Does the European Commission require more independence than investors?
A study of replies made to the Green Paper
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Jönköping International Business School

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Rani Afrem
Abstract

Background
In 2008 a global financial crisis erupted. Even though auditors were not to blame for the financial crisis the public questioned how auditors could issue a clean bill of health despite the serious weaknesses. This made the Commission release the 2010 Green Paper on audit policy: Lessons from the Crisis. The Green Paper is a consultation paper which received around 700 replies from various stakeholders. In 2011, the Commission presented their proposal on reform of the audit market, in which many of the key elements had been discussed in the Green Paper. The 2011 proposal seeks to enhance auditor independence and introduce a more dynamic audit market. The proposed reforms are very strict and if the proposal is passed in its current form it would imply a major change of the audit market. This thesis has studied the replies made by investors to the Green Paper; investors are the primary stakeholders and those who should be most concerned with auditor independence. It is therefore important and interesting to study their viewpoints to the Green Paper.

Purpose
The purpose of this study is to understand and explain investors’ standpoints on the proposals mentioned in the Green Paper to enhance auditor independence, and to examine whether the European Commission, as indicted by the 2011 proposal, require more independence than investors as indicted by the replies made to the Green Paper.

Method
This study has taken a qualitative approach where the data has been analyzed in-depth. The Green Paper consists of 38 questions; four of these have been studied as they strongly relate to auditor independence. Furthermore this thesis has studied the replies made by investors; investors are the primary stakeholders and those who should be most concerned with
auditor independence. It is therefore important and interesting to study their viewpoints to the Green Paper.

**Conclusion**

The majority of the respondents’ are negative to the ideas presented in the Green Paper but that does not imply that the Commission requires more independence than investors. Both the Commission and investors argue that status quo is not an option and that auditor independence must be strengthened. What separates their views is how to strengthen auditor independence. The Commission seeks to impose strict regulations while investors prefer good corporate governance as an alternative approach to strengthen auditor independence.
# Table of Contents

1. **Introduction** ................................................................. 1  
   1.1 Background ........................................................................ 1  
   1.2 Problem Discussion .......................................................... 2  
   1.3 Research Questions .......................................................... 4  
   1.4 Purpose .............................................................................. 4  

2. **Review of Literature** ............................................................. 5  
   2.1 History of the Audit Profession ............................................ 5  
   2.2 The Concept of Auditing ..................................................... 6  
   2.3 The Auditor’s Role ............................................................. 6  
   2.4 Independence .................................................................... 7  
   2.5 Possible Threats against Auditor Independence .................... 8  
   2.5.1 The Swedish “Analysmodellen” ....................................... 8  
   2.5.2 Non-Audit Services ........................................................ 9  
   2.5.3 Mandatory Rotation ...................................................... 10  
   2.6 Green Paper ...................................................................... 11  
   2.6.1 1996 Green Paper .......................................................... 12  
   2.6.2 2010 Green Paper .......................................................... 12  
   2.7 Rules and Regulations ....................................................... 14  
   2.7.1 Directive on Statutory Audit ............................................ 14  
   2.8 Recent Proposal on Reform of the Audit Market .................... 14  
   2.8.1 Mandatory Rotation of Audit Firms: ............................... 15  
   2.8.2 Prohibition of Non-Audit Services: ................................ 15  
   2.9 Importance of Shareholders ................................................. 16  
   2.9.1 Agency Theory ............................................................. 16  
   2.9.2 Legitimacy Theory ......................................................... 17  
   2.9.3 Shareholders the Primary Stakeholder ............................. 17  

3. **Method** ............................................................................. 19  
   3.1 Choice of Subject ............................................................. 19  
   3.2 Research Design .............................................................. 19  
   3.2.1 Research Approach ....................................................... 20  
   3.3 Data Collection .................................................................. 20  
   3.3.1 Qualitative Study .......................................................... 21  
   3.3.2 Secondary Data ............................................................ 21  
   3.3.3 Selection of Questions .................................................... 21  
   3.3.4 Selection of Replies ....................................................... 22  
   3.4 Quality Assessment .......................................................... 23  
   3.4.1 Reliability ..................................................................... 23  
   3.4.2 Validity ......................................................................... 23  
   3.4.3 Generalization .............................................................. 24  

4. **Empirical Findings** ............................................................... 25  
   4.1 Alliance Trust Plc .............................................................. 26  
   4.2 Association of British Insurers ............................................. 27  
   4.3 Association of Pension Funds Management Companies ........ 27  
   4.4 AVIVA ............................................................................. 28
I Introduction

The introduction begins with a background to the audit profession which is narrowed down to a problem discussion providing the reader with an overview of the topic. This is followed by research questions and the purpose of this study.

1.1 Background

An auditor’s work comprises to plan, review, evaluate and to express an opinion on the financial health of a company. Stakeholders with an interest in a company’s financial position must be able to rely on the information given out by a company. The CEO and the board of directors are responsible for this information while the auditor’s role is to secure the quality of the information. The audit profession exists for the benefit of the public; it is of great importance to shareholders, suppliers, customers, employees and other stakeholders.

Without the external auditor, stakeholders would have to secure the quality of the information themselves (FAR, 2006).

The audit profession involves a three party relationship where the practitioner (auditor) gathers evidence to provide an opinion on the responsible party (audit client). The audit opinion is expressed on behalf of the users (most commonly investors). Due to this three party relationship it becomes crucial for the auditor not to bias his/her opinion in favor of the audit client (IFAC, 2004). The audit profession exists as there is a demand for independent external opinions on firms’ financial reports. Moore, Tetlock, Tanlu and Bazerman (2006, p. 4) argue that without independence the audit profession would not exist, they state “it were not for the claim of independence, there would be no reason for outside auditors to exist, since their function would be redundant with that of a firm’s inside auditors.”

According to the European Commission directive (2006) on statutory audit 2006/43/EC section 11, “statutory auditors and audit firms should be independent when carrying out statutory audits.” IFAC’s *Handbook of the Code of Ethics for Professional Accountants* (2010a) defines and divides independence into independence of mind and appearance. If one of these two is comprised the independence of an auditor is comprised and the auditor should therefore decline or resign from the audit engagement.
1.2 Problem Discussion

Ever since the birth of the audit profession the auditor’s independence has been in constant debate (Gunz, 2009), and the definition of independence has developed along with the audit profession (Moore et al., 2006). The meaning and the importance of auditor independence has developed through regulations which have been put in place as a result of financial scandals (Hayes, Dassen, Schilder and Wallage, 2005). The Great Depression resulted in the Securities Act and the Securities Exchange Act; these laws required publically traded companies to provide financial reports which had to be reviewed by an independent external auditor (Moore et al., 2006).

In more recent years the debate surrounding auditor independence has escalated as a result of financial scandals (Reiter & Williams, 2004). Financial scandals such as Enron, WorldCom and Parmalat in the early 21th century have brought on more regulations to the audit profession. These major corporate collapses made the public question the audit profession which eventually resulted in the Sarbanes-Oxley Act in the U.S and later on the 2006 Statutory Audit Directive in the EU (Unerman & O’Dwyer, 2004).

At the time being the auditor’s independence is a hot topic which is discussed intensely within the EU. In 2008 a worldwide financial crisis erupted and the role of banks, hedge funds, rating agencies, supervisors, central banks and their auditors has been critically questioned. The fact that banks revealed huge losses during the financial crisis made the public yet again question how the external auditors could issue a clean opinion despite the serious weaknesses (European Commission, 2010). The role of auditors’ however had not been discussed to the same extent as the role of banks, that is, until the European Commission (hereafter referred to as “the commission”) presented the 2010 Green Paper on Audit policy: Lessons from the crisis (hereafter referred to as “the Green Paper”). The Green Paper opens a discussion for, among other things, the role of an auditor, the independence of an auditor and the market structure. In all, the consultation paper consists of 38 questions regarding proposals on reform of the audit profession. Even though the response time was short (eight weeks) around 700 replies were received from a wide group of stakeholders including investors, academics, practitioners and public authorities. The 689 replies is the highest response rate received by the Commission since 2008 (European Commission, 2011a), which indicates that the topic is controversial making it an interesting topic for further research. The 689 replies have been divided into seven groups, academia, audit com-
mittees, audit profession, preparers, public authorities, users and others. Figure 1 labels the different groups and the number of replies made by each group.

![Figure 1: Responses by stakeholder groups (European Commission, 2011a).](image)

In the Green Paper the Commission questions the existing independence of auditors and seeks to enhance auditor independence. Among other things the Green Paper argues that independence is threatened by auditing firms providing non-audit services and that an audit client generally tends to keep the same audit firm for many years (European Commission, 2010). In late November 2011, the Commission presented its proposal regarding the statutory audit of public-interest entities. Mandatory rotation of audit firms, mandatory tendering and prohibition of non-audit services were some of the key measures in this proposal (European Commission, 2011b).

As previewed in the Green Paper, the proposals presented by the Commission would result in a major change of the audit profession, and many of the replies to the Green Paper are, for various reasons, critical to the ideas presented (European Commission, 2011b). The replies by the Big 4 accounting firms have been studied and they strongly oppose these reforms as it would affect their business models in a negative way. However, users of financial reports are, in theory, those who are most concerned with the independence of an auditor as they suffer when lack of independence occurs. Therefore it becomes interesting to investigate investors’ viewpoints to the Green Paper.
1.3 Research Questions

The author’s choice of problem is the measures suggested in the Green Paper to enhance the independence of auditors’. The debate surrounding auditor independence highlights the importance of the following research questions:

- What views do investors have on the proposals mentioned in the Green Paper to enhance auditor independence?
- What standpoints are expressed by investors to strengthen their opinions?
- Does the European Commission, as indicted by the 2011 proposal, require more independence than investors as indicted by the responses to the Green Paper?

1.4 Purpose

The purpose of this study is to understand and explain investors’ standpoints on the proposals mentioned in the Green Paper to enhance auditor independence, and to examine whether the European Commission, as indicted by the 2011 proposal, require more independence than investors as indicted by the replies made to the Green Paper.
2 Review of Literature

The second chapter of this study presents the relevant theories for this study; it gives the reader a deeper understanding of the audit profession. The review of literature presents, among other things, the concept of auditing, auditor independence, Green Papers and the importance of shareholders.

2.1 History of the Audit Profession

Records of audit activities have been traced back to the ancient Greece, China, Rome and even earlier times, the Babylon era. In ancient Rome auditors’ would hear taxpayers giving their statements on the results of their businesses, the Latin meaning of the word auditor was a “hearer or listener” descending from this phenomenon (Hayes et al., 2005).

The modern audit which exists today began to emerge during the 19th century as countries became industrialized and more developed. Up until then family owned companies had been very common where owners and managers were connected, however with the industrialization new technology was invented and firms urged for more financial resources to expand their businesses. To obtain more resources firms began to sell a part of the company to external financiers (investors) which eventually created a separation of ownership and control (Diamant, 2004). As today, those who managed the firm had the control and the responsibility to report on financial matters, managers were also given the possibility to determine the content and formation of the financial reports. As external financiers vested money into a company they wanted to make sure their resources were used to maximize the value of the firm and that management did not misuse the resources provided. This created a need for an external review of the financial reports; this review would be carried out by an independent individual with special expertise on the area and thereafter reported in the shape of an audit report (Hayes et al., 2005).

The increase in demand for an independent external auditor led to the establishment of many audit firms which grew in a rapid pace. Today the Big 4; Deloitte, PWC, Ernst & Young and KPMG all have heritage from audit firms established in the late 19th century or early 20th century (Carrington, 2010). In 1980 audit firms began to merge together through fusions or acquisitions to grow and increase their profits. In the late 80’s there were eight big audit firms which through further fusions were reduced to five big audit firms (SOU 1999:43). In the early 21th century Arthur Andersen’s criminal indictment and the Enron scandal reduced the five big audit firms to just four (Cunningham, 2006). The Big 4 dominates the market in many European countries as they together audit more than 90% of all
publicly traded companies, this has made the Commission question whether there is a systemic risk or not (FAR, 2010). A systemic risk implies that if one of the Big 4 accounting firms would collapse it could consequently damage the financial system as a whole. For mid-tier audit firms such as Grant Thornton and BDO it can be very difficult to enter the top end market (European Commission, 2010).

### 2.2 The Concept of Auditing

According to the *International Standards on Auditing 200* (IFAC, 2010b) the objective of an audit is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respect, according to an identified financial reporting framework. This generally implies the auditor expressing an opinion on whether the financial statements are “presented fairly” or give a “true and fair view”.

