

## **Statutory audits of public accounts and of public-interest entities**

Appraisal by the EP Impact Assessment Unit of the Commission proposals for a Directive amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and for a Regulation on specific requirements regarding statutory audit of public-interest entities.

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This appraisal was undertaken at the request of the European Parliament's Committee on Legal Affairs and has been produced by the Impact Assessment Unit of the Directorate for Impact Assessment and European Added Value, within the Directorate General for Internal Policies (DG IPOL) of the General Secretariat of the European Parliament.

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## Executive Summary

This note seeks to provide a detailed analysis of the strengths and weaknesses of the European Commission's Impact Assessment (IA) accompanying the proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, and the proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities (PIEs). It does not attempt to deal with the substance of the proposal, but rather analyses whether the impact assessment provided by the Commission will help the JURI Committee's consideration of the proposal, in full knowledge of the facts, and whether the impact assessment meets, firstly, the standards which the Commission has laid down in its internal Impact Assessment Guidelines, and, secondly, the quality criteria which the Parliament has defined in its resolutions on the subject.

The first part of this note addresses the Commission's analysis of some existing problems in the field of audit, identified as in need of EU intervention. Although the Commission logically presents a number of problem areas in sufficient detail, the underlying drivers for the proposed policy change in the audit market seem to be less clearly evidenced. In particular, the causal link between an alleged general problem of deficiencies in audit quality in the EU and the worldwide financial crisis is not clearly demonstrated. Moreover, the Commission states that the competition on the market for audit services (especially audit of public-interest entities) is distorted as a result of the existence of a high level of market concentration. However, the existence of high market shares not being problematic per se, one might reasonably have expected the Commission, as the EU competition authority, to have provided a more thorough analysis of the market for audit services and to have made a more closely substantiated case for a possible distortion of the competition. Only when such problems are properly analysed is one able to assess whether the proposed actions could be reasonably expected to deal with the identified problem adequately.

The IA contains a very clear and well-structured presentation of objectives and policy options. It summarises which policy options are preferred by the Commission and how these measures would interact. However, for certain preferred policy options, there seems to be a proportionality problem. In particular, in the case of the proposed mandatory rotation for auditors and the proposed separation between audit and non-audit services to PIEs, the IA presents as preferred options those whose positive impacts are contested by a majority of stakeholders. Since neither the costs of these proposals, nor their expected benefits are fully quantified, the Commission does not seem to provide sufficient evidence that the preferred options are necessarily the most beneficial for the concerned market. Less radical alternative options have not been explored in the same detail. Moreover, the Commission does not seem to pay enough attention to unintended effects of its options.

In this note, some further methodological remarks are made, for instance on the use of market date from individual Member States.

## Introduction

This note seeks to provide a detailed analysis of the strengths and weaknesses of the European Commission's Impact Assessment (IA) accompanying two legislative proposals:

- the proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, COM(2011)778 *final*. This proposal contains policy options that are connected with the approval and registration of statutory auditors and audit firms, and policy measures connected with the audit of SMEs.
- the proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities, COM(2011)779 *final*. This proposal contains policy options connected with the audit of public-interest entities, including the ancillary rules on supervision of compliance with the obligations.

It has been prepared by the Impact Assessment Unit (of Directorate G, DG Internal Policies) within the Parliament's general-secretariat, at the request of the Parliament's Legal Affairs Committee (JURI). This note - which does not attempt to deal with the substance of the proposal - is drafted for informational purposes, to assist the JURI Committee in its work, and does not represent an official position of the Parliament.

This note analyses whether the Commission's impact assessment will help the JURI Committee's consideration of the proposal, in full knowledge of the facts, and whether the impact assessment meets, firstly, the standards which the Commission has laid down in its internal Impact Assessment Guidelines, and, secondly, the quality criteria which the Parliament has defined in its resolutions (EP Impact Assessment Handbook, point 13).

\* \* \*

In October 2010, the European Commission launched a public debate on audit, with the publication of its Green Paper on "Audit Policy: Lessons from the Crisis"<sup>1</sup>, seeking comments from stakeholders on a number of policy options relating to statutory audits.

