EU Green Paper

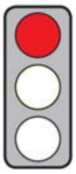
FUTURE AUDIT POLICY

Status: 17 January 2011

MAIN ISSUES

Objective of the Green Paper: The Commission presents its deliberations on how the auditting of annual company accounts could be "improved".

Parties affected: All companies, audit firms.



Pros: Disclosure requirements and ceilings for the admissible turnover share of individual clients of audit firms can increase the independence of auditors.

Cons: (1) In order to ensure the quality standard of audits, they do not have to be assigned by regulatory authorities, nor do consulting services have to be prohibited.

(2) There are no convincing arguments justifying interventions by the Commission into the structure of the auditor market.

(3) Audit firms are not systemically relevant. Hence, contingency and resolution plans are not necessary.

CONTENT

Title

Green Paper COM(2010) 561 of 13 October 2010: **Audit Policy**: Lessons from the Crisis

Brief Summary

- **Background and general context**
  - The current Directive on Statutory Audits (2006/43/EC)
    - regulates the activities and registration of auditors,
    - lays down the tasks of statutory auditors and the principles of professional ethics which are to ensure their independence and impartiality,
    - provides for supervision through national authorities.
  - The audit of annual accounts by statutory auditors is statutory, in particular in the case of annual accounts of public limited companies, of limited liability companies (Directive 78/660/EEC) and for banks, insurance companies and other financial institutions (Directives 86/635/EEC and 91/674/EEC).
  - Auditors must provide information (Art. 51 (1) lit. c, Directive 78/660/EEC) on whether the annual account of an audited company
    - is in accordance with the relevant financial reporting framework and gives a true and fair view of the actual facts and
    - is in line with statutory requirements.
  - The Commission now submits a Green Paper in order to discuss the future role and scope of an audit in the "general context of financial market regulatory reform".
  - Governance rules and an improved supervision are to contribute to more competition and increased stability in the financial system. (P. 3)
- **Role of the auditor**
  - The Commission criticises that auditors tend to neglect to verify whether the audit provides a true and fair view of the actual facts. Therefore, they should ensure that "substance prevails over form" and a "substantive verification of the audited company's balance sheet" be applied in future. (P. 7)
  - In future, audits are to ensure "that there is no arbitrage of the differences in regulatory frameworks between jurisdictions". (P. 6)
  - The Commission would like to see greater differentiation in the auditors' opinion in order to facilitate a comparison between the audited company and other competitors. To this end, the Commission intends to prescribe that the audit report must provide the following information:
    - "potential risks, sectoral evolution, commodity and exchange rate risk" (P. 7 et seq.);
    - future risks to intellectual property or intangible assets of companies;
    - future-oriented analyses, e.g. on the financial health of companies.
- **Governance and independence of audit firms**
  - The Commission would like to "reinforce the independence of auditors and address the conflicts of interest" (P. 11).
  - The Commission finds particularly troubling the fact that audit firms are appointed and paid by the audited company and that in several Member States they may even provide consulting services ("non audit services") along with the actual audit performance.

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– The Commission wishes to examine the following options:
  - the appointment, also of remuneration and duration of the audit assignment through a third party, for instance a regulatory authority;
  - a ban concerning the provision of "non audit services" (consulting);
  - disclosure requirements and limitations on the revenues received by one single client in relation to the total revenues;
  - easing the existing rule that the majority of voting rights of an audit firm must be exercised by auditors; the Commission would like to allow external capital to be raised so that capital companies can be established (p. 14) while at the same time ensuring that investors do not interfere with content-related tasks of auditors;
  - supervision of the audit firms' audits through public authorities;
  - reinforcing corporate governance in a manner similar to the Regulation on Rating Agencies or the British Governance Code;
  - reinforcing group auditors in auditing international companies.

► **Concentration and market structure**

– The Commission criticises that more than 90% of the revenues received for audits of listed companies are covered only by the four largest audit firms (the "big four": Deloitte & Touche, Ernst & Young, PricewaterhouseCoopers and KPMG). According to the Commission, this creates a systemic risk, as the collapse of one of these major audit firms could cause market disruptions. (p. 15)

– The Commission's view is that there is a "lack of dynamism" in the audit market. The reason for this is, they explain, that "being an auditor of large listed companies seems to create a reputational endorsement". (p. 15)

– Therefore, the Commission is considering the following actions:
  - joint audits: when auditing large companies, at least one small-sized audit firm could be called in mandatorily;
  - the obligation to rotate on a regular basis the audit firms and the auditors and to award audit assignments publicly;
  - the introduction of a "European quality certification", with which small-sized audit firms can prove that they are able to perform audits of large listed companies (p. 16);
  - developing contingency and resolution plans ("living wills") which would allow for a "rapid solution" in the event of the demise of a "systemic" audit firm (p. 16).

