures, independence). With the introduction of joint audits it is not discussed whether this may have ramifications on the quality of the audit.

A clear understanding of the regulatory purpose and its consequences are, however, an indispensable element of regulation which of course is also held to high quality standards. The prerequisites for high-quality regulation are effectiveness and efficiency (comp. IFAC Policy Position 1 Regulation of the Accountancy Profession December 2007). Each regulatory measure is to be examined in terms of whether it is capable of fulfilling this purpose (effectiveness test) and whether the costs of the measure are justified by a utility that exceeds the costs (efficiency test).

The Wirtschaftsprüferkammer is delighted to join in on considerations that may lead to improvement in the value of financial accounting and audits of financial statements along with their ability to be understood by their users. This is the regulatory purpose by which all regulatory measures are judged (effectiveness and efficiency). The Wirtschaftsprüferkammer also follows with interest the discussions on whether and how the value of audits can be improved for stakeholders. The core issue involves fulfilling the expectations of the stakeholders in the audit as such. If these expectations are fulfilled, then from the perspective of the stakeholders the audit is of high quality.

The objective of beginning with the relevance of audit results, in addition to making their capabilities and limitations more understandable to stakeholders and the interested public and, within this context, strengthening the confidence placed in the audit, clearly demonstrates how vital the EU Commission considers the audit for the functioning of the economy as a whole. In addition, the important role of the auditor is specifically emphasised as promoting confidence, trust in the market and protection of investors.

The green paper partly contains totally new considerations, but also revisits earlier activities of the EU Commission. The latter, for example, applies to the consultation with control structures at audit firms and their consequences for the audit market, which was carried out at the end of 2008/beginning of 2009, it applies further to the consultation begun in mid-2009 on the adoption of the "International Standards on Auditing" (ISA), and finally it applies for the consultation only

just recently conducted as part of the Green Paper on Corporate Governance in financial institutions. The latter consultation was already part of efforts by the EU Commission to examine the causes and repercussions of the financial and economic crisis and to devise measures designed to prevent a repeat of such a meltdown. Concerning these questions, we wish to refer to our previous statements.

The discussion launched by the Green Paper also demonstrates, however, that currently – unlike in the time pre-dating the Sarbanes-Oxley Act and the Directive on Statutory Audit – no manufacturing companies were the focus of spectacular accounting scandals and failures, rather it almost exclusively involved the banking sector. The severe economic crisis of 2008/2009 was a result of the banking and financial crisis. Banking, of all fields, at least in terms of oversight, is after all one of the most heavily regulated sectors in Germany.

The assumption of supervisory and control functions by government authorities or by institutions that are under direct government control does not per se lead to enhanced effectiveness. The basic principle of "substance over form" ought to be more heavily applied to regulation of the audit, but also with respect to the external environment of professional practice and its control mechanisms. This includes professional oversight, for which the principles of "equivalent quality" must apply both inside and outside the European Union, but which otherwise ought to be adapted, wherever possible, to the established structures of the Member States.

The principle of "substance over form" cannot, however, go so far as to require that the auditor "repairs" inadequate accounting standards within the scope of his reporting. Thus it most certainly cannot be expected of an auditor that he issues a qualified auditor's opinion when all accounting standards are upheld by the company being audited. With such an "auditor override", the auditor would take on a responsibility and a task which are to be borne and carried out by accounting standard setters, namely to develop accounting standards, the compliance with which ensures a snapshot that accurately reflects the asset, financial, and income situation of the company, not only in form but in substance.

Not least it also hinges on which accounting methods must be used and the extent to which particular accounting requirements may have led to the banking crisis. A review of the substance and complexity of current standards for financial accounting as well as oversight of their development is therefore even more important than considerations of a possible reorientation of the audit. In this context it is remarkable that the G20 in their Paper published in autumn of 2009 did manage to agree upon a common objective (strong, balanced and sustainable growth), which everyone wants to pursue. But in the paper, this objective is passed on to various financial market stakeholders, yet not to the International Accounting Standards Board (IASB). The latter is merely called upon as part of its activity as independent standard setter to engage in

discussions with the FASB, in order to bring about convergence of standards. In this regard, we believe that it is necessary for policymakers, in the same way that they exert influence on range of duties and the environment of the auditor, that they at least become involved in the purposes of accounting. The objective should be to prescribe accounting purposes to what is in fact an independent standard setter, IASB. The purposes of accounting determine the content of accounting standards and thus the content of annual and consolidated financial statements. A first step could be initiated by determining that accounting must also contribute to the stabilisation of the business and financial system ("balanced and sustainable growth"). With such a determination, all pro-cyclical individual rules in the accounting standards would be re-examined (e.g. systematic depreciation instead of "impairment only" for goodwill and immaterial assets, "expected loss" instead of "incurred loss model", historical cost instead of Fair Value).

With currently some 3,000 statutory items, it seems questionable whether the intention of increasing transparency and in doing so, paying proper attention to the information function of financial information can be obtained. This flood of information, however, can no longer be analysed and evaluated by the average balance-sheet reader. A consequence of these regulations and the deluge of information is manifest in the 2009 Activity Report by the German Financial Reporting Enforcement Panel (Deutschen Prüfstelle für Rechnungswesen – DPR). This agency reported that the scope and complexity of the International Financial Reporting Standard (IFRS) is a driving factor for the frequency of errors in financial statements.

Certain structures and strict rules as well as adequate transparency of procedures, in and of themselves, can indeed foster greater trust. The decisive factor, however – especially in the highly-sophisticated area of financial markets – is the professional expertise and the definitive experience of the supervisors – and of course of the auditors themselves.

*(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?*

What role an audit should perform, what role it performs now, and finally, what role it would be capable of performing, given rising expectations and a new legal environment, is not a novel question as such. As already illustrated under Question 1, the value of the green paper, however, is that it raises this topic for discussion using a unified approach.

A discussion of the audit's societal role assumes first of all that there is a consensus on the subject matter. Vastly different opinions and expectations may surface, however, depending upon whether members of the profession or the public at large, including policymakers, are surveyed. Among members of the profession, a discussion about the societal role of the audit in its current form is probably unnecessary. For the public at large and policymakers, it actually depends on

adequately communicating the role of the audit and its limitations, in order to at least narrow the so-called "expectation gap".

The predominant conception of the audit in Germany is specified in the German auditing standard PS 200 ("Objectives and General Principles for Carrying out Audits"). According to this standard, the audit should confirm the reliability, along with the regularity, of the information contained in the annual financial statements and management report and, in this respect, increase their credibility.

