

Will the European debate on audit policy find a better way forward under the Lithuanian Presidency?

An article by FEE, the Federation of European Accountants

This key question is soon to be answered as the Lithuanian Presidency is taking over from the Irish Presidency at a time where the Member States struggle to find an agreement while in comparison the European Parliament managed to find a compromise.

The Proposals

After the European Commission Green Paper of 13 October 2010 on the role of auditors¹ and the related public consultation, the adoption of a (non-binding) report of the European Parliament on the Green Paper and a Commission impact assessment, the European Commission released its Proposals on 30 November 2011, including:

- A revision of the Statutory Audit Directive² (2006/43/EC) setting 'minimum harmonisation' requirements for all statutory audits, requirements which would require transposition by European Union (EU) Member States into their national legislation, and
- A new Regulation³ regarding statutory auditors of Public Interest Entities (PIEs) within the EU, setting 'maximum harmonisation' requirements which are directly applicable in EU Member States.

The legislative process

This publication has initiated the legislative process. Indeed, the sole power of the European Commission (EC) is to make *legislative proposals*; the European Parliament (EP) together with the Council of Ministers (representing the EU Member States) are the co-legislators and have the *decision power* to amend and eventually adopt the legislation. The Dossier is currently in the hands of the EP and the Council of Ministers, a process known in EU history to take an absolute minimum of 14 months up to an astonishing record of 29 years, more precisely:

- In the EP, the debate has already taken place in the different relevant Committees. The Legal Affairs Committee (JURI) is the main Committee responsible with Sajjad Karim, ECR (European Conservatives and Reformists) nominated as Rapporteur on the Dossier, with enhanced cooperation of the Economic and Monetary Affairs Committee (ECON) and with an opinion of the Industry, Research and Energy Committee (ITRE). After a vote in the JURI Committee on 26 April 2013, two reports were published by this Committee, one on the Directive and the other on the Regulation (Respectively dated 13 May 2013⁴ and 20 May 2013⁵). These reports propose a number of amendments to the EC proposals which are developed further below. The Committees' proceedings in first reading would be finalised by a vote in a plenary session of the European Parliament adopting an opinion amending the European Commission Proposals. At the time of writing, although the timing of this final vote is foreseen before the end of the year, the exact time at which it should take place is still uncertain.
- In parallel, the Council - under the Irish Presidency until end of June 2013 and followed by the Lithuanian Presidency as from 1 July 2013 - is discussing the EC Proposals in its Company Law Working Group, which involves representatives of the Member States' relevant administrations, as well as the European Commission. National positions are being debated. At political level, an orientation debate has taken place in the Competitiveness Council

¹http://ec.europa.eu/internal_market/consultations/docs/2010/audit/green_paper_audit_en.pdf

²http://ec.europa.eu/internal_market/auditing/docs/reform/directive_en.pdf

³http://ec.europa.eu/internal_market/auditing/docs/reform/regulation_en.pdf

⁴<http://www.europarl.europa.eu/document/activities/cont/201305/20130514ATT66105/20130514ATT66105EN.pdf>

⁵<http://www.europarl.europa.eu/document/activities/cont/201305/20130521ATT66424/20130521ATT66424EN.pdf>

on 29 May 2013⁶, which involves the responsible Ministers of the 27 Member States and the European Commission. During this session, each Member State gave an indication of their then current views on the Irish Presidency proposed compromise amendments with regard to three much debated topics: the prohibition of non-audit services, the European coordination of audit oversight systems and mandatory audit firm rotation. These topics are developed further below. While the working process within the European Parliament has been relatively transparent, the proceedings that are taking place between the Member States are far more opaque. A likely outcome could be that the Council will adopt its own amendments in a so-called ‘common position’.

- To be formally adopted the proposed legislation needs the approval of both the European Parliament and the Council on exactly the same wording. This is achieved through the so-called ‘Trialogue’ discussions, involving the two co-legislators and the European Commission.

The issues at stake

The debate to reach a compromise is mainly concentrated on the following topics, being also the ones which are of most concern to EU Member States:

- a) The definition of Public Interest Entities (PIEs), determining the scope of the Proposed Regulation;
- b) The threats to the auditor’s independence and the provision of non-audit services to audit clients being PIEs;
- c) The possible obligation for mandatory audit firm rotation for audits of PIEs;
- d) Cooperation at EU level of national authorities competent for audit oversight;
- e) The requirements for the auditor’s public reporting on PIE audits;
- f) The role of accountancy professional bodies; and
- g) The choice of legal instrument, namely a Directive and/or a Regulation.

a) Definition of Public Interest Entities (PIEs)

The extension of the definition to include any entity involved with the provision of financial services may seem to make sense for supervisory purposes or for

protecting the interests of investors. However, some of the entities added to the extended definition of PIEs in the proposed Directive may in reality be small or medium-sized, low risk or low complexity entities with limited impact on the public interest.