The purpose of an audit and the reason why an auditor gives an opinion is to “enhance the degree of confidence of intended users in financial statements” (IFAC, 2010b p. 3). As the financial information tend to be used for decision-making by different stakeholders it becomes crucial for the information to coincide with the reality (FAR, 2006). Thus, an audit implies securing the quality of the information given out by a company so that stakeholders can rely on the information and make well-informed decisions (Diamant, 2004). Providing an independent external opinion on the financial health of a company gives stakeholders the confidence to rely on the financial information. An audit is done for the benefit of the public; it is of great importance to shareholders, suppliers, customers, employees and other stakeholders. Without the external auditor these stakeholders would have to secure the quality of the information themselves (FAR, 2006).

### 2.3 The Auditor’s Role

Stakeholders with an interest in a company’s financial position must be able to rely on the information given out by a company. The CEO and the board of directors are responsible for this information while the auditor’s role is to secure the quality of the information (FAR, 2006). An auditor gathers evidence on the audit client to express an opinion to the intended users, thereby increasing stakeholders’ trust in the financial information provided (Hayes et al., 2005).
The European Commission directive (2006, p. 6) on statutory audit 2006/43/EC describes appointment of an auditor; it states “the statutory auditor or audit firm shall be appointed by the general meeting of shareholders or members of the audited entity”.

In advance to the general meeting of shareholders a proposal on a statutory auditor or audit firm shall be presented by the audit committee. An audit committee should exist in public-interest entities, that is entities which have a “… higher visibility and are more economically important…” (European Commission directive, 2006, p. 6). In essence public-interest entities are all listed companies plus financial services sector companies (Bury, 2011).

In addition to the regular audit activities an auditor can also act as an advisor. There are two types of advisory services, audit services and non-audit services. An auditor is obliged to inform his audit client of faults that has been discovered during the audit process, advisory services that fit into this category are seen as audit services. Non-audit services are those services which have no connection to the audit process (Carrington, 2010). At the moment there is no clear distinction of what services are categorized as audit and non-audit services, however the new proposal brought forth by the Commission includes a more clear separation of the two. Those services which normally entail a conflict of interest will be categorized as non-audit services and also prohibited from being offered to an audit client. Examples of such services are; tax, bookkeeping, actuarial and legal services (Bury, 2011).

2.4 Independence

According to the European Commission directive (2006) on statutory audit 2006/43/EC section 11, “statutory auditors and audit firms should be independent when carrying out statutory audits.” As stated earlier it is crucial for the auditor to remain independent throughout the audit process in order for shareholders and other stakeholders to fully trust the financial information provided by a company. IFAC’s *Handbook of the Code of Ethics for Professional Accountants* (2010a) defines and divides independence into independence of mind and appearance.

Independence of mind refers to the real independence of the auditor; it is the state of mind an auditor is in. An auditor has independence of mind when he/she can exercise professional judgment without being affected by external influences. Independence in appearance is the perceived independence, that is, how a third party perceives the independence of an
auditor. An auditor can have independence of mind and make independent decisions even though there is a perceived lack of independence. However the two are equally important, if there is a lack of independence in appearance stakeholders will not trust the financial information given out by a company, thereby making it just as useless as if the auditor had a lack of independence in mind.

IFAC’s *Handbook of the Code of Ethics for Professional Accountants* (2010a) section 290 provides a conceptual framework approach to independence which assists auditors’ to achieve and maintain independence. The approach requires auditors’ to apply safeguards to eliminate threats or to reduce them to an acceptable level, when safeguards are not sufficient enough to do so, the auditor should resign or decline from the audit engagement.

### 2.5 Possible Threats against Auditor Independence

In May, 2002 the Commission’s recommendation regarding statutory auditors’ independence in the EU was released. The recommendation presents the fundamental principles regarding the auditor’s objectivity, independence and potential threats against independence. Among other things it is mentioned that an auditor must be independent from his audit client both in mind and appearance. The recommendation also presents threats against auditor independence; those mentioned are self-interest, self-review, advocacy, familiarity or trust, and intimidation (European Commission, 2002).

#### 2.5.1 The Swedish “Analysmodellen”

In 2002 Sweden implemented the so called “analysmodellen” into law. “Analysmodellen” is a model applied as a tool for an auditor to determine his/her independence. The model is built upon the Commission’s recommendation and Sweden was the first country to implement such a model into law (FAR, 2005).

The model requires an auditor to control whether there are any conditions which could result in the auditor losing his independence (Moberg, 2006). The conditions which should be inspected before each audit engagement are:

**Self-interest**

Self-interest exists if the auditor or any other person within the audit team has an economical interest in the audit client (Moberg, 2006). The self-interest threat can occur when an auditor possesses a number of shares in the audited company, or if the auditor becomes dependent on the profit from non-audit services offered to the client (Carrington, 2010).
Self-review
The Self-review threat occurs when the auditor in any way reviewing himself or his own work. In the situation where the auditor has participated in the preparation of accounts a self-review threat occurs (Far, 2006).

Advocacy
Advocacy occurs when the auditor is biased. For example advocacy may occur when the auditor represents the audit client in a negotiation concerning tax matters; the auditor has thereby taken the party of the client (Moberg, 2006).

Familiarity/trust
The familiarity or trust threat occurs if the auditor or any other person within the audit team has a close relation to the audit client. If the auditor and the CEO of the audit client are siblings or if they are childhood friends this would imply a familiarity or trust threat (Moberg, 2006).

Intimidation
Intimidation implies threats or pressures of any kind from the audit client which aims to influence the auditor. In the situation of intimidation the auditor may find it discomfortable to express the conclusions drawn from the audit process (Moberg, 2006).

2.5.2 Non-Audit Services
One of the proposals mentioned in the Green Paper is to prohibit non-audit services from being offered to audit clients (European Commission, 2010). There are different explanations to why auditors’ offer non-audit services. Providing non-audit services has been a tool for major audit firms to grow and increase their profits (Moore et al., 2006). Another explanation is that auditors’ generally have a wide knowledge which makes them suitable to compete in that market (Carrington, 2010). Non-audit services can be offered to both audit clients and non-audit clients. When offered to non-audit clients there are no indication of problems as there is no auditor independence to be concerned about. However when non-audit services are offered to a current audit client there is a possibility of the auditor losing his independence (FAR, 2006). A large percentage of audit firms’ total revenues are coming from non-audit services which are provided to audit clients (Firth, 2002). The debate surrounding non-audit services and its impact on auditor independence has lasted for a long time and many research studies have been made (Hay, Knechel, and Li, 2006). Much of the debate and many of the studies have focused on the provision of non-audit services. When
the provisions of non-audit services are high many argue that the high consulting fees threatens the independence of an auditor, however these conclusions are controversial and not shared by all (Moore et al., 2006).

When non-audit services are offered to an audit client the perceived independence is threatened as stakeholders believe there is a higher risk of the auditor losing his independence. When the provision of non-audit services is high the audit firm becomes more economically dependent on the client which increases the risk of an auditor acting in a biased manor (Svanström, 2008). Firth (2002) argues that it is difficult to examine the impact of non-audit services on auditor independence. His study however shows that a high degree of non-audit services reduces the independence of an auditor while it increases the understanding of the client’s operations, thereby increasing the quality of the audit. Those who oppose a ban of non-audit services argue that the independence of an auditor is intact and that such a regulation would only harm the quality of the audit. Those who support a ban argue that even though the understanding of the auditor is increased the ability to discover essential faults becomes useless if the auditor is not independent (Carrington, 2010).

2.5.3 Mandatory Rotation

Another proposals mentioned in the Green Paper is to apply mandatory rotation of audit firms (European Commission, 2010). Today rotation of the key audit partner is required. This implies that the key audit partners must be replaced within seven years of appointment and the replaced auditor cannot return to the audit engagement team until two years have passed (European Commission, 2002). Auditor independence is, as already mentioned, of great importance to stakeholders, therefore the Commission seeks to enhance auditor independence by establishing mandatory rotation of audit firms. However mandatory rotation of audit firms is very controversial and there are separate views on the matter (Ruiz-Barbadillo, Gómez-Aguilar and Carrera, 2009). Below arguments for and against mandatory rotation of audit firms will be presented.

Those who support mandatory rotation of audit firms note that such a regulation would avoid long-term relationship between the auditor and the audit client and thereby reducing the risk of familiarity or trust (Arel, Brody and Pany, 2005). Jennings, Pany and Reckers (2006) argue that a long-term audit engagement makes it more difficult for the auditor to be objective as it creates an audit-client relationship where the auditor may develop ties of friendship. Both economical and personal interest in the audit client increases the risk of an
The auditor to overlook essential faults in the organization. As mandatory rotation of audit firms would reduce the risk of familiarity or trust the perceived independence would be enhanced.

Bazerman, Loewenstein and Moore (2002) argue that the even the most honest and thorough auditor can make unintentional mistakes as a result of the close relationship between auditor and the audit client. The explanation to this phenomenon is “self-serving bias” where people unconsciously and unintentionally can make decisions which will benefit themselves. In the situation of mandatory rotation of audit firms this scenario would be eliminated as the auditor has no focus on keeping the audit engagement. No matter of his/her actions there is a time limit on the audit engagement, so the auditor will have no self-interest other than to be completely objective. Thereby mandatory rotation of audit firms would also enhance independence of mind (Arel et al., 2005).

There are also a number of arguments which oppose mandatory rotation of audit firms. Many of those who oppose mandatory rotation of audit firms claim that it is not necessary to enhance auditor independence as audit firms and auditors already strive to be independent. An auditor must strive to be independent to maintain a good reputation; endangering auditor independence may very well lead to a bad reputation which in turn would result in higher costs. So, the auditor will feel motivated to maintain and strengthen his independence in order to keep a good reputation (Ruiz-Barbadillo et al., 2009). In many situations auditors need special expertise for each specific client, to gather new information and to become an expert is time-consuming which in turn leads to higher costs for the audit client. Another argument against mandatory rotation of audit firms is that it will harm the quality of the audit. During the first few years of an audit engagement the probability of significant errors to occur is higher as it takes time for the auditor to become familiar with the client’s operations (Jackson, Moldrich and Roebuck, 2008).

### 2.6 Green Paper

The Commission presents Green Papers’ which concern a particular area within politics. Green Papers include proposals and ideas on how to change different areas which are under discussion. The purpose of Green Papers are to open a discussion and receive opinions and standpoints by those concerned as well as other interested parties (European Commission, 2012).
2.6.1 1996 Green Paper
In 1996 the Commission presented the Green Paper: The role, the position and the liability of the statutory auditor within the EU. The 1996 Green Paper discusses the role and independence of an auditor as a result of several financial scandals. The quality of an audit was questioned as the role, position and liability of an auditor did not correspond across the EU (European Commission, 1996a).

Even though the main focus of the 1996 Green Paper was to harmonize the auditor’s role across member states certain questions such as prohibition of non-audit services and mandatory rotation of audit firms were brought up. In 1996 the competition among audit firms had increased, as a result audit engagement fees were lowered. To compensate for the lower audit fees many audit firms began to offer non-audit services. This created a discussion on whether non-audit services compromised auditor independence and if non-audit services should be banned (European Commission, 1996a). The 1996 Green Paper resulted in a new approach to auditing aimed to harmonize the audit profession throughout the EU. Proposals on prohibition of non-audit services and mandatory rotation of audit firms were however not discussed further (European Commission, 1996b).

2.6.2 2010 Green Paper
In October 2010 the Commission presented the Green Paper on audit policy: lessons from the crisis. The Green Paper opens a discussion for, among other things, the role of an auditor, the independence of an auditor and the market structure (European Commission, 2010). In between the 1996 and the 2010 Green Paper the financial scandals in the early 21st century had a significant impact on the audit profession. Financial scandals such as Enron, WorldCom and Parmalat made the public question the audit profession. These major corporate collapses eventually resulted in the Sarbanes-Oxley Act in the U.S and later on the 2006 Statutory Audit Directive in the EU (Unerman & O’Dwyer, 2004).

In 2008 a worldwide financial crisis erupted and the role of banks was critically questioned. The fact that banks revealed huge losses during the financial crisis made the public question how the external auditors could issue a clean opinion despite the serious weaknesses. The role of auditors however had not been discussed to the same extent as the role of banks, that is, until the Commission presented the 2010 Green Paper. In the Green Paper the Commission questions the existing independence of auditors and seeks to enhance auditor independence. Among other things the Green Paper argues that the independence is
threatened by auditing firms providing non-audit services and that an audit client generally tends to keep the same audit firm for many years (European Commission, 2010).

