Malta's contribution to the public consultation on the Green Paper on Audit Policy: Lessons from the Crisis (COM(2010) 561)

Introduction

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

Malta supports the Commission's work to enhance financial stability and to avoid a recurrance of the recent financial crisis, and accordingly welcomes the debate raised by the questions posed by the Green Paper. It is understood that the debate is aimed primarily at the audit of Public Interest Entities (PIEs).

2. Do you believe that there is a need to better set out the societal role of the audit with regard to the veracity of financial statements?

This is particularly important in Malta. Malta believes that the auditing profession acquitted itself well, both in audits conducted before the crisis, as well as in the course of audits carried out subsequently in very difficult circumstances. Yet the statutory audit, and the financial reports to which it is tied, were proven inadequate to give an early warning of the extent of financial risk within the market (and were not alone in this shortcoming). Malta believes that reforms should be targeted primarily at addressing this weakness.

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

Maintaining audit quality is a constant endeavour, and Malta would welcome any steps that sustain it. Having said this, as stated above, Malta believes that the lessons emerging from the crisis are not tied primarily to audit quality but to the scope of a statutory audit.

Role of the Auditor

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

Malta would, in principle, be in favour of extending the audit remit in the direction indicated in the question. It would help address the key concern regarding statutory audit that in Malta's view emerged from this crisis – the relatively limited mandate of the statutory audit. However, Malta is of the opinion that there are serious practical issues that will need to be dealt with in the process.

This topic was discussed in the UK House of Commons Report entitled 'Banking Crisis: reforming corporate governance and pay in the City'[1] which is also referred to in the Green Paper. Malta notes that in its evidence before the committee, the UK Financial Reporting Council warned that any proposals to extend the purpose and intended audience of statutory audit would need to consider the competence of auditors to perform the new requirements; the costs involved; the exposure of auditors and others to liability risk; the need for legislation; and international considerations such as UK competitiveness. Bearing these factors in mind, the former Financial Reporting Council Chief Executive, Paul Boyle, argued strongly against extending the remit of audit to incorporate assurance regarding risk management. He doubted that auditors were well-placed to do such work, or even competent to do so.

Malta also shares these concerns. Other entities such as regulators, credit rating agencies and financial analysts fulfil the role of assessing the financial health of companies, and audits complement the work of such entities by providing comfort on the reliability of the underlying numbers.

Any proposal to extend an auditor's remit will, therefore, need to carefully consider the related practical implications, not least on auditors' training and experience requirements. Malta recognises the specialist expertise already available within the larger firms, but as a regulatory body it would be obliged to consider the preparedness of the profession as a whole.

With regard to the specific suggestion on providing comfort on the financial health of companies in terms of an overall assessment, Malta is uncertain as to what sort of audit report would be considered here. The typical form of brief 'pass or fail' audit opinion would not be suitable, as it may come across as providing assurance against the risk of corporate failure, which clearly no audit can provide. A more suitable form of report would be akin to those issued by rating agencies, but roles will then be duplicated.

The objective of expanding the audit mandate should nevertheless be pursued. The audit process could in the first instance be expanded to give more comfort around the client's business model, perhaps by subjecting to audit those parts of an annual report that are not part of the financial statements but that are nevertheless of vital importance to stakeholders. At the same time, the corporate reporting responsibilities of PIEs should be expanded to include data that permits stakeholders a better opportunity of assessing the financial health of companies – a more comprehensive analysis of risk perhaps, a discussion on going concern and more disclosures on loss provisioning. In such cases, the audit process should and could be expanded to include such additional reports.

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

Malta supports the initiatives in this direction, both with regard to the internal communications with the board and the audit committee, and also with regard of external communications with shareholders.

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[1] Published on 15 May 2009.

Malta believes that bridging the expectations gap is also assisted by the adoption of international standards such as the International Standards on Auditing (ISAs). It is pertinent to note that Malta adopted the ISAs in its national law in 1995, and, therefore, would welcome the implementation of these standards across the EU.

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

Malta believes that the application of ISAs across the EU, supported by external oversight and inspection, would serve to reinforce professional scepticism. The need for professional scepticism is clearly brought out in ISAs, and this requirement is again emphasised in the recently completed clarity project that emphasises the importance of scepticism in key areas pertinent to management judgements and representations.

Malta is also of the opinion that the external oversight system can also be used to reinforce professional scepticism, and to help overcome any cultural barriers that may be impede it, through focusing the review processes on the more judgmental aspects of an audit – provisions, impairment, valuations and so forth.

