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COMMISSION STAFF WORKING PAPER

IMPACT ASSESSMENT

Accompanying the document

Proposal for

**a Directive of the European Parliament and of the Council amending Directive
2006/43/EC on statutory audits of annual accounts and consolidated accounts**

and a

Proposal for

**a Regulation of the European Parliament and of the Council on specific requirements
regarding statutory audit of public-interest entities**

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INTRODUCTION

The measures adopted both in Europe and elsewhere in the direct aftermath of the financial crisis have focussed on the urgent need to stabilise the financial system¹. While the role played by banks, hedge funds, rating agencies, supervisors or central banks has been questioned and analysed in depth in many instances, little or no attention had been given to the role auditors played in the crisis – or indeed the role they should have played. Many banks revealed huge losses from 2007 onwards on the positions they had held both on and off balance sheet. Many of them have been aided by the Member States (and, *in fine*, the taxpayer). The maximum volume/exposure of Commission-approved measures, including schemes and ad hoc interventions, amounted to €4 588.9 billion for the period between October 2008 and October 2009. For 2009, the approved aid accounted for 39% of EU 27 GDP². In this context, it is difficult for many citizens and investors to understand how auditors could give clean audit reports to their clients (in particular banks) for those periods³. If indeed these reports were justified because current legislation is such that it allows clean audit reports in spite of acute intrinsic financial weaknesses in the audited entity, then the role of the audit as well as the scope of audit merit further discussion and scrutiny.

In this context, the Commission assumed leadership by launching a fruitful and intensive debate on this issue also at the international level (close co-operation with its global partners within the Financial Stability Board and the G20). Audit, alongside supervision and corporate governance, should be one of the key contributors to financial stability as it provides assurance on the veracity of the financial statements of companies. This assurance should reduce the risks of misstatement, and in doing so, reduce the costs of failure that would otherwise be suffered by both the company's stakeholders as well as by the broader society. Robust audit is key to re-establishing trust and market confidence. It contributes to investor protection by providing easily accessible, cost-effective and trustworthy information about the financial statements of companies. It also potentially reduces the cost of capital for audited companies by ensuring more transparency of information about financial statements and their veracity, thereby lowering the cost for financial institutions, analysing their financial situation before lending them capital.

¹ European Commission (2009) and European Commission (March 2010).

² The large amounts of support approved under schemes can be explained by the fact that some Member States adopted blanket guarantee schemes which covered all their banks' debt. Member States relied mainly on guarantee measures. €546.08 billion (4.5% of GDP) was approved as recapitalisation measures, of which Member States actually used about €141.5 billion in 2009. In the period between October 2008 and October 2010, the Commission authorised financial crisis measures in the field of State aid in 22 Member States: i.e. all Member States except Bulgaria, the Czech Republic, Estonia, Malta and Romania. See European Commission (April 2011c), p. 21.

³ See for instance Sikka (2009). This paper notes that many European and US financial institutions have sought state support within a short period of receiving an unqualified audit opinion. The events would raise questions about the value of company audits, auditor independence and quality of audit work, economic incentives for good audits and the knowledge base of auditors. In a similar fashion, a member of the US auditors oversight body, explains that "*the events of the last few years have been a case study of the inability of auditors to provide investors with any meaningful signal about increases in financial reporting risks when management assessments or estimates change dramatically, or when debates over significant accounting issues become difficult or contentious.*" He also explains that out of the 10 largest bankruptcies during the financial crisis, only two had going concern opinions. During the year leading up to their bankruptcy filings, the market capitalisation of the eight companies without going concern opinions diminished, resulting in a 99% loss in investor value. See Harris (2011)

It is also essential that any proposal adopted by the Commission reflects the objectives pursued by the Single Market Act⁴ and the Europe 2020 Strategy⁵, namely the creation of a stronger, deeper and extended single market, as well as improving the access for SMEs to the single market. The market for audit services, as it stands today, is very fragmented due to various barriers to the integration of the national markets. The creation of a Single Market for audit services would be beneficial for audit firms, in particular small and mid-sized firms.

Taking all the above into consideration, the subject of this Impact Assessment is to analyse the prevailing problems in the audit market and the potential impacts of a package of intended measures, aiming at reconsidering the role of auditors, the quality and scope of the services they provide to the market as well as the overall status of the audit profession in the society.

1. PROCEDURAL ISSUES AND CONSULTATION OF INTERESTED PARTIES

1.1. Procedural issues

An Impact Assessment Steering Group gathering all relevant departments within the Commission⁶ was set up and convened on three occasions: 15 March 2011, 12 and 27 May 2011.