In all, the consultation paper consists of 38 questions regarding proposals on reform of the audit profession. Even though the response time was short (eight weeks) 689 replies were received from a wide group of stakeholders including investors, academics, practitioners and public authorities. The 689 replies is the highest response rate received by the Commission since 2008 (European Commission, 2011a).

Out of the 38 questions in the Green Paper this study has its focus on four of those questions. The reason for selecting those four questions is because they have a strong connection to auditor independence. The selected questions are also a part of the proposal brought forth by the Commission in 2011. The questions below are identical to the ones in the Green Paper and are those which will be investigated:

- 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?
- 17. Would appointment by a third party be justified in certain cases?
- 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?
- 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 systematical financial institutions?” (European Commission, 2010, p. 13)

Today, the auditor is appointed and remunerated by the audited entity. The Commission questions the current practice, implying that there is a conflict of interest in the auditor being appointed and remunerated by the company itself. The commission would therefore wish to receive opinions on the possibility of a third party, such as a regulator, being responsible for appointment and remuneration of the auditor rather than the company itself (European Commission, 2010).

An audit client generally tends to keep the same audit firms for many years; this may comprise the independence of an auditor even when the key audit partners are regularly rotated. The Commission would therefore like to examine the pros and cons of mandatory rotation of audit firms (European Commission, 2010).
At the moment there is no EU-law preventing audit firms from offering non-audit services. As long as providing non-audit services does not comprise auditor independence audit firms are free to do as they wish. The Commission would therefore like to examine the possibility of a ban on non-audit services and the creation of pure audit firms (European Commission, 2010).

2.7 Rules and Regulations
The audit profession is characterized by a significant degree of regulations. Regulations regarding independence and objectivity are necessary for an audit opinion to be trustworthy. (FAR, 2006). In the EU, regulation concerning accounting and auditing is usually set through directives and recommendations. The directives are set by institutions within the EU, such as the European Commission. The directives are aimed to member states and require each state to implement the directive. Each member state can choose their own approach to implement the directive it is however required that the particular result shall be achieved within the set time-frame (Diamant, 2004). Many of the rules that an auditor must apply to can be found in the directive on statutory audit (2006/43/EC), recommendations and codes of professional ethics.

2.7.1 Directive on Statutory Audit
The European Commission directive (2006) on statutory audit 2006/43/EC establishes rules regarding the statutory audit of annual and consolidated accounts. The purpose of the directive is to strengthen the trust on auditors and to harmonize the rules between member states. Therefore the directive must be implemented by all member states. According to the directive member states must confirm that audit firms and auditors are subject to principals of professional ethics. These should include principals regarding integrity, objectivity and due care. Corresponding set of rules can also be found in IFAC’s Handbook of the Code of Ethics for Professional Accountants and International Standards on Auditing (ISA).

2.8 Recent Proposal on Reform of the Audit Market
In late November 2011, the Commission presented its proposal regarding the statutory audit of public-interest entities. The new proposal will focus on strengthening the independence of auditors and create more diversity to the high-concentrated audit market. The proposal will clarify the role of the auditors and introduce more strict rules to enhance the quality of an audit and restore confidence in the audit profession. Mandatory rotation of
audit firms and prohibition of non-audit services are some of the key measures in this proposal (European Commission, 2011b). The proposal is indeed a big and ambitious package which will have a significant impact on the audit of public-interest entities. Public-interest entities are in essence all listed companies and financial services sector companies. The proposal has not yet been passed into law. The proposal is currently being processed by different institutions and the expected decision time is said to be around 3-5 years. During this process the proposal may be altered, dropped or passed in its current form (Bury, 2011).

If passed into law in its current form the audit market would undergo a major reform. The strictness of the proposal can be compared to the Sarbanes-Oxley Act which was introduced in the U.S after the Enron scandal. The SOX Act introduced, among other things, rotation of audit partners and prohibition of nine non-audit services (Sarbanes-Oxley Act, 2002, sec. 201, 203). The proposal brought forth by the Commission goes further than that, introducing mandatory rotation of audit firms instead of just audit partners and prohibiting more than just nine non-audit services.

2.8.1 Mandatory Rotation of Audit Firms:
Mandatory rotation of audit firms implies an audit firm to rotate after a maximum audit engagement period of six years; it is possible to have the period extended by two years if authorized by the supervisor (Bury, 2011). Each member state should appoint a competent authority (the supervisor); this authority should be independent of auditors and responsible for the supervision of auditors (European Commission, 2011c). In the situation of joint-audits, which are encouraged but not obligatory, the maximum engagement period is nine years with a possible extension of three years if authorized by supervisor. The audit firm is no allowed to be involved with the same client until four years have elapsed (Bury, 2011).

2.8.2 Prohibition of Non-Audit Services:
This proposal will prohibit audit firms from providing non-audit services to their audit clients. Non-audit services are those services which normally entail a conflict of interest, that is services which implies self-review, a close relationship to management or if there is a commercial interest for the auditor in having that work. Examples of such services are tax services, developing risk management systems, actuarial services, legal services and participation in the internal audit. There are also services which potentially could entail a conflict of interest. Examples of such services are human resource services and providing confident
letters to investors. These services can be provided if authorized by the audit committee or the supervisor (Bury, 2011).

In addition to this proposal large audit firms will have to separate their audit consultancy services to a separate legal entity. In other words large audit firms will become pure audit firms, providing no other services than audit services. There is a numerical threshold on what defines a large audit firm, in most member states it implies the Big 4 accounting firms while in a few there may be some second tier audit firms which will fall into the category of large audit firms (Bury, 2011).

2.9 Importance of Shareholders

2.9.1 Agency Theory
In a company the management and the owner can be of the same person(s), alternatively these two can be separated. When owners are connected to the management the two will share the same interests, that is, to maximize the value of the firm. If however, the owners are separated from the management there is a possibility that the manager will not act in the best interest of the owner. The agency theory identifies the relationship between the principal (owner) and the agent (manager). This relationship can have negative effects as the agent may act in his self-interest, for example an agent may misuse his power for his own benefit (Mallin, 2010).

The Agency theory is often set in context of the separation of ownership and control. Adam Smith (1838 cited in Mallin, 2010, p. 15) in his book *The Wealth of Nations* questioned how managers could be expected to watch over other peoples’ money as if it were their own. Later on Berle and Means (1991) highlighted that the ownership and control of a company became separated as a result of countries developing their markets and becoming industrialized.

The theoretical solution to this problem has been to create incentives for the management to act in the best interest of the owners, usually by establishing bonus contracts. The amounts of these bonuses are generally based on the information and the financial reports which management provide to the owners (Deegan & Unerman, 2011). This creates the risk of managers’ manipulating the financial reports to increase their bonuses, which in turn leads to the need of an external independent auditor who can review the reports and make sure of their validity (Lambert, 2001).
2.9.2 Legitimacy Theory

The Legitimacy theory implies that organizations’ will strive to be perceived as operating within the norms and bounds of the society. In other words, organizations’ will make sure their activities are perceived as legitimate in the eyes of a third party. As the norms and bounds of a society may change over time it is crucial for an organization to adapt when changes occur. Organizations not perceived as legitimate must change their activities; otherwise the survival of the organization is threatened (Deegan & Unerman, 2011).

The separation between owners and managers made financial reports useful. Financial reports are provided by management to owners and other stakeholders. There is however the possibility of managers manipulating the financial reports, this has led to the need of audits. An audit make secures the quality of the financial reports and thereby it adds legitimacy to the financial reports. Moreover the auditor must also be perceived as legitimate by outside parties. It is the independence of an auditor which adds legitimacy to the auditor and consequently the audit.

2.9.3 Shareholders the Primary Stakeholder

The agency theory highlights the importance of shareholders while the stakeholder theory takes a wider group of constituents into account. Today, many companies apply the stakeholder theory, satisfying a wider group of stakeholders such as employees, providers of credit and suppliers. Nonetheless shareholders remain to be the primary stakeholder as they have invested resources in the company and take the profit remaining, while for example providers of credit have already been paid. Shareholders invest resources with the demand that the resources will be used to maximize the value of the firm; this in turn should be the benefit of the society as a whole. Another reason why shareholders are seen as the primary stakeholder is that shareholder rights are usually protected in law while other stakeholders in most countries are not protected by law. Many companies acknowledge the importance of taking a wider group of stakeholders into account; therefore many companies strive to maximize shareholder value while at the same time taking other stakeholders into account (Mallin, 2010).

This thesis will study the replies made by shareholders (also referred to as investors) to the Green Paper. Shareholders are the primary stakeholder and the most common user of financial reports. Therefore shareholders are those who are most concerned of the validity of
financial reports and thereby the independence of auditors. This makes it very interesting and important to investigate their views to the Green Paper.
The recent financial crisis which erupted in 2008 made the Commission question the existing independence of auditors. Even though auditors were not to blame for the financial crisis many questioned how auditors could issue a clean bill of health despite the serious weaknesses (European Commission, 2010). An audit is of great importance to shareholders, employees, suppliers, customers and other stakeholders. The auditor secures the quality of the information so that stakeholders can rely on the information and make well-known decisions, it is therefore crucial for the auditor to remain independent throughout the audit process (FAR, 2006). I have chosen to focus my study on auditor independence as it is an important question and a hot topic discussed intensely within the EU.

In 2010 the Commission presented the Green Paper on audit policy: lessons from the crisis. The Green Paper received around 700 replies which is the highest amount of replies received by the Commission since 2008 (European Commission, 2011a). A study of some of the replies will give a deeper knowledge in the proposals brought forth and a better understanding of the respondents’ viewpoints to the proposals. Many of the replies are, for various reasons, critical to the ideas presented in the Green Paper (European Commission, 2011b), I have chosen to study the replies made by investors. Investors are the primary stakeholder and those who care about auditor independence the most; it is therefore interesting and important to study their viewpoints. In particular how investors viewpoints, as indicted by the replies to the Green Paper, differ from the Commission’s viewpoints as indicated by the 2011 proposal, reform of the audit market.

3.2 Research Design
The research design is used to turn the research questions into a research project. The research design describes how the research questions will be answered and it is a crucial part in order for the researcher to perform the study and obtain the purpose. In other words the research design is the overall plan for the research and it describes how the researcher will go about to answer the research questions (Saunders, Lewis and Thornhill, 2009).
3.2.1 Research Approach
This study has taken an abductive approach, that is, a combination of deductive and inductive (Saunders et al., 2009). At the beginning of this study a brief observation of the replies made to the Green Paper was made, this shaped the research questions and the purpose. This indicates an inductive approach; the observations will thereafter be presented in the empirical findings. Auditor independence is a field which contains a great amount of research; therefore I believe that studying existing theories and scientific articles is of great importance. To exclude existing theories and scientific articles would make it more difficult to investigate the research object. The relevant theories have been presented in the review of literature, and in the analysis part the empirical findings will be tested against existing theories. Applying an abductive approach will enhance the ability to understand the problem through the study of existing theories and scientific articles. Thereafter observations will be presented in the empirical findings; this will give me the opportunity to create new knowledge by interacting theory and empiricism.

3.2.2 Descripto-Explanatory Research
At the beginning of this research when both research questions and the purpose was formed a separation of the terms explanatory, descriptive and exploratory was made. The answers to the research questions can take the form of either one of those mentioned or a combination of two (Saunders et al., 2009).

In this study a descripto-explanatory research is done, that is, a combination of descriptive and explanatory research. The study intends to describe and give a clear picture of investors’ viewpoints to the Green Paper which indicates a descriptive research. The study will however go further than that, I intend to draw conclusions from the data which has been described in order to understand if and why the Commission requires more independence than investors. This indicates an explanatory research; hence the study will use a combination of the two, a descripto-explanatory research.

3.3 Data Collection
For the research questions to be answered data needs to be collected and thereafter investigated. Usually data collection is separated into qualitative and quantitative collection of data. A quantitative study is characterized by large samples and numerical data which through the study are turned into information. A Qualitative study has its focus on non-numerical
data where the data is analyzed in-depth. A qualitative study characterize instead of quantifying the data (Saunders et al., 2009).

### 3.3.1 Qualitative Study

The most suitable approach for this study is a qualitative approach. This study has its focus on one particular area, auditor independence. The study will go in-depth and analyze respondents’ replies in order to give more detailed information. The main reason for selecting a qualitative study is because my main concern is with words rather than numbers. In this study I intend to interpret and understand respondents’ viewpoints regarding auditor independence. In a qualitative study the researcher’s interpretation and experience plays an important role (Saunders et al., 2009). According to Holme & Salvang (1997) the context and possible deviations are important; therefore this study will look at similarities as well as differences between investors’ viewpoints. The study will also draw conclusions from the described data in order to understand if and why the Commission requires more independence than investors. This requires the researcher to analyze the replies in-depth; therefore I believe a qualitative study is more suitable.

