



EUROPEAN PARLIAMENT

2009 - 2014

---

*Committee on Legal Affairs*

---

22.6.2012

## **WORKING DOCUMENT**

on a proposal for a Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities (COM(2011) 0779 – C7-0470/2011 – 2011/0359 (COD))

and

on a 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) 0778 – C7-0461/2011 – 2011/0389 (COD))

Committee on Legal Affairs

Rapporteur: Sajjad Karim

## **A. Background**

The rules covering statutory audit have been broadly defined at European level since 1984. A revision of the legislation took place in 2006<sup>1</sup> and further investigations and consultations have taken place in the years following, with a view towards increasing competition and improving the functioning of the audit market in the EU.

The present proposals, which were adopted by the Commission in November 2011<sup>2</sup>, build on two separate strands of investigation: firstly, how to further develop audit policy and secondly, how best to respond to the financial crisis as pertains to the audit profession.

The Commission is firmly of the view that the financial crisis has highlighted clear deficiencies in the law governing statutory audits<sup>3</sup>. Your rapporteur does not fully share this view. Whilst it is true that a number of financial institutions that faced severe difficulties were given clean audit reports during the crisis, the effect was not directly carried over to other sectors, indicating that the problem was not as a result of a failure in terms of audit quality.

While not necessarily subscribing to the 'catalyst' your rapporteur does however agree with the Commission that improvements to the regulatory framework covering statutory audits can be made, and thus the work of the Commission is generally welcomed.

## **B. Present Proposals**

The Commission's proposal is in two parts: an amending Directive which makes changes to the Directive 2006/43/EC, and a supplementary Regulation which introduces a harmonised regime for Public Interest Entities (PIEs) and auditors who carry out statutory audits for PIEs.

It is worth noting the European Parliament's response to the Commission's Green Paper<sup>4</sup>. The terms of the report adopted show areas of agreement between the Parliament and the draft proposals, but on a number of important areas there exist differences: principally these relate to the introduction of mandatory external rotation, the introduction of joint audit and the restriction of firms to provide audit-only services.

As a general philosophy, your rapporteur considers that the reforms should deliver strengthened audit quality and improve the value of a statutory audit for shareholders and investors. Of clear interest to many are issues of market concentration; however questions of competition and possible abuses where markets are heavily concentrated are, in your rapporteur's opinion, properly issues for the consideration of national competition authorities. Nevertheless, certain policy options currently being considered should also be examined for their impact on independence and audit quality, as benefits provided in this regard may

---

<sup>1</sup> Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 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, OJ L 157, 9.6.2006, p. 87.

<sup>2</sup> Commission proposal for a Directive amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts COM (2011)778 and Commission Proposal for a Regulation on statutory audits of annual accounts and consolidated accounts of public-interest entities. COM(2011)779, 30.11.2011.

<sup>3</sup> Green Paper on Audit Policy: Lessons from the Crisis, COM (2010)561, 13.10.2010.

<sup>4</sup> European Parliament resolution of 13 September 2011 on audit policy: lessons from the crisis.

outweigh possible impacts arising from market intervention.

With this in mind, your rapporteur wishes to explore the 'hot-topic' areas in this working paper, while briefly drawing attention to some other considerations which should be debated within the European Parliament.

## **I. Audit Committees**

Audit committees are given prominence in the Commission's proposal and the strengthening of their role is of key importance to your rapporteur.

It is essential that audit committees function in an honest, professional and independent manner in order for their duties to be carried out effectively. Requirements for audit committee members to hold certain expertise in auditing and accounting are therefore helpful developments; however care must be taken to ensure that rules relating to board compositions do not lead to difficulties for companies due to a shortage of suitable candidates.

Similarly, your rapporteur has concerns relating to communication between the audit committee and investors. Your rapporteur invites consideration of possible methods by which the audit committee's reporting responsibilities could be better defined in order to provide investors with access to greater and more relevant information than is available at present.

Returning to what is the main role of the audit committee, the supervision and appointment of auditors, your rapporteur wishes to consider how a more active approach could be combined with some of the other policy options open to the Parliament to consider, for instance in relation to prior approval of certain non-audit services and the possible setting of term boundaries in relation to appointments. Such an approach could be seen to align well with the more prominent role given to audit committees, and help to increase investor awareness of audit-related matters.

## **II. Auditor Reporting**

Auditor reporting represents a further key element of the reform for the rapporteur. The Commission has put forward in the draft Regulation a long list of elements upon which auditors are invited to comment, with the aim of developing a strong audit report of value to all stakeholders.

It is evident that boilerplate audit reports completed following a box-ticking exercise will not deliver the necessary added value, and your rapporteur would advise that the Parliament consider how best to further develop the proposals of the Commission to ensure that the audit report retains significance for investors and shareholders, beyond the basic signal that a statutory audit has been carried out and the financial statements have been approved.

It may be suggested that an old adage could hold true in this instance - that less is more - but it is important that the 'less' be more targeted and useful information.

## **III. Auditor Independence**

Considerable attention has been devoted to measures introduced in the Commission's proposal which are designed to guarantee auditor independence but which due to their nature will have considerable impact on the audit market.

#### a) Mandatory External Rotation

Mandatory external rotation has been proposed by the Commission as one method to help guarantee auditor independence by avoiding the problem of familiarity between the auditor and audited entity.