In a Resolution of 13 September 2011, the European Parliament broadly welcomed the Commission's Green Paper, stipulating that the independence of an auditor is of paramount importance and that steps need to be taken to prevent excessive familiarity, and urging the Commission to ensure greater transparency and competition in the audit market. At the same time, the Parliament expressed the need for "a wide-ranging and in-depth impact assessment", in order to assess the consequences of any proposed policy interventions in European audit markets. This IA "should cover a range of options, in

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<sup>1</sup> COM(2010)561*final*

particular on external rotation and the impact of voluntary joint audits". The IA should also focus in particular "on the viability and effects of a cap on non-audit services in relation to revenue". The Parliament also called on the Commission to analyse the added value generated by both the proposed regulation and the progressive harmonization of auditing standards and practices in the single market.<sup>2</sup>

The European Economic and Social Committee adopted an opinion on the Green Paper on 16 June 2011, in which it stated that "whatever policy the Commission is minded to adopt, [it] urges that a rigorous impact assessment is conducted before arriving at any decision".<sup>3</sup>

Following the stakeholder consultation on the Green Paper, DG MARKT of the European Commission prepared an IA, the stated aim of which was to "analyse the prevailing problems in the audit market and the potential impacts of a package of intended measures, aiming at reconsidering the role of auditors, the quality and scope of the services they provide to the market as well as the overall status of the audit profession in the society".<sup>4</sup>

The Commission's Impact Assessment Board provided an opinion on 15 July 2011, causing DG MARKT to revise partially its draft impact assessment to take into account the recommendations of the IA Board, namely:

- to analyse better the existing experience in some Member States, e.g. in relation to mandatory rotation in Italy or joint audits in France;
- to analyse each individual option not only in isolation, but also in relation to all other measures in the proposed policy package;
- to provide a more comprehensive analysis of the costs and benefits both for the individual options and the aggregate package;
- to discuss more extensively stakeholders' views, both in favour and against the IA's preferred options;

This note analyses whether the Commission's IA provides or identifies:

1. a clear definition of the problem or the drivers behind the proposed legislation;
2. objectives directly related to solving the identified problems;
3. an adequate choice of strategic scenarios and policy options ;
4. a proper justification of the preferred options in the light of the principles of subsidiarity and proportionality;
5. a balanced analysis of the economic, social and environmental impacts, and of other impacts where relevant (e.g. SME test, competitiveness, impact outside the EU, impact in terms of administrative burdens);

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<sup>2</sup> P7\_TA(2011)0359, in particular points 4, 6, 26, 54.

<sup>3</sup> Opinion of the EESC on the Green Paper: Audit policy: lessons from the crisis, 16 June 2011, point 1.1.2.

<sup>4</sup> Impact Assessment, p. 6.

6. an adequate presentation of stakeholders' views, both in favour and against the preferred policy options.

## 1. Policy context and problem definition

A good definition of the problem and a clear understanding of what causes it are preconditions for setting objectives and identifying options to address the problem; it is important to establish the 'drivers' - or causes - behind the problem and to identify clearly any assumptions made, risks and uncertainties involved.

The problem definition must include a clear baseline scenario, i.e. a description of how a problem is likely to develop in the future without new EU action.

*(European Commission IA Guidelines, point 5)*

The Commission's IA does identify clearly five issues ("problematic areas") in need of EU action and makes a comprehensive presentation of them:

- (1) an expectation gap related to the role of the auditor;
- (2) risks of conflicts of interest leading to impaired independence of auditors;
- (3) barriers to entry into the market of listed and large companies;
- (4) additional compliance costs due to fragmented national regulation;
- (5) lack of effective national and EU-wide supervision over audit firms.

However, the Commission, in its description of the background to these proposals, seems to indicate that the main drivers for considering policy interventions in the audit market are, on the one hand, a rather general deficiency in audit quality, which has contributed to the worldwide financial crisis and, on the other hand, a distortion of competition in the audit market (especially for PIEs), as a consequence of heavy concentrations.

### 1.1. Quality of audit and the financial crisis

In order to demonstrate that there is problem with impaired audit quality, the Commission's IA refers to three recent audit inspection reports, drafted in Germany, the Netherlands and the UK. It also mentions ongoing investigations regarding the audits of banks. From these reports, it becomes apparent that, in a (too high) number of cases, and not only in the financial sector, there were found to be deficiencies in audit quality and that auditors should exercise greater professional scepticism<sup>5</sup>. However, it is doubtful whether, on their own, these few inspection reports provide sufficient solid and clear evidence of a systemic and serious problem with audit quality in the EU.<sup>6</sup> The provision of a broader range of evidence would be helpful here.

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<sup>5</sup> Impact Assessment, p. 11.

<sup>6</sup> See also EP Resolution 13 September 2011, para 2 : « Welcomes the fundamental issue raised in the Green Paper, namely that of how auditing could be improved, even though in the past there has been

Furthermore, the IA is at least partly based on the assumption that there is a direct connection between deficiencies in the performance of the audit sector and the general financial crisis. This becomes particularly clear in Annex 20 to the IA, which deals with the summary estimates of the costs and benefits of the preferred policy options. The Commission goes as far as to suggest that the estimated costs of the proposal, quantified for only a limited number of policy choices, could be offset against general losses incurred as a result of the financial crisis (e.g. measures to support banks amounted to 4.59 trillion euro for the period from October 2008 to October 2010).<sup>7</sup>

In its Resolution of 13 September 2011, the European Parliament agrees with the Commission that, in principle, a well-functioning auditing profession would be, alongside proper supervision and corporate governance, an important contributor to financial stability. Moreover, it is clear that robust audit is an important factor in re-establishing trust and market confidence. However, a general causal link between (alleged lack of) audit quality and the failure of banks appears to be less than fully established or properly analysed in the Commission's text.

