



Fédération des Experts
Comptables Européens

Policy on EC Proposed Directive

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European Commission Proposed Directive on Statutory Audit of Annual Accounts and Consolidated Accounts

On 16 March 2004 the European Commission issued its proposals to modernise the Eighth Directive on the statutory audit of annual accounts and consolidated accounts.

FEE, the representative organisation of the accountancy profession in Europe¹, welcomes this initiative to modernise the law on auditing. The proposal builds on the important work carried out by the Commission since its Green Paper of 1996 on the Role, Position and Liability of the Statutory Auditor in the EU.

Auditing is central to ensuring the credibility and reliability of financial reporting. Over the past number of years, FEE has developed a series of detailed proposals aimed at restoring trust in financial reporting for capital markets. We support many of the proposals in the revised Directive published by the European Commission, noting its consistency with the FEE policy on key issues such as audit committees, international standards on auditing, internal rotation of audit partners and statutory backing for robust quality assurance and inspection.

Context

The Eighth Council Directive 84/253/EEC of 10 April 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents deals primarily with the approval of statutory auditors in Member States. Although the existing Directive contains some requirements on registration and professional integrity, it does not include requirements on how a statutory audit should be conducted and the degree of public oversight or external quality assurance which is needed to ensure high audit quality.

¹ The Fédération des Experts Comptables Européens (FEE) is the representative organisation for the accountancy profession in Europe. It groups together 41 professional bodies from 29 countries. FEE Member Bodies are present in all fifteen Member States of the European Union, nine European Union candidate countries and three member countries of EFTA. Between them, these bodies have a combined membership of 500.000 individuals, of whom approximately 94% are from EU countries.

The European Commission's proposal to modernise the Eighth Directive takes place against a backdrop of high profile financial scandals. However the proposal for a Directive on Statutory Auditing is not to be seen solely as a response to these recent events. Rather it is part of the ongoing development of public policy for the auditing profession, which has been in progress since the European Commission launched its Green paper of 1996. Since then FEE has worked closely with the European Commission and the Member States through the EC Committee on Auditing. In particular, FEE published surveys and discussion papers on continuous quality assurance (1998), auditing standards (1998 – 2000 – 2001) statutory auditors' independence and objectivity (1998 – 2001) and European co-ordination of public oversight (2003). FEE remains committed to contributing the technical expertise of the audit profession to the European institutions in order to ensure high quality audit regulation in Europe.

Global Standards

The general policy of FEE is to support global standards. In all areas of standard setting, the principles based approach is preferable to the rules based approach. The standard setting process needs appropriate arrangements to ensure that the resulting standards have widespread acceptance from political authorities, regulators, market participants and other stakeholders and are seen to be set in the public interest. FEE welcomes the proposal by the European Commission to require the application of International Standards on Auditing and the possibility of a similar policy on professional ethics and education of statutory auditors.

Within Europe it is essential that Member States act within the common framework provided by the European Commission and do not diverge from European and global standards, except where there are specific national issues that need to be addressed. FEE welcomes the proposals made which prevent Member States introducing, even inadvertently, regulations with extraterritorial effect.

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The main chapters of the proposal are surveyed in the following paragraphs which identify issues arising from the proposed solutions. Chapter I (Subject Matter And Definition) and XIII (Transitional and Final Provisions) will not be discussed in this paper.

CHAPTER II – APPROVAL, EDUCATION AND MUTUAL RECOGNITION

The Proposals

- The European Commission does not suggest major changes to education requirements. Some useful amendments are introduced in the curriculum in order to refer to international standards of accounting and auditing. Furthermore, an additional provision is introduced on continuous education.
- Important amendments are proposed to the conditions of approval of audit firms. Previous restrictions on legal form and the requirement to have a majority of domestically approved auditors in the capital and the management of the audit firm are removed.

- The existing Directive is not meant to regulate the free movement of auditors throughout the internal market. Accordingly, the general system of recognition of professional qualifications is applicable. The European Commission's proposals require registration in a host Member State after giving evidence of the knowledge of local laws or regulations through an aptitude test. This departure from the recent proposal for a Directive on Services in the internal market (COM(2004)2 final.13.01.2004) is justified because of the need for statutory auditors to be fully aware of the specific legislation of Member States (such as company law, fiscal law and social security law) that is relevant for statutory audit.

