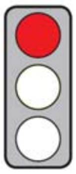
AUDITORS

cep**Policy Brief** 2012-22 of 21 May 2012

KEY ISSUES

Objective of the Regulation: The aim of the Regulation is to strengthen the independence of auditors and to boost competition amongst them.

Parties affected: Entities of public interest, audit firms, auditors, investors, creditors.



Pros: –

Cons: (1) The EU has no competency for the adoption of a regulation. The rules relating to fees and the absolute prohibition of non-audit services infringe the right to entrepreneurial freedom.

(2) The aim to strengthen the independence of auditors can be achieved by considerably milder means: enhanced supervision instead of rotation rules and reporting requirements instead of fee ceilings.

(3) The absolute prohibition of consultancy services is not necessary: if other entities than those audited are consulted, then there are no increased risks for the independence of auditors.

CONTENT

Title

Proposal COM(2011) 779 of 30 November 2011 for a **Regulation** of the European Parliament and of the Council on specific **requirements regarding statutory audits of public-interest entities.**

Brief Summary

Unless otherwise provided for, the articles quoted refer to the Regulation Proposal.

► **Scope and background**
- The Regulation lays down the requirements for the audits which an auditor and audit firms (in the following referred to as "auditors") carry out for "public-interest entities" ("entities")(Art 2).
  - An audit is a review of the annual statement of an entity carried out by an auditor or an audit firm. The audit is obligatory for a number of entities.
  - Public interest entities are listed entities, banks, insurance companies, investment firms, central depositories, central counterparties, investment funds ("undertakings for collective investments in transferable securities", UCITS) and alternative EU investment funds ("EU-AIF") (Art. 1 No. 2 lit. d of the Directive).
  - Large public interest entities ("large entities") are (Art. 4):
    - the ten largest listed enterprises in a Member State or, in any case, those with an average market capitalisation of more than 1 billion € for the previous three years;
    - banks, insurance companies and investment firms with a balance sheet total exceeding 1 billion €;
    - UCITS and EU AIF managing assets of more than 1 billion €.
- The Regulation Proposal is accompanied by the Directive Proposal COM(2011) 778 ("Directive") amending the Audit Directive (2006/43/EC). It revises the requirement rules for auditors and audit firms.

► **Rotation mechanism: external rotation**
- Audits carried out by one auditor only ("single audit"): an auditor may review an entity for a maximum of six years only. The audit duration may be assigned to two engagements only, of which the first must take at least two years. (Art. 33 (1) sub-para. 1 to 3)
- An audit carried out by two auditors ("joint audit"): an auditor may review an enterprise for a maximum of nine years. The audit period may be split into two engagements. The duration of nine years applies subject to the provision that the first engagement is assigned to two auditors and lasts for a continuous period of six years. (Art. 33 Abs. 1 UAbs. 4).
- In exceptional cases and upon request, international supervisory authorities may grant permission to an auditor for a third engagement for a period of two years to single auditors and of three years to joint auditors (Art. 33 (3)).
- Upon the expiry of the maximum term, the auditor must not carry out any audits with the entity concerned until a period of four years has elapsed (Art. 33 (2), (3)). They must provide the newly appointed auditor with a handover file which is to ensure the "continuity of the statutory audit". (Art. 33 (5) sub-para. 1)
- With regard to existing contract relations between the auditor and entities, transitional provisions are applicable (Art. 70).

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- **Rotation mechanism: internal rotation**
  - The key auditor ("key audit partner") must not participate in an audit for more than seven years. They may "participate again" after a period of at least three years (Art. 33 (4) sub-para. 1).
  - With regard to the remaining personnel, the auditor must introduce an "appropriate gradual rotation mechanism", gradually replacing individual persons of a team (Art. 33 (4) sub-para. 2). The European Securities and Market Authority (ESMA) establishes non-binding guidelines relating to this rotation mechanism (Art. 46 (3) lit. e).
- **Appointment of auditors (obligatory selection procedure)**
  - Each enterprise must establish an audit committee to appoint auditors. It is to be composed of members of the administrative body and/or supervisory body and/or of persons appointed by them. (Art. 31 (1) sub-para. 1 Art. 32 (3))
  - The audit committee must request at least one quotation by an auditor holding a market share that does not exceed 15% in the audit market for large entities (Art. 32 (3)).
  - The audit committee recommends at least two auditors to the administrative or supervisory body, justifies its selection and states its preference (Art. 32 (2) sub-para. 1 and 2). The administrative body or supervisory body proposes to the general meeting of shareholders one of these auditors (Art. 32 (5)). The general meeting then appoints one or more auditors (Art. 37 (1) of the Directive 2006/43/EC).
- **Prohibition of the provision of non-audit services (prohibition of consultancy services)**
  - Non-audit services are services that are or could be related to a conflict of interests (Art. 10 (3) sub-para. (3)). This includes above all tax advice, accountancy and internal revision. The Commission may define further non-audit services by delegated acts (Art. 10 (6)).
  - An auditor must "not directly or indirectly provide to the audited entity" any non-audit services at all (Art. 10 (3) sub-para. 1). With regard to certain services which incorporate only a potential conflict of interests, exemptions are admitted; in such a case, the audit committee or the competent authority – depending on the type of service – must give their consent (Art. 10 (3) sub-para. 4 and 5).
  - Audit firms must not provide any non-audit services at all (absolute prohibition of consultancy or advisory services), if (Art. 10 (5))
    - they generate more than a third of their annual revenues from large public-interest entities and if
    - they belong to a network whose members have combined annual audit revenues exceeding 1.5 billion Euros.