The Impact Assessment Board (IAB) met on 13 July 2011 and provided an opinion on 15 July 2011. Following the IAB meeting and its opinion, changes were made to the impact assessment in line with the recommendations of the IAB. More particularly, illustrations of certain Member States' experiences with joint audits, mandatory rotation and non audit services have been added. Further improvements were made in the analysis of individual policy options, cost and benefit analysis of the preferred policy options and stakeholders views.

1.2. External expertise and consultation of interested parties

A comprehensive public consultation on audit was launched on 13 October 2010⁷. A significant number of responses (around 700) were received and processed by the Commission. The summary of responses was published on 4 February 2011 (see Annex 1). In addition, the Commission held a conference on audit on 10 February 2011⁸.

The Consultation has shown both an appetite for as well as resistance to change; some stakeholders were particularly opposed to changes in the current market structure. Even though there was convergence on the general principles (e.g. there was a strong endorsement of the fundamental premise that *'independence should be the unshakeable bedrock of the audit environment'*), different stakeholders had very divergent views when it came to concrete solutions to address shortcomings such as the structure of the upper segment of the audit market: e.g. for instance, with regard to the possibility to require joint audit. There was also strong opposition from the audit profession to making significant changes with regard to the independence of auditors and addressing the conflicts of interest inherent to the audit business model: e.g. for instance with regard to the prohibition of the provision of non-audit services to the audit client or to the possibility to require mandatory rotation of firms. However, there was general support on the need to clarify the role of the auditor. Moreover, quite a broad number of the stakeholders support the introduction of a "European passport" for auditors as well as an EU wide co-ordination of audit

⁴ European Commission (April 2011a)

⁵ European Commission (March 2010)

⁶ IASG was led by DG Internal Market and Services and included members from DG Competition, DG Economic and Financial Affairs, DG Enterprise and Industry, DG Employment and Social Affairs, the Legal Service and the Secretariat General.

⁷ European Commission (October 2010).

⁸ <http://www.youtube.com/watch?v=XUyvBrX-POM> See also Woolfe (2011).

oversight, including the improvement of communication between the auditor and the regulators of the audited companies. The responses have provided very useful input in the preparation of the Impact Assessment not only in examining the policy options but also in defining the problem drivers.

The European Parliament adopted an own-initiative report on this matter, in reaction to the Commission's Green Paper on 13 September 2011. The European Parliament report requires more transparency and competition in the audit market⁹, but is critical of some of the ideas proposed in the Green Paper. The European Economic and Social Committee adopted a similar report on 16 June 2011¹⁰. The topic was also discussed with Member States at the Financial Services Committee of 16 May 2011 and at the Audit Regulatory Committee of 24 June 2011.

2. POLICY CONTEXT AND PROBLEM DEFINITION

2.1. Policy context

2.1.1. Financial Statements of companies and statutory audit

Confidence in financial statements is essential for all stakeholders of a company, in particular those with limited liability¹¹, as a basis to make a judgement on its financial situation. Basic trust in the veracity of financial statements is fundamental for normal market functioning and relations between economic entities, as confirmed in the context of the recent financial crisis. The verification by a third party of the veracity of such financial statements is crucial.

Indeed, the audit of companies' financial statements is a service provided in the public interest. The role of the auditor is to contribute to the credibility as well as reliability of these financial statements. Not only auditors, audited companies, shareholders and potential investors have a stake in the veracity of companies' financial statements, but also a wide range of other stakeholders benefit from audits. These include lenders, trade partners, employees, credit rating agencies or equity analysts. If investors, lenders and trading partners cannot trust the financial statements of companies, this could lead to less investments and higher costs of capital for companies and – ultimately – to higher prices for consumers. The auditors' output is also used for market stability by regulators/supervisors and for tax collection by tax and other government authorities.

The Statutory Audit Directive sets out requirements for statutory audit and defines 'statutory audit' as an audit of annual accounts or consolidated accounts insofar as required by European Union ('Union') law. For companies with limited liability, the 4th and 7th Company Law Directives¹² set out the content of the accounts as well as the requirement to have them audited. These directives are complemented by other texts regarding specific types of companies, such as issuers of securities admitted to trading in regulated markets ("listed companies") or financial

⁹ European Parliament (2011).

¹⁰ European Economic and Social Committee (2011).

¹¹ Due to their limited liability, companies are required to disclose their accounts. Such disclosure is even more important for listed companies. In unlisted companies, shareholders are more involved in the management of the company and creditors may have other means to assess the financial situation of the company. This is not the case for listed companies, where investors must essentially rely on publicly disclosed information. While for private companies, filing financial statements in a registry is enough, for listed companies there is a requirement to "publish" audited financial statements so that they reach investors.

