

# Cost outweighs benefit

A European survey has found implementations of individual EC proposals on the audit market lack beneficiary effects and could cause an additional expectations gap to emerge. German university professors **Annette Köhler, Klaus Ruhnke** and **Martin Schmidt** talk through their findings

In October 2010, the European Commission published its *Green Paper Audit Policy: Lessons from the Crisis*, which opened a debate on various audit issues, such as the role of the auditor, the governance and the independence of audit firms and the configuration of the audit market.

The measures proposed are not new, but rather have been discussed for several years from both practitioner and academic perspectives.

However, previous empirical research findings evaluating the measures proposed in the Green Paper appear to have been largely ignored by the Commission. Furthermore, the implementation of individual measures may not only lack net beneficiary effects, but may also facilitate the emergence of an additional expectation gap.

The ongoing discussion of potential consequences of some of the measures proposed takes place in an audit market that is characterised by significant fee-cutting and the predominance of the Big Four audit firms.

Not surprisingly, the practitioners' – the supply side – arguments are often presented with a view to potential shifts in market shares. The representatives of the demand side – in Germany the supervisory boards/audit committees – have hardly participated in the discussion so far.

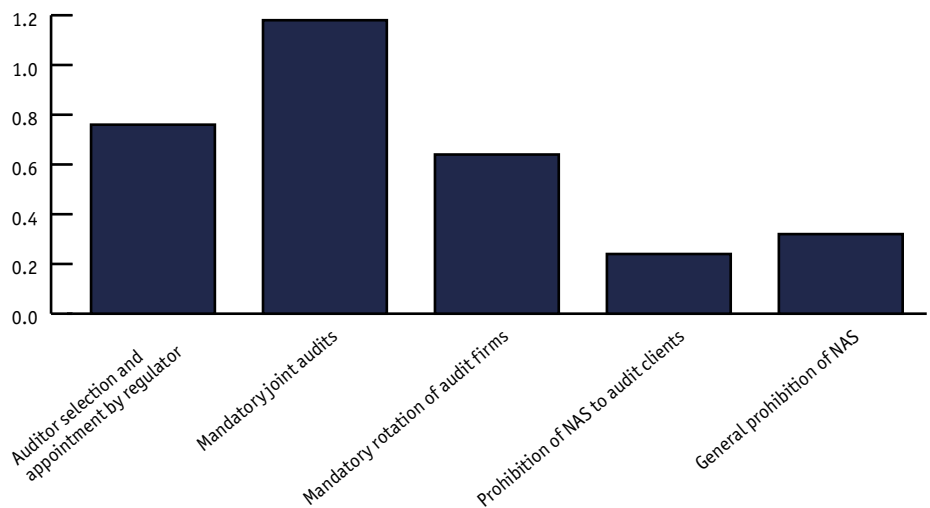
In this context, the purpose of our study, *Statutory Audit – Quo Vadis?*, is to assess the expected consequences of some of the measures proposed in the Green Paper from the perspective of supervisory board and audit committee members in Germany, who are responsible for the engagement of statutory auditors.

In January 2011, our survey of supervisory boards and audit committee board members in Germany was conducted. The Green Paper proposals we surveyed included:

- the prohibition of the provision of any non-audit services (NAS) by audit firms, which would lead to so-called “audit-only” firms;
- the prohibition of the provision of NAS by audit firms to audit clients;
- mandatory rotation of audit firms;

■ SURVEY

Evaluation of the potential impact of Green Paper measures on audit fees



Notes: -2 = strong decrease; 0 = no impact; +2 = strong increase. Sources: University of Duisburg-Essen; Freie Universität Berlin; European University Viadrina Frankfurt (Oder)

- mandatory joint audits; and
- the selection and appointment of auditors by an independent regulator.

A comprehensive evaluation of the proposed measures requires an assessment of their expected costs, other negative effects and not just of their benefits.

As a result, the survey covered the following effects: Change in auditor experience with the respective client; change in auditor's professional competence; change in audit fees; change in auditor reputation; change in auditor independence and scepticism; and reduction in the complexity and the degree of estimation uncertainties in the financial statements to be audited.

The following findings are based on 153 responses (response rate 14%).

### Audit fees of minor importance

The first question related to the relevance of the potential audit characteristics mentioned above for the supervisory board/audit committee member and, in addition, the relevance of financial reporting charac-

teristics that may also have an impact on the perceived benefit of an audit.

The results show (*See graph: Relevance of selected beneficial audit characteristics*), that auditor independence and scepticism, professional competence and client-specific experience are considered extremely relevant, whereas audit fees are of minor importance.

The participants' evaluation of the potential impact of Green Paper measures on auditor-specific beneficial audit characteristics show that an increase in auditor independence is generally expected to be, partly, offset by a decrease in auditor client-specific experience and general competence.

Since any analysis should not be biased by considering only the potential positive effects of the proposed measures, the survey covered not only the positive, but also any associated negative effects of the proposed measures.

For example, potential higher costs also need to be considered, rather than only the potential benefits. As such, the survey also



covered expected audit fee consequences. All measures were assumed by respondents to cause an increase in audit fees and the largest increase was associated with mandatory joint audits (See graph on p6: Evaluation of the potential impact of Green Paper measures on audit fees).

**Cost outweighs benefit**

From an overall perspective and considering all relevant costs and their associated benefits, the supervisory board/audit committee members' expectations indicate that none of the measures proposed by the Commission in the Green Paper would result in the expected incremental benefits substantially exceeding the expected incremental costs and in fact, with one exception, the net benefits are negative (See graph: Overall cost/benefit evaluation of the Green Paper measures).

The net benefits are lowest for auditor selection and appointment by an independent regulator as well as mandatory joint audits. However, the findings vary with the affiliation of the survey participants.