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

One of the difficulties encountered in the course of the financial crisis was that a qualified audit report could have rapidly led to the insolvency of a bank Given these circumstances, Malta understands the motivation for the suggestion that audit reporting should avoid the 'pass' vs' fail' absolute conclusions that exist today.

On the other hand, the present approach incentivises management to do all that is possible to avoid an audit qualification, and this is positive. The end result is also simple for investors to understand, clearly flagging issues of concern.

Malta believes that this suggestion needs to be explored further, and possible solutions tested, before firm conclusions could be drawn.

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

Malta would welcome any initiatives that would enhance the understanding that external stakeholders could form of the audit process, and of the interaction between the external auditors, the audit committee and the board.

One suggestion would be the provision of a report by the audit committee on its activities during the year and, *inter alia*, on the scope of its discussions with the external auditors. It should be possible, without an undue loss of commercial confidentiality, which would be counter productive, to place on record the topics that received particular emphasis during an audit and which warranted discussion between the external auditors and the audit committee. A disclosure of this nature would focus the attention both of the auditor as well as of the audit committee on the topics that shareholders and analysts would expect to see addressed, and might make the dialogue between them more meaningful.

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

Malta believes that there is an adequate and regular dialogue between the external auditors and the audit committee, and where relevant also with a company's internal auditors in Malta.

The dialogue between the external auditors and the audit committee is particularly important and, although the topic is not regulated, the communications encountered are typically quite formal. Malta would welcome the introduction of a formal report from the external auditor to the audit committee, effectively formalising what is already best practice, although Malta would also encourage flexibility in respect of its form.

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

Malta believes that this will happen as a matter of course as Corporate Social Responsibility (CSR) reporting assumes more importance, with corresponding expectations of an independent attestation thereof.

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

Malta believes that audit reporting should remain tied to the financial statements being reported upon and, therefore, to the public reporting deadlines of their clients, which are already tightly regulated. Shorter reporting timeframes may represent a threat to quality.

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

Malta looks forward to hearing what suggestions are made in reponse to this question Specific measures to be applied to the audit of PIEs could include:

- Enhanced dialogue with regulators.
- More meaningful analysis of risk, a discussion on going concern and more disclosures on loss provisioning, to be covered by the audit process (kindly vide Malta's reply to question 4 above). In Malta's view one of the disappointing aspects of the crisis was that risks were being widely underestimated and that the risk reporting provisions in IFRS, and their manner of implementation, generally failed to alert stakeholders to this.
- More disclosure of the dialogue between auditors and the audit committee (kindly vide Malta's reply to question 8 above).

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

Malta already mandates the use of ISAs and, therefore, would welcome their use within all EU Member States. There should be a common definition of what constitutes a statutory audit across all EU territories.

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

ISAs are already in widespread use across many EU countries. The audit firm networks – and not just the Big 4 Firms – have adopted their use on a global basis. Malta would encourage the mandatory application of ISAs across the EU, and not necessarily only for PIE's. Malta believes that there is a sufficiently wide acceptance of the value of ISAs (and International Standards on Quality Control (ISQCs)) to dispense with the need for a standard by standard endorsement process such as that adopted for International Financial Reporting Standards (IFRS).

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

Malta believes that ISAs are capable of being applied to the audit of Small and Medium-sized Enterprises (SMEs). Malta notes that the International Auditing and Assurance Standards Board (IAASB) has provided guidance in this regard but perhaps more needs to be done. Malta needs to ensure that practitioners dealing with small entities are given sufficient flexibility to adapt ISA standard procedures to the needs of their engagements, therefore, ensuring a focus on the substance of the audit rather than on form.

Governance and Independence of Audit Firms

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?*

Malta strongly supports the principle that auditors should be appointed by the shareholders, supported by the recommendations of active audit committees that are independent of management.

The key requirement in Malta's view is independence from management. In this regard there is an aligned interest in the robustness and independence of the audit process that is shared by non-executive directors, who carry significant personal responsibilities, and by shareholders, whose investment is at stake.

Malta would support measures that strengthen the relationship between the audit committee and shareholders. Malta has already suggested an audit committee report to shareholders on, inter alia, the scope of its discussions with the external auditors. A further enhancement could be the appointment of a shareholders' committee at periodic intervals, say every five years, to review the audit appointment and the terms thereof. This would strengthen the role of shareholders in the selection, appointment and remuneration of auditors.

