



14 MARCH 2012

# REFORM OF STATUTORY AUDIT

## Assessing the legislative proposals

This briefing sets out our initial assessment of the legislative proposals to reform statutory audit published by the European Commission in November 2011. It indicates provisions that may enhance audit quality, provisions which could strengthen audit if amended, as well as provisions which could undermine quality and confidence. A top-level assessment of the main provisions on an article-by-article basis of both the draft Regulation and the draft Directive is also provided. Our comments are meant to be of general relevance to the EU debate, although some of our detailed remarks may refer more specifically to the situation in the UK.

### 1 ENSURING A SUCCESSFUL OUTCOME

The legislative proposals to reform statutory audit, published by the European Commission in November 2011, set out a wide range of provisions which would have a considerable impact on the audit profession and the wider business community in the EU. It is vital that the evidence base and the possible consequences of any future legislation are fully understood. We look forward to sharing our insight and experience in the discussions to follow, in support of considered regulation that will achieve the key objectives of improving audit quality, addressing independence concerns and ensuring market confidence – while not imposing unnecessary burdens on business. ICAEW will also continue to take forward initiatives on the future of audit, an aspect not sufficiently addressed in the proposals.

### 2 SUPPORT FOR MEASURES THAT HAVE MERIT

We believe some of the proposals have merit and should be supported including the introduction of International Standards on Auditing (ISAs), greater transparency of the audit process, and better dialogue between auditors and prudential regulators. We also support in principle a number of provisions, although we believe that greater consideration needs to be given to their potential impact. Moreover, close attention has to be paid to the detailed wording of various articles.

Increasing market choice is an important objective. In our view, this can be increased over time by ending restrictive bank covenants, ensuring transparent and objective auditor selection processes and relaxing audit firm funding rules. Audit regulators should also consider the potential impact of their activities on choice while recognising, as in the case of the UK Competition Commission's current audit market investigation, that competition authorities have responsibility for market structure issues.

### 3 SIGNIFICANT CONCERNS REMAIN

ICAEW does not agree with all the proposals tabled by the Commission. We believe some of the proposed measures are likely to have unintended consequences. For instance, the requirement for

public interest entities (PIEs) to change their auditor every six years would increase costs and have a negative impact on audit quality. Restricting the provision of non-audit services beyond those already in international independence requirements also increases costs to business and restricts choice of best provider in circumstances when safeguards against independence threats can be applied. Likewise, banning large audit firms from doing anything but audit would have adverse consequences on audit quality; restricting their access to specialist knowledge, vital for auditors to be able to do their job properly. Recruitment of graduates would also be likely to suffer.

## 4 THE BIGGER PICTURE

It is critical that this debate does not become a distraction to the vital day-to-day work that the accountancy profession carries out. Trusted professional advisors are particularly important in these challenging economic times. Reforms must serve the purpose of giving investors greater confidence, enabling businesses to grow and create jobs.

ICAEW is a professional membership organisation, acting in the public interest to support over 138,000 chartered accountants around the world and is a founding member of the Global Accounting Alliance, representing over 775,000 of the world's leading professional accountants in 165 countries. In the UK, ICAEW is a recognised supervisory body for company auditing.

Our views are drawn from consultation and input with stakeholders and our broad membership, including investors, professional accountants in business and internal auditors, as well as external auditors in firms of all sizes. We welcome comments to help us develop this briefing at [europa@icaew.com](mailto:europa@icaew.com).

### OVERVIEW

#### PROVISIONS WHICH MAY ENHANCE QUALITY

Disclosure of audit papers to third countries	Art 13, draft Regulation
Responsibility of the group auditor	Art 18, draft Regulation
Audit committee report	Art 23, draft Regulation
Dialogue between auditors and financial supervisors	Art 25 & 32(6), draft Regulation
Transparency reporting	Chp V, draft Regulation
Prohibition of restrictive clauses	Art 32(7), draft Regulation & art 37(3) draft Directive
Rotation of key audit partner	Art 33(2), draft Regulation
Provision of handover file to incoming auditor	Art 33(5), draft Regulation
Resignations to be communicated to competent authorities	Art 34, draft Regulation
Monitoring market developments, including liability systems	Art 42, draft Regulation
Contingency plans	Art 43, draft Regulation
Pan-European quality certification	Art 50, draft Regulation
Ownership rules	Art 3 & 22(2), draft Directive
Calibrating audit for smaller entities	Art 43, draft Directive