The subject of the annual financial audit includes besides the annual financial statements the bookkeeping and, where relevant, the management report, and encompasses the task of determining whether the prevailing accounting rules including the general principles of proper accounting and any supplemental provisions of the letter of incorporation or company statutes have been observed. For corporate entities and their equalents, compliance with regulations is supplemented by the requirement that the annual financial statements, in observance of proper accounting practices, reflect a true and fair view of the company's asset, financial and profit and loss situation. The management report must be consistent with the financial statements as well as with the observations of the auditor and convey overall an accurate picture of the company, the risks of future developments must be accurately portrayed and additional statutory details must be included. In certain cases this scope may be widened by law.

The statements of the auditor allows the users of the audit report and the auditor's opinion to more accurately assess the reliability of the financial reporting as well as the credibility of the bookkeeping, the annual financial statements and, where appropriate, the management report. The users cannot assume, however, that the statements issued by the auditor constitute a guarantee of the future viability of the entity or the effectiveness and business acumen of the management. The users of the auditor's opinion and audit report can take the findings of the audit into account when making decisions, whereby they must remain aware of the limits to the informational value of annual financial statements and management reports as well as the knowledge that can be derived from an audit.

The Wirtschaftsprüferkammer supports every initiative that leads to a reduction of the expectation gap in the public. Concerning the "correctness" of an audit, however, it should be mentioned that this is always to be construed in terms of the accounting principles used in each case. Thus it is conceivable that the equity in annual financial statements prepared according to principles of the German Commercial Code would differ considerably from the equity in annual financial statements prepared according to IFRS for one and the same company – whereby both financial statements are "correct" in terms of the accounting standards applied in each case.

In general, it must be noted that annual financial statements, even if they are essentially based on historical financial information, will always contain (explicit or implicit) expectations about the future. If, for example, an asset is valued in the financial statements at cost, and although the costs represent historical information, they also implicitly include a prediction about future expectations, such that the company issuing financial statements assumes it will be able to at least earn them back. That the value of assets or also the valuation of liabilities depends on future developments and the circumstance that the future is uncertain, are undeniable facts. The inherent risks resulting from this uncertainty or insecurity about future developments cannot be completely overcome by applying any accounting principles and/or an audit. If the assumptions in the financial statements about future developments do not occur, this does not mean that the financial statements and the auditor's opinion should be looked upon as being "false".

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

The profession itself is highly interested in an additional enhancement of audit quality. This aim is continuously being pursued by the standard setters, not only nationally but also internationally through revisions in auditing standards. Audit practices are also constantly working on ways to improve that quality of the "audit" service.

Today, audit quality in Germany is already considered to be of a very high level. This is substantiated by what is learned from the quality controls and professional oversight including "inspections" each year. In addition, we wish to refer to our remarks on Question 6.

Audit quality at the end of the day depends – as already mentioned in Question 1 and 2 – on the audit subject matter and the auditing principles that apply. Audit quality cannot be viewed on its own, but rather only in connection with the accounting principles applied, the audit objectives to be discussed, the legal framework and the design of Corporate Governance.

Risks that jeopardize quality may occur in individual cases as the result of non-adequate fees. From this standpoint, it should be evaluated which instruments could counter the risk of prices that jeopardize quality.

## 2. The Role of the Auditor

From the perspective of professional oversight by the Wirtschaftsprüferkammer, culpable auditing negligence, to be punished by sanctions, will be alleged only when the accounting and auditing standards for the particular auditing subject matter are clear and unambiguous.

In the context of this discussion we would like to point out that even prior to this latest green paper being published, a basic discussion on the role of the auditor and the value of the audit had already begun.

- Already in February 2010 the worldwide operating Association of Chartered Certified Accountants (ACCA) published a strategy paper entitled "*Restating the value of audit*". This paper contains theses and suggestions intended to not only underscore but to further enhance the value of the audit. The paper explains the special value of the audit to business and society and logically questions the observable trend of reducing the statutory audit's range of application by gradually increasing the corresponding threshold values. This is also significant in the context of Question 35. At the same time, the profession, particularly with regard to the auditing of large companies, is advised to consider new models that are more closely geared towards the needs of the market: for example in evaluating risk management, Corporate Governance as well as the premises, opportunities and risks underlying the business model and its future sustainability. Meanwhile, considerations along these same lines have been put forth by the German Institute of Wirtschaftsprüfer (IDW).
- An additional study on the value of audit was published by the ACCA in collaboration with the national oversight agency of Singapore, the Accounting and Corporate Regulatory Authority (ACRA), in July 2010 under the title, "*The value of audit: views from audit committee chairmen*". For the study, audit committee chairmen of listed companies in Singapore were surveyed for their views on the value of audit. According to the study, the respondents consider the audit a vital link in the chain of financial reporting. In this context, the respondents appreciate the fact that alongside the assurance that the financial statements reflect a true and fair view of the company's asset, financial and profit and loss situation, the audit also provides an associated assurance that the internal processes, systems and employees involved have generated a reliable set of figures. Moreover, the study cited the independence of the auditor, in combination with the discovery of weaknesses in the internal control system, as an invaluable component for improving Corporate Governance.
- A study entitled "*The Value of Audit*" was carried out by the Maastricht Accounting, Au-

ding and Information Management Research Center at the University of Maastricht and published in March 2010. In the study, chief financial officers, members of audit committees, and financial analysts were asked to weigh in on the value of audit. According to the study, the respondents' expectations of the audit were basically fulfilled. In particular, financial analysts' trust in financial statements was reported to be significantly enhanced by the audits involved. It is remarkable that this level of trust has not been diminished even by the financial and economic crisis. However, there was a call for a stronger preventative role of audit, a holistic view of the company's business activities, along with a more in-depth consultative role by the auditor in complex accounting matters.

- The green paper itself refers to the paper published in June 2010 by the British oversight agency, Financial Services Authority (FSA) and by the independent body responsible for Corporate Governance rules in United Kingdom, the Financial Reporting Council (FRC), through which a debate is to be initiated about the role of audit in the aftermath of the financial and capital market crisis (*"Enhancing the auditor's contribution to prudential regulation"*).

## **2.1. Information provided by the Auditor to the Stakeholders**

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

We wish to refer to the statements in our preliminary remarks on this section of the green paper. In general, we would like to add the following remark concerning this question: An audit is a budgeted-versus-actual comparison. It examines whether the information in the financial statements conforms to the rules established through accounting standards (congruence with accounting standards). The audit cannot do more than the accounting standards themselves. Independent of this, it must be realized that to answer the call for "certainty about the financial solidity of companies" is the equivalent to answering the call for "certainty about the future". Certainty about the future is something that neither accounting standards nor audits can provide.