FEE Positions

- FEE agrees that the existing provisions on education have been very useful to achieve the objective of having equivalent education requirements for auditors. However, the existing provisions detailing a curriculum (list of subjects) do not reflect a principle-based approach which would be more appropriate in promoting high quality auditing. Furthermore, it is important to consider the effect of the Bologna agreement² on Article 7 of the proposed Directive.. The FEE Council has approved a position paper on 24 March 2004, which makes concrete proposals in this respect.
- FEE supports the proposal to maintain the current system of recognition of professional qualifications of auditors in the EU with an aptitude test restricted to the knowledge of laws and regulations of the host Member State related to auditing.
- FEE has previously proposed to remove restrictions on the form of audit firms and limitations linked to nationality requirements in the voting rights. The proposals made by the European Commission are supported. We expressed, however, reservations on adopting the same approach concerning the calculation of the majority of the management and supervisory board of the audit firm on a EU-wide base

CHAPTER III – REGISTRATION

The Proposals

- Statutory auditors and audit firms must be registered and make information available to the public through the register.

FEE Positions

- FEE supports the proposals since they increase transparency in the public interest.

² The Bologna agreement refers to the Declaration signed on 19 June 1999 by 29 European Ministers in charge of higher education, establishing the European Area of higher education by 2010 and promoting the European system of higher education worldwide. Since then the Ministers have worked on a comprehensive restructuring of the European landscape for the European Higher Education Area, based on the two-cycle system.

CHAPTER IV – PROFESSIONAL ETHICS

The Proposals

- The Commission refers to integrity, objectivity, confidentiality and professional competence and due care, which are also the fundamental principles in the Code of Ethics of IFAC. The Commission is entitled to adopt implementing measures on these principles by using the comitology procedure.
- Article 22 covers the exchange of information between the auditor and the competent national authorities. Rules on confidentiality and professional secrecy must not stand in the way of enforcement of financial reporting requirements of exchange of relevant information between competent authorities of the Member States.

FEE Positions

- The policy of FEE is to support global standards in all areas. The European profession is committed to respecting the fundamental principles established by the Code of Ethics of the International Federation of Accountants. When an auditor issues an audit report in compliance with International Standards on Auditing (ISAs) as proposed by the Commission, this automatically requires compliance with the IFAC Code of Ethics. Hence FEE is glad to see that the Explanatory Memorandum refers to the IFAC Code of Ethics. However, the question must be raised whether it is necessary to reserve legislative power to the European Commission in this field. .
- FEE has also some reservations on Article 22.(2) on exchange of information because it is not clear how the procedures foreseen in Article 34(2) will apply. The use of exchanged information should be restricted to the exercise of enforcement functions within the scope of the Directive and should not give rise to any conflict with any other EU legislation, such as on data protection.

CHAPTER V – INDEPENDENCE

The Proposals

- Article 23 includes a general principle on independence of statutory auditor. It refers to categories of risks which might compromise the auditor's independence.
- The Commission also provides for principles on audit fees suggesting that the fee for a statutory audit should be adequate to allow proper audit quality, that the fee cannot be based on any form of contingency and that the fee cannot be influenced by the provision of additional services to the audited entity.

FEE Positions

- FEE welcomes the proposal as it emphasises the general principles of independence. Article 23, paragraph 2, demonstrates that the Commission applies a “threats and safeguards” approach which is also applied in the IFAC Code of Ethics. FEE has been a long-time supporter of such an approach (see for example the FEE discussion paper on Statutory Auditors’ Independence and Objectivity (1998)) which has also been applied in the European Commission’s Recommendation on Statutory Auditors’ Independence in the EU (May 2002)
- FEE considers that the requirement to document “all threats to the independence of the statutory auditor” should be limited to those risks which are not clearly insignificant. In addition, the principal requirement that the auditor “shall not in any way be involved in management decisions of the audited entity” should be clarified to ensure that auditors can be effective in undertaking their work.
- Unnecessary regulation of the setting of audit fees should be avoided. In particular, clarification is needed so that the prohibition of any form of contingency fees does not prevent the auditor from re-negotiating audit fees if specific events occur in the year since this would threaten audit quality.