It is often remarked that audit quality may suffer at the beginning and end of an audit engagement when rotation is in effect. At the beginning problems may occur due to the new auditors not having a full understanding of the audited entity's business, and evidence does suggest that a greater number of audit failures occur in the early years. At the end of the tenure auditors may face a negative incentive vis-à-vis audit quality, as they are aware that they are losing the business and their attention is drawn elsewhere to more commercially attractive work.

In addition, academic studies into the Italian audit market have shown that mandatory external rotation increases concentration, as audit engagements are rotated between the largest firms with little evidence of a breakthrough for mid-tier competitors.

Your rapporteur recognises the concerns expressed in relation to mandatory rotation; however there are some proponents who consider that contrary to the above evidence there are possible positive effects; that audit quality may increase in the early years, through the introduction of a 'fresh pair of eyes' that effectively challenge prior assumptions and practices and thus a more valuable audit service for investors. Towards the end of the audit engagement the auditor also has an incentive to retain the highest quality, as once they end their tenure a new auditor may question assumptions if insufficient scepticism and prudence have been shown, which could be damaging to a firm's reputation.

Your rapporteur therefore invites further debate of the appropriateness of mandatory rotation, in view of the representations made so far.

#### b) Mandatory Re-tendering

A similar proposal which benefits from introducing less direct market intervention is the introduction of mandatory re-tendering. It is suggested that the introduction of more systematic re-tendering would present competitors in the audit market with much greater access to potential clients, as at present many audits are only rarely, if at all, put out to tender. By helping to address the information and opportunity failure, mandatory re-tendering could be an effective method of improving audit competition while reinforcing audit quality through competitive pressures.

It may be argued though that such a proposition is too optimistic and in reality re-tendering would not in fact improve audit quality or increase market 'churn'. Re-tendering may be seen as fixing the term of the auditor, and thus decreasing the likelihood of a change being proposed outside of the term limits. Secondly, re-tendering may encourage price competition

on audit fees, which may have a knock-on effect on audit quality. As fees are reduced, the commercial attractiveness of audits could be reduced and less man hours may be devoted to improving audit quality. Finally, there is a cost associated with re-tendering which would be felt by both audit firms and audited entities.

Consideration must therefore be given to whether the benefits afforded by mandatory re-tendering will outweigh the costs associated with such an approach.

#### c) Joint and Shared Audit

The Commission has proposed combining mandatory rotation with joint audits, permitting longer audit tenures due to the reduced risk of over-familiarity where two or more firms are involved. Most stakeholders have expressed concerns about the effectiveness of joint audits, which are seen by some as costly and don't necessarily increase audit quality.

Shared audit is similar to joint audit as two or more firms are engaged by the audited entity; however in the case of a shared audit only the lead firm is required to sign off the audit report. The division of audit work under a shared audit may take several forms, as a percentage of the overall audit engagement, via a geographical division or on the basis of auditing selected subsidiaries.

The main advantages of adopting a joint or shared audit are the availability of a second opinion and mitigation of any problems caused by over-familiarity between the auditor and the audited entity, though in the case of a shared audit this is reduced due to the way in which work is divided.

#### d) Pure Audit Firms

Finally, the Commission has suggested the introduction of pure audit firms, when certain market caps are exceeded. It is argued that pure audit firms are necessary in order to provide safeguards against conflicts of interest when large audit networks provide audit services to many large clients in a Member State.

Your rapporteur does not however find this proposal necessary. The preclusion from providing non-audit services once a certain market cap is reached is a disproportionate response to possible issues of independence, in view of existing and proposed safeguards in place governing conflicts of interest where non-audit services are provided.

Furthermore, the suggestion that firms should be obliged to divest of clients in order to stay under the cap introduces an artificial barrier in the marketplace. This may result in a situation whereby audited entities find that their existing auditor is no longer able to continue to service them and the alternatives in the market are limited or possibly non-existent in view of professional conflicts or lack of suitable experience.

#### e) Non-audit Services

The Commission proposes to introduce much clearer requirements in relation to non-audit services. At present each Member State is permitted to draw up its own regime in relation to

the provision of non-audit services by auditors engaging in statutory audits. This has led to considerable variance across the EU as to what is available to companies operating in different jurisdictions. Certain Member States, such as France, have ostensibly stricter regimes; however when looking across Europe attention should be given to how the definitions in each Member State of 'audit' and 'non-audit' are applied to certain services.

Your rapporteur agrees strongly with the proposal that the audit committee is involved in the designation of appropriate services; however he considers that further work may be necessary to satisfactorily designate services. It should be considered how the lists align with existing international approaches, and the experiences in various Member States, to ensure that a well-functioning system can be implemented.

### **C. Conclusion**

It is the view of your rapporteur that this reform of the regulatory framework should be focused on strengthening audit quality, both internally via robust procedures and professional scrutiny, and externally by increasing transparency and investor confidence. Any reform must help resolve the gap that exists between what auditors are asked to do and what some stakeholders and citizens generally understand the audit process to mean.

With this in mind the rapporteur invites further consideration of the appropriate boundaries that should be established by legislation in this field, and looks forward to a detailed debate in the months ahead.