## **1.2. Distortion of competition on the market for audits, in particular of PIEs**

The second underlying driver for the Commission's policy changes is the proposition that the highly concentrated market for audits leads to a distortion of competition, to an increased risk of moral hazard for firms 'too big to fail' and, ultimately, to higher prices. Annex 7 to the IA deals with the level of market concentration. The market share of the "Big Four" audit firms (Deloitte & Touche, Ernst & Young, PricewaterhouseCoopers and KPMG) as regards the audits of large, listed companies, exceeds 85% for the majority of Member States.

However, the levels of concentration on the market are not necessarily problematic *per se*. The Commission does not substantiate with clear and exhaustive findings the issues leading to a distortion of the functioning of the internal audit market. It seems that there is no empirical evidence that the high level of concentration has led to impaired quality, higher audit prices or in general that the current market structure is unhealthy.

The IA does not clearly demonstrate that the level of concentration in the audit market is problematic *per se*. The Commission presents the Big Four audit firms' market share in different member states<sup>8</sup>, as well as in the EU, G8, G20, US and China<sup>9</sup>, but it does not analyse the level of competition between the Big Four.

At the same time, in other sections, the IA recognises that high concentration of the audit market does not automatically represent a problem (see examples below):

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no serious evidence to suggest that auditing has not been carried out in accordance with the relevant rules and requirements. »

<sup>7</sup> Impact Assessment, Annex 20 (Summary estimates of costs and benefits), p. 242.

<sup>8</sup> Impact Assessment, Annex 7 (Market Concentration), p. 128

<sup>9</sup> Impact Assessment, Annex 7 (Market Concentration), p. 130

- "High concentration per se, does not result in an infringement of EU antitrust rules".<sup>10</sup>
- "The consolidation also allows big audit firms to take advantage of economies of scale, expand industry-specific knowledge and technical expertise, and potentially increase the capital base in order to spread risk".<sup>11</sup>

Without questioning the merit of the policy analysis, even if we assume that high concentration is problematic, we could argue that a holistic approach would be appropriate to create an enabling environment that attracts new entrants and enable smaller scale firms to grow (e.g. investment in technology at a reasonable cost affordable by smaller firms, creation of networks to share expertise, measures to increase professional capacities in mid-tier firms, etc). However, these reflections do not seem to feature in the IA.

In one reference, the IA provides details of the relation between market concentration and increase of audit fees: "2010 data from the UK market shows that the average profit margins in Big Four audit firms were 50% higher than the next four audit firms".<sup>12</sup> In this specific case, the IA does not say if similar data are applicable to the EU market overall (e.g. if this is the working assumption), however, it appears that general conclusions are drawn from limited data from a single Member State. The ESCP report commissioned by the Commission however, concluded that the EU audit market is heterogeneous with diverse market characteristics: "One of the main observations for this study is how diverse the national markets are. Differences between Member states exist on several issues...".<sup>13</sup>

Finally, in this section, the IA does not provide details that allow the reader to understand why the Commission has considered it appropriate to compare certain data or why comparable data do not lead to the same conclusions (see examples below):

- Barriers to competition: In comparison with legal services, the audit market appears more concentrated. The IA does not provide any element to explain why the legal services market would be a reasonable comparator.<sup>14</sup>
- The position of Big Four audit firms in China is significantly weaker<sup>15</sup>: they audited only 14% of the listed companies considered. Their position in India, Russia and some other G20 countries is not as strong as in western economies. The IA does not explain what are the peculiarities of the different markets mentioned above that might explain such a difference.

In analysing the existing barriers to entry in the audit market of listed companies, the ESCP report for the European Commission mentioned that these main "barriers are in

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<sup>10</sup> Impact Assessment, p. 20, footnote 75.

<sup>11</sup> Impact Assessment, p. 126.

<sup>12</sup> Impact Assessment, p. 21.

<sup>13</sup> ESCP Europe Study, p.5.

<sup>14</sup> Impact Assessment, Annex 7 (Market Concentration), p. 127.