CHAPTER VI – AUDIT STANDARDS

The Proposals

- The Commission proposes that all statutory audits prescribed by Community law should be carried out in accordance with ISAs. In order to be able to endorse International Standards on Auditing, the Commission needs to examine whether the standards are accepted internationally and whether they have been developed with proper due process, public oversight and transparency.
- Article 26(3) indicates that Member States may impose additional audit procedures only if these follow from specific requirements relating to the scope of the statutory audit.
- The Commission may adopt a common standard audit report for annual or consolidated accounts which have been prepared in accordance with adopted International Accounting Standards.
- Article 27 introduces the principle that the group auditor bears full responsibility for the audit report in relation with the consolidated accounts. It also requires that the group auditors needs to ensure that they maintain sufficient documentation of the review performed by another auditor or audit firm which audits part of the group and that they obtain copies of the audit documentation if that auditor or audit firm has not been approved in a Member State.

FEE Positions

- FEE proposed in November 2001 that by 2005, EU national auditing standard setters should require auditors to perform audit procedures that comply with ISAs and to report on financial

statements in accordance with the same international standards. ISAs could be supplemented by additional standards covering issues connected to the national regulatory framework. Other differences should be gradually eliminated. The aim is to reduce variations in auditing and audit reporting practice.

- FEE welcomes the proposal to make ISAs applicable in Europe. Because an audit is an audit, ISAs should be applicable, as proposed, to all audits and not only when the company uses IFRS. However, in the interests of innovation and improvement some flexibility should be allowed to national standard setters to maintain additional requirements on audit procedures. Furthermore, the question is raised whether it would be appropriate to require the application of International Auditing Practice Statements by law (article 2). FEE believes that it is preferable to mention only ISAs in the text of a Directive.
- FEE supports global standards in auditing and ethics. These standards are set under new public interest oversight arrangements which have been enthusiastically endorsed by the Financial Stability Forum. Such endorsement confirms that the public interest will always be upheld in setting these standards. FEE favours an endorsement of the of international standard setting process but fears that endorsement of individual standards could undermine application of the global audit standards
- In November 2001 FEE has also recommended a new format of the audit report which would allow European auditors to demonstrate clear compliance with ISAs whilst providing separately additional information as required by national laws and standards. However, such a format should be developed in an update of ISA 700 on the audit report (which is presently under revision) and not as a legislative power reserved to the Commission, which would be unnecessary and result in inflexibility.
- FEE supports the principle that the group auditor bears full responsibility for his audit report on the consolidated financial statements. However, we are concerned about the proposal that the group auditor must retain a copy of the documentation of the audit work performed by auditors not approved in the EU. The purpose of the requirement as drafted is not evident. We believe that such a requirement is actually impracticable and would not contribute to audit quality. This would provide an unnecessary burden on the auditor, would delay audit completion and would increase cost. Instead we believe that it would be more sensible to have a robust principle establishing that “the group auditor maintains documentation which supports his group audit reports, including when a component of the group undertaking is audited by another statutory auditor or audit firm whether approved in the EU or otherwise”.

CHAPTERS VII AND VIII – QUALITY ASSURANCE, INSPECTIONS AND SANCTIONS

The Proposals

- Regular inspections are a good means to support a consistent high quality of statutory audits. Statutory auditors and audit firms should therefore be subject to a system of quality assurance that is organised in a manner which is independent from the reviewed statutory auditors and audit firms.

- Member States' systems of investigations and sanctioning still vary to a large extent. Article 30 sets up the general principle that Member States shall organise effective systems of investigation and effective and dissuasive sanctions, which may be civil, administrative or criminal.
- The Commission intends to develop the principles mentioned in the proposed Directive using the comitology procedure to legislate further.