#### PROVISIONS WHICH COULD STRENGTHEN AUDIT, IF AMENDED

Scope	Art 1 – 4, draft Regulation
Internal organisation & independence from audited entity	Art 5 – 8, draft Regulation
Performance of the audit & audit reporting	Art 14 – 17, draft Regulation
International Standards on Auditing (ISAs)	Art 20, draft Regulation & art 26, draft Directive
Public audit report	Art 22, draft Regulation
Reporting material facts or decisions to competent authorities	Art 25, draft Regulation

Audit committees	Art 31, draft Regulation
EU-wide regulatory co-ordination	Art 46, draft Regulation
Passport	Art 3b, 15 & 17, draft Directive
Cross-border provision of audit services	Art 3a, draft Directive
Harmonisation of aptitude test	Art 6 & 14, draft Directive
Approval of statutory auditors from other member states	Art 14, draft Directive

## PROVISIONS WHICH WILL UNDERMINE QUALITY AND CONFIDENCE

Limitation of audit fees for related financial audit services	Art 9, draft Regulation
Non-audit services	Art 10, draft Regulation
Mandatory tendering	Art 32, draft Regulation
Mandatory rotation	Art 33, draft Regulation
Quality assurance & the role of professional bodies	Art 38 & 40, draft Regulation & art 32, draft Directive

## ASSESSMENT OF MAIN ARTICLES

### DRAFT REGULATION

#### SCOPE

The scope of the draft Regulation (Articles 1 to 4) is more extensive than existing legislation by amending the definition of Public Interest Entities (PIEs) to also include additional types of financial entity, thereby capturing a larger number of organisations. While it may make sense to include some financial categories, the impact on small entities within the potential definition – listed and otherwise – needs to be taken into account, as well as the impact on the smaller audit firms that audit them.

#### INTERNAL ORGANISATION & INDEPENDENCE FROM AUDITED ENTITY

Articles 5 to 8 (draft Regulation) provide that statutory auditors must comply with provisions relating to their internal organisation as well as with measures to ensure independence from the audited entity. These provisions are sensible in principle. A number cover procedures that firms are already required to have to ensure independence under the code produced by the International Ethics Standards Board for Accountants (IESBA) and under the International Standard on Quality Control 1 (ISQC 1), produced by the International Auditing and Assurance Standards Board (IAASB). However, some provisions need to be substantially amended and / or interpreted proportionately.

#### LIMITATION OF FEES FOR RELATED FINANCIAL AUDIT SERVICES

Article 9 in the draft Regulation provides that fees should not be based on any form of contingency as well as for disclosure of total fees from PIE clients above a certain threshold. These measures are important safeguards against threats to independence: we support them.

The article also states that related financial audit services to the audited entity should be limited to 10% of the audit fee. This new measure is highly restrictive, limiting PIEs' ability to purchase related financial audit services, even where permitted in the draft Regulation (Article 10). By their very nature, these services are least likely to compromise independence and safeguards are likely to be available. Many of these services are required by regulators to be performed by auditors. Others are often required to a tight time scale, and the auditors are often best suited to provide them.

#### NON-AUDIT SERVICES

The draft Regulation (Article 10) introduces new levels of prohibition with regard to non-audit services for PIE clients. There are already comprehensive international independence requirements in this area. We believe that this provision will be extremely restrictive for PIEs and the evidence does not prove that such

measures are needed to enhance independence further. It is vital that the impact on smaller PIEs is taken into account as well as potential extra-territorial issues for audits with components outside of the EU. In addition, although not the prime purpose of these measures, they are also unlikely to enhance competition.

In particular, banning the largest audit firms from doing anything but audit (Article 10(5)) would be likely to harm audit quality by restricting their access to specialist knowledge vital for auditors to be able to do their job properly. Introduction of such a measure would also raise some significant extraterritorial issues with international audits and other parts of the firms' networks.

## DISCLOSURE OF AUDIT PAPERS TO THIRD COUNTRIES

The draft Regulation (Article 13) introduces a limited exemption from confidentiality rules to allow the transfer of audit papers to third country auditors and authorities. We believe this will assist group audits and regulatory investigations.