¹² For the full details of the legal instruments mentioned in this document, see REFERENCES.

institutions. According to the latest available data¹³ 7.3 million limited liability companies are covered by the 4th Directive on annual accounts and around 150,000 are covered by the 7th Directive on consolidated accounts. Among those, there are around 7400 companies that prepare their consolidated accounts under International Financial Reporting Standards (IFRS)¹⁴. A vast majority of the latter are listed on stock exchanges. The ongoing process to amend the 4th and 7th Company Law Directives¹⁵ aims to reduce burdens on small enterprises by *inter alia* exempting them from statutory audit requirements (Member States already have the right to exempt small companies from audit). Figure 1 summarises the relevant Union legal framework for the most important entities¹⁶ (see [Annex 2](#) for a description of the existing legal framework).

Figure 1 – Summary of EU legal framework: audit of annual and consolidated accounts				
The following entities shall:	a) publish their accounts	b) prepare their accounts in conformity with	c) have their accounts audited	d) be audited in accordance with
Listed companies	Transparency Directive (TD)	Article 4 of TD: IFRS for consolidated accounts and 4 th Company Law Directive for annual accounts	Article 4 of TD	Statutory Audit Directive, which establishes: - rules on the qualification of the auditors (approval, registration etc.) - principles on the independence criteria of auditors (ethics, conflict of interest etc) - rules on public oversight and quality assurance - some additional rules of the audit of PIEs, including transparency of auditors
Credit institutions	Unless TD applies, Directive 86/635/EEC shall be applicable	Unless TD applies, Dir. 86/635/EEC shall be applicable	Unless TD applies, Directive 86/635/EEC shall be applicable	
Insurance undertakings	Unless TD applies, Directive 91/674/EEC shall be applicable	Unless TD applies, Directive 91/674/EEC shall be applicable	Unless TD applies, Directive 91/674/EEC shall be applicable	
Unlisted companies	1 st Company Law Directive and 4 th Company Law Directive or 7 th Company Law Directive	4 th Company Law Directive for annual accounts 7 th Company Law Directive for consolidated accounts	4 th Company Law Directive for annual accounts 7 th Company Law Directive for consolidated accounts [except for small companies]	

2.1.2. Statutory auditors, audit firms and the audit market

The provision of statutory audit is regulated. Only natural persons (statutory auditors) or legal persons (audit firms) approved by the competent authorities at the national level are allowed to perform statutory audits (see [Annex 3](#) on approved auditors and firms). They are subject to external quality assurance as part of public oversight. In general, statutory audit services to "public-interest entities" (PIEs)¹⁷ are provided by audit firms rather than individual statutory auditors.

Although audit markets are national, not least because of the need to be locally approved to perform the audit, the market for PIEs and, in particular, large listed companies is concentrated at a national as well as Union level: the so-called "Big Four" audit firms (PWC, KPMG, Deloitte

¹³ See European Commission (October 2011a), section 3.6.

¹⁴ IFRS are world-wide financial reporting standards. The consistent quality of audits across the EU countries is paramount to make sure that accounts of EU listed companies are of equal quality, trustworthy and comparable by international investors

¹⁵ See European Commission (October 2011b).

¹⁶ Concerning certain types of financial institutions, other EU Directives specifically set the obligation to have their accounts audited.

¹⁷ A collective term comprising listed companies, credit institutions, insurance undertakings and other entities considered by individual Member States of systemic importance by their sector of activity or size. See Article 2 of the Statutory Audit Directive.

and Ernst & Young) have a higher than 85% market share for large listed companies in most Member States.

Although not identical, certain elements of the audit market for large entities are similar to the market of Credit Rating Agencies (CRAs). While the former is dominated by the Big Four audit firms, the latter is dominated by three large CRAs (S&P, Moody's and Fitch). Moreover, in both markets there is inherent conflict of interest in that the subject of the opinion is also the client. From a listed company perspective, the issuer of securities on whose accounts and on whose credit worthiness audit and rating opinions are being provided is also the party that pays the auditor and the CRA. Both auditors and CRAs derive their business from a legal requirement: companies must have their financial statements audited and many legal provisions require credit ratings.

Recent consultations and hearings¹⁸ show that audit market concentration and limited competition are particularly serious issues for the audit of PIEs. As a consequence, this Impact Assessment is particularly focussed on the statutory audit of PIEs. Nonetheless, this Impact Assessment also assesses implications for the SME sector, covering both small and medium sized audit firms and practitioners (SMPs) as well as SMEs as audited entities (see [Section 8.2](#)).