For supervisory board/audit committee members of listed entities, the expected net benefits of the measures proposed is significantly lower than for such members of non-listed entities.

Prior to any regulatory initiative, the European legislator is required to take into account the impact on all relevant stakeholders by conducting a detailed impact assessment. We question whether such an impact assessment as required has been undertaken.

So far, it is unclear how the arguments and the structure and scope of the questions in the Green Paper contribute to a consistent and convincing basis for a balanced consideration of the net benefits of the measures proposed and their related distribution effects.

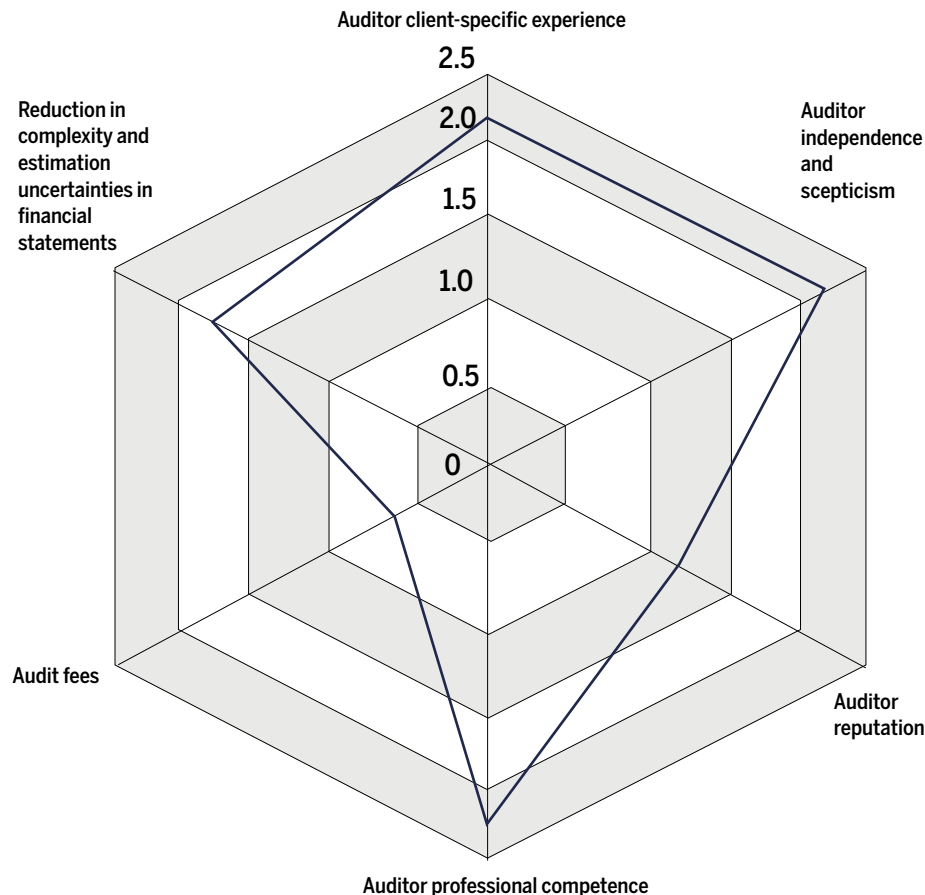
From the perspective of German supervisory board/audit committee members, who consider all relevant stakeholder interests when they take their decisions concerning the selection and engagement of the statutory auditor, no significant overall net benefits are expected from the noted measures proposed by the Commission in the Green Paper.

Moreover, with one exception, these members explicitly expect negative net benefits.

Consequently, based on the results of this study, there does not appear to be any empirical support for any of the measures proposed by the Commission in the Green Paper. ■

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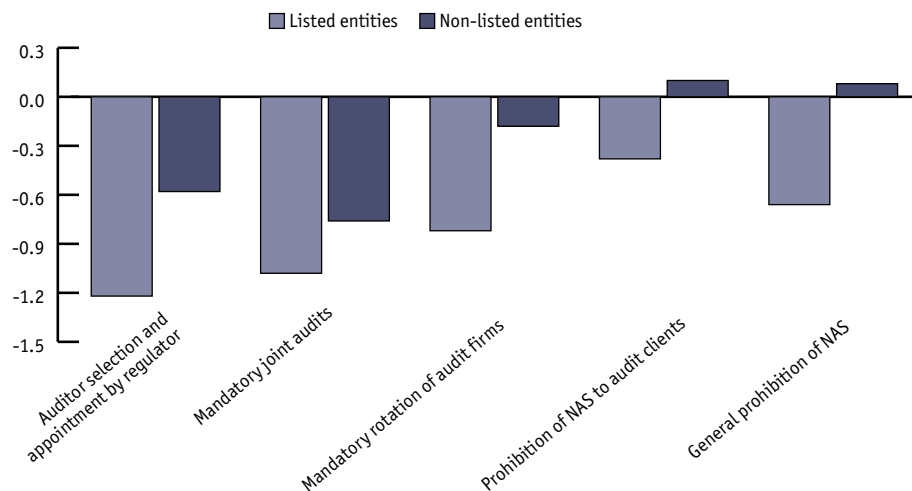
Relevance of selected beneficial audit characteristics\*



\* 0 = not relevant; 3 = extremely relevant. Sources: University of Duisburg-Essen; Freie Universität Berlin; European University Viadrina Frankfurt (Oder)

■ SURVEY

Overall cost/benefit of the Green Paper measures



Notes: -2 = incremental benefits substantially smaller than incremental costs; 0 = incremental benefits equal incremental costs; +2 = incremental benefits substantially larger than incremental costs.

Sources: University of Duisburg-Essen; Freie Universität Berlin; European University Viadrina Frankfurt (Oder)