<sup>15</sup> Impact Assessment, Annex 7 (Market Concentration), p. 130.

particular lack of size or insufficient capacity in terms of number of auditors in mid-tier audit firms, limited geographical reach of mid-tier audit firms, a strong preference among large companies to choose Big Four audit firms because of their reputation, resistance among companies and the absence of incentives to change the audit firm".<sup>16</sup> The increasing demand in the audit market for sector expertise and the impact of technology on the audit process have also become challenges faced by mid-tier audit firms. Mid-tier firms realise they need to increase their professional capacities but are faced with increasing costs and risks related to listed company audits.

## INTERIM CONCLUSION

Generally speaking, the analysis of the different problematic areas in need of EU intervention is quite rich in details and presented logically. However, the underlying drivers - the financial crisis and distorted competition on the audit market - are not sufficiently clearly demonstrated nor adequately underpinned by evidence. Furthermore, the causal link with the identified problems is not sufficiently clearly presented.

Especially for the connection between a possibly problematic impairment of audit quality in the EU and the financial crisis, one could imagine that a clear causal link would be hard to conclusively demonstrate. In this case, the Commission should perhaps openly acknowledge and explain the lack of available evidence.

For the "distortion of competition" argument, the Commission, as the EU competition authority, could be expected to explore and explain more convincingly and systematically how the current situation distorts competition of EU audit market. The far-reaching policy actions proposed by the Commission should be based on a sound analysis of the competitive situation on a well-defined market. Only when the problems are properly analysed, would one be able to assess properly whether the proposed actions could be reasonably expected to deal with the problem adequately.

## 2. Objectives

All Commission IAs must have clear objectives that are directly related solving the problems which have been identified.  
*(EC IA Guidelines, point 6)*

The five main objectives defined by the Commission are:

- (1) to clarify and define the role of the statutory auditors;
- (2) to reinforce the independence and professional scepticism of statutory auditors and audit firms in the provision of statutory audit to PIEs;

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<sup>16</sup> ESCP Europe Study, p.6

- (3) to improve market conditions for audits of PIEs with a view to increasing audit quality;
- (4) to avoid unnecessary additional compliance costs for audited SMEs;
- (5) to improve the effectiveness, independence and consistency of the regulation and supervision of auditors.

Additionally, there are fourteen "operational" objectives, relating to the five main objectives.

In general, these objectives are consistent with the broad policy strategies and with other relevant policy objectives. The IA is coherent in so far as the objectives correspond to the identified problems.

### 3. Policy options

Options must be clearly related to the objectives and must be proportionate. The set of options should include: the "no policy change" baseline scenario; "no EU action" (discontinuing existing EU action), where legislation already exists, improved implementation/enforcement; self- and co-regulation; international standards where they exist.

*(European Commission IA Guidelines, point 7)*

The Commission puts up a very clear and well-structured presentation of 23 policy options. These options are logically linked to the five objectives stated above.

However, in certain specific cases, the IA presents as preferred options those options that are seemingly very costly for the audit sector and whose positive impacts are contested by a large majority of stakeholders. It is therefore questionable whether the proposed solutions are helpful in achieving the Commission's stated objectives simply because evidence provided is not sufficient.

According to the ESCP Europe study, produced at the request of the Commission, three of the key proposed options (ban on non-audit services, mandatory firm rotation and mandatory tendering) score zero or negative on "attractiveness" in terms of their impact on audit quality independence and concentration.

The ESCP Europe study states that these three proposed options will not help on entry, quality or independence - or at least that positive impacts in one respect are counter-balanced by negative impacts in another respect, such that overall there is little evidence of the positive impact of each of them.

It is therefore doubtful whether the Commission has produced a range of all realistic options, proportionate to the identified problems, in the sense that they do not go beyond what is necessary to achieve the objective satisfactorily (see point 5 below on the

principle of proportionality) and in the light of the possible constraints (e.g. compliance costs). Moreover, if options favoured by stakeholders are discarded, a more thorough explanation should be provided (see below).

The Commission is under an obligation to examine in a meaningful way the alternative options that might be available. In particular, it has to take duly into account alternatives to "traditional" regulation, such as regulation through information, principles-based regulation, or self- or co-regulation. Especially for some of the policy choices made in the proposed Regulation on audits of PIEs, the Commission seems to have opted for the more radical options (e.g. mandatory external rotation of auditors), without fully assessing whether a softer form of regulation might be able to achieve the same result.

The Impact Assessment Board also asked DG Markt to include in the IA a more detailed discussion of those options that were discarded without an in-depth analysis of their impacts (such as, for instance, public third-party provision of auditing services and strengthening of the sanctioning régime). This request did not receive an appropriate follow-up in the final version of the IA.