It would be conceivable, however, to expand accounting standards throughout Europe to include future-oriented statements from the company and that these details about future developments undergo a plausibility check by the auditor. It is also conceivable that the company be obliged to explain its business model and the resulting opportunities and risks be subjected to a plausibility check by the auditor. For this, international accounting standards and the International Standards on Auditing would have to be expanded.

Thus in Germany for companies of a particular legal form and size, there is a requirement to prepare and have audited a management report which is to contain, among other things, an explanation and evaluation of the likely developments with significant opportunities and risks from a management perspective. In addition, statements are to be made concerning significant events occurring after the balance sheet date. The auditor is to subsequently assess the management report to determine whether it is congruent with the annual financial statements and insights gained during the audit and whether the management report provides an overall accurate portrayal of the company's situation. He additionally evaluates to see whether the opportunities and risks in the future development are accurately depicted. With respect to such prognoses in the management report, the auditor must evaluate whether they are complete and plausible against the backdrop of the details contained in the annual financial statements and the assumptions and interdependencies on which the prognoses are based, along with the type of prediction and its time horizon.

The inherent risks resulting from the uncertainty or insecurity about future developments, as was previously mentioned, cannot be overcome completely by any accounting system and/or audit. Moreover, an audit can never provide absolute certainty about matters. First of all, the audit is not designed as a 100 % assurance, which means that not each and every entry voucher can be examined, but rather only as many as is necessary to enable "sufficient" certainty concerning an audit statement. Second of all, the benefit derived from a 100 % audit would not be in reasonable proportion to the cost.

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

As already illustrated in response to Question 2, policymakers and all other interested third parties should be more clearly informed about the role, capability and limitations of the audit. This is important, first of all, in order to accurately assess the informative value of the audit results with respect to one's own asset and investment decisions, and second of all, in order not to summarily place co-responsibility onto the auditor when the company is in crisis.

Furthermore, in Germany the supervisory board or the General Assembly are informed in detail by means of an audit report ("long form report") about various facts including the subject, scope and focus of the audit, along with the audit method.

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

We do not share the argument put forth by the FSA and the FRC in their discussion paper, according to which the basic principle of professional scepticism has not been adequately observed in the past. In the course of exercising professional oversight of auditors, we thus far

have not detected any significant auditing misconduct among the auditors and audit firms within our jurisdiction, even in connection with the financial and economic crisis.

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

Of all things, the stigma of qualified auditor opinions and even more the adverse opinion are the auditor's most effective forms of leverage to encourage proper accounting practices.

The frequently-voiced suspicion that the low number of qualified or adverse audit opinions is somehow based on inadequate conducts of audits, also needs to be addressed here. The special value of the audit lies already in the fact that inadequacies or errors in the annual financial statements can be discovered and corrected during the audit which otherwise would have led to qualified or adverse audit opinions. This is also manifest after an analysis of published auditor's opinions. Thus according to a random sample by the Wirtschaftsprüferkammer in Germany in the year 2009 of some 3,400 auditor's opinions, only some 170 were qualified or denied.

In this, the Wirtschaftsprüferkammer favours a so-called audit certificate with a standard format, i.e. an auditor's opinion that essentially provides for a standardised text template for the profession, as opposed to an auditor's opinion with non-standardised, individual text. In the latter case, there is a lack of comparability and there is also the danger that the recipients would have to bear an "interpretation risk".

*(8) What additional information should be provided to external stakeholders and how?*

The statutory professional reporting duty of the auditor in Germany within the scope of the audit essentially encompasses the following two established elements:

- Auditor's opinion – describes the subject, type and scope of the audit, while specifying the accounting and auditing principles applied and is to contain an unambiguous evaluation of the audit results. The auditor's opinion is published together with the annual financial statements and thus informs the public about the judgement of the auditor.
- Audit report ("long form report") - contains a statement by the auditor which goes above and beyond the auditor's opinion in examining the company's current situation by the legal representative in the management report, including a going-concern prognosis. Furthermore, the audit report includes any errors or breaches of regulations as well as facts that could seriously jeopardize the audited company as a going concern or that indicate grave violations of the law, the letter of incorporation or the company statutes, by the legal representatives or

by company employees. The addressee of the audit report within the "two board system" in Germany is not the company management but rather the supervisory board of the company.

The supervisory board is the control body of the company. The statutory duties of the supervisory board consist of monitoring the management and contracting the auditors. As part of the audit contract, the supervisory can agree upon areas of audit focus with the auditor. Accordingly, critical issues (e.g. grooming transactions, the exercise of choice of accounting methods, or areas of discretion as well as weaknesses in the internal controls discovered by the auditor) belong in the audit report and should not be released to the public.

In Germany the supervisory board is also to include labour representatives, so that via this channel a significant share of the stakeholders has access the information contained in this audit report.

External stakeholders are currently already provided with comprehensive information via the annual business reports, including the auditor's opinion. From recent financial reports it is apparent that annual business reports of large corporations that previously encompassed 150 pages may today reach a volume of some 400 pages. In addition to the growing complexity of economic matters, this is attributable not only to the increasing tendency of companies to try to cover all their bases but also to the ever increasing scope of rules and reporting requirements of the IFRS.

Moreover, the response to the question concerning additional information depends on the findings of the discussion about what expectations are placed on the audit above and being the tasks up until now. In general, the Wirtschaftsprüferkammer is of the opinion, however, that it is the task of company management – and not of the auditor – to provide additional information to the stakeholders as part of financial reporting.

The "going concern" statement by the auditor in the Green Paper mentioned under the heading "Expansion of the Audit Mandate" as being desirable, as described above, has been included for a long time in Germany in the audit report. It should be considered expanding this to the entire EU.

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

The Wirtschaftsprüferkammer welcomes all measures that will lead to even closer collaboration between the auditor and the supervisory board or audit committee and embraces the mention of the German audit report in the Green Paper to this topic. Regardless of the question surround-

ing the auditor's spectrum of tasks, a regular exchange between the control bodies and the auditor as part of the audit would be sensible.

In Germany there are already statutory (see also remarks on Question 8) provisions and principles specified by the German Corporate Governance Code, which are intended to promote and ensure intensive and regular dialogue between auditors and supervisory boards or audit committees. This opportunity to communicate with the auditor could be more heavily utilised by supervisory boards and audit committees. In our view, efforts should therefore be made to foster an awareness of the auditor as a partner for dialogue that includes the assessment of risks that perhaps will not impact the current year's financial statements but may indeed play out in the future. This could involve developing a "best practice" for identifying, assessing and communicating even latent risks between the auditor and the supervisory board or audit committee. But the prerequisite for this is always the willingness of the supervisory boards and audit committees to enter into a more active and intensive exchange of ideas with the auditor concerning these topics.