2.2. Summary of problems

There are five main problematic areas (see [figure 2](#)): (1) an expectation gap related to the role of the auditor, (2) risks of conflicts of interest leading to impaired independence of auditors, (3) barriers to entry into the market of listed and large companies, (4) additional compliance costs due to fragmented national regulation; (5) lack of effective national and EU-wide supervision over audit firms. These problems are represented in the problem tree depicted in figure 2. A detailed explanation of the problems are provided in the ensuing sections (2.3 to 2.5).

¹⁸

Also confirmed by many respondents to the Green Paper as well as by the House of Lords (March 2011).

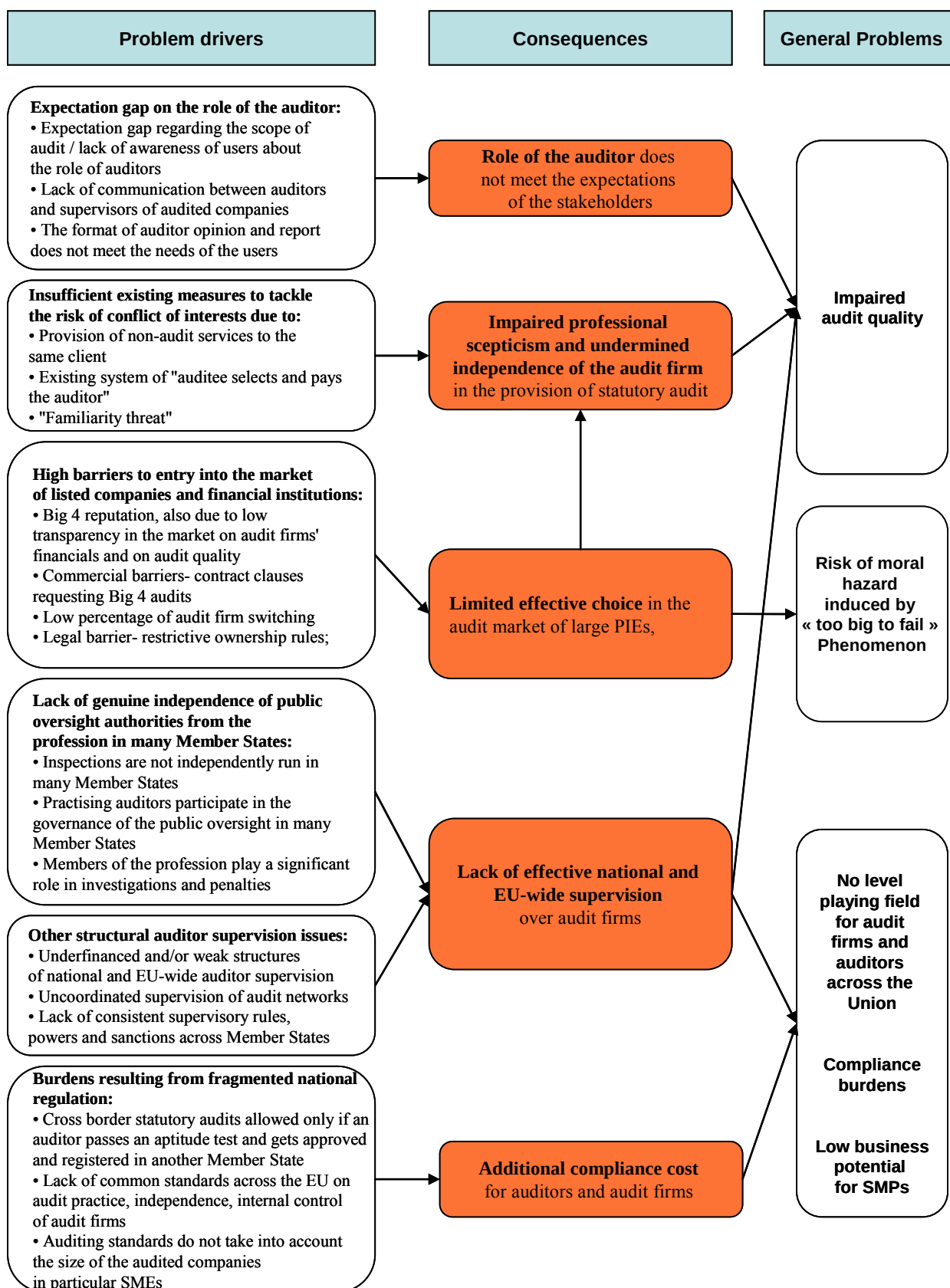


Figure 2 – Problem tree

2.3. Problems particularly affecting the statutory audit of PIEs

2.3.1. The question of impaired audit quality

As mentioned in the introduction to this Impact Assessment, the financial crisis has raised questions as regards the quality of the audits of PIEs. There are a number of ongoing investigations regarding the audits of banks in the EU/EEA¹⁹. In addition, recent audit inspections in EU Member States have indeed revealed audit quality issues in major audit firms (for more information on inspection findings see [Annex 4](#)):