    This prohibition enters into force three years following the publication of the Regulation (Art. 72).
- **Independence from audited entities**
  - Auditors or the key audit partners of an audit firm must not before the expiration of at least two years from the audit engagement take up the duties (Art. 8 Abs. 1)
    - of an "executive" member of the administrative body or member of the supervisory body;
    - of a "key management" position or;
    - become a member of the audit committee.
- **Audit fees**
  - Audit fees must not be contingent fees (Art. 9 Abs. 1).
  - With regard to audit-related services (e.g. the review of interim financial statements), only 10% of the fees charged for the final audit statement may be calculated (Art. 9 (2) in conjunction with Art. 10 (2)).
  - Where the fees paid by an entity exceed 20% or 15% for two consecutive years of the annual fees of an auditor, the audit committee must be notified. If the 15%-limit is exceeded two times in a row, the competent authority must also be informed. The authority may issue an instant audit ban or allow for a continued audit for a maximum period of two years. (Art. 9 (3))
- **Approval of auditors and supervision**
  - Each Member State must appoint an authority for the approval of auditors (Art. 35 (1)). The competence can be assigned to other authorities or bodies, e.g. a chamber of auditors (Art. 1 No. 3 lit. a lit. ii and No. 16 of the Directive).
  - An audit firm can be approved only if a "majority" of the administrative or management body (to date: 75%) is composed of auditors (Art. 1 No. 3 lit. b of the Directive). The precondition that a majority of an audit firm's voting rights is held by auditors is deleted.
  - Each Member State must appoint a central authority for the supervision of auditors, for instance the authority competent for the approval. (Art. 35 (1))
- **Further provisions**
  - The supervisory authorities may exempt *Sparkassen* and *Volksbanken* (two types of German banks), which according to national law may or must be members of non-profit audit organisations, from "certain provisions" of the Regulation. The independence of auditors must be ensured (Art. 38 (5)).
  - The national supervisory authorities must request from the six largest audit firms for large entities in each Member State the establishment of contingency plans. They must contain measures which in the case of the insolvency of an auditor, prevent e.g. the contamination of other audit firms. (Art. 43 (2)). The authorities may prescribe the taking up of measures to prepare an orderly failure of the firm affected (Art. 43 (3)).

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Statement on Subsidiarity by the Commission

The Commission argues that without EU action "important differences would emerge in the regulatory framework" which could "seriously" undermine the single market. Furthermore, many entities operate at cross-border level. A harmonised regulatory framework could help avoid regulatory arbitrage.

Policy Context

Since 1984, the approval of auditors has been regulated at EU level (1984/253/EEC). In 2006, the requirements relating to audits were harmonised (2006/43/EC). In October 2010, the Commission published a Green Paper on audits (COM(2010) 561; see CEP Policy Brief), which also provided for joint audits. In September 2011, the European Parliament mainly welcomed the Commission's proposals in an Initiative Report on said Green Paper.

Legislative Procedure

30 November 2011	Adoption by the Commission
Open	Adoption by the European Parliament and the Council, publication in the Official Journal of the European Union, entry into force

Options for Influencing the Political Process

Leading Directorate General:	DG Internal Market
Committees of the European Parliament:	Law (leading), Rapporteur for Regulation and Directive: Sajjad Karim (ECR Group, UK); Economy and Monetary Affairs; Industry, Research and Energy; Internal Market and Consumer Protection
Committees of the German Bundestag:	Law (leading); Finances; Economy; EU Affairs
Decision mode in the Council:	Qualified majority (approval by a majority of Member States and at least 255 out of 345 votes; Germany: 29 votes))

Formalities

Legal competence:	Art. 114 TFEU (Internal Market)
Form of legislative competence:	Shared competency (Art. 4 (2) TFEU)
Legislative procedure:	Art. 294 TFEU (ordinary legislative procedure)

ASSESSMENT

Economic Impact Assessment

External rotation: The statutory definition of maximum terms of audit engagements represents a serious, and in terms of ordoliberalist thinking highly problematic **interference with the freedom of contract**. Rotation can actually help counter interest conflicts – such as biased reviews to gain follow-up engagements – which can occur due to long-term business relations between auditors and audited entities. On the other hand, rotation also incorporates the risk of reviews being less reliable because the specific knowledge on the audited entity gets lost or must be newly acquired. **The dangers associated with a conflicts of interest can, however, be tackled by** much milder means, namely through **enhanced supervision**: where a supervisor detects biased audits, it damages the auditor's reputation enormously. Due to the resulting pressure from creditors and investors, the auditor might even lose his or her engagement.