The auditor should support the supervisory board in its monitoring function with regard to uncovering weaknesses and improving the systems, processes, and controls of the internal control system. This means that the auditor is required to voice his opinion to the supervisory board in terms of his findings from the appraisal of the internal control system. Stronger awareness of the auditor's tasks in consultation with the supervisory board is only to be welcomed in this context. To the extent that due to company law, there is no provision for the establishment of a supervisory board (certain German limited liability), the auditor carries out this responsibility directly vis-à-vis the shareholders.

In addition to communication with the supervisory board and the audit committee, German audit principles provide for close cooperation between the auditor and the internal auditors of the audited company. The risk-oriented auditing approach, codified in German auditing standard PS 261, says in particular that the auditor must look into the existence, design and effectiveness of the internal control system (ICS) of the client. A key element of the ICS is internal auditing. Moreover, there are detailed rules in German audit standards for evaluating the work of the internal auditing department as well as time coordination and reconciliation of the audit with the internal auditors.

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

The German auditing profession is open to examining information provided by the company in the area of "Corporate Social and Environmental Responsibility" (CSR). As in all other possible

expansions of the auditor's mandate, the area of CSR requires close dialogue among all the stakeholders in order to reconcile the expectations of the company and the public with the auditing means available to the auditor.

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

As for the question concerning making information available to stakeholders, we would first of all like to refer to our remarks under Question 8. A higher frequency of information beyond the annual audit from the perspective of listed companies is in fact already common today. Listed companies are required to prepare semi-annual financial reports and a quarterly so-called "Interim Management Statement". The latter is mostly used to prepare quarterly financial statements that meets the requirements of the semi-annual report. At the behest of investors, these reports are generally subject to audit review by an auditor. There is no statutory requirement for this, however. One solution could be to also introduce a requirement of statutory audit review for these "Interim Management Statements".

The possibility of shortening the interval between the fiscal year end and the date of the auditor's opinion is in large part influenced by the client. Here it depends on how quickly the client can complete substantive preparation of financial statements at fiscal year end and thus create a state of "audit readiness". Corresponding measures completed on the client side to speed up the audit preparation process (so-called "fast close") or the early closing of books, if need be, prior to fiscal year end, in connection with an estimate of remaining figures (so-called "hard close"), should be critically questioned in terms of increasing quality of financial statement preparation and auditing.

Even the shortening of the time period in which the auditor's opinion is to be issued would appear hardly practical and would seem to detract from the objective of improving audit quality.

*(12) What other measures could be envisaged to enhance the value of audits?*

On this topic we would like to reiterate our remarks on Question 8 and in particular, the typical and well-established reporting procedure in Germany by the auditor to the supervisory board by means of an audit report ("long form report") and repeat our suggestion to consider also applying this reporting concept to other European countries.

We would also like to refer to the accounting instrument of management report, which is already part of the audit in Germany. The management report could be expanded to include an explanation of the business model and the associated opportunities and risks. Here we would once again like to mention that the quality and thus the value of the audit correspond very heavily to

the quality (and therefore the complexity and clarity) of the accounting standards. Providing the financial statements' users with a high-quality audit does not make highly-sophisticated financial accounting standards any easier to comprehend.

## **2.2. International Standards on Auditing (ISA)**

*(13) What are your views on the introduction of ISAs in the EU?*

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

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

In response to Questions 13 to 15 we would like to refer to our statement on the consultation on "Adoption of the International Standards on Auditing" (ISA). In that statement we had endorsed making the ISA binding in the EU and thereby observing the option provided by the ISA to make the type and depth of the audit as well as accompanying documentation dependent upon the type, size and complexity of the audited company. This methodology ought to also be observed by the oversight agencies. Moreover, we had argued that the EU Commission should expressly point out the appropriate options for differentiation (scalability) within the scope of the adoption process.

We find it unfortunate that the EU Commission has once again put forth this topic for discussion. The professional organisations, in view of what up until now was the adoption of the ISA announced for 2011/2012, called upon the members of their profession to become familiar with the auditing standards of the International Auditing and Assurance Standard Board (IAASB) and to prepare for them to become binding. The insecurities now raised in this area are therefore detrimental to the objective of implementing worldwide auditing standards that are as unified as possible.

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

First of all we would like to mention that the remarks in the green paper on this segment and the following questions, when viewed in isolation, are indeed plausible, but in our view the underlying arguments are not accurate. It is indeed remarkable that the unrestricted access of commercial investors in audit firms is being propagated and the threat to independence or at least the appearance of lack of independence caused by their profit motive is somehow supposed to

be mitigated by internal company safeguards. The level of inconsistency in the considerations of the green paper is particularly manifest in the section on "Independence".

*(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?*

The argument put forth in this green paper, as well as in the green paper on Corporate Governance of Financial Institutions, whereby remuneration of the auditor by the company to be audited may lead to conflicts of interest, is one that has been brought up occasionally for years now, although in other areas it is not unusual that the "auditee" pays his "auditor". The same applies to the choice of auditor by the auditee.

That this topic is now being raised again in the wake of the financial and economic crisis, should come as no surprise, but it probably mainly has to do with the fact that this topic is viewed as problematic as it applies to the what at the time were unregulated rating agencies, whose oversight has been introduced initially as a consequence of the financial and economic crisis, and this viewpoint is now being applied to the auditing profession in absence of understanding for an environment which is in no way comparable.

Equating auditors and rating agencies in terms of the remuneration issue is inappropriate for the following reasons:

- In Germany auditors of stock corporations are not appointed by the board of management, which is responsible for the annual financial statements. The auditor is appointed by the General Assembly at the suggestion of the supervisory board and subsequently engaged by the controlling body, the supervisory board. The level of remuneration is also negotiated with the auditor by the supervisory board. In addition, the audit report is not to be submitted to the management board but rather to the controlling body. For other legal forms the General Assembly takes on the monitoring function.
- Unlike rating agencies, auditors are subject to a comprehensive catalogue of statutory duties, which includes the duties of conscientious and independent professional practice.

The compliance with the aforementioned catalogue of duties has always been monitored by an ever-more stringent external oversight system, which provides the legal grounds for ad hoc and routine controls.

Add to this the fact that there is a congruence of interests among the supervisory board and the auditor with respect to the auditor's independence from the company being audited. The auditor is required by law to be independent of the company being audited. This enhances the credibil-

ity of his work. The supervisory board requires the information about the accounting practices and the internal control system determined and detailed in the report by the auditor, in order to carry out its monitoring duties. In this respect, the statements of an objective third party (of an auditor) are more credible and more helpful.