## PERFORMANCE OF THE AUDIT & AUDIT REPORTING

Basic requirements for the performance of statutory audits are defined in the draft Regulation (Articles 14 to 17). These go beyond ISAs in some areas, for example in relation to documentation and recording of an 'incident which may have serious consequences for the integrity of the statutory audit activities'. It is unclear how some of these measures could be applied. Adoption of ISAs would form a better basis for ensuring audit work meets appropriate standards.

## RESPONSIBILITY OF THE GROUP AUDITOR

The draft Regulation also provides that the group auditor should bear full responsibility for the audit report on consolidated financial statements (Article 18). This is already required by ISA 600 – the article therefore aligns actual and apparent responsibility. However, the interaction with other EU requirements concerning third country auditors and authorities may be complex.

## INTERNATIONAL STANDARDS ON AUDITING (ISAS)

Article 20 in the draft Regulation and Article 26 in the draft Directive provide for the introduction of International Standards on Auditing, allowing for add-ons but not carve-outs. The draft Regulation covers a number of areas also dealt with by ISAs: it will be important to ensure consistency and avoid conflicting measures.

ICAEW has been a long-time supporter of the wider adoption of ISAs, which we believe would be beneficial to the internal market in terms of improved audit quality, consistency and effectiveness. However, the proposals could be read as undermining the integrity of ISAs by permitting the splitting of requirements and application material. We believe ISAs are proportionate and scalable to smaller audits provided that the integrity of ISAs is maintained and that a full suite of complete ISAs, including application material, is promulgated by member states.

## PUBLIC AUDIT REPORT

Article 22 (draft Regulation) significantly expands the content of the public audit report. Although we think the article strays into areas that are more appropriately covered by ISAs, we see benefit in providing additional information about the work that underpins an audit to enhance transparency. However, as currently drafted, Article 22 may also result in a widening of audit scope way that goes substantially beyond that intended, potentially giving rise to a number of unintended and costly consequences.

For audit firms, Article 22 presents unmanageable risk issues not least given the word-count limitation and confusion over what is reported by the PIE and what is reported by the auditor.

For PIEs, some of the provisions could have costly implications, exceeding those of section 404 of the US Sarbanes-Oxley Act (which are confined to internal control over financial reporting). In particular, Article 22 requires the audit report to include an assessment of the internal control system, generally interpreted as the controls used by an entity to manage risks (business and operational risks as well as financial reporting).

We call for substantial consideration to be given to the consequences of the Article 22, as currently drafted, to avoid significant negative impact on PIEs at a time when they need to be driving increased investment and focusing on growth.

## AUDIT COMMITTEE REPORT

Under Article 23 (draft Regulation), auditors will have to prepare a longer and more detailed report for presentation to the audit committee and management. Many auditors do this already. We support enhanced transparency but caution against over-formalising or over-prescribing the flow of information between auditors and audit committees.

## REPORTING MATERIAL FACTS OR DECISIONS TO COMPETENT AUTHORITIES

Article 25 (draft Regulation) requires auditors to report any facts or decisions relating to PIEs which could lead to a material breach of laws / regulations, impair PIEs' continuous functioning or result in a refusal to give a clean audit report. We support greater transparency and improved dialogue with appropriate regulators. But we believe the wording needs to be amended or needs proportionate interpretation. Otherwise it could significantly extend regulatory reporting and increase potential extra risk without benefit to law enforcement.

## DIALOGUE BETWEEN AUDITORS AND FINANCIAL SUPERVISORS

Regular dialogue is to be established between supervisors of financial institutions and auditors (Article 25, draft Regulation). ICAEW has advocated enhanced dialogue in the UK as a means of further improving audit quality.

Article 32(6) (draft Regulation) gives prudential supervisory authorities the right to veto the audit choice proposed by financial institutions, provided any opposition is duly justified. We believe this is a reasonable precaution, assuming such authorities would only go against shareholder wishes in exceptional circumstances.

## TRANSPARENCY REPORTING

Chapter V of the draft Regulation introduces a number of provisions to enhance transparency reporting by auditors of PIEs. While some of the proposed measures are already in place to some degree, the change of PIE definition may require a greater number of auditors to provide such information.

- Disclosure of audited financial information (Article 26), including the split between audit fees from PIEs and non-PIEs as well as fees for other services. Many of the larger firms already provide some of this information.
- Publication of an annual transparency report (Article 27). Many of the larger firms already disclose some form of report.
- A statement on corporate governance (Article 28) is already published by the larger firms in the UK, where ICAEW has been actively involved in developing the Audit Firm Governance code.

