

Czech National Bank response to Green Paper – Audit Policy: Lessons from the Crisis

A) General comments

1. We are of the opinion that here, as in other areas, the financial crisis is just being used as an excuse for new regulation. The situation identified as a problem (i.e. high concentration in the audit market) existed before the crisis erupted and was meant to be addressed by the only recently approved Directive 2006/43/EC¹ (whose transposition deadline expired on 29 June 2008), transposed into Czech law in the Act on Auditors², which took effect on 14 April 2009.

2. The Green Paper lacks the necessary risk and impact analysis and cost-benefit analysis of the planned regulation. The sequence of actions, i.e. first of all the opening a debate about the "revolutionary" regulatory proposals contained in the Green Paper and then commencing an external study in 2011 to gather more detailed information about the current situation, does not make sense either. Another problem is the ambiguity and vagueness of the Commission's proposals. We see no reason for change in the absence of convincing reasons and a Regulatory Impact Assessment (RIA). The Directive on statutory audit reacts to the bulk of the problems that the Green Paper is trying to address. However, it was not transposed until the crisis was already in progress, so it is too early to judge its benefits.

3. We do not agree with the Commission that effective configuration of the audit market can be implemented by regulation and that a single European regulator is the solution. The Czech National Bank rejects the concept of a single regulator. Standard cooperation between national audit oversight bodies (the Council for Public Audit Oversight etc.) can be regarded as sufficient. There is no need to create a new agency or Lamfalussy Level 3 Committee. The emphasis needs to be put on effective self-regulation.

4. The Czech National Bank is fundamentally against dealing with the conflict of interest between auditor and audited entity by transferring responsibility for the auditor's appointment, remuneration and duration of engagement to a third party, probably the regulator. Such a proposal will not resolve the problem of familiarity, but will lead to moral hazard. The Czech National Bank is firmly opposed to increasing the public sector's involvement in areas where it has no value added. A public authority cannot have the requisite knowledge of an audited entity to recommend the most appropriate auditor for it and to stand in for its own bodies (a statutory body, a general meeting).

5. The Czech National Bank does not support passports, since audit professionals are already mobile. Aptitude tests are important because of the Member States' different legal and accounting systems.

6. The Czech National Bank is in favour of tightening up the principal of mandatory rotation, i.e. shortening the period for the exchange of key (coordinating) audit partner(s) (from 7 to 5 years) and extending the time-out period, but is against extending the principle of mandatory rotation to audit firms.

¹ Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC.

² Act No. 93/2009 Coll., on Auditors and Amendments to Certain Acts (Act on Auditors), as amended.

7. The Czech National Bank is against the introduction of joint audits. The experience of the countries which have introduced them is negative and should be analysed in more detail. We refer to Denmark, Canada and Italy (the Parmalat case). Local conditions are crucial to the functioning of joint audits, and long regulatory experience is required (what has proved successful in France is not necessarily appropriate for other countries). Audits conducted by consortia of auditors lead to fragmentation of responsibility and thus constitute a risk in itself.

8. The Czech National Bank is against the regulation of corporate governance in private companies. This would lead to a weakening of the responsibility of shareholders and members of company bodies and to moral hazard.

9. The Czech National Bank is against the introduction of new rules allowing SMPs to raise capital and points to the negative experience with SMPs and their audits in the Czech Republic. The Czech National Bank favours a debate about new rules for audits conducted in SMEs (simplification for SMEs).

B) Detailed comments

Section 1 – Introduction (Questions 1 – 3)

The Czech National Bank understands why the role of auditors and statutory audits is being reviewed in the context of the financial crisis. On the other hand, it notes that many of the problems outlined existed in the market before the financial crisis erupted.³ The response was the adoption of Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC (hereinafter the “Audit Directive”). Given the short period that has passed since it was transposed (on 29 June 2008), the effectiveness and impacts of the Audit Directive have not had time to materialise fully. However, the Audit Directive introduced a series of significant measures, such as quality control, public oversight and regulation of group audits. It requires companies to establish an audit committee and defines the audit committee’s relations with the statutory auditor. Given these facts, the Czech National Bank proposes that any changes should, after careful consideration, be made within the framework of the Audit Directive and after some time will have elapsed, so that the benefits and downsides of the recently adopted regulation can be assessed. The conclusions of the external study planned for 2011 should be thoroughly evaluated and the costs and benefits of any new regulation should be analysed prior to the proposal of any legislative changes.