*(17) Would the appointment by a third party be justified in certain cases?*

As already mentioned on Question 16, the auditor in Germany is appointed by the General Assembly at the suggestion of the supervisory board and subsequently engaged by the supervisory board. Because the supervisory board has the statutory duty of overseeing company management, it is in fact, in our opinion, already a "third party", even if it is a company organ within the bounds of the company statutes.

Selection of the auditor by a third party outside the company, such as a regulating agency, would run counter to efforts towards reduction of bureaucracy. Along with being an encroachment on the freedom of choice of the supervisory board and a restriction of the property rights of the shareholders, this consideration would lead to additional costs. It is questionable whether an institution, without having any connection to the sector in question, the business processes of the company to be audited and the auditing procedure of the auditor, would gain sufficient knowledge to identify an appropriate auditor. In any case, owing to its role, the supervisory board has considerably more information at its disposal. The supervisory board, as an institution closer to the subject matter, is best at finding the "right" auditor for the company. In addition, an outside institution would have to be subject to special rules and be supervised in its selection process. It would likely be difficult to develop objective criteria for auditor selection, so one could expect auditor appointments to be challenged not only by auditors but also by companies.

These are all arguments against shifting the auditor selection to a state regulator.

*(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?*

The question as to whether the introduction of external audit firm rotation leads to greater independence and thus to higher-quality audits has been heavily debated for decades, most recently after the accounting scandals at the beginning of the new millennium. This discussion occurred both during the time leading up to the Sarbanes-Oxley Act in 2002 (SOX) as well as after the Directive on Statutory Audit in 2006. Despite what may seem at first glance to be plausible arguments for the introduction of external rotation, independent studies have always come to the conclusion that the drawbacks of external rotation far outweigh their advantages. For example, in addition to internal rotation in Sec. 203 SOX, along with Sec. 207, the US Government

Accountability Office (GAO), was charged with the task of investigating the advantages and disadvantages of external rotation. The study published in 2003 states the following:

*GAO believes that mandatory audit firm rotation may not be the most efficient way to strengthen auditor independence and improve audit quality considering the additional financial costs and the loss of institutional knowledge of the public company's previous auditor of record, as well as the current reforms being implemented. The potential benefits of mandatory audit firm rotation are harder to predict and quantify, though GAO is fairly certain that there will be additional costs.*

Therefore, external rotation has not been introduced in the United States to this day. It is also worth noting the examples of three EU member states that had adopted external rotation in the recent past. After just a few years it was abandoned in favour of internal rotation.

In any case, external rotation as a mandatory measure did not make its way into the Directive on Statutory Audit 2006, because the EU Parliament and the EU Council not only saw no increase but actually the risk of a decrease in audit quality.

Therefore, external rotation is not an adequate measure for safeguarding audit quality. Quality is a function of the auditor's being sufficiently familiar with the company being audited. It is indeed true that an auditor must always be capable of carrying out a proper audit, even when he is taking on a new client engagement. Any risks to audit quality in such a case are, however, the highest, especially among the first- and second-time audits. While initially the auditor may not have extensive knowledge of the company, this can be remedied only by extensive study of the entire environment and internal workings of the company. This greater time commitment leads to considerable increases in cost. As mentioned under Question 11, the shortening of the timeframe between the end of the fiscal year and the submission of the audit opinion, which is problematic enough already, would appear even more unrealistic from this perspective.

Also from the standpoint of strengthening competition in the audit market (Questions 28 – 32) – especially with regard to audits of companies listed on the stock exchange – we do not believe external rotation is an appropriate measure. In our view, external rotation in this segment would likely replace one Big Four practice with another Big Four practice. Due to rotation, medium-sized audit practices with existing clients in this segment would be more likely to be replaced by a Big Four practice than appointed as auditors. External rotation accordingly leads to market concentration and not to a strengthening of competition.

By contrast, we consider internal rotation for audits of public-interest companies (in Germany after seven years) to be an adequate instrument for strengthening the independence of the auditor. The mandatory change of the responsible audit partner after a certain number of auditor

opinions issued for an audit client leads to the safeguarding of proper distance between the authorised auditor and the client over time.

*(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?*

A complete prohibition on the provision of non-audit services or indeed the creation of exclusive auditing practices is to be rejected.. This far oversteps forbidding unsuitable activities in a concrete client engagement. We also see the danger of further market concentration at the expense of small to medium-sized practices. A basic reduction in the auditor's fields of activity leads to a loss of expertise and the risk of economic dependency, which no one wants. The combination of auditing and non-audit services must of course be impermissible if they would either lead to self-review or they would cause the auditor for economic reasons to issue a tailored opinion, in order not to lose the engagements involving non-audit services.

Concerning the first point it should be noted that the Directive on Statutory Audit 2006 specifies self-audit among several reasons posing a threat to independence.

Additionally, the scope of non-audit services would decline solely from the standpoint of self-review, the broader the content of an audit is focused. The evaluation of opportunities and risks from business models would necessarily mean that certain services, for instance in the area of management consulting, might no longer be allowed to be rendered.

The second aspect (issuance of tailored opinions in order to safeguard revenues from non-audit services) might have been viewed as a general threat and thus considered not permissible, if the accounting scandals over the past ten years had given cause for this. Such cases of wilfully false issuing of an opinion by the auditor have not yet been discovered in Germany, however. To the extent that there were isolated cases of faulty auditing, these were attributable to other circumstances.

The retention of multidisciplinary audit practices is a key prerequisite for maintaining and improving the quality of the audit. Thus questions arise regularly during the course of an audit which require substantial expert knowledge. Examples here include knowledge of information technology (i.e. when evaluating bookkeeping systems), in the field of valuation (i.e. in the area of company acquisitions), fiscal statutes (i.e. the evaluation of provisions for taxes as well as deferred taxes), in the field of forensics (e.g. within the scope of assessing transactions in the area of money laundering). A pure auditing practice often does not have the necessary requisite expertise in order to cover all the requirements of the audit, and it may not always be from the standpoint of confidentiality or economically feasible to call in a third party. And after all, it is the

interdisciplinary work that enhances the attractiveness of the auditing profession. Young people can be introduced and retained to the profession due to the versatility and attractiveness of the auditor profession. The audit is a multidisciplinary service and can only be of high quality when rendered by a multidisciplinary practice.