The auditor supervisor in the Netherlands – Netherlands Authority for the Financial Markets (AFM) – concluded that *"The quality of audits must fundamentally improve <...> at the four largest audit firms in the Netherlands: Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers (the Big 4 firms). The AFM has concluded that a fundamental change of conduct is necessary to improve the quality of audits."*²⁰ In the same report, AFM underlined that Big Four auditors "failed to exercise sufficient and appropriate professional scepticism in the conduct of their audits as well as to apply or to apply sufficiently, auditing standards in too many cases. The AFM identified relevant weaknesses in 29 of the 46 audits reviewed in the context of its regular inspections". The report also mentions that recent inspections show that the deficiencies in audit quality are more widespread and systemic and do not concern only the performance of audits of companies in the financial sector but also other sectors like real estate and automotive.

Inspections of UK audit firms revealed that *"notwithstanding the quality of firms' policies and procedures, the number of audits assessed as requiring significant improvement at major firms (eight audits or 11 % of audits reviewed at major firms excluding follow up reviews) is too high. Firms are therefore not always consistently applying their policies and procedures on all aspects of individual audits."*²¹ In this respect, the UK report underlines that *"auditors should exercise greater professional skepticism particularly when reviewing management's judgments relating to fair values and the impairment of goodwill and other intangibles and future cash flows relevant to the consideration of going concern"*²².

In Germany, a report of the Auditor oversight commission for the period 2007 – 2010 shows that, on average, 25% of inspections of audit firms having PIE clients led to disciplinary proceedings, and the tendency is negative (19% in 2008, 24% in 2009, 27% in 2010)²³. In the

¹⁹ Investigations are currently ongoing in a number of jurisdictions into the audits of the banks most affected by the crisis (but no sanctions so far). In Ireland, Ernst & Young is being investigated in relation to their audits of Anglo Irish Bank by a Special Investigator appointed in February 2009 by the ICAI Complaints Committee under the oversight of the IAASA (see IAASA 2009). In the UK, an investigation into the role of Ernst & Young LLP in Lehman Brothers' UK operations is being undertaken by the Accountancy and Actuarial Discipline Board (AADB) of the Financial Reporting Council (see FRC (June 2010)). In Iceland, PWC, auditor of Landsbanki and Glitnir banks in Iceland, is being investigated by the Icelandic Special Prosecutor as at December 2010. This is a criminal investigation.

²⁰ AFM (2010a)

²¹ FRC (July 2010), p.3. The 2011 report presents *"slightly better"* results than those of 2010. But the UK inspection body *"cannot confirm that this is a positive underlying trend"* yet. See FRC (July 2011).

²² International Standards on Auditing 570 (ISA 570) states that *"Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future"*.

²³ Abschlussprüferaufsichtskommission (2010), p.12.

context of the financial markets and the economic crisis, the report observed a number of issues, such as the audit firms' assessment of going concern assumptions, the measurement of goodwill and other assets²⁴. It also mentions weaknesses in the assessment of the risks of breaches and irregularities (fraud), mainly due to a rather *pro forma* conduct of the audit work²⁵.

In addition, the same report identified several major weaknesses related to the internal quality control and remuneration systems of partners in big audit firms. In this respect, the report mentions that *"in individual cases the partner appointment, assessment and remuneration systems did not provide for any sufficient performance incentives to secure the audit quality. Instead, economic and acquisition aspects were put in the foreground. There was also partly a lack of consistent sanctioning of revealed quality defects"*.

On quality control, this report underlines that "an engagement quality control review is mandatory in the case of annual audits of public interest entities. During inspections, however, it was repeatedly observed that the required engagement quality control review was not made at suitable points in time during the engagement process or did not include all audit steps. Furthermore, there were some indications that the engagement quality control review was not always carried out with sufficient professional due care. In individual cases, the engagement quality control review was also carried out by persons who were themselves involved in conducting the relevant audit ."