The Czech National Bank is fundamentally against influencing the market configuration. For example, an obligation for joint audits to be conducted by a Big Four audit firm and another smaller auditor could be very costly (remuneration of two audit firms), especially for small audited companies. The real benefit, moreover, is more than arguable.⁴

The Czech National Bank is fundamentally against any change in the area of audit oversight. There is no evidence that the current concept of self-regulation by auditors and the recently introduced public audit oversight is failing. The idea to establish a European audit oversight

³ For example, the Enron, Parmalat and Ahold scandals.

⁴ For example, Denmark and Canada abandoned this idea in the past.

body is therefore entirely unjustified. The Czech National Bank firmly rejects the idea of delegating audit oversight to the ESMA or of creating a regulatory framework like that for rating agencies.

The Czech National Bank favours a debate about tightening up the mandatory rotation rules, and in particular about tightening up time tests, i.e. shortening the period during which an audit partner may conduct an audit in a company (e.g. from 7 to 5 years) and extending the time-out period (from 2 to 3 years). In this regard we refer to the situation in the USA, where the mandatory rotation principle has not been extended to audit firms (the costs are said to exceed the benefits; a strictly formulated principle of mandatory rotation for audit partners is regarded as sufficient; emphasis is placed on the audit committee and its accountability when choosing the auditor).⁵

In the opinion of the Czech National Bank, there is no need to refine or redefine the role of mandatory audits. The efforts of the Commission and of auditors themselves should be focused on ensuring sufficient transparency and explaining the function of mandatory audits, the way in which they are conducted, and the ensuing limitations.

Section 2 – Role of the auditor

Subsection 2.1 – Communication by auditors to stakeholders (Questions 4 – 12)

According to the Czech National Bank, statutory auditors perform their function and provide users with reasonable assurance that financial statements give a true and fair view of audited entities. General conclusions about the point of audits cannot be drawn from occasional failures and extraordinary events (such as the well-publicised Enron, Parmalat and Ahold cases). The Czech National Bank believes that statutory auditors are performing their function and can continue to do so.

What does need to be changed is the misperception of audit reports by users. The possible solution could be transparency and explaining the function of statutory audit, but not redefining auditors' activities in line with users' (mis)understanding. The Czech National Bank also does not agree with categorisation of clients and with comparison of the relative quality of financial statements, as this constitutes an unjustified and problematic change compared to the current understanding of statutory audits.

The Czech National Bank also opposes any extension of the set of information that an auditor should provide to external users (for example in the area of corporate social and environmental responsibility). The Commission's efforts should be focused on enhancing the qualitative framework, not on quantitatively extending the auditor's mandate. The Czech National Bank believes that the current format and scope of audit reports is satisfactory, but it is open to discussion on certain changes towards making auditors' reports shorter and easier to understand.

One question we could discuss is whether the relations between the external auditor, the internal audit function, the supervisory board and the audit committee as set by the Audit Directive are appropriate. Strengthening the position of the audit committee and tightening the

⁵ cf. United States General Accounting Office, Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee of Financial Services, 2003.

requirements for the independence and/or expertise of its members (currently only one member has to fulfil these criteria) should be subject to analysis. However, the Czech National Bank is simultaneously of the opinion that communication between external auditors, internal auditors and the audit committee goes on and is workable, and it has no evidence to the contrary.