The report voted in the JURI Committee proposes to keep the 2006 Statutory Audit Directive PIE definition, mainly including listed entities, financial institutions and insurance undertakings.

FEE agrees with this analysis and recommends therefore that the EC proposals are amended in order to exclude these low risk entities from the definition: a balance has indeed to be struck between public interest and administrative burden. Member States could nevertheless be authorized to designate as PIEs entities that are of significant public relevance because of the nature of their business, their size or the number of their employees.

FEE strongly recommends the Council to follow the lead of the JURI Committee in respect of the PIE definition.

b) Threats to auditors’ independence and provision of non-audit services to audit clients being PIEs

The report of the JURI Committee advocates the application of the principles and requirements of the International Code of Ethics (IESBA) instead of the Commission’s proposals related to independence.

FEE agrees with this approach as this global Code is significantly more robust and demanding than the current EU requirements. Moreover, a global solution is definitely the way forward as it will limit administrative burdens, avoid extraterritorial impacts and preserve a level playing field. FEE is indeed of the view that the European Commission proposals on the introduction of pure audit firms, the far reaching prohibition on the provision of non-audit services to PIE audit clients and the limitation of the provision of related audit services to only ten per cent of audit fees will isolate Europe on the world stage, will increase the administrative burden but, most importantly, will reduce the expertise and knowledge within audit firms of their audit clients.

The Council of the European Union is still split on this issue. FEE nevertheless notes the vast support expressed by the Council for an approach where the text only mandates a closed list of prohibited non-audit services (the so-called ‘black list approach’).

⁶ This Competitiveness Council was public and thus can be broadcasted at the following link:
<http://video.consilium.europa.eu/webcast.aspx?ticket=775-979-12981>

However, FEE highlights that a majority of Member States question the extensive list of prohibitions proposed by the EC. FEE finds it unfortunate that the proposed list of prohibited services does not include the concepts of materiality and relevance to the financial statements of the audited entity which are embedded in the IESBA Code of Ethics. A significant number of Member States are also against the principle of capping or limiting the provision of other services as a percentage of audit fees. When the time to compromise will come, it will be important that Member States remain attentive to the content of this list and do not turn it into something that would be impracticable, disproportionate or an international anomaly.

c) Possible obligation of mandatory audit firm rotation for audits of PIEs

The European Commission Proposed Regulation requires external rotation of the auditor every six years and bans the reappointment of the incumbent auditor. In the case of a joint audit, this period is extended to a maximum duration of nine years for each auditor or audit firm.

The report of the JURI Committee proposes instead a yearly renewable engagement over a maximum of 14 consecutive years. However, after the expiry of this duration of 14 years, the statutory auditor or audit firm shall not undertake the statutory audit of the public-interest entity concerned until a period of at least four years has elapsed except if: (a) a public tendering process for the statutory audit is conducted; or (b) a comprehensive assessment of the audit engagement is performed by the audit committee; or (c) a joint audit is performed. Renewal is possible upon recommendation of the audit committee, the administrative or supervisory board to the general meeting of shareholders and after approval by the latter. In addition, a maximum duration of 25 years has been set for an audit engagement of a PIE.

In the Council, the views of Member States in relation to mandatory rotation of audit firms differ to some extent on the principle, duration and scope of such rotation. Discussions to reach a compromise in the Council are understood to be still in progress.

FEE has studied the very limited evidence available on the practical effects of mandatory audit firm rotation and has weighted the pros and cons of the proposal. The majority of FEE Members concluded that such a measure would be unhelpful as it would have limited benefits from an independence standpoint and may lead to further concentration in the audit market and therefore oppose the principle of making auditor's rotation mandatory as it is detrimental to audit quality and, as shown by experience, will increase – not reduce – concentration

on the audit market. In the framework of good corporate governance, it should be up to the audit committee to decide when to rotate the company's auditor.