## AUDIT COMMITTEES

Audit committees play a crucial role in the audit process and ensuring that they have the necessary expertise as well as operational and decision-making independence from management is critical. Article 31 (draft Regulation) provides that PIEs shall have an audit committee. Most listed companies already comply with this provision. The draft regulation suggests that two members should have recent and relevant financial experience (including one specifically in auditing). Such experience is a sensible provision given the requirements placed on audit committees, but we believe one may be sufficient, in line with existing guidance. Indeed, there may not be sufficient qualified people readily available. The new provisions may therefore have some disruptive impact on boards beyond that which is necessary.

## MANDATORY TENDERING

Under Article 32 (draft Regulation), a mandatory tendering process would be required when PIEs change their auditor. Although as a general aim, ICAEW firmly supports a more frequent tendering process, alongside measures to improve the auditor selection process, mandatory tendering would be likely to add significant costs for both PIEs and auditors, which may outweigh perceived benefits.

## PROHIBITION OF RESTRICTIVE CLAUSES

Restrictive clauses are prohibited (Article 32(7) of the draft Regulation / Article 37(3) of the draft Directive). ICAEW supports the removal of such anti-competitive restrictions.

## MANDATORY ROTATION

We do not agree with a requirement for rotation of audit firms in EU legislation (Article 33, draft Regulation). Mandatory auditor rotation is a complex issue that has been debated on and off for nearly 50 years. The most critical question is '*does it work?*' The evidence to date has tended to point towards a loss of audit quality. This is why international independence requirements focus on rotation of the engagement partner and other key audit partners rather than the rotation of firms. They are the ones who take the decisions and that is where the safeguards need to be applied.

There is no evidence to suggest that mandatory rotation will enhance competition in the market. In our view, it is ultimately beneficial for audit committees to exercise judgement on the renewal of their choice of auditor, based on their assessment of a company's needs, and for them to be accountable to their shareholders for that choice. As highlighted above, we support measures to improve the auditor appointment process.

## ROTATION OF KEY AUDIT PARTNER

Key audit partners are required to rotate after 7 years and a gradual rotation mechanism established for senior personnel (Article 33(2), draft Regulation). This is already effectively in place under independence rules. ICAEW supports partner rotation as a sensible safeguard for PIE audits. The change in definition of PIEs means that more audit firms may be affected and the proposals may force firm rotation where small practices are engaged.

## PROVISION OF HANDOVER FILE TO INCOMING AUDITOR

The incoming auditor is to be provided with a handover file (Article 33(5), draft Regulation). We believe this could help audit quality and is a reasonable pro-competition measure which can be supported.

## RESIGNATIONS TO BE COMMUNICATED TO COMPETENT AUTHORITIES

Competent authorities shall be informed of the dismissal or resignation of the auditor and an explanation given (Article 34, draft Regulation). We support measures which will enhance transparency with regulators.

## QUALITY ASSURANCE & THE ROLE OF PROFESSIONAL BODIES

Articles 38 & 40 of the draft Regulation as well as Article 32 of the draft Directive provide for quality assurance reviews to be organised in a manner that is independent of professional bodies. We accept that such a framework needs to be in place for PIEs and that it is wholly appropriate that the work of the professional bodies in this area be subject to independent oversight. As a Recognised Supervisory Body, we take requirements to report regularly on how we carry out such responsibilities extremely seriously.

We do not believe extending such provisions more widely, as proposed in the draft Directive, will result in any improvement in quality control. Rather, it is likely to be less efficient and discourage good professional judgement. We believe that the current arrangement in the UK, for example, whereby the FRC has responsibility for PIEs as well as oversight of Recognised Supervisory Bodies, works effectively and cost-efficiently, while ensuring independent oversight of the process. The existing framework under the Statutory Audit Directive, which ensures that member states' authorities retain ultimate responsibility for ensuring an independent quality assurance system, remains fit for purpose and should be retained.

## MONITORING MARKET DEVELOPMENTS, INCLUDING LIABILITY SYSTEMS

The draft Regulation tasks competent authorities to monitor developments in the market for statutory audit of PIEs (Article 42). Article 46 provides that ESMA and the European Commission shall evaluate the impact of the regulations on the structure of the audit market, including assessing the influence of member states' liability systems. We support regulatory monitoring, including of unlimited liability regimes which can inhibit competition.