## INTERIM CONCLUSION

Without making any judgment about the appropriateness of the proposed options, from a methodological point of view, the Commission could be reasonably expected to provide a more solid justification for the reasons why some of its policy options have been selected, given both the ambition of the proposals and the widespread criticism from stakeholders, including detailed claims that these policies may not be helpful in solving the problems and could even have the opposite effect.

The Commission could also be asked to explain clearly the reasons for excluding certain "milder" options from further analysis.

## 4. Subsidiarity principle and choice of legal instrument

Although the justification for EU action and the respect of the subsidiarity principle are one of the key analytical steps in every IA of the European Commission, this note does not analyse the IA in relation to subsidiarity, which it would not be appropriate to do so. However, it is worth noting that no serious criticism has been levelled, in any quarter, about the right of the EU to act in this field, where there is already existing legislation.

The Commission needs to indicate in the IA:

- why the objectives if the proposed action can not be achieved sufficiently by the Member States (necessity test);
- that, as a result of this, objectives can be better achieved by action at the EU level (test of EU Value Added)

*(European Commission IA Guidelines, point 5.2)*

The Commission states that action at EU level is necessary and justified, in order to deal with the problems described above, and to get a robust solution at the Union level, avoiding regulatory arbitrage.

As a general principle, the form of the legal instrument chosen should be as simple as possible, and coherent with the satisfactory achievement of the objectives. It should also allow effective enforcement.

In its IA, the Commission explains its choice of legal instrument, in favour of a Regulation, aside from amending the Statutory Audits Directive 2006/43/EC. The explanation provided by the Commission reflects generic differences between a Regulation and a Directive, rather than clear reasons for this choice.<sup>17</sup> In addition, no clear explanation is provided by the Commission concerning its choice for a Regulation to regulate PIE audits and for a Directive to regulate SME audits. In fact, the Commission accepts that its objectives can be achieved through 'a Regulation or a more detailed Directive'.<sup>18</sup>

## 5. Proportionality

Article 5(4) of the TEU also requires that EU action meets the conditions set by the principle of proportionality. This principle has to be taken into account when assessing and comparing policy options.

In European Union law there generally acknowledged to be four stages to a proportionality test<sup>19</sup>, namely:

- there must be a legitimate aim for a measure;
- the measure must be *suitable* to achieve the aim (potentially with a requirement of evidence to show it will have that effect);
- the measure must be *necessary* to achieve the aim, that there cannot be any less onerous way of doing it;
- the measure must be reasonable, not imposing an excessive burden on the individual in relation to the objective (proportionality *stricto sensu*).

As explained above, the Commission's objectives seem to be based on the (contested) hypothesis that there is direct, clear link between the financial crisis and poor audit quality in the EU. Therefore, the proportionality of the proposed measures should rather be assessed in relation to the main five more limited "problem areas" identified by the Commission, namely, (1) an expectation gap related to the role of the auditor, (2) risks of conflicts of interest leading to impaired independence of auditors, (3) barriers to entry

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<sup>17</sup> Impact Assessment, Annex 14 (Choice of legal instrument: detailed examination), p.191

<sup>18</sup> Impact Assessment, p.55

<sup>19</sup> P Craig and G de Burca, EU Law (5th edn OUP 2011) p. 526.

into the market of listed and large companies, (4) additional compliance costs due to fragmented national regulation and (5) lack of effective national and EU-wide supervision over audit firms.

The IA includes proportionate and effective measures that could be implemented to address in particular the expectation gap in the audit sector and the risk of conflict of interests. The elements that address the oversight and regulation of the audit profession, the adoption of international audit standards and the improvement of audit reporting do not seem to raise important concerns regarding their proportionality with the problems to be addressed.

However, other measures represent more radical market intervention and seem to be more problematic in terms of proportionality. Specifically, the IA does not appear clearly to show how the Commission's proposals for a mandatory six-year external rotation, the pure audit firm requirement and the prohibition of non-audit services are suitable to attain the proposed policy objectives, that they are necessary and do not impose excessive burdens.

In addition, the proposed Regulation will apply to all PIEs<sup>20</sup> and it seems that the definition of the latter has been considerably extended, compared to that relating to the existing Statutory Audits Directive 2006/43/EC.

## INTERIM CONCLUSION

The main part of the proposal for an amendment of the Statutory Audits Directive appears to respect both the subsidiarity and the proportionality principles. However, some of the proposed policy measures in the draft Regulation on audit of PIEs could raise concerns in relation to the application of the proportionality principle.

## 6. Analysis of impacts and comparison of options

Identify direct and indirect environmental, economic and social impacts and how they occur. Identify who is affected (also outside the EU).

Identify whether there are specific impacts that should be examined (fundamental rights, SMEs, consumers, competition, international, national, regional).

Assess the impacts in qualitative, quantitative and monetary terms or explain why quantification is not possible or proportionate.