In all this process, the role of the audit committee is of fundamental importance.

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

Malta understands the spirit in which this and certain other suggestions have been made, and recognises the relevance of having this debate. Malta's view would be contrary to the appointment of an auditor by a third party. Such a move would, in Malta's opinion, lead to a fundamental shift in the nature of an audit, and Malta does not perceive a need for this or a resultant benefit.

A change of this nature would in the first place remove from shareholders a choice that properly appertains to them. It would instead concentrate the audit appointments of PIEs or of certain institutions of systemic proportions in the hands of regulators who will in consequence wield a very significant commercial power and influence over the auditing profession. As the regulatory body responsible for oversight over the accountancy profession in Malta, this concentration of influence is not regarded as a healthy development.

Malta would have concerns on the effectiveness of audit appointments in such a system. The appointment of a group auditor requires a number of judgements which may occasionally be subjective – on the industry experience of the auditor, on how well its geographical coverage is aligned with that of the group, on how its audit approach fits with the risk management culture of the group, and on the individual qualities of the proposed team. In Malta's experience, public procurement processes tend to shy away from subjective judgments in favour of straightforward criteria such as cost. This would not be conducive to higher quality audits.

Such a system would also lead to a transformation in the nature of auditing towards what the Green Paper describes as statutory inspection, effectively a regulatory role. Regulators have an essential role to play, one that gives them the power to influence the behaviour of the entities they regulate, and which by necessity often results in a high degree of formality in their relationship. Their task is made easier through the opinion on regulatory returns that is usually requested from the statutory auditors.

The statutory auditors, however, enjoy an easier relationship with their clients, one that is not characterised by the higher powers enjoyed by regulators, and this is typically conducive to more openness and trust. It is a relationship that requires professionalism and the maintenance of audit scepticism, together with dialogue, balance and judgment. Malta believes that if the audit process is transformed into one of statutory inspection, the relationship between external auditors and their clients may well be undermined, and this will make the audit mandate much more difficult to fulfill.

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?*

Malta notes that the Green Paper states that:

> (…) the Commission would like to reinforce the independence of auditors and address the conflicts of interest which are inherent to the current landscape characterised by features such as the appointment and remuneration of the auditors by the audited firm, low levels of audit firm rotation or the provision of non audit services by audit firms.

Malta also notes that the EU has recently terminated an intensive debate on auditing, culminating in the enactment of the Statutory Audit Directive[2]. The discussion process leading to this directive was one held in the backdrop of material corporate failures, such as Enron Corporation and Parmalat SpA, which were characterised by a failure in their respective audit processes and not by a financial crisis. The debate was an extensive one that, *inter alia*:

- Rejected the concept of limiting the term of an audit appointment, and the complementary concept of mandatory audit firm rotation, opting instead for introducing mandatory partner rotation. In the course of this debate, references were made to studies that have over the years demonstrated that audit failures were more commonly encountered in the early years of an audit appointment than subsequently, and that mandatory firm rotation was potentially a threat to audit quality.
- Introduced new rules, based on a principles based (threats and safeguards) approach, that properly defined when and how non-audit services were to be permitted (the debate on Article 22 of the Directive).

The Directive has been implemented across the EU only recently, and experience is still now being gained on important processes such as mandatory external inspections of audit firms. Other issues, such as mutual recognition of third party inspection processes and exchange of information, are only now being resolved. The practical impacts of the Directive have yet to be studied and assessed, and we would in principle not advocate change at this stage in the absence of a clear need for this.

Malta must at the same time consider the anxieties caused by the financial crisis, that need to be addressed – Malta's comment in favour of continuity at this stage must not be construed as questionning the need for the fresh debate generated by the Green Paper.

One needs to consider carefully, therefore, whether the recent crisis necessitates such a change. This has not been a crisis characterised by audit failures, or by lack of auditor independence. Malta has had no cases of audit failures connected to the crisis and Malta is not aware of a major swathe of claims against auditors within the EU. If one looks at the UK, one of the countries most severely impacted by the banking crisis, it is again pertinent to quote the House of Commons Treasury Committee on the banking crisis which, when commenting upon the performance of auditors stated

> We have received very little evidence that auditors failed to fulfil their duties as currently stipulated.

The Committee then rightly focused on whether the audit as currently defined is good enough, and in Malta's opinion this is the key question that emerges from the recent crisis in so far as external auditing is concerned.