### 3.3.2 Secondary Data

To understand investors’ viewpoints to the Green Paper, replies made by investors will be studied. The replies made to the Green Paper are well thought through and comprehensive as respondents have answered the questions in a representative way. They also give an overall picture and represent the interest of many rather than a personal opinion. The replies made to the Green Paper are publically available at the European Commission’s webpage, thus access to these replies is not a problem.

### 3.3.3 Selection of Questions

In all, the Green Paper consists of 38 questions regarding proposal on reform of the audit market. The questions which will be studied have already been presented in the review of literature but for the ease of the reader the questions will be presented here as well.

- 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?
- 17. Would appointment by a third party be justified in certain cases?
- 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?
• 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 systematical financial institutions?” (European Commission, 2010, p. 13)

There are two reasons why these questions were selected. First and foremost all four questions are strongly connected to auditor independence. Secondly, the ideas have been brought forth as requirements in the new proposal presented in 2011 which makes them relevant. Many of the replies have answered to question 16 and 17 together as they are connected and therefore question 16 and 17 will be treated as one. So, in both empirical findings and in the analysis part these two questions will be presented together.

3.3.4 Selection of Replies

The replies made to the Green Paper are publically available at the European Commission’s webpage. The 689 replies have been divided into seven groups, academia, audit committees, audit profession, preparers, public authorities, users and others. I have chosen to study the replies from the group “users”. The group consists mostly of shareholder associations and investment companies representing numerous interests. The reason why I will study the replies made by investors is because they are the primary stakeholder and the ones who should be most concerned with auditor independence.

There are 23 replies categorized as users. An elimination process has been done in order to select those replies which are suitable for this study. Out of the 23 replies one reply did not have sufficient answers to any of the four questions and has therefore been eliminated from the study. There were also a few replies which did not answer sufficiently to all four questions. In this situation the sufficient answers will be taken into consideration while the insufficient answer will be eliminated from the study. There were three replies made by trade unions, these trade unions represent the interest of employees and unemployed. Even though categorized as users, and indeed, users of financial reports trade unions are not investors and these three replies will therefore be eliminated from this study.

Furthermore, two of the replies are written in a language other than English. The replies are written in French and Dutch. These have not been eliminated from the study but translated by individuals with a first language in the respective language. The translations are provided in appendix 1.
The elimination process has concluded that 19 replies are suitable for this study. The number of replies which will be studied can be seen as a small number out of the total amount of replies, 19 out of 689 replies will be studied. However, it is important to understand that the replies made by the group categorized as users are shareholder associations and investment companies, representing numerous interests. For example, Hermes Equity Ownership Services respond to the consultation on behalf of some of their clients as well, including the BBC Pension Trust and the National Pension Reserve Fund of Ireland (Hermes Equity Ownership Services, 2010).

3.4 **Quality Assessment**

It is important to critically evaluate the research findings, according to Saunders et al. (2009) one must consider three important aspects. These are, reliability, validity and generalizability.

3.4.1 **Reliability**

It is important for a study that the research undertaken is reliable and that it has not been affected by coincident. The degree of reliability is determined by the consistency of a study's findings. In other words if the same research is undertaken the outcome of that study should be the same as the previous one (Saunders et al., 2009).

In advance to this study I had no preconceptions regarding auditor independence and I have throughout the process remained objective so that the outcome of this study will not be reflected by my own beliefs. Therefore if a similar study with the same purpose and conditions would be undertaken the study would achieve the same result as long as the researcher would remain objective.

Furthermore 19 replies will be studied, a small sample size out of the total 689 replies made to the Green Paper. The sample size is not randomly selected and does not refer to any statistical applicability. This is however not an issue as this is a qualitative study with a main focus on words rather than numbers. The 19 replies may be seen as a very small sample out of the total 689 replies made to the Green Paper. However, many of the replies categorized as users represent numerous interests.

3.4.2 **Validity**

Validity can be defined as the researcher's ability to measure what is supposed to be measured. When speaking in terms of secondary data validity is often referred to how the data
was collected and by whom it was collected. There are several factors that one should take into consideration to establish a high validity, this can be done through a quick assessment of the secondary data. Reputation of the source, accessibility and method used to collect the data are important factors to consider (Saunders et al., 2009).

In this study the secondary data which will be observed has been gathered by the Commission. Large and well-known organizations such as the European Commission are most often seen as a valid and credible source (Saunders et al., 2009). The survey and the replies made to it are all publically available at the European Commission’s webpage, thus there is no problem of accessibility. Another important criterion is whether the secondary data is suitable for the study, also referred to as measurement validity (Saunders et al., 2009). This will not be a problem as the purpose of the Green Paper is similar to the purpose of this study, therefore the replies made to the Green Paper will also provide the information I need to answer my research questions.

### 3.4.3 Generalization

Generalization also referred to external validity concerns whether your findings can be generalized (Ghauri & Gronhaug, 2010). In other words it refers to the extent to which you can generalize your findings to other research settings such as populations, settings or periods (Saunders et al., 2009).

It is important to understand that this study only investigates the replies made to the Green Paper. Many of the replies categorized as users are shareholder associations and investment companies, thereby representing numerous interests rather than a personal opinion. Even though the replies represent numerous interests the opinions may differ from reply to reply. Also, the opinions expressed are not necessarily shared by all investors around the world. This study does not intend to generalize all investors but rather to see whether investors’ viewpoints differ from each other and from the Commission’s viewpoints.
Chapter 4, Empirical Findings, will present the result of this thesis. Each reply studied in this thesis will be presented. The study has focused on four questions; question 16 and 17 will be treated as one and therefore presented together, while question 18 and 19 will be presented in separate parts. Respondents’ viewpoints will be presented, that is, whether they oppose or support the ideas presented in the Green Paper and their arguments expressed to strengthen their beliefs. Furthermore the Commission’s view on auditor independence as indicted by the 2011 proposal will be presented here.

Before the replies are presented a short presentation of the 19 respondents will be made. Table 1 presents the respondents’ studied in this thesis as well as their respective country and industry. As previewed from Table 1 the respondents’ consist of various investment companies and various associations. The investment companies consist of mostly asset managers and pension funds. The various associations represent the interest of pension funds and investors, both private and institutional.

The respondents are located in nine different countries; a small number considering the European Union consists of 27 member states (European Union, 2012). The location of the company or associations may imply different set of rules and codes to comply with. Moreover none of the respondents’ originate from Germany, Italy or Spain, three major members of the European Union. The fact that no respondents’ categorized as “users” were made from Germany, Italy or Spain is however acceptable as the majority of the respondents’ operate worldwide representing the interest of investors from several countries. Furthermore some of the respondents’ are also global organizations (e.g. ICGN and the CFA Institute) which make the location of their headquarters irrelevant.

<table>
<thead>
<tr>
<th>Respondent</th>
<th>Country</th>
<th>Industry</th>
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<tbody>
<tr>
<td>Alliance Trust Plc</td>
<td>United Kingdom</td>
<td>Asset Management Industry</td>
</tr>
<tr>
<td>Association of British Insurers</td>
<td>United Kingdom</td>
<td>Insurance, investment and long-term savings industry</td>
</tr>
<tr>
<td>Association of Pension Funds Manage-ment Companies</td>
<td>Slovakia</td>
<td>Association for Pension Funds</td>
</tr>
<tr>
<td>AVIVA</td>
<td>United Kingdom</td>
<td>Long-term savings, fund management and general insurance</td>
</tr>
<tr>
<td>BlackRock Inc.</td>
<td>USA</td>
<td>Asset Management Industry</td>
</tr>
<tr>
<td>CFA Institute</td>
<td>USA</td>
<td>Association for Investment Management</td>
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<tr>
<td>Dutch Shareholders Association</td>
<td>Netherlands</td>
<td>Association for Private and Institutional Investors</td>
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<tr>
<td>Eumedion</td>
<td>Netherlands</td>
<td>Association for Institutional Investors, Corporate Governance Forum</td>
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<tr>
<td>Hermes Equity Ownership Services</td>
<td>United Kingdom</td>
<td>Asset Management Industry</td>
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</table>
4.1 **Alliance Trust Plc.**

As one of the largest investment companies in the UK, Alliance Trust has expressed a deep concern over some of the ideas presented in the Green Paper. They believe some of the ideas may have an adverse effect, harming audit quality instead of strengthening audit quality and simultaneously depriving shareholders of their responsibilities and control (Alliance Trust, 2010).

Alliance Trust opposes the idea of a third party, such as a regulator, appointing the auditor instead of the company itself. They believe shareholders have the right to choose which audit firm to appoint, shareholders can then appoint the auditor which will deliver quality and value in form of both independence and expertise (Alliance Trust, 2010).

Regarding mandatory rotation of audit firms, question 18, Alliance Trust oppose the idea. They believe mandatory rotation of audit firms will increase the costs during the year of change. Audit quality and decreased costs will not be achieved through regulation but rather through more control by shareholders. They believe that audit committees should assess the performance of an auditor and when found necessary rotate the auditor (Alliance Trust, 2010).

Alliance Trust does not support prohibition of non-audit services. They believe the creation of pure-audit firms with the purpose of becoming inspecting units would be a reversed step. They believe that the current practice is sufficient to secure auditor independence. The current practice requires provision of non-audit services to be approved by the audit committee and disclosed in the annual report. This practice does not only safeguard auditor independence it enables the best suitable audit firm to be appointed, for example for their
special expertise. Alliance Trust believes the creation of pure audit firms would also decrease the attraction of high quality employees (Alliance Trust, 2010).

### 4.2 Association of British Insurers

The Association of British Insurers (ABI) with over 300 members represents the UK’s insurance, investment and long-term savings industry (ABI, 2010).

ABI does not believe appointment by a third party can be justified. They believe that the auditor should be appointed by the board of directors or the audit committee. They also believe that shareholders must approve the appointment of the auditor during the general meeting (ABI, 2010).

ABI do not support mandatory rotation of audit firms. They do not see the need for a maximum length on an audit engagement. They do however highlight the role of the board of directors and the audit committee. They believe the audit committee should review the auditor’s performance and when found necessary rotate the auditor (ABI, 2010).

ABI does not support the creation of pure audit firms. They do realize the risks which arise from providing non-audit services, however they believe this is an area where good corporate governance is important. They believe that the audit committee should have the control of the non-audit services purchased and that disclosure of these should be made to shareholders. They believe this approach is the best as the benefits of non-audit services being provided by the auditor may outweigh the risks (ABI, 2010).

### 4.3 Association of Pension Funds Management Companies

The association of pension funds management companies consists of eight members. The association serves to protect and enforce the common interest of the pension funds management companies in Slovakia (Association of Pension Funds Management Companies, 2012). The Association have reviewed the ideas suggested in the Green Paper and have presented their opinions on those ideas which they oppose (Association of Pension Funds Management Companies, 2010).

The Association do not believe there is a conflict in the auditor being appointed and remunerated by the audited entity and does therefore oppose appointment by a third party. In Slovakia, where the association is active, an auditor is appointed by the shareholders and in the case of public-interest entities, the audit committee. According to Slovak legislation entities under the supervision of the National Bank of Slovakia (NBS) must disclose the NBS
of their appointment. The NBS has the function of a regulator and may require the entity to select another auditor than the one requested by the entity. The association believes that the current practice is enough to prevent appointment of unprofessional auditors’ and that the shareholders should have the right to appoint the auditor. However they do recognize that in some circumstances a third party may be acceptable, such as the one defined in Slovak legislation where the NBS in some cases has the right to interfere with the appointment of auditors (Association of Pension Funds Management Companies, 2010).

Regarding mandatory rotation of audit firms the association believes that it would interfere with shareholders right to appoint the auditor. The Association opposes the idea of mandatory rotation of audit firms and highlights that rotation of audit firms were required by Slovak legislation until it was removed after a few years as the practice failed to prove any advantages (Association of Pension Funds Management Companies, 2010).

4.4 AVIVA

Aviva provides insurances worldwide making them one of the world's largest insurance groups. Aviva highlights the importance of harmonization between member states in their legislations and frameworks before the Commission seeks to impose further regulations to the audit market (AVIVA, 2010).