In addition, it is questionable whether external rotation really boosts competition. As the Commission itself admits, rotation in Italy – where rotation requirements were established back in 1974 – has had very "limited effects" on the market structure [see Impact Assessment SEC(2011) 1384, p. 172].

A positive thing, however, is that the planned rotation requirements – unlike those for rating agencies (see CEP Policy Brief) – do not lead to large international entities having to request the services of smaller audit firms which hitherto could not establish themselves in this market segment. This is due to the fact that the cooling down phase of four years is shorter than the admitted engagement period of six years and more (see CEP Accompanying Document). This is appropriate: as a result of the complexity of international accounting standards, a certain consolidation of the market for the audit of such entities is hardly avoidable. Today, four large auditors share this market (Deloitte Touche, Ernst & Young, KPMG, PwC). Actually forcing smaller auditors to take on such complex audits would undermine the quality of the audits.

Prohibition of non-audit services: The absolute prohibition for high-revenue auditors specialised in auditing large entities **of providing any non-audit services** at all forces them to either get rid off certain fields of business excellence or to shrink. For this **there is no objective justification**. **If other firms than those audited are consulted, then there are no increased risks** for the independence of auditors. In all other cases, the efficient supervision of audits should tackle the dangers related to conflicts of interest. Moreover, the independence of an audit does not per se depend on the auditor's turnover or the size of the client. Besides, the prohibition discriminates the audit firms affected for no real reason. It also reduces the incentives for other entities to "grow" and for consulting companies to offer audit services. Thus the Commission undermines its own aim to strengthen competition on the audit market.

Ceilings for audit fees: Limiting audit fees for audit-related services restricts the freedom of contract in an inappropriate manner. **The Commission does not give any evidence of the correlation between the amount of fees and the degree of dependence of an auditor**. And even if such dependence existed, the independence of the auditor could be strengthened by means of less profound interventions than the setting of ceilings. **Completely appropriate are the existing obligations regarding fee disclosure** and the services provided.

Setting fee ceilings can also aggravate the market entry of new auditors. Normally, at first young audit firms have a relatively small number of clients . Therefore they would meet the set thresholds of 15% or 20% very quickly.

Ownership rules: Further opening up audit firms to investors who are not auditors does not endanger independence provided the shareholders are not also direct or indirect clients. For such investors also have an interest in the prosperity of the audit firm, independence being essential for their reputation. However, the aim intended by opening up audit firms in this way, namely to foster the growth of existing auditors and new establishments, can hardly be achieved, for this is based on human capital rather than on capital.

Contingency planning: The obligation to establish contingency or failure plans is not appropriate, as even large audit firms are not systemically relevant. Their default neither threatens other companies nor burdens the economy as a whole.

Legal Assessment

Competency

The EU may base supervisory rules on Art. 114 TFEU (internal market). However, the Proposal focuses on the independence of auditors. This independence serves to protect investors, creditors and business partners (cp. Recital 7). Hence, the legal basis is the more specific – and therefore has precedence over Art. 114 TFEU – Art. 50 (2) lit g TFEU (measures to implement the freedom of establishment). However, **Art. 50 TFEU allows only the adoption of Directives. In other words, the EU does not have the competency to adopt a Regulation.**

Subsidiarity

Unproblematic.

Proportionality

See compatibility with EU law.

Compatibility with EU Law

The obligation for external rotation, setting ceilings for the fees of audit-related services and the absolute prohibition of non-audit services by large audit firms infringe the entrepreneurial freedom (Art. 16 of the Charter of Fundamental Rights of the EU) of auditors. The aim is to strengthen the auditors' independence. If one assumes, as the Commission (Recital 27) does, that external rotation strengthens this independence, then its introduction is, irrespective of economic criticism, legally permissible. **Fee ceilings and the absolute prohibition of consultancy services, however, infringe the right to entrepreneurial freedom (Art. 16 Charter of Fundamental Rights of the EU)**. For in order to prevent conflicts of interests, it suffices to introduce reporting requirements for fees and the prohibition of providing both audit and non-audit services to the same client.

Conclusion

Rotation rules are unnecessary: the danger of a conflict of interests can be also tackled by enhanced supervision. The absolute prohibition of consultancy services and ceilings to the fees of auditors infringe the right to entrepreneurial freedom. The absolute prohibition of consultancy services cannot be justified; if entities other than those audited are being consulted, no increased risks exist for the independence of auditors. The aim to strengthen the independence of auditors by setting fee ceilings can be achieved only through the obligation to disclose fees. Opening up audit firms to investors does not constitute a threat to the independence of auditors. The EU does not have the competency to adopt a regulation.

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