As regards assessing potential future risks, the Czech National Bank believes that the auditor already has scope to do so at present and can mention such risks in the audit report where it considers this appropriate. By issuing a qualified audit report, the auditor is also expressing its opinion on the assumption that the company will continue as a going concern for 12 months from the balance sheet date. The Czech National Bank rejects the idea of changing the statutory audit from being a review of historical data to being a prediction of the future condition of the audited company. Such a change in the perception of the statutory audit would blur the distinction between audit and rating.

In relation to time limits, a deadline of four months from the end of the accounting period is set in the Czech Republic for listed companies and entities subject to supervision by the Czech National Bank for disclosing annual reports, including auditor's reports. The Czech National Bank regards this time limit as sufficient. We cannot agree to shorter time limits, as this might be to the detriment of the quality of audits and auditors' reports.

Subsection 2.2 – International Standards on Auditing (Questions 13 – 15)

The Czech National Bank supports the idea of observing widely recognised international standards. However, it does not support the idea of making ISAs legally binding at the level of EU law, as it feels there is a risk of the content of standards deviating in some cases from the regulation in force (on the financial market from prudential regulation). Conflicts between the standards themselves or with other standards (e.g. in the internal audit and corporate governance area) cannot be ruled out either.

The Czech National Bank supports steps to reduce the costs and administrative burden on SMEs and SMPs. However, any changes should be conditional on achieving a broad consensus on the usefulness and feasibility of such a specific reduction of the audit requirements for the selected segment (SMEs). It is worth pointing out that the valid ISAs contain/express the proportionality principle and take account of adapting the regulations to the needs of SMEs.

It is also not clear how to understand SMEs. The term SME varies over time, according to location (SMEs will be viewed differently in a large Member State with a developed capital market than in a small Member State), and also according to area of regulation or business (different definitions are needed for the purposes of economic competition, state support and the capital market or auditing).

Section 3 – Governance and independence of audit firms (Questions 16 – 24)

The Czech National Bank sees a possible conflict of interests, if the statutory auditor conducts a statutory audit of the entity that appointed it and is also remunerated by the same entity. However, this conflict of interests is already addressed in the current Audit Directive, in particular by the rules for appointment of the auditor, by the establishment of the audit

committee, by mandatory rotation and by other measures. The Czech National Bank believes that support should not be given to a new, untested and extremely costly solution involving the auditor being appointed and remunerated by a public body (the regulator). Instead, it recommends analysing the effectiveness of the tools introduced by the Audit Directive and looking into the possibility of strengthening them. If the Commission were to decide to introduce third-party appointment of auditors, a precise risk and impact analysis and an analysis of the costs of such a step would be needed. At a time when individual EU Member States are endeavouring to consolidate their public budgets, the cost and infeasibility of the proposed measure are plain to see. At the same time, such a step would not guarantee adequate treatment of the threat of familiarity, which exists regardless of who appoints and remunerates the auditor. Furthermore, by appointing and remunerating the auditor, a public body could not assume responsibility for the correctness of the outputs of the mandatory audit anyway.

The Czech National Bank believes that it is appropriate to discuss strengthening the role of the audit committee in the appointment of the auditor and tightening up the proficiency and independence requirements for members of the audit committee (currently only one member; moreover the criteria for assessing the independence of the audit committee member are not clearly defined).

A suitable response to the threats stemming from the conflict of interests would be to strengthen the principle of mandatory rotation. The Czech National Bank believes that the period of 7 years contained in Article 42(2) of the Audit Directive is too long and suggests shortening it to 5 years (a period of 5 years applies to lead and concurring audit partners in the USA). We also recommend extending the time-out period from 2 to 3 years. However, the Czech National Bank is against extending the principle of mandatory rotation to audit firms or of applying it to a wider set of entities (i.e. besides public interest entities).

The Czech National Bank is against the introduction of a complete ban on the provision of non-audit services to audited entities by statutory auditors. The proposed ban for selected auditors (the Big Four) or for selected audited entities could give rise to serious doubts about the observance of the equality principle by European legislators, especially if SMPs were simultaneously allowed to provide non-audit services to a greater extent and thus fill the gap left after the departure of the Big Four firms.