It is also pertinent to ask whether there have been any other developments or studies, since the Statutory Audit Directive, that would warrant a change in approach. Perhaps of most significance is the decision taken in the United States (US), following the Sarbanes–Oxley Act

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

of 2002[3], to again reject the notion of mandatory firm rotation; and the study conducted by Bocconi University (Milan, Italy), which once more illustrated the higher risk of audit failure that follows a change of auditor.

The last point to be considered, as suggested in the Green Paper, is whether mandatory rotation could serve as a means to reduce the market dominance of the Big 4 Firms. Experience would however suggest the opposite happening – smaller firms often continue auditing clients that have grown and acquired listed company status, but once such clients move to a larger firm they rarely change back. This was demonstrated in the Bocconi University study, which confirmed that the Italian listed company audit market, where rotation has long been mandatory, is one of the most concentrated in Europe. A similar point was also made recently in the UK by Jeremy Newman, Chief Executive, BDO International:

> I don't think audit rotation dynamises the market but it has the opposite effect as research shows once the auditors and clients enter the Big Four arena they just rotate within it (International Accounting Bulletin, pages 476-477, October 2010)

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?

Kindy vide Malta's reply to question 18 above. Malta believes that the reforms introduced within the Statutory Audit Directive, along the principles of a threats and safeguards approach, and reinforced by public oversight and inspection, adequately addressed the related independence concerns. In Malta's view, the recent crisis has not demonstrated any renewed concerns on auditor independence that would warrant a change.

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

Yes, in the interests of financial independence. This is already provided for in Malta's legislation.

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

Malta believes that the financial statements of audit firms should be regulated in the same manner as other entities, consistent with the legal form of their incorporation.

Further information, going beyond the above, is published annually in terms of the Statutory Audit Directive (the annual transparency report). Audit firms also provide further financial information in the course of the oversight inspections, which would seek to ascertain, inter alia, whether a firm is operating under financial contraints that may undermine its independence. Compliance with mandatory insurance rules is also confirmed. With regard to Malta's circumstances, any further needs are not perceived.

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[3] Also known as the 'Public Company Accounting Reform and Investor Protection Act' (in the Senate) and 'Corporate and Auditing Accountability and Responsibility Act' (in the House).

Malta does not object to the requirement for more transparency at the level of the financial statements of a global network, but is uncertain on what the objectives would be. These financial statements would in most cases by an aggregation, not a consolidation, of member firms that are legally and financially autonomous. There would presumably be no global resources that could be pooled to meet the costs of a catastrophe claim, but rather the resources of those member firms whose work is implicated in the claim. Malta would rather see a pan-EU regulator that can discourse with the large firms to better understand the risk of an audit firm failing.

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

Malta believes that the public oversight and inspection that has been introduced into the profession, coupled with the requirements of standards such as ISQC 1 (compliance already mandatory in Malta), should suffice. Malta expects firms to maintain, and to be able to demonstrate, the procedures maintained to safeguard independence. At this moment, Malta has no further suggestions to make.

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

Providing independence issues can be dealt with satisfactorily and, therefore, Malta suggests that this issue is explored further.

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

There are difficult data protection and privacy issues which need to be addressed if one goes further than Article 27 of the Statutory Audit Directive. Malta supports any initiative that facilitates the work of the auditor in terms of ISA 600.

Supervision

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

Malta does not wish to express its views on this topic.

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

Malta strongly welcomes changes that would provide for a regular dialogue between auditors and regulators, particularly in the area of financial services. Regular tripartite (with the client participating) and bipartite meetings would enable both the auditor and the regulator to share observations and to discuss areas of potential concern, and this would benefit the work of both parties.

Concentration and Market Structure

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

Malta believes that the use of the word 'systemic' in relation to audit firms is perhaps not suitable. The impact of a collapse of one the Big 4 Firms is not likely to have economic repercussions similar to, or even approaching, those arising from the failure of a large systemic financial institution. Malta has moreover seen that the networks have in more recent years been quite successful in dealing with individual member firm failures, such as, in Italy and Japan, without disrupting the network as a whole. A more extreme event, such as the collapse of an entire audit firm network, would have a more disruptive impact on the audit market.