– The Commission is considering whether or not the "broader rationale" of the last few decades ("i.e. global offers, synergies"), which have led to the consolidation of the "big four", are still valid or "should be reversed" (p. 17).

► **Supervision and international co-operation**

– The Commission wishes to strengthen the co-operation between national supervisory authorities and therefore proposes two models:
  - establishing a European supervisory authority similar to the financial supervisory authorities EBA, EIOPA and ESMA [Proposals COM(2009) 501–503; cp. CEP Policy Briefs] or
  - transforming the European Group of Auditors' Oversight Bodies (EGAOB) into a committee, which "could reinforce co-operation at the European level and foster convergence in the application of the rules and ensure a common approach to inspections of audit firms", as well as provide advice to the Commission on audit matters ("Lamfalussy Level 3 Committee") (p. 14).

– The Commission proposes delegating the supervision of international audit firms to one single central European supervisory authority, as is already being planned for rating agencies [Proposal COM(2010) 289; cp. CEP Policy Brief].

– The Commission is further considering introducing a reporting requirement for auditors vis-à-vis regulatory authorities, where "large and listed" companies commit a "material" breach of law which affects the ability of the company to continue as a going concern (p. 14). To date, such a rule exists only for auditors of banks and investment firms (Art. 53 of the Directive 2006/48/EC, resp. Art. 55 of the Directive 2004/39/EC).

– The Commission is to draw up a list of third countries whose supervision systems are equivalent to that of the EU. The supervision of global audit firms by these third countries and the Member States is to become "more effective and efficient" (p. 23).

► **Creating a European market**

– The Commission has established that the cross-border activities of audit firms and the mobility of auditors is still low.

– In order to create a "single European market for the provision of audit services", it wishes to set up a "maximum" harmonisation of the legal framework (e.g. through harmonised professional qualifications).

– It further wishes to introduce a "European passport for auditors", whereby their registration and supervision would be subject to the oversight of a single regulator, as is being planned for rating agencies [Proposal COM(2010) 289; cp. CEP Policy Brief]. (p. 18)

► **Small and medium-sized enterprises (SME) and audit firms**
– In order to reduce the administrative burden for SME, the Commission proposes exempting them from the obligation to submit a statutory audit or to introduce a "limited audit" (p. 19).
– In order to foster the development of small and medium-sized audit practitioners (SMPs) and not to burden them with complex rules, the Commission intends to draw up "proportionate rules on quality control and oversight" regarding the "limited audit". (P. 19)
– Moreover, auditors of SMEs could be partly exempted from the ban concerning the provision of non audit services.

Statement on Subsidiarity by the Commission

The Commission does not address the principle of subsidiarity.

Policy Background

Against the background of the global financial crisis the Commission presents a Green Paper as a further measure to reinforce the stability of the financial system. What has already been established in this area are new EU supervisory authorities for banks (EBA), insurances (EIOPA), investment firms (ESMA) [see CEP Theme Page] and for macro-prudential supervision (ESRB) [see CEP Theme Page]. Moreover, the Commission has proposed intensifying and centralising the supervision of rating agencies (see CEP Theme Page) as well as better regulating OTC derivatives (see CEP Theme Page). In February 2009, the Commission already proposed exempting small and medium-sized enterprises from the obligation to submit annual statements (see CEP Theme Page). However, recently there has been disagreement between the Council of Ministers and the European Parliament as to whether it would not be better to wait for a general simplification of the entire underlying Directive (78/660/EEC).