FEE Positions

- FEE strongly supported the European Commission's Recommendation of 15 November 2000 that Member States establish robust quality assurance systems for auditors, as they inspire public confidence. The Recommendation provides that quality assurance systems should have adequate public oversight consisting of a sufficient number of non-practitioners on the oversight board of the quality assurance system. Incorporating key elements of this Recommendation into European legislation will help guarantee that the quality assurance system is seen to be carried out in accordance with common European benchmarks, thus supporting the single market and also dialogue with regulators in other jurisdictions.
- FEE believes that investigative and sanctioning systems should uphold principles of fairness and due process and should include the possibility for appeals. This should be explicitly mentioned in the Directive.
- FEE also has some concerns about the publication of all measures taken in respect of auditors because, for example, the publication of all recommendations for improvement could undermine confidence unnecessarily.

CHAPTER IX – PUBLIC OVERSIGHT

The Proposals

- The current lack of confidence is partly based on a public perception that a self-regulating profession runs a serious risk of conflicts of interests in dealing with its shortcomings. Therefore, a credible element of public oversight over the audit profession is crucial. The proposed Directive gives some details on the responsibilities of the oversight bodies, the required transparency and the necessity to provide for adequate funding.
- Credible supervision of the audit profession requires a clear majority of non-practitioners to oversee the audit profession. For public interest entities, the oversight of auditors should be carried out exclusively by non-practitioners. Nonetheless, those who govern the public oversight system should be sufficiently knowledgeable about accounting and auditing.
- The explanatory memorandum says that in the light of the emerging EU capital market there is a need for a EU coordination mechanism to bring together the national systems into a cohesive, efficient pan-European network. This should serve to encourage convergence of principles and practice. However the provisions of the Directive do not establish a separate mechanism for this purpose.

- Article 34 sets out the rules for effective cooperation between Member States in investigations of audit firms.

FEE Positions

- FEE has long been calling for the creation of a European-level body to coordinate oversight arrangements at Member State level. Our proposals have been summarised in a discussion paper in 2003. Unfortunately, the proposed Directive lacks clarity regarding the organisation of the European coordination. It is imperative that this coordination body be visibly structured in the public interest and involve all stakeholders appropriately.
- FEE believes that a separate oversight for listed companies will introduce a false dichotomy, without any evidence that this could improve oversight results or enhance the credibility of the mechanism. To be effective, oversight bodies need significant auditing expertise. This provides them with a better insight into the environment in which the auditing profession is working. It is important that oversight mechanisms can be confident that proposals they make or decisions they implement will represent practical solutions to improve audit quality. Accordingly, there is a strong case for the involvement of a minority of active professionals in the governance of oversight for auditors and audit firms of both listed and unlisted companies. This is confirmed by recent legislation in several EU Member States, for example France and Ireland, as well as in Canada. Members of oversight bodies should be appointed following a transparent procedure and internal rules should require them to stand aside in cases where there are clear conflicts of interest.
- It is not necessarily the responsibility of a public oversight body to make standards or to carry out quality assurance programmes. FEE supports the proposal of the European Commission that the public body should focus on the supervision (oversight) of the system, whereas other bodies, which include professional bodies, could contribute to, or be delegated, the implementation of the tasks.
- FEE supports home country regulation and oversight and regulatory cooperation between Member States in investigations.
- The proposed Directive requires Member States to make one entity responsible for ensuring co-operation (article 32). The reason for such limitation should be further considered.

CHAPTER X – APPOINTMENT, DISMISSAL AND COMMUNICATION

The Proposals

- Article 35 requires that the statutory auditor or audit firm shall be appointed by the shareholders, if needed subject to prior approval of competent supervisory authority or by a court.
- Dismissal is only acceptable if there are proper grounds.

- An adequate explanation of the reasons for dismissal or resignation must be disclosed to competent authorities.