Aviva do recognize that in theory there is a conflict in the auditor being appointed and remunerated by the audited entity. However they do not support the idea of a third party appointing the auditor. As an audit is done to protect investors Aviva believes an alternative approach would be to increase the involvement of shareholders in the appointment of the auditor. Aviva believes the conflict in the auditor being appointed by the audited entity can be eliminated through effective corporate governance and robust audit committees rather than the idea mentioned where a third party would appoint the auditor (AVIVA, 2010).

Aviva does not support mandatory rotation of audit firms. They believe the idea will decrease audit quality as during the first years of an audit engagement an audit firm goes through its learning curve. During this learning curve, which may last up to two years, there is an increased risk of the auditor missing out on significant faults in the entity. Instead Aviva suggests better disclosure around audit relationships and audit partner rotation as well as the audit committee annually reviewing the auditors’ (AVIVA, 2010).
Aviva do recognize the potential risks in providing non-audit services. They do however oppose a total prohibition of non-audit services and the creation of pure-audit firms. Non-audit services may in some situations increase the knowledge and insight of an auditor and thereby increase the quality of an audit. Aviva do recognize the idea presented but points out the different frameworks applied by member states in the EU. They would wish for the Commission to harmonize these frameworks as in some member states disclosures of non-audit services are limited and an increase in the extent of disclosures may therefore be needed in some member states (AVIVA, 2010).

4.5 BlackRock Inc.

BlackRock Incorporation is a global investment manager, providing advisory services and managing investment companies, private equity funds, hedge funds and exchange traded funds. BlackRock opposes the idea of a third party being responsible for the appointment and remuneration of the auditor. BlackRock highlights the complexity of large companies which requires the auditor to have special expertise and adequate resources to understand a company’s risks and controls. The responsibility of appointment should therefore fall on an independent audit committee rather than a third party. The audit committee can thereby appoint an auditor which is not only independent but also an auditor which understand the business, risks and controls of the company. Unlike the audit committee a third party will not have the same understanding of the company’s business, risks and controls and should therefore not be responsible for the appointment of the auditor (BlackRock, 2010).

BlackRock recognize the importance of auditor independence and for the auditor to remain objective throughout the audit process. They do however not support mandatory rotation of audit firms. The current practice, rotation of key audit partners, is enough to secure auditor independence. BlackRock believes independent reviews of auditor performance is a better approach than to impose mandatory rotation of audit firms (BlackRock, 2010).

BlackRock opposes a total prohibition of non-audit services and the creation of pure-audit firms. They argue that non-audit services may relate to the audit and increase the knowledge of the auditor thereby increasing the overall audit quality. BlackRock suggests the Commission to develop additional guidance around non-audit services defining which services that will be allowed respectively banned. Even though against a total prohibition of
non-audit services BlackRock supports a ban of some non-audit services such as those in the Sarbanes-Oxley Act (BlackRock, 2010).

4.6 CFA Institute

The CFA Institute is a global non-profit organization. With over 100,000 members it is the world’s largest association of investment professionals (CFA Institute, 2010).

The CFA Institute understands that there is a conflict in the auditor being appointed and remunerated by the audited entity. They stress the importance of shareholders and wish to increase the role of shareholders in the appointment of the auditor. The CFA Institute supports the idea of a third party, such as a regulator, being responsible for appointment and remuneration of auditor in the case of systemically important financial institutions. As some financial institutions are too big to fail there is a systemic risk which the CFA Institute believes justifies a third party appointing the auditor instead of the entity itself (CFA Institute, 2010).

The CFA Institute does not support mandatory rotation of audit firms. Even though audit-client relationship raises concerns the costs associated with mandatory rotation does not exceed the benefits. The CFA Institute believes another option to strengthen auditor independence is to focus on audit standards and a prohibition of non-audit services (CFA Institute).

The CFA Institute supports the idea of a prohibition of non-audit services being offered by auditors’ to their audit client. They argue that it is difficult for an auditor to exercise professional skepticism while at the same time working for an extended business relationship with the client (CFA Institute, 2010).

4.7 Dutch Shareholders Association (VEB)

The Dutch Shareholders Association (VEB) consists of more than 45,000 members representing the interest of private and institutional investors in the Netherlands (VEB, 2012). The VEB have provided their reply in Dutch and translation into English is provided in appendix 1.1.

The Dutch Shareholders Association (VEB) does not support the idea of a third party, such as a regulator, being responsible for appointment and remuneration of the auditor. The VEB believes the auditor should be appointed at the annual general meeting of shareholders and for the audit committee to be empowered. The VEB believes the audit com-
committee should have a more important role in the appointment and remuneration of the auditor and the board of directors a decreased role (VEB, 2010).

The VEB supports mandatory rotation of audit firms. They believe the current practice where the key audit partners are rotated is not sufficient enough to secure auditor independence. The VEB would propose rotation of audit firms every 8 years (VEB, 2010).

The VEB supports a prohibition of non-audit services and the creation of pure-audit firms. They believe consultancy services should not be provided by an audit firm to its audit client as it may impair auditor independence. The prohibition of non-audit services should also apply to subsidiaries of the parent company, this way an auditor cannot provide non-audit services to the subsidiaries of the audit client (VEB, 2010).

4.8 Eumedion

Eumedion is a Dutch based corporate governance forum open for institutional investors in listed companies. They welcome the Green Paper and believe that the recent financial crisis has highlighted shortcomings in the audit profession. They believe that status quo is not an option as current regulations serve the interest of management boards and auditors rather than investors (Eumedion, 2010).

Eumedion believes there is an inherent conflict in the auditor being appointed and remunerated by the company itself. In the Netherlands an auditor is appointed by the General Meeting of Shareholders but even though it is usually the CFO who selects the auditor. However, Eumedion does not support the idea of a third party, such as a regulator, being responsible of appointing the auditor. They believe the role of shareholders and the audit committee should be increased in order to eliminate this conflict. They believe the Commission’s idea on a third party would create more bureaucracy and more independence issues and this is not preferable (Eumedion, 2010).

Eumedion recognize the issues that arise from long-term relationships between the auditor and the audit client. They believe more research should be done in the area of audit partner rotation, if research shows that audit partner rotation is inefficient then, and only then, should mandatory rotation of audit firms be considered. Eumedion has a negative standpoint to mandatory rotation of audit firms as a lot of audit knowledge and history will be lost, especially in the case of large and complex companies (Eumedion, 2010).
Eumedion believes that some non-audit services may have a negative effect on auditor independence but they do not support a total prohibition of non-audit services. Some non-audit services increases the knowledge of the auditor and consequently the quality of an audit while it does not impair auditor independence. Eumedion believes the current framework in the directive on statutory audit provides sufficient guidelines to safeguard auditor independence against the provision of non-audit services (Eumedion, 2010).

### 4.9 Hermes Equity Ownership Services

Hermes Equity Ownership Services (hereby referred to as Hermes) is one of the largest asset managers in London, England. Hermes provides consultations to clients worldwide including the BBC Pension Trust and The National Pension Reserve Fund of Ireland (Hermes Equity Ownership Services, 2010).

Hermes does not support the idea of a third party, such as a regulator, to be responsible for appointing the auditor. Hermes believes appointment of auditors is a fundamental right of shareholders. Introducing a third party would undermine the right of shareholders and Hermes therefore strongly opposes the idea of a third party responsible for appointment and remuneration of the auditor (Hermes Equity Ownership Services, 2010).

Hermes recognize the risks involved when the same auditors are in place for too long, creating an audit-client relationship which may have a negative impact on auditor independence. Mandatory rotation of audit firms would imply that shareholders are only able to appoint an auditor every sixth year. Even though, Hermes believe mandatory rotation of audit firms would increase audit quality and competition, so that the possible benefits would outweigh the costs. Therefore Hermes would welcome the Commission’s idea of mandatory rotation of audit firms (Hermes Equity Ownership Services, 2010).

Hermes does not support the idea of a total prohibition of non-audit services and the creation of pure-audit firms. They do however support a ban of some non-audit services. Hermes has been active in discussions surrounding non-audit services and believes better disclosure is an alternative approach. Through more and better disclosure of non-audit services shareholders will be able to raise concerns with the audit committee. Hermes recommends the Commission to adopt a similar approach to non-audit services as the Auditing Practice Board’s Ethical Standards, where some but not all non-audit services are banned (Hermes Equity Ownership Services, 2010).
4.10 International Corporate Governance Network

The International Corporate Governance Network (ICGN) is a global membership organization consisting of institutional and private investors. ICGN believes the current audit function serves the interest of auditors and management boards rather than the need of investors. According to ICGN the status quo is not an option and the current situation needs to be changed (International Corporate Governance Network, 2010).

ICGN does not support the idea of a third party deciding on the auditor’s appointment and remuneration. They do however recognize the conflict of an auditor being appointed and remunerated by the company. An alternative approach to eliminate this conflict would be to increase the role of the audit committee. ICGN believes the audit committee should be responsible for appointing and remunerating an auditor and that shareholders should have a last say at the annual general meeting of shareholders (International Corporate Governance Network, 2010).

ICGN acknowledge the risk of an auditor staying in place for too long but does not support the idea of mandatory rotation of audit firms. They believe mandatory rotation of audit firms will be unnecessary if an independent audit committee is responsible for appointment and remuneration of auditors’. They also believe in an increased involvement of shareholders and more transparency (International Corporate Governance Network, 2010).

ICGN does not support a total prohibition of non-audit services. They believe some non-audit services provide more knowledge about the business and thereby increasing the overall audit quality. However, ICGN believes those non-audit services which include a conflict of interest and which may have a negative impact on auditor independence should be prohibited. ICGN believes the current directive on statutory audit provides sufficient guidelines on non-audit services, they do however wish for these to be harmonized throughout the EU as investors invest internationally (International Corporate Governance Network, 2010).

4.11 Investment Management Association

The Investment Management Association (IMA) operates in the asset management industry; they provide consultations to fund managers, investment banks, life insurers and others (Investment Management Association, 2010).
IMA does not support the idea of a third party, such as regulator, deciding on the auditor’s appointment and remuneration. An alternative and more preferable approach would be to increase transparency and shareholder engagement. This approach could also increase rotation of audit firms and therefore mandatory rotation of audit firms would become unnecessary. IMA believes if increased transparency and shareholder engagement does not have the desired effect on rotation of audit firms, then and only then, should mandatory rotation of audit firms be considered (Investment Management Association, 2010).

IMA does not support a total prohibition of non-audit services. They do recognize that non-audit services may impair auditor independence but believes more transparency and prohibition of some non-audit services is a more suitable approach. IMA highlights the implementation of different standards around member states and wish for more consistency throughout the EU as investors invest internationally (Investment Management Association, 2010).

4.12 Irish Funds Industry Association
The Irish Funds Industry Association (IFIA) is a representative body representing fund managers, professional advisors, custodian banks/trustees and administration companies located in Ireland. The IFIA highlights the differences between investment funds and public-interest entities. Furthermore they point out that the ideas presented in the Green Paper take a broach approach and that such is not preferred. The ideas presented in the Green Paper would apply to all industries which according to the IFIA could result in additional costs with no benefits in certain industries. Therefore the IFIA recommends the Commission to rethink in terms of specific industries instead of applying rules to all industries (Irish Fund Industry Association, 2010).

The IFIA believes the existing audit framework is sufficient for the investment funds industry and does not support any further regulations to enhance auditor independence. The IFIA does not support mandatory rotation of audit firms, as the risk of frauds or errors are increased during the first few years of an audit engagement. In all, the IFIA acknowledge the importance of improving audit quality and learning from the crisis but does not support the ideas mentioned in the Green Paper to enhance auditor independence. The current regulations are seen to be sufficient for the investment funds industry and further regulations would not be beneficial. Instead the IFIA recommends the Commission to consider specific regulations for specific industries (Irish Fund Industry Association, 2010).
4.13 Local Authority Pension Fund Forum

The Local Authority Pension Fund Forum (LAPFF) is a voluntary association for authority pension funds based in the UK. As a result of the recent financial crisis members of the LAPFF have lost confidence in the audit function. Despite the serious weaknesses of UK and Irish Banks the auditors provided a clean audit report which in turn has led to members of the LAPFF losing their investments (LAPFF, 2010).

The LAPFF does not support the idea of a third party, such as a regulator, to decide on auditor’s appointment and remuneration; they believe this a fundamental right of shareholders. The LAPFF agrees that there is a conflict of interest in the auditor being appointed and remunerated by the company itself but believes this conflict is eliminated through good corporate governance (LAPFF, 2010).

The LAPFF supports the idea of mandatory rotation of audit firms and recommends a rotation after five years, audit engagement that are longer than ten years should be avoided according to the LAPFF (LAPFF, 2010).