## CONTINGENCY PLANS

Contingency plans should be drawn up by the largest audit firms in each member state (Article 43, draft Regulation). We believe this is a reasonable risk management measure.

## EU-WIDE REGULATORY CO-ORDINATION

Article 46 (draft Regulation) provides that EU-wide cooperation between national competent authorities should take place within ESMA, replacing EGAOB. We believe that there is a need to enhance the level of coordination between European audit supervisors and that EU structures need to evolve accordingly. However, any future framework must acknowledge that audit is likely to remain closely linked to national legal environments.

## PAN-EUROPEAN QUALITY CERTIFICATION

A voluntary pan-European quality certification for statutory auditors of PIEs is to be developed and run by ESMA (Article 50, draft Regulation). We support competition and agree with this provision in principle, although we have doubts that the measures will have a significant effect in practice. It will be important that such certification maintains quality, taking account of existing national certifications.

## DRAFT DIRECTIVE

### OWNERSHIP RULES

Changes are introduced to the ownership rules (Articles 3, 22(2) of the draft Directive) by removing minimum voting rights or capital requirements. This could be a significant change although it is unclear whether many audit firms would take up the option. ICAEW believes that alternative ownership structures should be allowed to develop within the parameters of appropriate safeguards so long as they are not prejudicial to audit quality. Particular consideration would be needed with regard to the potential involvement of financial services entities in the ownership of audit firms.

### PASSPORT

The draft Directive introduces 'passporting' measures for audit firms across the EU (Articles 3b, 15, 17). We support such measures as a way of encouraging further competition and enhancing mobility across the EU, provided quality is maintained. The potential impact, however, is unclear and will depend also on whether host member states will require some form of registration from home member states – and whether member states implement the necessary infrastructure to ensure a smoothly functioning system.

### CROSS-BORDER PROVISION OF AUDIT SERVICES

Under the revised Statutory Audit Directive, statutory auditors approved by a member state shall be entitled to provide cross-border statutory audit services on a temporary or occasional basis (Article 3a). In line with the Directive on the Recognition of Professional Qualifications it is important to achieve greater clarity regarding the practical implementation of 'temporary and occasional audit services', as well as with regard to quality assurance and regulation.

### HARMONISATION OF THE APTITUDE TEST

Under Articles 6 & 14 in the draft Directive, competent national authorities should cooperate to attain a level of harmonisation in the requirements of the aptitude test across the EU, alongside ESMA. We support measures to enhance 'transportability' in this way. It is important that appropriate public interest safeguards are in place, where migrants select an adaptation period, so as to ensure fair and consistent treatment.

Real differences in auditor mobility could be achieved through work at the level of professional bodies. Common professional qualification requirements have already been implemented on a voluntary basis by nine professional bodies in six EU member states in the Common Content project ([commoncontent.com](http://commoncontent.com)). The project ensures a high standard of harmonisation while retaining each country's unique national elements.

### APPROVAL OF STATUTORY AUDITORS FROM OTHER MEMBER STATES

Approval of statutory auditors from other member states is aligned more closely with provisions required under the Professional Qualifications Directive with regard to adaptation period and aptitude tests (Article 14, draft Directive). This will help reduce inconsistencies between regulations, but it is important to maintain quality.

## CALIBRATING AUDIT FOR SMALLER ENTITIES

SMEs are critical to economic recovery and need the best available advice and support. The draft Directive provides for audit to be calibrated to the size of the audited entity (Article 43). While further analysis is needed, we believe the measures appear sensible and could be a way of upholding a principles-based approach, minimising unnecessary burdens on smaller and medium-sized entities.

A common EU framework for alternatives to audit, including assurance services for smaller entities, which allows member states to address audit exemptions according to their national environment, should be established.

ICAEW is a professional membership organisation, supporting over 138,000 chartered accountants around the world. Through our technical knowledge, skills and expertise, we provide insight and leadership to the global accountancy and finance profession.

Our members provide financial knowledge and guidance based on the highest professional, technical and ethical standards. We develop and support individuals, organisations and communities to help them achieve long-term, sustainable economic value.

ICAEW has been present in Brussels for over a decade, facilitating dialogue among stakeholders on key public policy issues and providing technical advice across a broad range of topics including financial reporting, audit, business law, corporate governance, financial services, tax, skills, regulation, ethics and sustainability.

Because of us, people can do business with confidence.

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