FEE Positions

- FEE agrees that the statutory auditor cannot be appointed by those who prepare the financial information. However, the text should be clarified to cover adequately the two-tier board system or any other committees established by national law. Furthermore, it should be clear that the appointment by a court or another organisation is only possible in exceptional circumstances and cannot be the principle.
- FEE questions the reasons for a general requirement to disclose the reasons for dismissal to competent authorities. Such disclosure should of course be made to the shareholders and the governance body of the company.
- FEE welcomes Article 37 concerning communication with the governance body. As pointed out in the FEE Discussion Paper on The Financial Reporting and Auditing Aspects of Corporate Governance, it is essential that adequate rules be in place which provide for effective communication between the statutory auditor and those charged with governance. This is primarily a matter for auditing standards. Some clarification is however advisable on the requirement that communication should be “properly recorded” as not all day to day communication between members of the audit team and company staff are relevant in this respect. .

CHAPTER XI – SPECIAL PROVISIONS FOR STATUTORY AUDIT OF PUBLIC INTEREST ENTITIES

The Proposals

- Article 38 requires the audit firms that carry out statutory audit(s) of public interest entities to provide a detailed transparency report, available on the firm’s website, that gives an insight into the audit firm and the network to which it belongs.
- The requirement to set up an audit committee in Article 39 will strengthen monitoring of the financial reporting process and the statutory audit and help to prevent any possible undue influence of the executive management on the financial reporting of the audited entity. One of the functions of the audit committee is to monitor that control activities are performed and communication and reporting processes are in place for breaches of internal control policies and applicable laws and regulations. The Directive proposes that the statutory auditor or audit firm shall assist the audit committee in fulfilling its tasks and communicate on a timely basis with the audit committee on those matters of governance interest that arose from the audit of the financial statements.
- Article 40 gives the audit committee a central role in guarding auditor independence. Article 43 foresees that the audit committee shall assist in the nomination process for the statutory auditor or audit firm by selecting the statutory auditor or audit firm for the proposal for appointment to the general meeting of the audited entity.

- With regard to auditor independence Article 40 also provides for a Member State option to require either internal rotation of key audit partners after 5 years or external rotation of the audit firm after 7 years.
- Article 41 shortens quality review cycles to every three years.
- Article 42 sets stricter requirement for public oversight by excluding any practitioner from the governance of public oversight systems.

FEE Positions

- FEE welcomes the proposal to require an audit committee in public interest entities. FEE agrees with the main tasks attributed to the audit committee, including monitoring the company's internal control and risk management system. We understand that the European Commission intends to issue a recommendation on independence of non-executive directors. This recommendation should include a requirement that the majority of the members of the audit committee need to be independent.
- FEE, however, believes that the wording of paragraph 3 of Article 39 should be improved since it cannot be the responsibility of statutory auditors to “assist” directors of the company, even the members of the audit committee as this would give at least the appearance of participation in directors' responsibilities.
- FEE agrees with the proposal to develop further the requirements on transparency of audit firms auditing the accounts of a public interest entity. However FEE expresses some concern about reporting publicly on the effectiveness of internal quality control systems of audit firms because we believe that any weaknesses are a matter to be addressed by external quality assurance carried out under public oversight that avoids undermining public confidence.
- The explanatory memorandum of the Commission's proposals calls for a study on the possibility of a general prohibition on provision of non-audit services to audit clients. FEE does not believe that such restrictive rules will improve the quality of audits, which requires a sound understanding of the audited enterprise and the markets in which it operates. Audit related and other appropriate services can provide auditors with additional insight which contributes to the quality of the audit. We call on the Commission to clarify the real situation by immediately bringing forward their plans for a study of non-audit services.
- The proposed Directive, if adopted, would establish a special regime for public interest entities, including the possible option for member states to require audit firms to rotate every seven years. A few countries in the world, such as Italy, already apply mandatory rotation of firms. The arguments for and against mandatory audit firm rotation concern whether the independence of an audit firm is adversely affected by a firm's long-term relationship with the client and the desire to retain the client. Concerns about the potential effects of mandatory audit firm rotation include whether its intended benefits would outweigh the costs and the loss of company specific knowledge gained by an audit firm through years of experience auditing the client.
- It is widely believed that the costs of mandatory audit firm rotation are likely to exceed the benefits and that the current requirements for audit partner rotation, auditor independence, and

other reforms will achieve the intended benefits of mandatory audit firm rotation. Given that there is widespread doubt about the actual effects of such a regime on audit quality, in light of evidence from empirical studies that the risk of audit failure is higher in the first years of an audit, FEE does not support the specific proposal in the directive on rotation of audit firms. A better result would be obtained through a robust system of quality assurance and inspection as required in chapters VII and VIII of the proposed Directive.