Consider the risks and uncertainties in the policy choices, including expected and unexpected compliance patterns.

*(Guidelines, point 8)*

<sup>20</sup> Public interest entities are: listed entities, credit institutions, insurance undertakings, investment firms, investment funds ("undertakings for collective investments in transferable securities", UCITS), electronic money institutions and alternative EU investment funds ("EU-AIF"), central depositories and central counterparties (Art. 1 No. 2 lit.d proposed Directive)

All assessments should be based on evidence, including quantitative data. The reasoning that leads from the evidence to the assessments has to be fully transparent. (*Guidelines, point 9.1*)

In this section, we evaluate whether the Commission has assessed all relevant impacts of its proposals in adequate depth on the basis of robust evidence. The analysis should be proportionate and balanced across the three pillars (economic, social and environmental impacts). First, we will outline a few methodological remarks, followed by examples chosen from the assessment of the most controversial policy choices.

## 6.1. Methodological remarks

### - *Presentation of the impacts*

The impacts for each of the Commission's individual preferred policy options are reasonably clearly summarised in a comparable manner. The options are assessed for efficiency and coherence. The Impact Assessment Board recommended that the Commission analyse the proportionality of each individual option in relation to all other measures in the package. As a follow-up to this request, the Commission introduced Annex 18, to present an overview of the accumulation of the preferred policy options. However, the explanation of the interaction of the impacts considered still lacks clarity.

The three main impacts (economic, social and environmental) are addressed. The Commission states there would not be any direct environmental impacts of the proposals.<sup>21</sup> It also states that there is no direct social impact on national employment levels, but that the proposal could contribute to a more efficient functioning of the market.<sup>22</sup>

In most instances, methodological choices, limitations and uncertainties are acknowledged and made clear. As regards the lack of evidence, it is worth noting that the IA acknowledges the lack of structured evidence on specific points (see examples below - non exhaustive list).

- "Information is not publicly available as to how frequently this right [right to 'veto'] has been exercised by supervisors".<sup>23</sup>
- "The concrete significance of this option [to prohibit contractual clauses limiting the choice of audit firms] cannot however be assessed due to the confidentiality of contracts including this type of clause".<sup>24</sup>

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<sup>21</sup> Impact Assessment, p.59

<sup>22</sup> Impact Assessment, p.59

<sup>23</sup> Impact Assessment, p. 23.

<sup>24</sup> Impact Assessment, p. 42.

- "The lack of sufficient and comprehensive data on the cost side of the joint audit does not provide sufficiently strong arguments to justify its mandatory introduction".<sup>25</sup>

*- Use of data from (individual) Member States*

Generally speaking, there is no need to provide specific estimates for each Member State, unless to do so would be proportionate. In most cases, one could easily estimate EU data by extrapolating available data at national level. When data are available for only a very limited number of Member States, or even a single Member State, one could reasonably expect the IA to indicate the working assumptions but also the methodological limitations (e.g. including a warning about the nature of the data presented - estimates and not exact measures).

*- Aggregate costs / benefits of the package*

The Commission's Impact Assessment Board, in its opinion, stresses that the IA should provide a comprehensive analysis of costs and benefits both for individual options and in the aggregate. Therefore, it is unfortunate that the IA states that "due to a lack of comparable data and to some quality data considerations, it is not possible to provide a reliable estimation of the aggregate cost of the package".<sup>26</sup>

*- Quantification of costs and benefits*

The analysis of costs is generally (not always) provided for specific and individual measures. The effects of the different components of the proposals are mostly assessed in qualitative, rather than in quantitative or monetary terms.

The Commission admits that it is difficult to quantify costs on several occasions in Annex 20. For instance:

- "It is difficult to quantify precisely the overall cost of the strengthening of the audit committee since the increase in remuneration and input of expert days will depend very much upon the specificities of the PIE".<sup>27</sup>
- for the prohibition of the provision of non-audit services to the audited entities, "the indirect costs cannot be estimated since they largely depend on the overall restructuring of the market segments of statutory audit and non-audit services as a result of the whole package of policy options".<sup>28</sup>

In general, the IA focuses more on the costs and less on the benefits of the proposed measures.

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<sup>25</sup> Impact Assessment, p. 45.

<sup>26</sup> Impact Assessment, Annex 20, p. 241.

<sup>27</sup> Impact Assessment, Annex 20, p. 244.

<sup>28</sup> Impact Assessment, Annex 20, p. 246.

As a consequence, it is often unclear to what extent the measures contribute to reaching the policy objectives.

*- Long-term vs. short-term impacts*

The IA focuses more on short-term impacts and less, or almost not at all, on long-term impacts.