Furthermore, it is up to the market to judge whether from its perspective, there is a threat to independence through an imbalance between revenues from auditing and non-audit services. Sufficient transparency is guaranteed through mandatory disclosure by the companies of the itemised fees for various services provided by the auditor. Auditors of public-interest companies must publish their revenues from various service categories in the transparency report. This is yet another way in which the market can form its own opinion. Incidentally, a study by the Wirtschaftsprüferkammer on fee volume and fee distribution among consolidated statements of public-interest companies for the year 2009 revealed that the ratio of revenues from audits to non-audit services does not conform to general expectations. Whereas 63.5 % of the fees were earned from audits, only 36.5 % represented the rendering of other non-audit services. Therefore there are no implications with regard to a threat to independence in our view.

At the same time, an additional measure could be considered for public-interest companies to not only make the appointment and fee negotiations in the area of audits the responsibility of the supervisory board but to also make the procurement and remuneration of consulting and other services subject to approval by the supervisory board. There could also be variations, such as the example of public-interest engagements or engagements only above a certain amount are to be approved by the supervisory board. Currently these possibilities indeed already exist. But the legal codification of these requirements to obtain approval by the supervisory board for certain types of engagements or beyond a certain threshold should be considered as well.

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

Specifying a certain amount of revenue per client which must not be exceeded is a vital element in safeguarding economic independence. The key is to consider all revenues that an audit practice earns from a particular client, not just those derived from auditing. The absolute amount is not important. The decisive element is the ratio to the practice's total revenues.

There is such a rule already in existence today. Consistent with the provisions of the IESBA Code of Ethics, an auditor in Germany is therefore excluded if within the past five years prior to the concrete engagement, he has derived more than 30 % of his entire income from professional activity for the corporate entity to be audited or from companies in which the corporate entity

to be audited has ownership of more than 20 % and this is expected to be the case in the running year as well. For public-interest companies the scope is reduced to 15 % of total revenues.

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

Based on their legal form, audit firms are just as obliged to publish their financial statements as any other firm. In addition, auditors of public-interest companies are required to make substantial disclosures in the transparency report. Especially among audit firms with one or few audits of public-interest companies, the transparency report is viewed as being harmful to fair competition and as a means of driving competitors out of the market. The objective of the EU Commission, to broaden the number of providers in the audit market, is already being undermined rather than promoted by existing requirements. In Germany the notes to the financial statements of audited companies according to § 285 No. 17 German Commercial Code (HGB) represent an additional information source concerning auditor fees. This does not lead to a broader structure of service providers in the audit market.

Additional transparency regulations are thus neither necessary nor constructive.

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

From our perspective, no further action is required in this area. The existing statutory and professional rules as well as the external control mechanisms (quality control, ad hoc special inspections) are sufficient in order to guarantee independence and to sanction breaches that can never be ruled out in individual cases. In any case it would be detrimental to independence to expand the opportunity for commercial investors to have ownership in audit firms (see the following Question 23).

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

In our below response to the question, we wish to reiterate the earlier remarks that we submitted as part of a consultation about the findings of the so-called Oxera Report concerning control structures in audit firms and their consequences for the audit market.

*"Audits are professional services and thus non-capital-intensive. The market success of an audit firm is primarily determined by the human capital it commits and its expertise. In case capital is required in individual cases, there are numerous*

*other ways of raising it, by taking out a loan, for example. Opening up ownership structure to commercial investors therefore seems unnecessary.*

*Additionally, there is the problem of a possible threat to independence when there is outside participation in ownership and even more so at the executive level. From the perspective of all market stakeholders, independence is a very precious commodity and one of increasing significance, for which extensive efforts have been made over the past years at the national and international level. A few examples include the revision of the independence rules in the IFAC Code of Ethics, the EU Recommendation on Independence, the requirements of the Directive on Statutory Audit as well as its subsequent implementation in the German Commercial Code and the Professional Charter for Wirtschaftsprüfer/vereidigte Buchprüfer – (BS WP/vBP). Especially with regard to third-party participation in audit firms, German lawmakers already decided back in the year 1985 to address the aspect of independence by introducing so-called capital commitment.*

*The higher level of credibility achieved by audit services in this area would once again be diminished. A good example of this is the situation surrounding the rating agencies in the financial and capital crisis. Their reliability and objectivity – whether justified or unjustified, it remains to be seen – is currently being called into question for exactly the same potential exercise of influence by, or consideration of, commercial investors.*

*In addition to independence, increasing audit quality is an ongoing priority of all stakeholders. This objective is also called into question, because participation of commercial investors and subsequent profit expectations may result in the threat of stronger focus on sales and returns at the expense of audit quality."*

In our opinion, the aforementioned considerations remain valid without reservation. In particular, we believe that the reasons that led German lawmakers to introduce capital commitment requirements in 1985 are still convincing.

In this context, we believe it is counterproductive to assume that opportunities for commercial investors to exercise influence could be reined in through special independence rules for individual cases. The market is integrated on too many levels to absolutely exclude the audit of a unit affiliated with an investor. Particularly in the case of banks as shareholders with numerous additional minority interests, we cannot see how the potential for conflict could be adequately identified by the companies requiring statutory audits, the auditors, and oversight agencies in

order to assess and demand individual prohibitions on activities, and to oversee their enforcement.

Additionally we would like to note the following in response to the concern by the Commission that system-relevant audit companies possible do not have sufficient resources in order to deal with potential liability claims:

In Germany there is a limitation of liability to € 1 million for statutory audits, and € 4 million for public-interest companies. Professional statutes require that audit firms obtain appropriate insurance. Insurance coverage must be made available for each insurance incident. For other clients, claims for damages may be limited to € 4 million using predefined contractual terms, to the extent that insurance coverage exists. German legal precedent thus conforms to the EU Commission's basic intent concerning the limitation of the civil liability of statutory auditors and audit firms, dated 5 June 2008 (K (2008) 2274 (2008/473/EC)).

Against the backdrop of comprehensive insurance coverage, statutory limitations in liability for audits and the common practice of limited liability clauses in miscellaneous engagements, the risk of an audit firm failing in case a liability case occurs is considered very low in Germany at any rate. This is yet another reason why opening up the companies for investors outside the profession is unnecessary.

We are of the opinion that a limitation of liability by law has no detrimental effect on the quality of the audit. Financial burdens from liability lawsuits can be mitigated by relevant insurance. A practice cannot insure itself against loss of reputation, loss of contracts, or not receiving new engagements. These risks weigh heavier and are effective even in the case of statutory limitation of liability. Based on these considerations, it follows that the audit practice's innate interest, to safeguard the quality of audits provided, is not negatively affected by a statutory limitation of liability.