The LAPFF also supports a ban of non-audit services from being offered to audit clients. They recognize the conflict of interests that arise from the provision of non-audit services and strongly advise their members to oppose auditors who receive more profit from non-audit services than from the audit services (LAPFF, 2010).

4.14 Proxinvest & ECGS

Proxinvest is a French proxy voting advisory company. Proxinvest provides its services to investors only, services such as voting recommendation and guidelines. ECGS, European Corporate Governance Service, is a joint venture of local market experts. They provide consultation services similar to Proxinvest (Proxinvest & ECGS, 2012). The reply was made in French, translation into English can be found in appendix 1.2.

Proxinvest and ECGS believe there is a conflict of interest in the auditor being appointed and remunerated by the audited company. They believe the auditor should be appointed by an independent audit committee and for the selection to be unanimous. In the case where the independent audit committee is not unanimous a third party such as the, Authority of financial markets, should be responsible for appointing the auditor. So Proxinvest and ECGS support the idea of a third party being responsible for appointing and remunerating the auditor (Proxinvest & ECGS, 2010).
Proxinvest and ECGS support mandatory rotation of audit firms and believe that an audit engagement should not last more than five years. They also believe non-audit services should be prohibited as the conflict of interest is too clear. Proxinvest and ECGS believe the prohibition of non-audit services is an essential measure to strengthen auditor independence and would want the prohibition to apply to all industries (Proxinvest & ECGS, 2010).

4.15 Railpen Investments

Railpen Investments manage the assets of the Railways Pension Trustee Company and works as a corporate trustee for several UK railway pension funds (Railpen Investments, 2010a).

Railpen Investments acknowledge that there might be a conflict of interest in the auditor being appointed and remunerated by the company itself. They do however not support the idea of a third party, such as a regulator, being responsible for appointment and remuneration of the auditor. In the UK shareholders have the power to approve or decline the appointment of an auditor at the annual general meeting. Shareholders are however not a part of the selection process and it is very rare that a proposal of an auditor has been declined by the shareholders. An alternative approach as explained by Railpen Investments to eliminate or at least reduce the conflict of interest is to increase the role of shareholders. The appointment of the auditor is a fundamental right of shareholders and Railpen Investments strongly oppose the idea of transferring this power to a third party. Railpen Investments recommends the Commission to make sure that shareholders have the last say in the appointment and remuneration of the auditor as this is not the case in all member states. Railpen Investments also stresses the importance of better disclosure; they suggest a minimum standard of disclosure so that shareholders can make well-informed decisions (Railpen Investments, 2010b).

Railpen Investments recognize that long audit engagements over decades may create an audit-client relationship which may impair auditor independence. They do however not support mandatory rotation of audit firms. Railpen Investments believe mandatory rotation of audit firms may harm audit quality as during the first few years of an audit engagement there is a higher risk of errors or frauds taking place. Similar to question 16 and 17 Railpen Investments stresses the importance of better disclosure, they believe an alternative approach to trigger rotation of audit engagements would be for the company to justify a long
audit tenure. An example would be for a company and their audit committee to explain why an audit engagement after around 10 years is extended. If shareholders do not find the explanation sufficient to justify an extended audit engagement then they have the right to demand rotation of the auditor (Railpen Investments, 2010b).

Railpen Investments opposes a total prohibition of non-audit services as they believe some services are closely related to the audit and provides knowledge of the business which in turn increases the overall audit quality. They do however recognize that some non-audit services have no natural connection to the audit and could potentially impair auditor independence, these should be discouraged or prohibited. Railpen Investments would however desire a clear distinction of non-audit services and audit services as well as more and better disclosure around non-audit services. Through better and clearer disclosure of non-audit services shareholders can make decisions on whether these are to be purchased or not (Railpen Investments, 2010b).

4.16 Standard Life Investments

Standard Life Investments (SLI) is one of Europe’s largest asset managers. SLI believes it is important for the Commission to consider audit policy in combination with good corporate governance when reviewing the replies made to the Green Paper (Standard Life Investments, 2010a).

SLI believes appointment and remuneration of the auditor is a fundamental right of shareholders, transferring this power would thereby undermine the relationship between auditors and shareholders. SLI accept that there is a conflict of interest in the auditor being appointed and remunerated by the company itself, however they do not support the idea of a third party being responsible for this task. SLI believes that appointment and remuneration of the auditor should be subject to the shareholders, however this is not the case in all member states and SLI would therefore recommend the Commission to make sure that shareholders have the last say in the approval of the auditor. SLI also believes better disclosure would eliminate or at least reduce the conflict of interest that may arise. Through better disclosure of the auditors’ and their relationship to the company shareholders will be able to make well-informed decision (Standard Life Investments, 2010b).

Standard Life Investments opposes mandatory rotation of audit firms as they believe it may harm the quality of the audit. The risk of a lower audit quality may increase as errors and frauds occur more frequently during the first few years of an audit engagement. There is al-
so the possibility of decreased audit quality due to behavioral factors as an auditor knows he will not be reappointed. Instead of mandatory rotation of audit firms SLI believes greater transparency regarding the company’s policy for tendering is a better approach. Furthermore SLI acknowledge the conflict of interest that may arise from long term audit engagement and recommends the Commission to present an independent audit regulator which exercises greater oversight of audit tenures. When audit-client relationships have lasted for around 20 years the company must provide an explanation to reassure that relationship does not harm audit quality. The independent audit regulator will have the final word, if not satisfied with the explanation then company may be forced to rotate audit firms (Standard Life Investments, 2010b).

Standard Life Investments does not support a prohibition of non-audit services, in their view this would not be in the best interest of the company or the shareholders. SLI would however welcome the Commission to introduce higher minimum standards of disclosure regarding non-audit services. For example more and better disclosure of the quantity and nature of non-audit services as well as the provision of those non-audit services (Standard Life Investments, 2010b).

### 4.17 Swedish Shareholders’ Association

The Swedish Shareholders’ Association or Sveriges Aktiesparares Riksförbund (SARF) is a national independent organization consisting of over 72,000 members. The organization works in the interest of private investors with the aim of defending the rights of minority shareholders (Swedish Shareholders Association, 2010).

The SARF opposes the idea of a third party being responsible for appointing and remunerating the auditor. The SARF argue that such a regulation would create more bureaucracy and undermine the right of shareholders as they believe appointment and remuneration is a fundamental right of shareholders. An introduction of a third party would also decrease the responsibilities of shareholders, an approach which is not preferable (Swedish Shareholders Association, 2010).

SARF strongly opposes mandatory rotation of audit firms as they believe it will increase costs and lower audit quality rather than increasing the quality. Furthermore the organization believes the current regulations regarding audit tenures are sufficient to secure auditor independence (Swedish Shareholders Association, 2010).
The SARF agrees that in theory non-audit services may impair auditor independence, but argue that in practice this is rarely the case. The opposite in fact, SARF believes non-audit services can generate advantages in form of knowledge of the business and thereby increasing the overall audit quality. Therefore the SARF opposes a total prohibition of non-audit services and in general the organization is very skeptical to the Commission’s approach to strengthen auditor independence (Swedish Shareholders Association, 2010).

4.18 The British Venture Capital Association

The British Venture Capital Association (BVCA) is the representative body for UK private equity and venture capital industry. With over 450 firms as members it represents the majority of UK-based private equity and venture capital firms and their advisors (BVCA, 2010).

In general the BVCA believes current practice is sufficient to secure auditor independence and that further implementation of regulations would only increase costs without adding any value. Therefore the BCVA opposes mandatory rotation of audit firms and introducing a third party being responsible for appointment and remuneration of the auditor. The BCVA opposes prohibition of non-audit services. They believe that current practice is sufficient to make sure that conflict of interest does not occur (BVCA, 2010).

4.19 The California Public Employees’ Retirement Systems

The California Public Employees’ Retirement System (CalPERS) is the largest public pension fund in the U.S. (CalPERS, 2010).

The CalPERS does not support the idea of a third party being responsible for appointment and remuneration of the auditor. They believe an auditor should be appointed by an independent audit committee and the shareholders. The CalPERS would however wish for audit committees to expand their consideration of auditors and provide more disclosure around the selection of auditor. The CalPERS highlights the importance of shareholders and wish for the selection of the auditor to be approved by shareholders annually (CalPERS, 2010).

The CalPERS does not support mandatory rotation of audit firms, instead they believe the audit committee should promote rotation of the auditor. The CalPERS has a similar view on question 19, they oppose a prohibition of non-audit services and wish for the audit committee to be empowered. They believe the audit committee should give explanations to
why certain non-audit services were purchased and why auditor independence is not compromised by these. To further reduce conflict of interest that may give rise the CalPERS would wish for the Audit Committee to annually approve non-audit services and disclose these (CalPERS, 2010).

4.20 Commission’s Proposal on Reform of the Audit Market

In 2010 the Commission presented the Green Paper on audit policy: Lessons from the crisis. According to the Commission the replies to the Green Paper have shown different views on the ideas presented, some with a negative standpoint and others in eager for change. The Commission presented its proposal on reform of the audit market in 2011, a package brought forth after reviewing the replies made to the Green Paper (European Commission, 2011c). In this section the proposal with respect to question 16, 17, 18 and 19 will be presented, the Commission’s motives for the proposed changes will also be explained.

4.20.1 Appointment and Remuneration

In the 2010 Green Paper the Commission presented their idea of a third party, such as a regulator, being responsible for appointment and remuneration of the auditor. In the 2011 proposal the Commission has chosen not to introduce this idea as a regulation. Instead the Commission aims to implement stricter rules regarding appointment of the auditor and to increase the role of audit committees (European Commission, 2011c).

The new proposal will require each public-interest entity to have an audit committee which should consist of at least two independent members and at least one member with competence in auditing. Furthermore the audit committee will have the responsibility to submit a recommendation consisting of at least two options for the audit engagement. The recommendation shall thereafter be discussed at the general meeting of shareholders. In the case of credit institutions or insurance the recommendation of the auditor must be submitted to the competent authority, the competent authority has the right to veto the choice of auditors’ mentioned in the recommendation (European Commission, 2011c).

4.20.2 Mandatory Rotation of Audit Firms

In the 2010 Green Paper the Commission asks whether engagement of audit firms should be limited in time. As explained in section 2.8.1 of this thesis the Commission has presented in the 2011 proposal, mandatory rotation of audit firms every sixth years with a possible
extension by two years if authorized by the supervisor. In the case of joint-audits the maximum engagement period is nine years with a possible extension of three years if authorized by the supervisor (Bury, 2011). The Commission promotes joint-audits and has therefore chosen to give joint-audit engagements a maximum length of nine years, three more years than a regular audit. Moreover, the Commission believes long term audit engagement creates an audit-client relationship which impairs auditor independence. Current regulations require key audit partner rotation but the Commission argues that this is not enough to secure auditor independence as main focus remains on client retention. The Commission also highlights the importance of mandatory rotation of audit firms and argues that it is an essential action for the whole package as other measures are not enough to strengthen auditor independence by themselves (European Commission, 2011d).

4.20.3 Prohibition of Non-Audit Services

In the 2010 Green Paper the Commission presented their idea of a total prohibition of non-audit services and the creation of pure-audit firms. As explained in section 2.8.2 in this thesis the Commission has chosen to propose this as a regulation. The Commission believes non-audit services being offered to audit clients involve obvious issues of potential conflicts of interest. A prohibition of non-audit services would therefore prevent potential conflict of interests and strengthen auditor independence. The Commission has also chosen to create pure-audit firms which will apply to larger audit firms, in essence the Big 4 accounting firms. The Commission has explained their motive around the creation of pure-audit firms, the majority of the audits of public-interest entities are made by large audit firms and it is therefore important for these not to become economically dependent on the client. Commercial interest in the client may arise from the provision of non-audit services (European Commission, 2011d).
5 Analysis

In the analysis part question 16 and 17 will be analyzed together while question 18 and 19 will be analyzed separately. The results presented in the empirical findings will be critically analyzed with the review of literature, chapter two. Finally an overall assessment of the questions will be made in order to answer my last research question, whether the Commission requires more independence than investors.

5.1 Analysis of Question 16 and 17

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?

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

In the Green Paper the Commission questions whether there is a conflict of interest in the auditor being appointed and remunerated by the company itself. Furthermore the Commission suggests a third party, such as a regulator, being responsible for appointment and remuneration of the auditor to eliminate the potential conflict of interest and secure an independent selection of the auditor.