*- Unintended impacts*

The Commission appears to have given insufficient attention to unintended impacts of the some of the proposed policy options. It is clear that large audit companies would have to restructure their business as a result of the proposals. The Commission does not provide or analyse scenarios where audit firms would either restructure in order to avoid reaching the thresholds (targeting smaller clients) or would give up on audit services to focus on the provision non-audit services.

*- SME impact*

The Commission dedicates Annex 16 to the IA to the impact of the proposals specifically on SMEs. It states that the impact of policy options on smaller companies was taken into account in their design of the measures. It is of the opinion that SMEs are hardly affected by these policy options, unless they are also PIEs.<sup>29</sup> For SMEs which are not PIEs, Member States shall adapt the audit standards to the size of the audited entity, which "should result in better targeted audit services provided to SMEs".<sup>30</sup>

*- Impact on relations with third countries*

Concerning the impact on third countries, the measures proposed are rather neutral but are expected by the Commission to have an indirect, positive impact on global economy.<sup>31</sup> There is no change regarding the scope of application of the EU audit rules. It has no impact on third-country companies. The possibility for a third-country national to audit an EU PIE or an EU company is not adversely affected, but rather facilitated. The proposed measures take into account the particularities regarding the audit of consolidated financial statements with a view to facilitating such audit when either an EU company has subsidiaries in third countries or a third-country company has subsidiaries in the EU. Finally, the proposed measures are neutral towards supervisory cooperation with third country authorities.

*- Budgetary impact*

There do not seem to be any direct budgetary implications of the proposals.

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<sup>29</sup> Impact Assessment p. 56

<sup>30</sup> Impact Assessment, p.58

<sup>31</sup> Impact Assessment, Annex 17

## 6.2. Examples of methodological shortcomings

### - *Mandatory rotation*

Article 33, § 1 of the proposed Regulation limits the maximum duration for an auditor engagement in a PIE to six years. Only in cases where throughout audit has been performed by two auditors (on a voluntary basis), the maximum duration of the engagement can be extended to nine years.

The purpose is both to mitigate the risk of any potential conflict of interest due to a "familiarity threat" and to create more competition for audit services in the internal market.

This part of the proposed Regulation is one of the most controversial. It has met with opposition from the majority of the profession, which refers to academic research suggesting that mandatory rotation of audit firms would harm audit quality and increase costs. The European Parliament has expressed the view that "the existing partner rotation arrangements provide the independence necessary for audits to be effective".<sup>32</sup>

The Commission itself indicates that it is crucial to find the right balance between the appropriate duration of the mandate of the auditor, to ensure that disproportionate costs due to very short mandates are avoided, whilst equally ensuring that the "familiarity threat" is addressed.

However, the IA leaves the reader unclear about the reasons why a six-year rotation period has been considered appropriate. The IA repeatedly seems to indicate that a nine-year period would be preferred. It even estimates the costs of tendering on the basis of a rotation period of nine years.<sup>33</sup>

The Commission identifies some costs as a consequence of the introduction of the rotation (such as management time and loss of knowledge), but admits that the cost of this mandatory rotation learning curve is not quantifiable.<sup>34</sup> It is doubtful whether all or even some of these costs can be reduced by obliging auditors to make a hand-over report.

Concerning the mandatory rotation of an audit firm via tendering, tendering rules require that non-Big Four firms should be invited to tender.<sup>35</sup> However, the IA does not clarify how could this could be ensured or guaranteed. In addition, it could be argued that, because of the complexity of international accounting standards, forcing smaller

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<sup>32</sup> Resolution 13 September 2011, para. 26.

<sup>33</sup> Impact Assessment, Annex 20 (Summary estimate of costs and financial benefits), p. 257. In order to justify a nine-year period, the Commission also refers to Brazil, where currently auditors rotate every five years and the stock exchange supervisor is envisaging an extension of this period to 10 years., p. 38 footnote 142.

<sup>34</sup> Impact Assessment, p. 257.

<sup>35</sup> Impact Assessment, p.40.

auditors to take on a complex audit would undermine the quality of the audits<sup>36</sup> and this could result in lower confidence of investors.

The effect of the introduction of a mandatory external rotation is also not unequivocal. The conclusion of a scenario analysis carried out for the German market<sup>37</sup> is that, in the absence of changes in behaviour, mandatory rotation would lead to a significant increase in market concentration.

Furthermore, one of the conclusions of the ESCP Europe study is that mandatory firm rotation has led to further concentration in the Italian market, the only EU Member State which has implemented firm rotation.

*- Provision of non-audit services and "audit only" firms*

Article 10, § 3 of the proposed Regulation prohibits the direct or indirect provision of non-audit services to the audited entity, to its parent undertaking or to its controlled undertakings.