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

It is now already spelled out in the Directive on Statutory Audit that the group auditor bears full responsibility for issuing opinions on consolidated financial statements. The implementation of this prescription in Germany as part of the Accounting Law Reform Act (Bilanzrechtsmodernisierungsgesetz) led to the following rule:

*"The auditor of group financial statements is to also audit the financial statements summarized in the group financial statements, in particular the modifications made due to consolidation, in*

*subsequent application of Section 1. In case these financial statements have been audited by another auditor, the group auditor is to review his work and to document this procedure."*

As necessary as the expansion of the group auditor's responsibility may be in terms of audit quality, the implementation of the Directive on Statutory Audit in this area has already raised considerable opposition on the part of small to medium-sized audit practices, because this rule is viewed as a further element promoting market concentration. The EU Commission should be aware of this in light of considerations to change the current structures in the audit market.

#### **4. Oversight**

In monitoring auditors and audit practices, public control systems play a decisive role. That is why since 2001 the oversight system in Germany has been thematically expanded in the form of several amendments and structurally reformed. This also avoids the conflicts of interest with the auditor profession mentioned in the Green Paper and safeguards the independence of the auditor.

The remarks in the green paper address three key areas:

- independence of national oversight agencies from the auditor profession,
- the monitoring of audit practices at the European level and closer collaboration of national control systems, as well as
- the dialogue between the auditors and the regulatory authorities responsible for the companies being audited.

Both Questions 25 and 26 in the Green Paper refer to European audit oversight as well as the dialogue between the auditor and the regulatory agencies of the audited companies. Based on its significance in the overall scheme of things, however, we would also like to comment on Germany's oversight of the auditor profession, especially because there is a parallel evaluation of the oversight systems of member states being conducted by the EU Commission.

##### Independence of the national oversight agencies from the auditor profession

In addition to existing legal supervision of the Federal Ministry of Economics and Technology, already as at 1 January 2005 and in proactive implementation of Article 32 of the Directive on Statutory Audit, Germany established the Auditor Oversight Commission (AOC) and placed it above the Wirtschaftsprüferkammer and thus above the auditors. In addition, inspections were introduced at audit practices with public-interest engagements.

Moreover, complete independence of the oversight agency from the profession is to be guaranteed through a procedure partially practiced by all members of the Wirtschaftsprüferkammer, and the codification of which has already been recommended by the Wirtschaftsprüferkammer among other entities:

- the Auditor Oversight Commission has sole responsibility for the structuring of the oversight proceedings, their staging and subsequent appraisal,
- the correspondence and, in particular, the subsequent decisions, are made under the sole responsibility and communicated in the name of the Auditor Oversight Commission,
- the role of the Wirtschaftsprüferkammer is limited to delegating employees who are subject to the Auditor Oversight Commission's authority to issue directives,
- the Wirtschaftsprüferkammer limits itself to professional consultation as part of the investigative processes of the Auditor Oversight Commission and is not involved in the decision-making process.

This consultation ensures input of expertise specific to the profession, without jeopardising the independence of the Auditor Oversight Commission. This rule does not go as far as the scope opened up by the Directive on Statutory Audit that possibly goes too far by allowing members of the profession to be represented in the public oversight agency. Such representation is prohibited in the German oversight system. The decision-making processes of the public oversight agency therefore cannot be influenced in the slightest by representatives of the profession.

#### Monitoring of audit practices at the European level and closer collaboration of national control systems

*(25) Which measures should be envisaged to improve further the integration and co-operation on audit firm supervision at EU level?*

Oversight must be structured in such a way that it can be carried out effectively. Therefore, for certain transnational EU-wide engagements, it must be guaranteed that EU-wide oversight can be performed as well. For auditors with EU-wide engagements, it may be useful to change the existing oversight authorities within the European Group of Auditors' Oversight Bodies (EGAOB) by establishing a Lamfalussy Level 3 Committee. The decisive factor as regards the structure of the oversight authority is the strict principle of subsidiarity. Additionally, judgement of the subject matter should be sufficiently tempered by professional expertise, irrespective of the unrestricted decision-making authority of persons or institutions from outside the profession.

Dialogue between the auditors and the oversight/regulatory agencies responsible for the audited companies

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

The Wirtschaftsprüferkammer basically welcomes considerations concerning more intensive communication between auditors and oversight/regulatory agencies. Outside of the banking and insurance sector, there is in Germany currently no oversight/regulatory agency in the area of large listed companies – which would monitor the business activity of the companies. A transference of professional duties that exist in the banking and insurance sector to all large listed companies would require setting up a relevant oversight/regulatory agency for these companies. We currently see no necessity for an expansion beyond the field of banking and insurance.

## **5. Concentration and Market Structure**

We would like to preface our remarks by mentioning that the Wirtschaftsprüferkammer, against the backdrop of representing the entire German profession of Wirtschaftsprüfer and vereidigte Buchprüfer as a rule does not make any market-oriented statements, to the extent that business interests of members of the Wirtschaftsprüferkammer are affected (as with Questions 29 – 32).

*(27) Could the current configuration of the audit market present a systemic risk?*

As we understand the question, considerations on the part of the EU Commission as regards the systemic significance of certain banks and the banking system for the functioning of the economy have been projected onto the audit market. In our view, however, only very limited comparisons can be made between the banking sector and the audit market. While the banks safeguard the circulation of money through their role as institutions for money deposits as well as lenders for the economy and thus influence entire macroeconomic developments, audit firms are isolated, and indeed, personnel-intensive yet not capital-intensive, entities which do not play such a comparable critical role in the economy

After the dissolution of Arthur Andersen, the ability of the audit market to continue functioning was not in jeopardy in any way. The availability of necessary professional capacity remained unchanged and was absorbed by other market players. Moreover, from our perspective no other sectors of the economy were affected by the failure. In comparable cases, this mechanism would also come into play.

The risk of failure of an audit practice as the result of liability to pay compensation to clients, at least from the perspective of the German liability regime, is very limited, as was already discussed under Question 23. We are not aware of any ramifications of limited liability on audit quality compared to countries without limited liability. In fact, we would once again like to put forth for consideration the idea of European-wide introduction of basic principles of limited liability.

*(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?*

The division of labour between two audit firms may make sense, in particular if the audit requires particular expertise or there has been a fusion of two companies subject to statutory audit. Obligatory audit consortia – involving at least one smaller audit practice – from our perspective would lead to more comprehensive participation in the segment of larger audits.

A joint audit requires additional communication and coordination of the auditors among one another as well as between auditors and clients, which leads to increased costs.

It appears useful to gain insights into the experiences that other member states have had with joint audits. In this context, it ought to be clarified which type of division of labour is possible and logical as part of a joint audit.

*(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?*

With respect to Question 29 we refer to our answer to Question 18.