The Czech National Bank does not agree with uncritical support of SMPs and points to the negative experience with the poor quality audits which SMPs have conducted in the Czech Republic in financial institutions that have subsequently gone into bankruptcy proceedings without audit reports having identified problems in them.

The Czech National Bank does not agree with regulation of the remuneration of auditors, even after consideration of the reason given by the Commission for this proposal (safeguarding the independence of auditors). If it is to make sense, any regulation will have to be focused on the remuneration of audit partners, not on the remuneration of audit firms. As far as the Czech Republic is concerned, self-regulation works. The Czech code of ethics for auditors makes direct mention of the threat to the auditor's independence arising from an excessively close business relationship between auditor and client and excessive dependence of the auditor on remuneration from the client (for the latter case the code requires safeguards). Article 22 of the Audit Directive provides for the independence and objectivity of the statutory auditor and audit firm and lays down the safeguards that must be applied in order to mitigate threats

such as self-interest of the auditor and familiarity with the audited entity. The divergent implementation of Article 22 of the Audit Directive mentioned by the Commission could be dealt with by appropriate international cooperation (and if possible by uniform interpretation) and potentially by amending the Audit Directive to make it clearer and give less scope for subjective assessment, but not by strictly banning the provision of non-audit services and by regulating remuneration.

The Czech National Bank is fundamentally against any public intervention in the management and governance of private companies, especially in areas where such intervention is not sufficiently justified. This is the case with the measures being considered for audit firms. The inspiration found in the Regulation on Credit Rating Agencies is conceptually flawed, because in the auditing area there are detailed rules for business activities and statutory audits, including rules covering training, at the level of both regulations and soft law (see, for example, the ISAs and the standards issued by chambers of auditors). In the auditing area, self-regulation has also been operating for a long time, and public oversight has recently been introduced by the Audit Directive. However, strengthening the responsibility of key audit partners signing audit reports is an issue for discussion.

The Czech National Bank has no information or evidence that the current partner model is failing or that audit firms are suffering from a shortage of capital. As regards coverage of potential liability claims, it is more important to analyse the scope for measures in the area of insurance for audit firms.

In view of the Czech National Bank the proposals to reinforce the role of the group auditor are up for discussion (for example, ensuring that the group auditor has appropriate access to the reports and other documentation of the auditors reviewing sub-entities of the group). However, the Czech National Bank emphasises the risks that could be posed by insufficiently balanced measures to reinforce the role of the group auditor (in particular the risk of loss or undervaluation of information that is of little relevance from the group point of view but might be highly relevant from the local perspective).

Section 4 – Supervision (Questions 25 – 26)

The Czech National Bank stresses the importance of the tried and tested self-governance model, in which chambers of auditors play a key role, and fundamentally disagrees with the central role being assigned to public oversight of auditors. The situation in the Czech Republic is evidenced by good cooperation between the Czech National Bank and the Chamber of Auditors of the Czech Republic, including functioning exchange of information and consultation.

The Czech National Bank is resolutely opposed to the proposals to create new European supervisory agency in any of the proposed forms. There is no compelling reason for such a step. In particular, it is not clear how the model recently introduced by the Audit Directive (self-regulation complemented by public audit oversight) is failing. Therefore, we do not regard it as appropriate to delegate specific and extensive responsibilities for audit matters to the ESMA either. The Green Paper does not even make clear the benefits of transforming the EGAOB into a Level 3 Committee, and the Czech National Bank, given its practical experience, fundamentally opposes such a change.

As regards communication between auditor and financial market supervisory authority, the Czech National Bank states that in the Czech Republic the auditor is required, for the purposes of prudential supervision, to provide the Czech National Bank with information and explanations relating to the course of statutory audit and information acquired on the basis of statutory audit being conducted in audited entity subject to supervision by the Czech National Bank. The relevant statutory provisions provide for inspection of the quality of auditors, and the Czech National Bank may initiate inspections of auditors to be conducted by the Chamber of Auditors.