Malta acknowledges that this topic has been the subject of considerable debate in recent years, also from a competition and conflicts of interest perspective mainly in respect of non-audit services (such as, in the context of supporting a large market transaction). Nevertheless Malta doubts if situations of this nature can be solved through regulatory intervention and thus suggests they would be best left to market forces. A collapse of any one of the Big 4 Firm is possibly more likely to lead to a major realignment of the market, with more work being spread amongst the mid-tier firms, than can be attained through regulatory change.

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

Malta is uncertain of the value of this suggestion. Joint audits increase cost, and produce a higher audit risk. In recent years, Malta noticed the risks posed by group audits and the advantage of having one audit network audit all major elements of a group. Therefore, Malta fears that the joint audit proposal contradicts this trend, in the pursuit of a doubtful objective.

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

Malta does not support mandatory rotation. Kindy vide Malta's reply to question 18 above.

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

Malta has a small market that until fairly recently was overwhelmingly characterised by local clients. Big 4 Firms dominated the market largely as the more successful local firms were successful in attaining the representation of their respective networks and not the other way around. In more recent years, as inwards investment had increased, all the profession has grown but the larger firms have obviously benefited from brand recognition.

Local public oversight inspections are currently in their third annual cycle and have covered all audit firms of any import that operate in Malta. In these inspections, the local Big 4 Firms have scored well in terms of quality.

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

Malta has no experience of how such instruments could be applied in the case of an audit firm, and looks forward to seeing the outcome of this debate.

32. *Is the broader rationale for consolidation of large audit firms over the past two decades (i.e. global offer, synergies) still valid? In which circumstances, could a reversal be envisaged?*

This question is not an issue in the Maltese context. Looking at the wider market, the Green Paper notes the increased size and complexity of the global clients today faced by auditors. It would appear that the profession has emulated the consolidation exhibited by its client base. Any reversal of this trend, eg., the break-up of a large firm, would, in Malta’s opinion, appear to create an increased independence threat, in that all the clients of the resultant component firms would have doubled in terms of the significance of the fees generated by any one client. It could also result in audit network weaknesses, such as, in geographical representation, in a dispersal and duplication of Research and Development (R&D) expenditure, with little corresponding benefit.

Creation of a European Market

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

Malta welcomes initiatives that enhance cross border mobility of audit professionals. However Malta believes that it is too early to draw conclusions as to whether the reforms made in Articles 3 and 14 of the Statutory Audit Directive are having the desired effects, and more time is needed given the relatively recent implementation of the Directive. Malta needs to bear in mind as well that many network firms are established across EU territories and that staff are frequently transferred within such firms, below partner level, without requiring registration in the host country. In Malta there is substantial mobility of audit professionals to and from other EU territories.

34. *Do you agree with "maximum harmonisation" combined with a single European passport for auditors and audit firms? Do you believe this should also apply for smaller firms?*

Malta believes that harmonisation of professional rules should be kept to a level consistent with the Statutory Audit Directive, with individual member states being free to impose additional rules that may be consistent with local culture. Malta is also of the opinion that aptitude tests on Malta’s company law and tax should be retained for local registration.

Simplification: Small and Medium Sized Enterprises and Practioners

35. *Would you favour a lower level of service than an audit, a so called "limited audit" or "statutory review" for the financial statements of SMEs instead of a statutory audit? Should*

such a service be conditional depending on whether a suitably qualified (internal or external) accountant prepared the accounts?

Malta believes that decisions regarding the introduction, if at all, of the audit thresholds, and in the case of the levels thereof, should be taken exclusively at individual member state level, in order to properly take account of local market conditions.

Malta currently mandates audits on all companies except for micro enterprises, and are in the course of extending the mandatory audit to registered partnerships. Malta believes that while the audit is an added cost imposed on SMEs, it greatly enhances the value of financial statements and attains other social / economic benefits (such as, added comfort on tax compliance that serves to reduce tax enforcement costs generally).

Nevertheless, in principle, Malta supports the development of a global review product that gives an adequate degree of assurance comfort, and are following closely the work of the IAASB in this direction. Any such product must be clearly differentiated from the statutory audit. Care must be taken not to dilute the meaning of the word 'audit' and not create confusion in the market place.

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

Malta considers all the ideas discussed in this paper as possibilities that could be applied in the audit of PIEs. However Malta does not consider the discussion as relevant to the audits of other entities.

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

Malta prefers the public oversight and inspection processes to remain in place if the 'limited audit' will have a statutory role.

International Co-opearation

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

Malta supports the measures which would enhance mutual reliance between audit oversight authorities in different jurisdictions.