The majority of the replies acknowledge and accept that there is an inherent conflict of interest in the auditor being appointed and remunerated by the audited entity, however only one respondent support the idea of transferring this power to a third party. 17 replies oppose the idea while one respondent supports the idea for systemic financial institutions only.

Many of the respondents which oppose the idea argue that appointment of the auditor is a fundamental right of shareholders and transferring this power to a third party would undermine shareholder rights. Some respondents also highlights the complexity of large companies, they note that a third party would not have the insight of a business controls and risks which must be considered when selecting the auditor. The company in the other hand has knowledge of these factors which makes them suitable to select the auditor which will add the most value, both in form of independence and special expertise thereby increasing the overall quality of the audit.

As stated, many of the respondents’ acknowledge that there is an inherent conflict of interest in the auditor being appointed and remunerated by the company itself. However they do not support the Commission’s idea to eliminate this conflict but instead provide alternative approaches to eliminate or at least reduce the potential conflict of interest. Many of the respondents have similar views on how to reduce the conflict of interest, through increased responsibilities of the audit committee and increased shareholder involvement.
In more detail, respondents’ would like to have an independent and robust audit committee being responsible for recommendation of at least two auditors. Many respondents also wish for better disclosure around auditor relationships to the company and an explanation to why the recommended auditors were nominated. Many also highlight the importance of shareholder involvement and for shareholders to have a last say. Before an auditor is appointed shareholders must approve the selection at the general meeting of shareholders. Together with better disclosure by the audit committee shareholders will be able to make well-informed decisions and raise concerns if they disagree with the audit committee. This selection process is already implemented in some member states however the respondents would wish for the Commission to harmonize standards and introduce the same appointment process in all member states.

Considering the many negative opinions to the idea of a third party makes it very interesting to see how the Commission has proceeded on the matter in the 2011 proposal, reform of the audit market. As presented in section 4.20.1 of this thesis the Commission has chosen not to introduce a third party being responsible for appointment and remuneration of the auditor. It is very clear that the Commission has taken the replies made by investors into consideration when proceeding with the 2011 proposal. As many investors believe appointment of the auditor is a fundamental right of shareholders and a transfer of that power would undermine the right of shareholders’ the Commission has chosen to drop the idea. Instead the Commission has taken a new approach to eliminate the conflict of interest in the auditor being appointed by the audited entity. The Commission seeks to implement stricter rules regarding appointment of the auditor and to increase the role of audit committees. The 2011 proposal will require audit committees to consist of at least two independent members and at least one with competence in auditing. The audit committee should provide a recommendation of at least two options for the audit engagement, thereafter a discussion and approval is held at the general meeting of shareholders. This new approach presented by the Commission is very similar to the approach recommended by many investors in their replies to the Green Paper. Instead of removing shareholder’s control over appointment of the auditor the Commission now seeks to increase their involvement.

In my view the Commission has considered the replies made by investors in a very good way. Implementing stricter rules regarding appointment of the auditor and to increase both shareholder and audit committee involvement will secure an independent selection process.
A third party would secure an independent selection of the auditor but it would be very possible for the third party to appoint an auditor who does not possess the necessary knowledge for the audit engagement and the overall audit quality would be harmed. As investors are just as concerned with auditor independence as the third party would be they will most likely be very cautious with the appointment of the auditor, making sure that he/she is independent. Simultaneously investors will also be able to select an auditor who possesses the necessary skills required for their specific business. According to me this approach is more preferable, the success of the approach does however rely highly on better disclosure from the audit committee and for shareholders to make use of their power and raise concerns when needed.

5.2 Analysis of Question 18

Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?

The Commission is concerned with situations where a company has appointed the same audit firm for decades, they argue that long-term audit engagement impairs auditor independence as the familiarity threat may occur. In the Green Paper the Commission questions whether audit engagements therefore should be limited in time. Current regulations require rotation of key audit partners but the Commission would like to receive opinions on rotation of audit firms and not just the auditor.

To this question the majority of the respondents studied oppose mandatory rotation of audit firms. 15 replies have a negative standpoint while only 4 respondents support mandatory rotation of audit firms. Those few who support mandatory rotation of audit firms argue that long-term audit engagements may impair auditor independence and current regulations are not sufficient to eliminate the familiarity threat that may occur. They also believe mandatory rotation of audit firms will increase audit quality and competition.

Those respondents who oppose mandatory rotation of audit firms argue that imposing such a regulation will only harm audit quality and that costs associated will not exceed the benefits. They argue that an auditor goes through a learning curve which may last up to two years. During this learning curve the auditor becomes familiar with the controls and risks of a business and the possibility of errors or frauds to occur during this time is higher. As an auditor may not have the knowledge of company’s unique processes he/she stands a higher chance of missing out on significant faults. These beliefs have been confirmed by
Jackson, et al. (2008) in their study, where they argue that during the first few years of an audit engagement there is a higher possibility of errors or frauds to occur as it takes time for the auditor to become familiar with the client’s operations. Some of the respondents who oppose mandatory rotation of audit firms argue that current regulations are sufficient to safeguard auditor independence. Others recognize the risks involved in long-term audit engagements and believe these must be eliminated or reduced to an acceptable level. Those who recognize the risks associated with long-term audit engagements does not support the Commission’s idea on mandatory rotation of audit firms, instead they suggest an alternative approach. Many would like the role of the audit committee to be empowered, they argue that the audit committee should have the responsibility to annually review auditor performance and when found necessary rotate. Furthermore, for long-term audit engagements which have lasted up to 20 years the audit committee must provide an explanation to why the engagement should be extended. If shareholders do not find that the explanation justifies an extension of the audit engagement than they will be able to raise concerns.

In the 2011 proposal: reform of the audit market the Commission has proposed mandatory rotation of audit firms every sixth year with a possible extension in the case of joint-audits as described in section 2.8.1 of this thesis. Even though many of the replies made by investors oppose mandatory rotation of audit firms the Commission has chosen to proceed on the matter. The Commission argues that mandatory rotation of audit firms is the essential action for the whole proposal as other measures taken are not enough to strengthen auditor independence without rotation of audit firms. The Commission is very eager for change as the status quo where audit firms tend to stay with the same clients for decades creates familiarity threats against auditor independence. Furthermore the Commission argues that key audit partner rotation is not enough to secure auditor independence as the main focus remains on client retention. The Commission’s arguments to impose mandatory rotation of audit firms are similar to the studies made by Arel, et al. (2005) and Jennings, et al. (2006). They argue that long-term audit engagements create an audit-client relationship where the auditor may develop both personal and economical interest. The audit-client relationship increases the risk of an auditor to overlook essential faults in the organization.

It is indeed interesting to see how the Commission has proceeded on the matter of mandatory rotation of audit firms. In my opinion the costs associated with mandatory rotation of audit firms does not outweigh the benefits, even though auditor independence may be strengthened the overall quality of the audit will be harmed as argued by both investors and
Jackson, et al. (2008). However status quo should not be an option, long-term audit engagements may create familiarity threats and impair auditor independence as argued by the Commission, Arel, et al. (2005) and Jennings, et al. (2006). Another, and more efficient, approach as highlighted by investors would be to strengthen the role of the audit committee. Through more and better disclosure of audit tenures shareholders and other stakeholders will be able to raise concerns. To force rotation of audit firms every sixth year would most likely result in more errors or frauds and this should not be preferred. Instead I believe the Commission should seek to motivate for rotation rather than to force it. An empowered audit committee and increased shareholder involvement will make sure that auditor independence is intact.

5.3 Analysis of Question 19

Should the provision of non-audit services by audit firms be prohibited? Should any such prohibition be applied to all firms and their clients or should this be the case for certain types of institutions, such as systematical financial institutions?

At the moment there is no EU-wide regulation prohibiting non-audit services from being offered to audit clients. Current regulations regarding non-audit services differ across member states within the EU. In the Green Paper the Commission therefore seeks to reinforce the prohibition of non-audit services by implementing stricter rules and possibly creating pure-audit firms.

The majority of the respondents oppose a total prohibition of non-audit services and the creation of pure-audit firms; only four respondents actually support the idea. Three of the respondents supporting a total prohibition of non-audit services also support mandatory rotation of audit firms. Those who support a total prohibition of non-audit services and the creation of pure audit firms argue that non-audit services create conflict of interest which may impair auditor independence. Furthermore they state that the provision from non-audit services creates commercial interest which makes it difficult for an auditor to remain independent and exercise professional skepticism. Moore, et al. (2006) and Svanström (2008) argue that audit firms becomes economically dependent from high consulting fees, this creates a commercial interest for the auditor which increases the risk of the auditor acting in a biased manor.

The majority of the respondents oppose a total prohibition of non-audit services and the creation of pure-audit firms. They argue that some non-audit services increases the knowledge of the auditor which increases the overall quality of the audit. These conclu-
sions have been confirmed by Firth (2002). His study shows that a high degree of non-audit services increases the understanding of the client’s operations which consequently increases the overall audit quality. Most of the respondents do however recognize the risks associated with non-audit services and would therefore wish for some but not all non-audit services to be banned. Some respondents refer to the Sarbanes-Oxley Act where nine non-audit services are prohibited and believes these are enough to eliminate the conflict of interest.

Most investors would like the Commission to increase the responsibilities of the audit committee. As stated to previous questions many investors believe in an empowered audit committee and increased shareholder involvement. They argue that the audit committee should be responsible for which non-audit services that are purchased and better disclosure around these. The audit committee should provide explanations of why non-audit services are purchased and why they do not impair auditor independence. Furthermore the fees for non-audit services must be disclosed and many argue that the fees of non-audit services should not be higher than the fees paid for the audit services as this may create a commercial interest for the auditor.

In the 2011 proposal the Commission has chosen to proceed as intended in the Green Paper. As explained in section 2.8.2 of this thesis the Commission has proposed a total prohibition of non-audit services from being offered to audit clients. The Commission has also provided a clear distinction of what characterizes non-audit services. Services which normally entail a conflict of interest will be categorized as non-audit services. The Commission has also proposed the creation of pure-audit firms for “large audit firms”. There is a numerical threshold on what defines a large audit firm and in essence it implies the Big 4 accounting firms.

The Commission has indeed proposed stricter rules regarding non-audit services, much stricter than desired by most investors studied in this thesis. The Commission argues that the provision of non-audit services creates obvious conflict of interest and prohibiting these will ensure high quality audits. The Commission intends to prohibit non-audit services that creates self-review, a close relationship to management or a commercial interest. As argued by both Moore, et al. (2006) and Svanström (2008) non-audit services may create a commercial interest which impairs auditor independence. Furthermore Carrington (2010) argue that even though an auditor’s knowledge may be increased from non-audit services
and consequently lead to an increase in the overall audit quality this will be useless if the auditor is not independent.

Similar to mandatory rotation of audit firms the Commission has chosen not to pay close attention to the replies made by investors. Even though many recognize the conflict of interest that may arise from the provision of non-audit services they do not support a total prohibition of these. Instead they suggest a ban of some but not all non-audit services together with increased responsibilities of the audit committee.

I believe the Commission has failed to consider the negative impacts of a total prohibition of non-audit services. Firth (2002) argues a high degree of non-audit services reduces the independence of an auditor while it increases the understanding of a client’s operations. A total prohibition of non-audit services would strengthen auditor independence but it would also decrease the overall quality of the audit, this should not be preferred. Instead the Commission must consider an alternative approach, one which strengthens auditor independence while audit quality is not harmed.

5.4 Final Discussion

In the above sections of the analysis investors viewpoints to the questions studied have been summarized and presented. Furthermore investors’ arguments expressed to strengthen their beliefs and the Commission’s motives for the proposed changes have been presented and analyzed. In this final section an overall assessment will be made to answer my final research question, whether the Commission requires more independence than investors.

Regarding mandatory rotation of audit firms and prohibition of non-audit services the majority of the investors do not support these regulations. Even though most investors opposed these regulations the Commission has chosen to proceed with these in the 2011 proposal: reform of the audit market.

So based on investors’ negative viewpoints to the proposed reforms can one say that the Commission requires more independence than investors? Not necessarily, I believe investors require independence just as much as the Commission.

The recent financial crisis highlighted shortcomings in the audit function and despite the serious weaknesses companies were given a clean bill of health by their auditors. Many investors have indeed lost confidence in the audit profession. Current regulations serve the
interest of auditors and management boards rather than the interest of investors. As expressed by both the Commission and many investors this must change, status quo is not an option. The measures proposed to change the audit profession are however not shared by most investors. Mandatory rotation of audit firms and prohibition of non-audit services are very strict proposals which would imply a major reform of the audit market. Many investors fear this approach may harm audit quality rather than increasing it and therefore the majority of the investors do not support these regulations. Instead investors would prefer an empowered audit committee with more responsibility as well as increased shareholder involvement.