Also in the US, it is reported that *"[t]oo often, PCAOB inspectors find that auditors have failed to exercise the required scepticism and have accepted evidence that is less than persuasive"*. It is also indicated that *"[t]he PCAOB has now conducted annual inspections of the largest audit firms for eight years. Our inspectors have reviewed more than 2,800 engagements of such firms and discovered and analyzed hundreds of cases involving what they determined to be audit failures"*²⁶. The PCAOB (US audit oversight body) remains *"concerned about both the frequency and the type of audit deficiencies it continues to find."*²⁷

For instance, as a result of a such investigation of an audit performed by Ernst & Young, PCAOB launched disciplinary proceedings and recently announced settled disciplinary orders against a former Ernst & Young partner and a senior manager for their roles in providing misleading documents and information to PCAOB inspectors and altering working papers. The orders imposed financial sanctions as well as barring the auditors concerned from associating with a PCAOB-registered accounting firm²⁸.

The next sub-section describes the problems that contribute to this insufficient audit quality.

2.3.2. Problem drivers and consequences

Cause	Expectation gap regarding the scope of audit and the audit report
Effect	The role of the auditor does not meet the expectations of stakeholders

²⁴ *Ibid*; page 9.

²⁵ *Ibid*, page 8.

²⁶ See Doty (2011a), section III.B.

²⁷ US PCAOB (August 2011), p. 5 and seq.

²⁸ PCAOB Announces Settled Disciplinary Orders Against Former Ernst & Young Partner and Senior Manager For Providing Misleading Documents to PCAOB Inspectors And Altering Working Papers (Washington, D.C., August 1, 2011).

i) Expectation gap regarding the scope of the audit. Many stakeholders and the larger public still do not understand how it was possible that large financial institutions failed only a few months after their financial statements were given unqualified (clean) audit reports²⁹. EU rules do not require the audit opinion to give assurance as to the future sustainability of the audited company. In addition, they do not require any further information e. g. explaining the methodology used or any other description of the work carried out by an auditor. EU rules only require that the auditor provides an opinion on the veracity of the financial statements and the ability of the audited company to continue as a "going concern"³⁰. This creates some confusion about the scope of the auditor's assessment and explains the expectations created among certain stakeholders. This expectation gap raises questions about the existing legal requirements concerning the mission of the auditor, the scope of the audit and the type of verification carried out by auditors to confirm the auditee's ability to continue as a "going concern"³¹. For instance, the Nyberg report of March 2011 on the causes of the systemic banking crisis in Ireland refers to the statutory auditors as the "*silent observers*" in the lead up to the crisis and is critical of the scepticism of the auditors³².

ii) Audit opinion and report do not meet the needs of the user. Although under their current statutory audit mandates, auditors have access to substantial information about the audited company they do not provide sufficient facts in their audit report³³; the most common audit opinion is effectively a "template" clean opinion, especially when it comes to the audit of listed companies or financial institutions (see example in [figure 3](#)). However, this "all or nothing" paradigm is not helpful to those who have an interest in the audited company³⁴.

iii) There is not enough communication between auditors and supervisors of PIEs. In the specific case of financial institutions and providers of investment services, auditors are required³⁵ to

²⁹ An examiner of the Lehman Brothers bankruptcy stated that "*the investing public is entitled to believe that a 'clean' report from an independent auditor stands for something.*" See Valukas (2011).

³⁰ Going concern is the company's ability to continue functioning as a business entity (concern being an early-20th century term for "business" or "enterprise"). It is the responsibility of the directors to assess whether the going concern assumption is appropriate when preparing the financial statements. A company is required to disclose in the notes to the financial statements whether there are any factors that may put the company's status as a going concern in doubt.

³¹ For instance, a representative of a large European investor stated at the February 2011 conference organised by the European Commission that "*when there have been material problems at companies, audit reports have been useless time and time again*" (see Accountancy Magazine, March 2011, p.5). See also Harris (2011) citing the opinion of US investors. It should be noted, however, that chief financial officers in audited companies appear comfortable with the current value of audit. See, for instance, Deumes et al (2010) or PWC (2011).

See also House of Lords (March 2011), p. 38 and seq.

³² Nyberg (2011). This report does not criticise specific auditors but does consider issues such as the statutory audit and going concern, audit limitations and an "expectations gap"- which widens during times of crisis, other communication by bank auditors, auditor communication with authorities.

³³ The majority of the replies to the 2010 Green Paper on audit related to the section on the role of auditors, underlining the usefulness of audit methodology being better explained to the audited companies by auditors as one of the tools to close the expectation gap about the value-added of auditors work.