- FEE calls on the Commission to remove the proposal to exclude practitioners from public bodies overseeing statutory auditors of public interest entities. As described under Chapter IX above, there is a strong case for the involvement of professionals in the public oversight bodies overseeing both auditors of public interest entities and other entities. Member states will be reluctant to establish separate oversight arrangements for public interest entities and for others and so the effect of this proposal would probably be to exclude practitioners from public oversight altogether.
- FEE is also concerned that the proposal for separate oversight of the audit of public interest entities may be inconsistent with legislation recently introduced or to be introduced shortly in Member States after considered national debate.

CHAPTER XII – INTERNATIONAL ASPECTS

The Proposals

- Auditors and/or audit firms from third countries that issue audit reports in relation to securities traded in the EU or parents of EU undertakings, need to be registered in the EU on the basis of Article 45 and be subject to Member State systems of oversight, quality assurance and investigations and sanctions. In order to prevent unnecessary international regulatory overlap, Article 46 allows for exemption from registration, oversight, quality assurance and investigations and sanctions if audit firms from third countries are subject to equivalent systems.
- It is important that international regulators and supervisors cooperate on the basis of true partnerships and confidence. Several Articles of the proposed Directive include appropriate requirements for registration, public oversight, quality assurance investigations and sanctions on audit firms and could underpin reciprocal cooperative arrangements with third countries' regulators and supervisors.
- These activities will include the need for access to audit working papers which, under a cooperative approach, will be possible if they are transferred by national competent authorities. Such a transfer requires reciprocal cooperation by the third country. As the exchange of audit working papers remains a sensitive matter for all parties involved, Article 47 imposes some additional requirements in comparison to the intra-EU cooperation in investigations as defined in Article 34.

FEE Positions

- FEE welcomes enhanced cooperation between international regulators that can bring about a

reduction of inefficient regulatory overlap. We also welcome enhanced cooperation which results in consistent quality of oversight.

- FEE understands that Article 46 which allows derogation in the case of equivalence is central to the proposed regime. We hope that such provision, if approved, will be implemented in such a way that it avoids unnecessary duplication of oversight regimes. Furthermore, we would like to draw attention to the many practical challenges resulting from the requirement to register audit firms from third countries.
- The European Commission itself recognises that the access to working papers is a sensitive matter. FEE agrees with a system based on contacts with the competent authorities in the home country of the statutory auditor. Other aspects of this issue need to be further considered including relevant legal issues such as on data protection, especially in relation to Article 47.4.
- FEE urges the European Commission to continue its dialogue with other major regulators, including the US SEC and PCAOB. The discussion should aim to establish a basis for acceptance, by all parties, of the equivalence of arrangements in terms of the highest quality of oversight, corporate governance, financial reporting auditing and related enforcement in both jurisdictions.

ADDITIONAL REMARKS

The risk of catastrophic losses arising from huge claims in relation to audit is a most serious threat to the viability of the auditing profession. The proposed Directive does not include any provision concerning the liability of auditors. The Commission announced in its Communication of 21 May 2003 that it would launch a study on economic impact of auditors' liability.

We contend that reform is a major issue in the public interest. It is essential that audit liability fairly and reasonably relates to the consequences of unsatisfactory audit performance. In order to perform high quality audits, the audit profession needs to attract and retain individuals of the highest personal qualities, able to address the many complexities of financial reporting and auditing. Such persons need to be able to understand properly the businesses which they are auditing and possess the personal qualities of integrity and character necessary to report with candour. Such individuals need to see in auditing the potential for an attractive career with opportunities for undertaking a variety of work and in a framework of reasonably balanced personal risk.

FEE therefore urges the European Commission to accelerate its study of this issue.