Options for Influencing the Political Process

Leading Directorate General: DG Internal Market and Services

ASSESSMENT

Economic Impact Assessment

Ordoliberal Assessment

The Commission is leading a valid and fundamental discussion on the general role of auditors. However, the inherent inconsistency this contains needs to be pointed out: if correctly audited annual accounts do not convey "a true and fair view of the actual facts", then this is not the fault of the auditor. Rather the legislator must modify the accounting principles which prescribe or allow for a distorted view. **Obliging auditors to ignore** such **accounting principles in the interest of a "substance over form" approach would be wrong**.
The Commission is right to stress that **audits can involve conflicts of interest which jeopardise the independence and impartiality of auditors**. **The** Commission's **proposal that audits are assigned by regulatory authorities and the ban concerning the provision of non audit services** can indeed reduce dependence; at the same time, however, they create new conflicts of interest and **might even lower the quality standard of audits.** On the one hand, company knowledge of long-standing auditors is lost if assignments are allocated by authorities on an annual basis and if consulting assignments leading to a detailed analysis of single details of an audited company are completely banned. On the other hand, the auditor's motivation to audit with more due diligence than statutorily prescribed is reduced, as the audited company cannot reward such extra performance with a renewed assignment in the subsequent year.
According to existing law, auditors – unlike rating agencies, which the Commission uses as a misleading reference – are not at all unregulated or unsupervised. The Auditor Directive (2006/43/EC) prescribes a professional aptitude test, a registration obligation for impartiality, expertise and professional diligence. An independent public supervisory body is in charge of monitoring compliance with these rules.
An existing conflict of interests can also **be addressed by supervisory and sanctioning rules**, rather than through massive intervention into the companies freedom of choice. It would be worth considering a tightening of the existing rules, for a damaged reputation is a luxury auditors cannot afford. However, it is questionable whether or not the existing disclosure and sanction options of supervisory authorities are sufficiently discouraging and if the existing limited liability of auditors should be maintained.
Disclosure requirements and ceilings for the revenues received by single clients are justifiable and partly already in effect, for instance in the Code of Ethics of the International Ethics Standards Board for Accountants (IESBA). They **strengthen the economic independence of auditors**.
The fact that the audit market is dominated by four large companies is a consequence of the strong demand for these companies' services and is also rooted in the increasingly complex international accounting principles which inevitably lead to concentration. Apart from that, in its Audit Inspection Unit's (AIU) annual report of 2010, the British supervisory authority concludes that mainly the audit quality of smaller audit firms is in need of improvement. The fact that the Commission would like to see a different market structure **does not**

justify interference, as long as market barriers do not exist and competition law is not infringed. However, the Commission does not refer to this.

Efforts to positively discriminate smaller audit firms – e.g. by mandatorily involving them in audits – reduce the incentive for further training and **should be rejected**. If small-sized audit firms are sufficiently qualified, they will be assigned complex audits without help.

Audit firms in the form of a capital company should be allowed in future. The assumption that only auditors organised in a partnership would focus on quality over profit is wrong. Neither the auditor nor the investor is interested in jeopardising the reputation of the audit firm. However, the Commission's aim to create more competition for the "big four" cannot be achieved with this opening. The bottleneck of audit services is know-how, not capital.

Moreover, there is no reason to believe that the current market structure entails risks to the stability of the financial system. Audits are not cost-intensive but staff-intensive. The auditors' know-how is not lost after an insolvency and can be quickly re-applied. To this end, **audit firms are not "systemic", hence, contingency and resolution plans are superfluous**.

In supervising international audit firms, a close co-operation between national supervisory authorities is necessary. However, there is no need to establish a European supervisory authority for that. It would be less bureaucratic, to establish colleges of national supervisors, as is done with banking supervision.

Impact on Efficiency and Individual Freedom of Choice

An open European audit market in which authorised **auditors can operate across borders without problems** intensifies competition and increases efficiency. However, it **is subject to a comprehensive harmonisation of tax and corporate law that is almost impossible to implement**.

Therefore, the proposal to authorise auditors centrally by a European regulatory authority is overhasty and only feasible **for auditors who audit annual accounts in accordance with the International Financial Reporting Standards** (IFRS). **An alternative** for IFRS **would be to mutually acknowledge the registration of auditors between member states**.

SMEs should not be exempted from the obligation to prepare an annual statement. Unlike very small enterprises (for which the Commission proposes an exemption of the annual accounts obligation, see CEP Theme Page), the annual accounts of SMEs provide employees, investors, creditors and business partners with information that is important due to the SME's substantial size and external financing. Depending on the actual shaping of the proposal, limited audits for SMEs might, however, be reasonable and cost-saving.

Impact on Growth and Employment

No significant impact.

Impact on Europe as a Business Location

No significant impact.

Legal Assessment

Legislative Competence

The statutory regulation of audit firms can be based on Art. 53 TFEU (the taking-up and pursuit of self-employed activities), the supervision of audit firms on Art. 114 TFEU (harmonisation of rules to complete the internal market).

Subsidiarity

Currently not foreseeable.

Compatibility with EU Law

A ban concerning the provision of consulting or any other non-audit services through audit firms constitutes a tightening of the European legal position. The existing rule excludes an audit if "an objective, reasonable and informed third party concludes that the statutory auditor's or audit firm's independence is compromised" (Article 22 (2) of the Auditors Directive 2006/43/EC). There are great differences in the implementation of this rule into national law. In France, for instance, auditors are generally prohibited from offering non-audit services to clients.

Conclusion

In order to maintain the quality of audits, existing supervision rules and sanctions suffice. It is not necessary to have audits be assigned by regulatory authorities or to ban consulting services. There are no convincing arguments to justify the Commission's interfering with the structure of the auditor market. Disclosure requirements and ceilings for the admissible turnover share of individual clients of audit firms can increase the independence of auditors. Contingency and resolution plans are not necessary, since audit firms have no systemic relevance.