³⁴ For instance, the majority of respondents to a recent survey organised by the CFA Institute think that more specific information is needed about how the auditors reach their opinion on whether a company has fairly presented its financial statements in accordance with the required financial reporting standards (see CFA (March 2011). Another 2010 survey also confirmed that the audit report needs to contain more information (see CFA 2010). See also IOSCO (2010), p.8 and seq.

See also House of Lords (March 2011), p.39, quoting an important investor: "*[...] audit reports [...] are very, very standardised in their content[...] are often [...] riddled with 'get out of jail free' clauses*".

³⁵ Article 55 of MIFID, Article 53 of the Banking Directive, paragraph 4 of Article 15 of the Payment Services Directive, Article 106 of UCITS Directive, the first paragraph of Article 3 of the e-money

report promptly to the competent authorities any fact or decision which is liable to constitute a material breach of laws, affect the ability of the company to continue as a going concern or lead to a qualified audit report³⁶. But this has not led to sufficient engagement between auditors and supervisors of PIEs³⁷. The UK House of Lords expressed a strong opinion on this issue: "[w]e regard the recent paucity of meetings between bank auditors and regulators, particularly in a period of looming financial crisis as a dereliction of duty by both auditors and regulators"³⁸

AUDITORS' REPORT ON CONSOLIDATED FINANCIAL STATEMENTS To the Shareholders of XXX We have audited the consolidated financial statements of XXX ("the Bank") and Subsidiaries ("the Group"), which comprise the consolidated balance sheet at 31 December 2010 and the related consolidated income statement, consolidated statement of recognised income and expense, consolidated statement of changes in total equity, consolidated statement of cash flows and notes to the consolidated financial statements for the year then ended. As indicated in Note 1.b. to the accompanying consolidated financial statements, the Bank's directors are responsible of the Group's consolidated financial statements in accordance with International Financial Reporting Standards as adopted by the European Union and the other provisions of the regulatory financial reporting framework applicable to the Group. Our responsibility is to express an opinion on the consolidated financial statements taken as a whole based on our audit work performed in accordance with the audit regulations in force in YYY which require examination, by means of selective tests, of the evidence supporting the consolidated financial statements and evaluation of whether their presentation, the accounting principles and policies applied and the estimates made comply with the applicable regulatory financial reporting framework. In our opinion, the accompanying financial statements for 2010 present fairly, in all material respects, the consolidated equity and consolidated financial position of XXX Group at 31 December 2010, and the consolidated results of its operation and the consolidated cash flows for the year the ended, in conformity with International Financial Reporting Standards as adopted by the European Union and the other provisions of the regulatory reporting framework applicable to the Group. The accompanying consolidated directors' report for 2010 contains the explanations which the Bank's directors consider appropriate about the Group's situation, the evolutions of its business and other matters, but it is not an integral part of the consolidated financial statements. We have checked that the accounting information in the consolidated directors' report is consistent with that contained in the consolidated financial statements for 2010. Our work as auditors was confined to checking the consolidated directors' report with the aforementioned scope, and did not include a review of any information other than that drawn from the accounting records of XXX and Subsidiaries. Signature 31 March 2011

Figure 3: Example of audit report.

There has been strong support from stakeholders who replied to the Green Paper consultation on audit policy and to the Green Paper on corporate governance in financial institutions³⁹ to improve the dialogue between supervisors and auditors, as there is a broad acceptance that the knowledge gathered by external auditors through their work may be useful to the regular work of regulators/supervisors⁴⁰.

Cause	Insufficient existing measures to tackle the risk of conflict of interests
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Directive and Article 72 of the Solvency II Directive. See also Article 20 of the MIFID Implementing Directive.

³⁶ A qualified audit report indicates that a company's financial statement gives a true and fair view subject to certain qualifying remarks.

³⁷ Concerning the UK market, for instance, it has been observed that "[...] the regular dialogue ... appeared to fall into desuetude following the 1997 transfer of supervisory responsibility from the Bank [of England] to the FSA.". See House of Lords (March 2011), §160 and 161.

³⁸ *Ibid.* §161.

³⁹ See question 3.1 in European Commission (June 2010), p.15: "Should cooperation between external auditors and supervisory authorities be deepened? If so, how?" In the various responses received so far, there seems to be a general support for improving cooperation between external auditors and supervisors.

The responses to a UK consultation also go in the same direction. See FSA and FRC (2011).

⁴⁰ See for instance Dewing and O'Russell (2011), FSA and FRC (2010).