In this respect, it is worth mentioning that on 19 June 2013 the US House Financial Services Committee unanimously approved the Audit Integrity and Job Protection Act which would prohibit the Public Company Accounting Oversight Board (PCAOB) from implementing mandatory audit firm rotation in the United States. The Audit Integrity Act was approved by the US House of Representatives on 8 July 2013 with an overwhelming majority. The bill will now move to the Senate, where it must be approved before being signed by the president to become law. It is not clear which impact this development in the US can and will have on the discussions in the Council of Ministers of the European Union Member States.

d) Cooperation at EU level of national authorities competent for audit oversight

The Commission proposal envisages EU-wide cooperation on auditor oversight between the national competent authorities takes place within the European Securities and Markets Authority (ESMA). This committee would assume functions previously undertaken by the European Group of Auditors' Oversight Bodies (EAOB), an expert group chaired by the Commission.

The report of the JURI Committee supports that ESMA be the coordination body for public oversight of the audit profession on European level, but curtails the regulatory and other powers of ESMA to a certain extent.

In the Council, a number of EU Member States do not agree with the compromise put forward by the Irish Presidency to set up a Committee of European Auditing Oversight Bodies (CEAOB) within ESMA, composed of the members of EAOB and having decision making powers. These EU Member States propose an alternative to ESMA, namely the strengthening of existing co-operation provided under the EAOB. The majority of EU Member States seem to support such alternative.

FEE strongly supports public oversight of the profession as it is crucial to enhance audit quality and the long-term sustainability of auditors and audit firms. Nevertheless, an appropriate balance between independence and competence within supervision should be sought and this balance may not be easy to find within ESMA.

e) Adaptations to the auditor's public reporting on PIE audits

FEE supports the European Commission's idea to enhance the auditor's public communication for PIEs, especially on:

- Qualitative information on the significant audit risks;
- More reporting on going concern assumptions based on information provided by management.

Nevertheless, in the EC Proposals, there are a number of matters that are too prescriptive or too detailed, like auditor's reporting on methodology, on materiality, on identification of each member of the entire engagement team, on the length of the audit report, etc.

In its report, the EP JURI Committee has improved the Commission's proposals to make them more practicable and useful. The EP indeed has not ignored the current project of the International Auditing and Assurance Standards Board (the IAASB), the relevant international standard setter on auditor reporting⁷ as global markets need global solutions.

FEE very much appreciates this approach even if some further thoughts could be given to some amendments that will not really be practicable in reality: for instance, the JURI report contains an amendment requesting the auditor to disclose, in the public report of PIEs, all other services provided to the audited entity. FEE puts into question the added-value of such disclosures in the public audit report.

f) Role of professional bodies

Concerning the role of professional bodies, the EC Proposal only allowed delegation of approval and registration of statutory auditors and audit firms. All other tasks such as the whole process of education, qualification and quality assurance reviews for non-PIEs are not possible to be delegated by the competent authorities to the professional bodies.

The JURI report deleted this limitation of delegation. The understanding is that Council is seemingly disagreeing with the EC with regard to such limitation in delegations.

FEE agrees with the amendments put forward by the EP Committee and therefore recommends that delegation to professional bodies, under the

supervision of the competent authority, means at least:

- Approval and registration of auditors including the whole process of education, initial qualification and continued professional development;
- Quality assurance reviews for non-PIEs.

Indeed, these professional accountancy bodies currently have the experience and expertise in performing such reviews in a cost effective way while contributing to the constant improvement in audit quality.

g) The choice of legal instrument, namely a Directive and/or a Regulation.

As stated above, the EC has issued two legal instruments: (a) a revision of the Statutory Audit Directive setting 'minimum harmonisation requirements' for all statutory audits, requirements which would require transposition by European Union (EU) Member States into their national legislation, as well as (b) a new Regulation regarding statutory auditors of PIEs within the EU, setting 'maximum harmonisation' requirements which are directly applicable in EU Member States.

The EP JURI Committee proposes to transfer a number of stipulations from the Regulation to the Directive, the major ones being: (a) on the 'Internal Organisation of Auditors and Audit Firms', (b) on 'Independence from the Audited Entity' and (c) on 'Performance of the Statutory Audit', making them applicable to all entities. The article of the Regulation on 'Audit Committee' is also proposed to move to a new article of the Directive, but applicable to PIEs only.

The Council is understood to consider those and even further shifts from the Regulation to the Directive.

Conclusion

FEE urges all stakeholders, and in particular the parties involved in the Trialogue, to approach the matter from the viewpoint of the public interest.

As regards the profession, FEE invites all its Members to focus on the long-term collective interest of the entire accountancy profession, whatever the size of firms, areas of practice or Member State, taking into account the European public interest.

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⁷ <http://www.ifac.org/auditing-assurance/projects/auditor-reporting>