Article 10, § 5 obliges an audit firm generating more than one third of its annual audit revenues from large PIEs and which belongs to a network whose members have a combined annual audit revenues which exceed EUR 1 500 million in the EU to separate completely audit from non-audit services and to unconnected to firms providing non-audit-services.

The Commission thinks this policy option will not have any direct cost on the auditor or on the audited company, but it admits that there could be indirect financial impacts. However, the "indirect costs of this measure cannot be estimated since they largely depend on the overall restructuring of the market segments of statutory audit and non-audit-services as a result of the whole package of policy options".<sup>38</sup>

Concerning the prohibition of non-audit firms, there appears to be no objective justification offered by the Commission for why audit firms should get rid of certain fields of business or shrink their activities. This issue of the independence of auditors could be solved if other firms than those audited benefit from non-audit services. In addition, it also reduces the incentives of audit entities to grow and for consultation companies to offer audit services. Therefore the Commission might undermine its own purpose of strengthening competition on the audit market.<sup>39</sup>

The benefits of this separation between audit and non-audit services are hardly quantified, which makes it difficult to estimate the possible net benefit of the Commission's proposals.

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<sup>36</sup> CEP, p.3.

<sup>37</sup> Mandatory rotation in the German Audit Market - A Scenario Analysis, Prof. Dr. Annette G. Köhler, University of Duisburg-Essen.

<sup>38</sup> Impact Assessment, p. 246.

<sup>39</sup> CEP (2012), p. 3.

## INTERIM CONCLUSION

For some of the policy options proposed in the draft Regulation on audits of PIEs, it is not sufficiently clearly demonstrated in the IA that they would provide immediate or long-term benefits that would exceed possible negative impacts.

The Commission does not seem to provide sufficient evidence that the preferred options are the most beneficial for the concerned market. The Commission should have formulated more convincing arguments as to why it prefers certain policy options (restriction on non-audit services, mandatory tendering and mandatory firm rotation) that, according to the findings of the ESCP study which it commissioned, would not have a positive impact on market concentration, audit quality or auditor independence.

## 7. Stakeholder views

The external consultation appears to have been carried out properly by the Commission. Stakeholders were consulted on a subsidiarity analysis, a description of options and their impacts. However, the stakeholder consultation could have been clearer on the problem description and the underlying drivers for the proposed policy change. Annex 1 of the Impact Assessment presents a summary of responses of all groups of stakeholders to the most important policy options proposed. At the request of the Impact Assessment Board, a summary table comparing the views of key groups of stakeholders was annexed.

The IA is transparent in acknowledging the fact that some of the important policy options are not supported by a majority of stakeholders, even if the Commission does not seem to have taken much account of the results of the public consultation. This is particularly the case for policy options referring to mandatory firm rotation, audit-only firms, joint audits and tendering. For example, on mandatory rotation, the profession is afraid that this could increase concentration and costs, while the Commission is of the opinion that required mandatory rotation would increase competition both among the Big Four companies and with other existing or potential mid-tier firms. The Commission does not provide a clear justification for its choice.

The Impact Assessment Board recommended that the IA should analyse in greater depth the divergences between the proposal and the position in the European Parliament's Resolution on these issues. Apparently, DG Markt has not followed up on this opinion.

## **8. Monitoring, transposition and compliance**

The Commission appears to make a proper assessment of transposition and compliance aspects. It proposed plausible and operational monitoring and evaluation arrangements.

The Commission proposes some possible indicators which could be used in the evaluation, such as audit quality in the future, the levels of market concentration and competition and supervisory activity.

## **Conclusions**

Many of the measures proposed in the Directive 2006/46/EC, in particular as regards the facilitation of cross-border recognition of audit performers' competence and streamlining audit standards, seem to have been properly assessed, in accordance with the standards which the Commission has imposed on itself in its Impact Assessment Guidelines.

However, this note has identified a number of weaknesses in the IA. Without making any judgment on the substance or the value of the policy proposals tabled by the Commission, from a methodological point of view, the IA fails in part to provide solid evidence for certain claimed problems. Both these and the underlying drivers for the proposed policy change should be more clearly demonstrated. The IA should also provide a more solid justification for some of the policy options chosen, stronger justification for why certain other options have been rejected, and a more detailed assessment of the likely costs and benefits of the specific measures envisaged, if that is possible.

It would seem that the main problem lies not so much with the general objectives of the initiative, which have been broadly supported, but rather with the proportionality of some of the particular policy options proposed and their likelihood of rectifying or solving, partially or wholly, the issues identified.

The Commission might be invited to provide additional justification for the analysis contained in its impact assessment on these and other points. The JURI Committee may wish to discuss them with the Commission, with a view to seeking clarification.

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