Considering the strict proposals on reform of the audit market it is easy to believe that the Commission requires more independence than investors, but I beg to differ. Shareholders are the primary stakeholder and the most common user of financial reports (Mallin, 2010). As users of financial reports shareholders are concerned with the legitimacy of financial reports and consequently the legitimacy of audits. As independence is the criterion which adds legitimacy to an audit, shareholders automatically becomes concerned with auditor independence. Moreover both the Commission and investors believes status quo is not an option and that auditor independence must be strengthened. So, both investors and the Commission require a higher degree of auditor independence, what separate their views is how to strengthen auditor independence.

So which approach is to be preferred, imposing stricter rules as proposed by the Commission or good corporate governance as preferred by many investors?

The audit profession exists as users, most commonly investors, demand an independent external opinion on firms’ financial reports (Moore, et al., 2006). As shareholders are the primary stakeholder and the most common user of financial reports (Mallin, 2010) they consequently become concerned with the overall audit quality, both in form of independence and special expertise of the auditor. Therefore it is important to consider the impact of stricter regulations on the overall audit quality. Mandatory rotation of audit firms and a total prohibition of non-audit services may very well strengthen auditor independence as argued by Arel, et al. (2005), Jennings, et al. (2006), Moore, et al. (2006) and Svanström (2008). However it may also harm audit quality as argued by Jackson, et al. (2008) and Firth (2002). So, the proposed reforms will most likely strengthen auditor independence but harm the overall audit quality, this is an approach which should not be preferred. An alter-
native solution, which will strengthen auditor independence without harming the overall audit quality, is to increase shareholder involvement and good corporate governance. The success of this approach does however rely heavily on more and better disclosure so that shareholders can make well-informed decisions. Furthermore it will be crucial for shareholders to make use of their power; shareholders can no longer be inactive and blame others for corporate collapses. They must become more involved and more accountable.


6 Conclusion

Chapter 6 will conclude this study by summarizing the output from the analysis. Research questions will be answered and recommendations for further research will be presented.

- What views do investors have on the proposals mentioned in the Green Paper to enhance auditor independence?
- What standpoints are expressed by investors to strengthen their opinions?

The Commission’s view regarding appointment of the auditor is similar to the view of the investors studied in this thesis. The majority of the investors and the Commission recognize that there is a conflict of interest in the auditor being appointed and remunerated by the company itself. However neither investors nor the Commission believes in a third party being responsible for this task. Instead increased shareholder involvement and an empowered audit committee is a more preferable approach shared by both investors and the Commission.

Regarding mandatory rotation of audit firms, the majority of the respondents’ oppose the proposal. Many investors argue that it takes time for an auditor to become familiar with a client’s operations; the auditor goes through a learning curve. During this learning curve, which may last up to two years, there is a higher possibility of the auditor missing out on significant faults in the organization. Many investors oppose mandatory rotation of audit firms as they fear it will harm the overall audit quality. The Commission, in the 2011 proposal, has proposed mandatory rotation of audit firms every sixth year; they argue that long-term audit engagements create an audit-client relationship which impairs auditor independence.

The majority of the respondents’ oppose a total prohibition of non-audit services and the creation of pure-audit firms. Many argue that non-audit services increases the knowledge of the auditor and consequently the overall audit quality, prohibiting non-audit services would therefore harm audit quality. Many of the respondents’ do however recognize the risks associated with non-audit services and would wish for some but not all non-audit services to be banned. In the 2011 proposal the Commission has proposed a total prohibition of non-audit services and the creation of pure-audit firms for large audit firms. The Commission argues that the provision of non-audit services creates a commercial interest which impairs auditor independence.
- Does the European Commission, as indicted by the 2011 proposal, require more independence than investors as indicted by the responses to the Green Paper?

In all, the respondents’ are negative to the ideas presented in the Green Paper but that does not imply that the Commission requires more independence than investors. Investors are concerned with auditor independence and many of the respondents’ argue that status quo is not an option and that auditor independence must be strengthened. Both the Commission and investors require a higher degree of independence what separate their views is however how to strengthen auditor independence.

6.1 Further Research

The proposal brought forth by the Commission is currently being processed by different institutions. The expected decision time is said to be around 3-5 years. It would be very interesting to study the outcome of their proposal, especially if passed in its current form.

Furthermore if the proposed reforms are passed into law it would be very interesting to examine the result of those reforms, that is, whether auditor independence has been strengthened and whether audit quality has been improved.
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Appendix 1 – Translations

Two of the replies are written in a language other than English. The replies are written in French and Dutch. These have not been eliminated from the study but translated by individuals with a first language in the respective language. The translation for each reply is illustrated below.

Appendix 1.1 Dutch Shareholders Association (VEB)

Reply in Dutch:

“(16) Is er sprake van een conflict als de auditor wordt aangesteld en beloond door de gecontroleerde entiteit? Wat voor alternatieve regelingen zou u in dit verband aanbevelen?

De VEB staat het volgende voor. De accountant dient te worden benoemd door de aandeelhoudersvergadering. Dit zou kunnen op voordracht van de auditcommittee. In deze context lijkt het logisch dat de vennootschap de rekening van de accountant ook betaalt. Door de auditcommittee naar voren te schuiven en de raad van bestuur meer op de achtergrond te houden kan een bepaalde distantie gecreëerd worden. De auditcommittee moet de accountant betalen op basis van de uren die de accountant aan zijn controlewerkzaamheden heeft verricht. De raad van bestuur dient hier geen invloed op te hebben. De raad van bestuur mag de accountant ook niet voor andere diensten inhuren.

(17) Zou aanstelling door een derde partij bepaalde gevallen gerechtvaardigd zijn?

Het is moeilijk voor te stellen welke derde partij een accountant zou kunnen aanstellen, het huidige speelveld overziend. Zoals gezegd is de VEB geen voorstander van een door de Staat benoemde accountant. De AMF heeft als toezichthouder een eigen rol ten aanzien van de vennootschap en de accountant en valt daarmee ook af.

(18) Moeten doorlopende opdrachten aan audiktantoren aan een tijdslimiet worden onderworpen? Zo ja, wat zou dan de maximale duur van een opdracht aan een audiktantoor moeten zijn?

In het algemeen is het goed om een accountant niet constant op hetzelfde dossier te laten opereren. De accountant raakt hierdoor niet afhankelijk van een opdrachtgever en werkt ook met andere bedrijven, wat zijn ervaring ten goede zal komen. Het zou goed zijn een
accountant om de acht jaar (vier jaar plus maximal vier jaar herbenoeming) te vervangen door een accountant van een ander kantoor met andere uitvoerende werknemers.

De VEB is voorstander van wisseling van kantoor, want als enkel de controlerend accountant wisselt en de opdracht dus bij het accountantskantoor blijft, hoeft in de samenstelling van het controleteam niets te veranderen. Dat lijkt voorhands niet juist.

De VEB kiest voor een periode van acht jaar – omdat op grond van de Nederlandse Corporate Governance Code ook voor commissarissen een benoemingsperiode van vier jaar geldt, waarbij de mogelijkheid bestaat deze met vier jaar te verlengen. Een verlenging met nog eens vier jaar voor de accountant lijkt hiermee in overeenstemming te zijn. Op die manier kan een accountant acht jaar een vennootschap bedienen en dient daarna het dossier te worden overgedragen aan een andere accountant van een ander kantoor met een ander team.

(19) Moet de levering van net-auditdiensten door auditkantoren worden verboden? Moet een dergelijk verboden gelden boor alle kantoren en hun cliënten of moet het alleen worden toegepast op bepaalde soorten instellingen, zoals systeemrelevante financiële instellingen?

De VEB is een voorstander van audit-only firms. Niet-auditdiensten als consultancy met betrekking tot jaarrekeninggerelateerde zaken, fiscal of juridisch advies dient niet plaats te vinden door controlerende accountants. Zie ook de algemene inleiding. In principe dienen alle beursgenoteerde vennootschappen volgens de VEB door een dergelijk audit only kantoor gecontroleerd te worden. Dit houdt in dat dochtermaatschappijen geen advies mogen krijgen van de auditfirma die de moeder controleert.

De VEB kan zich voorstellen dat voor het MKB minder stringente eisen in worden genomen, maar doet daar verder in dit kader geen uitspraken over.” (VEB, 2010).

Reply translated into English:

(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 VEB presents the following. The auditor should be assigned by the annual general meeting of shareholders. This could happen on recitation of the audit committee. In this context it seems logical that the company also pays for the bill of the auditor. By putting
the audit committee more on the foreground and the board of directors on the background, a certain distance can be created. The audit committee should pay the auditor based on his hours that he or she has worked. The board of directors should not have any influence in this. The board of directors shouldn’t hire the auditor for any other services either. The VEB isn’t proponent of an auditor appointed by a third party.

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

It is difficult to imagine which third party could appoint an auditor, seeing the current situation. As said before, the VEB is not in favor of an auditor appointed by a third party. The AFM has its own role as a supervisor in respect of the company and the auditor and is this also reduced.

(18) Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?

In general it’s good not to let an auditor operate on the same file constantly. The auditor then wouldn’t be reliant on a constituent, and would work with different companies, what would be beneficial to his experience. It would be good to substitute an auditor every 8 years (4 years maximum, plus another extension of 4 years) for another audit firm.

The VEB is a proponent of changing offices, because if only the controlling auditor changes, and the objective stays with the audit firm, then nothing changes in the composition of the control team. That does not seem right.

The VEB chooses for a period of 8 years – based on grounds of the Dutch Corporate Governance Code, in which for commissars’ a period of 4 years is set which is possible to extend for another 4 years. An extension with another 4 years for an auditor seems in accordace with this. That way, an auditor can serve a company for 8 years, after which the engagement should be handed to a another audit firm.

(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?
The VEB is a proponent of audit-only firms. Non-audit firms such as consultancy in relation to year balance related business, fiscal or law advice should not be practiced by controlling auditors. See also the general introduction. In principle, the opinion of the VEB is that all the stock-based companies should be controlled by an audit-only office. This also means that subsidiaries should not receive advice from the audit firm who reviews the parent company. The VEB understands that for the MKB less harsh demands are made, but doesn’t want to comment on that in this setting.

**Appendix 1.2 Proxinvest & ECGS**

**Reply in French:**

"(16) Y a-t-il conflit lorsque l'auditeur est désigné et rémunéré par l'entité auditée? Quelles autres solutions conseillerez-vous dans ce contexte?

Oui, il y a conflit lorsque l'auditeur est désigné et rémunéré par l'entité auditée. Nous pensons que la direction de la société ne doit plus choisir le commissaire aux comptes : celui-ci doit être au moins sélectionné par un comité d'audit indépendant, à l'unanimité des administrateurs indépendants, le conseil s'obligeant à respecter cette proposition. Sinon, en l'absence d'unanimité des administrateurs indépendants, le ou les commissaires devraient être nommé par l'Autorité des marchés financiers sur une liste de tour de rôle.

(17) Une désignation par un tiers serait-elle justifiée dans certains cas?

Oui

(18) Le recours répété à une société d'audit donnée devrait-il être limité dans le temps? Si oui, quelle serait la durée maximale pendant laquelle la même société d'audit pourra être désignée?

Oui Pas plus de Cinq ans

(19) La fourniture de services autres que d'audit par des sociétés d'audit devrait-elle être interdite?
Oui, c'est une mesure essentielle, le conflit d'intérêts est par trop évident.
Une telle interdiction devrait-elle s'appliquer à toutes les sociétés et leurs clients ou uniquement à certains types d'entités, comme les établissements financiers d'une importance systémique?
Cette interdiction devrait s'appliquer à toutes les sociétés et leurs clients.” (Proxinvest & ECGS, 2010)

Reply translated into English :

(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?

Yes, there is a conflict. We believe that the board of the audited company should not choose its legal auditors anymore. The latter should be at least selected by an independent audit committee (unanimously chosen by the independent administrators). The board needs also to be committed to accept the decision.
In case independent administrators are not unanimous, the legal auditor(s) should be named by the Authority of financial markets following a rolling list.

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

Yes

(18) Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?

Yes. Not more than 5 years.

(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?

Yes indeed. That is an essential measure. The conflict of interest is too clear. Such an interdiction should apply to all kind of companies and their clients, or to a certain
type of entities only (such as financial organizations with a systemic importance)? This interdiction should apply to all kind of companies and their clients.