*(30) How should the „Big Four bias“ be addressed?*

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

*(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?*

The following remarks pertain to Questions 30 to 32.

With the growth, intricate interconnectedness and additional development of so-called one-stop firms, the Big Four in our estimation have addressed the requirements of the market. The client

companies, which are more and more globally networked and organised as groups, expect auditors to be capable of auditing large multinational accounts. These market requirements continue to exist and would seem to be one of the main reasons why the Big Four are so disproportionately represented in this segment. To roll back previous developments could possibly mean reducing or completely eliminating the number of service providers in the particularly sensitive area of international group audits, against the intent of the EU Commission.

## **6. Creation of a European Market**

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

In assembling a team of auditors, cross-border mobility is already a daily reality. Large audit firms in particular select their team of auditors according to interdisciplinary and international criteria, according to the requirements of the specific audit engagement. In this context there is, however, the problem of permissibility of the auditor's opinion being signed by foreign members of the profession.

At the level of the responsible auditor, given the prevailing legal situation, cross-border activity is not necessarily possible, because the responsible auditor must be appointed as an auditor, pursuant to the Directive on Statutory Audit, based on the regulations prevailing in the receiving country. This is mitigated, however, by the fact that members of the profession from EU member states do not have to take the full examination required for appointment but rather a so-called aptitude test. This also applies to auditors having their own practice. A prerequisite of greater mobility in this area would be further harmonisation of the European market, as mentioned under Question 34.

In practice up to now there have been only few ramifications in Germany from unrestricted participation of non-German EU auditors in German audit firms as well as their collaboration at the executive level within the scope of the Professional Oversight Reform Act (Berufsaufsichtsreformgesetz) and in implementation of the Directive on Statutory Audit. Only eight audit firms have thus far taken advantage of the opportunity of appointing foreign EU auditors as shareholders or members of the executive level.

*(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?*

From a macro political viewpoint, it would be desirable to have not only "maximum" harmonisation but a complete standardisation of the European auditing market. But in this case it can only

be the result of medium and long-term advancement of overall European integration. It would be conceivable to have isolated, partial harmonisation in the area of auditing above and beyond the Directive on Statutory Audit, for example in the area of independence, where differences persist among individual members states despite the general principles of the Directive on Statutory Audit.

Having a European "auditor passport" for all audits of financial statements, however, would, above all, run counter to the largely different reporting regulations, aside from all the divergent frameworks relating to corporate, economic and fiscal laws. We would also like to refer to our remarks in the consultation on the International Financial Reporting Standard for small to medium-sized companies. There we had argued against the adoption of the IFRS for small to medium-sized companies. We are otherwise basically in favour of largely uniform financial reporting in the EU zone. A prerequisite for this, however, is a standardisation of the remaining legal and, in particular, fiscal environment, along with the expectations of the stakeholders in financial reporting.

It would be conceivable to have a European auditor passport, however, for the area of statutory IFRS financial reporting. The decision as to which auditor or auditing firm could receive such a passport must therefore be based on whether the auditing practice can or will carry out audits of IFRS financial statements. If it involves a smaller auditing firm, this firm should naturally receive the auditor passport as well.

## **7. Simplification: Small-to-Medium Audit Firms (SMA's)**

*(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?*

From its inception, the Wirtschaftsprüferkammer has always taken the stance, "an audit is an audit". This means that audit quality and the reliability of the audit opinion must be uniform. The decisive factor is the recognition that the type, scope and depth of the audit must be able to vary according to the size, type of business and market significance of the company being audited. We had already touched on this so-called scalability in our statement on the consultation concerning the adoption of the ISA. If this is taken into sufficient consideration by practitioners, regulators and oversight bodies, there will be no need for a "limited statutory audit" or even an audit that fulfils merely the principles of an audit review. Moreover, size-related alleviations with respect to accounting and publication for companies subject to financial reporting already today have a mitigating effect on the auditing of such financial statements.

Additionally, with a limited audit and relevant "limited" auditor's opinion we see the problem of a threat of increasing the expectation gap among the users of the financial statements. The contrary would probably be the case: an auditor's opinion – however it may be worded – that falls short of the current statutory requirements, cannot increase trust in and credibility of the auditor.

We also assume that the stakeholders of the companies, especially the lenders, will accept nothing but a full audit. The fact that this may differ in the United States does not in our view and in this context support an argument for reducing the requirements for an audit of an SME, actually the contrary is the case. In USA only listed companies are regulated nationally in a uniform way. The manner and degree of regulation of other companies lies in the authority of the individual US states, some of which do not require a statutory audit at all.

As we explained in our statement on the consultation for revising the Directive on Statutory Audit, we do not see an example here worth emulating for the EU.

*(36) Should there be a „safe harbour“ regarding any potential future prohibition of non audit services when servicing SME clients?*

As for the topic of "Auditing and Consulting", we would like to refer to our remarks under Question 19. In our view, this question is even less relevant for audits of companies which are not public-interest entities. A general prohibition on the provision of consulting services to audit clients would jeopardize the existence of small-to-medium auditing practices in particular and fuel additional audit market concentration.

Safe harbours should be considered for small audit practices. However, the principle also applies here that the core area of the auditor's professional duties, the auditor's "impartiality", must not be affected and "steadfast" basic rules of safeguarding independence, such as the prohibition on self-audit, cannot be allowed to be abandoned.

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

As mentioned under Question 35, we reject the introduction of a "limited statutory audit" or a general "statutory review" in lieu of the statutory audit. The mandatory introduction of a quality control system has been proven to considerably boost quality among small to medium-sized auditing practices in particular, at the height of also increasing bureaucracy. There should not be a reduction of requirements commensurate with the reasonableness of the quality control system if audit quality is deemed a higher priority. As with the audit procedure, here the decisive factor is to pay proper attention to the scalability, which is already expressed in the term, "rea-

sonableness". Thus even now the quality control system of a small auditing practice with a manageable number of clients is not to be subjected to the same requirements as, for example, one of the Big Four accounting firms.

As regards external control, it should be noted that the Directive on Statutory Audit already differentiates between intervals for auditors of public-interest entities (at least once every three years) and other auditors (at least once every six years).

## **8. International Cooperation**

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

Our remarks in Section 4 on the appropriateness of EU-wide oversight also apply accordingly to the requirements for global oversight structures. Here we also see that primarily the public auditor oversight bodies are called upon to evaluate the current possibilities for international co-operation within the scope of the International Forum of Independent Audit Regulators (IFIAR) also in view of the ramifications of adequacy decisions already taken or still pending.

We hope that our remarks will be incorporated into further considerations, and we would be delighted to answer any queries.

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