Section 5 – Concentration and market structure (Questions 27 – 32)

The Czech National Bank opposes the artificial market reconfiguration for numerous reasons. The Czech National Bank does not regard the current audit market structure as a systemic risk. It sees no reason for regulatory intervention directed at artificially weakening the Big Four audit firms. However, it is willing to support and further analyse some of the measures proposed by the Commission, for example transparency regarding the results of inspections of audit firms. It might also be useful to tighten up and extend the principle of mandatory rotation (although we view this as a measure to ensure independence, not as a measure to influence market structure).

The Czech National Bank does not agree with the introduction of joint audits. Any introduction of such a measure should be left to the Member State level. In the opinion of the Czech National Bank, joint audits would not generate adequate benefits. On the contrary, an increase in mandatory audit costs could be expected. This is evidenced by the negative experience of several countries (Canada, Denmark and Italy – the Parmalat case).

As for the Commission's proposal to introduce an obligation for audited entities to announce a tendering procedure for the auditor, the Czech National Bank does not support such a blanket proposal. The said obligation would increase costs and bureaucracy.

Open to the discussion could be the introduction of European quality certificate as a measure to counter excessive market concentration and to support SMPs. Such certification could eliminate the doubts of managers (board members) when choosing auditors (so that they cannot be criticised for failing to fulfil their professional diligence requirements if they choose a non-Big Four auditor). Such a measure could be particularly useful in the case of SMEs and SMPs.

The Czech National Bank has a very negative experience with the audits conducted by SMPs in financial institutions in the 1990s. Therefore, the competent national financial market supervisory authority should in any event retain the option of rejecting the auditor proposed by an audited financial institution if the competent authority finds that this auditor has conducted a substandard audit in a financial institution, has made fundamental mistakes or has caused repeated problems regardless of whether it has a quality certificate or is a member of the Big Four.

Section 6 – Creation of a European market (Questions 33 – 34)

The Czech National Bank has no information that mobility of audit professionals is currently a problem. The legislation in force provides for aptitude tests; these should be retained, because auditors provide their services in individual Member States with different legal and accounting systems. The fact that an auditor has obtained authorisation in one country does not mean he is able to conduct statutory audits in other Member States. The Czech National Bank does not regard maximum harmonisation as the right way forward. In this regard, we would like to point out that legislation can (and will) be interpreted differently across the Member States – depending on their legal culture and doctrine – even if it is worded identically.

Section 7 – Small and Medium Sized Enterprises and Practitioners (Questions 35 – 37)

The Czech National Bank strongly emphasises the risks associated with limited audits. It is unclear how limited audits would take place or whether they would not cause a further widening of the gap between the function of audits and how they are perceived by stakeholders.

The Czech National Bank does not agree with the introduction of a dual system, i.e. with the prohibition of non-audit services for Big Four audit firms and, on the other hand, the creation of a safe harbour for SMPs, which would mean broad provision of non-audit services to audited entities, including the preparation of tax returns and the keeping of accounts.

The Czech National Bank points to its negative experience with the poor quality audits which SMPs have conducted in banks subject to its supervision. Experience has clearly shown that it is inappropriate for SMPs to conduct complex audits in financial institutions.

The Czech National Bank is against regulatory intervention in the corporate/internal governance of audit firms, regardless of their size.

As for supervision, the Czech National Bank prefers self-regulation and industry solution accompanied by some degree of public oversight compared to the introduction of prudential supervision as currently applied, for example, to financial institutions.

Section 8 – International Co-operation (Question 38)

The Czech National Bank agrees with the introduction of the principle of mutual trust as proposed by the Commission, as this would facilitate better cooperation among audit oversight bodies, especially in the case of group audits. The Czech National Bank also supports steps to expand cooperation between financial market supervisory authorities as regards the sharing of information about statutory audits in regulated entities and as regards the quality or deficiencies of auditors and their audits. However, the application of the principle of mutual trust must not be allowed to limit the right of financial market supervisory authorities in the Member States to reject the auditor of a financial institution if they are not convinced it is suitable.