Effect	Impaired professional scepticism and undermined independence of audit firms in the provision of statutory audit
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There are different threats to the independence of the auditor. The following paragraphs present three which have a major impact on auditors' independence: the provision of non-audit services, the "*auditee selects and pays the auditor*" and the familiarity threat. None of these threats are considered to be, *per se*, a greater source of conflict of interest than the others. On the contrary, they are considered to have a cumulative effect on the overall independence of auditors. At the same time, in at least one of the cases ("*auditee selects and pays the auditor*"), the conflict is inherent in the existing business model for the provision of audit services.

i) Conflict of interest arising from the provision of statutory audit and other non-audit services. Providing non-audit services (NAS) while auditing a company presents a potential source of conflict of interest arising from or within the audit firm: i.e. the audit firm has an interest to secure additional revenue from the provision of other (non-audit) services⁴¹. In instances where the revenues from NAS become substantial from a statutory audit client, the independence of the auditor is even more at risk. If the provision of statutory audit effectively becomes a gateway to the provision of NAS to the same client, "professional scepticism" – i.e. the ability of the auditor to question the assumptions made by the audited entity – would naturally be compromised⁴².

There is currently no EU-wide ban preventing auditors from offering NAS to audit clients. According to Article 22 of the Statutory Audit Directive, audit should not be provided in cases where "*an objective, reasonable and informed third party would conclude that the statutory auditor's or audit firm's independence is compromised*". However, Article 22 stipulates only the principles and, given the Member States' discretion, it has so far been implemented in a very divergent manner across the EU. For example, in France there is a ban on the provision of NAS from any member of the auditor's network to any member of the audited company's group⁴³. In many other Member States, rules are less restrictive and the provision of NAS by auditors to the companies they audit remains commonplace⁴⁴.

⁴¹ It has also been brought to the attention of the Commission services that legislation (whether at the EU or national level) regarding the provision of other assurance services (e.g. regarding the review of the corporate governance statement, of corporate social responsibility information etc) is leading to an additional problem. The legislation often requires the statutory auditor (of accounts) in place to also provide those additional assurance services (which, strictly speaking, would not be "non-audit services"), therefore, creating a captive market. Conceptually, however, it could be possible that these other assurance services be provided by competing auditors.

⁴² The International Standards on Auditing (ISAs) define professional scepticism as "*an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence*". The application of an appropriate degree of professional scepticism "*is a crucial skill for auditors*". See FRC (March 2011), p.1. See also FRC (August 2010) generally.

⁴³ There is, however, some *margin of manœuvre* concerning some NAS provided to the parent or the subsidiaries of the audited entity by members of the network of the auditor. As a result, for instance, in the case of BNP Paribas the provision of NAS by its auditor(s) amounted to 28% of total fees; and in the case of Crédit Agricole to 13%. See AMF (2010), p.5. In Belgium there are also strict rules on the provision of NAS to the audit client.

⁴⁴ For instance, the provision of NAS amounted to 34%, on average, of the combined audit and NAS fees of 8 important UK banks (Abbey National, Alliance & Leicester, Barclays, Bradford and Bingley, HBOS, Lloyds TSB, Northern Rock and Royal Bank of Scotland). Data from Sikka (2009). In the case of 11 Eurostoxx 50 (non-French) members active in the financial sector (Aegon, Allianz, BBVA, Deutsche Bank, Deutsche Börse, Generali, ING Group, Intesa Sanpaolo, Munich Re., Santander and Unicredit), the NAS provided amounted to 17% in 2009 and 14% in 2010, on average, of the combined audit and NAS fees,

The importance of NAS for audit firms is growing: the share of NAS provided to their (not necessarily audit) clients relative to audit services is increasing both globally and in the Union⁴⁵. Audit is no longer the dominant revenue generator for audit firms⁴⁶.

Recent evidence from the UK market shows cases of potential/perceived conflict of interest: *"In addition to auditing Northern Rock, PwC received some £700,000 in 2006 in consultancy income from Northern Rock. The House of Commons Treasury Select Committee referred to this as an apparent conflict of interest"*⁴⁷. Also, in May 2009, the Treasury Select Committee of the House of Commons called for the appropriateness of the provision of non-audit services by auditors to the entities that they audit to be revisited, stating: *"We strongly believe that investor confidence, and trust in audit would be enhanced by a prohibition on audit firms conducting non-audit work for the same company, and recommend that the Financial Reporting Council consult on this proposal at the earliest opportunity"*⁴⁸. The UK inspection report of 2010 stated that: *"firms are perhaps too ready to conclude that existing procedures, required in any event in the audit, provide the necessary degree of safeguard. They must accept that non-audit services should not be provided where safeguards cannot appropriately mitigate threats to their independence. [...] and the AIU is concerned that one major firm has embarked on a growth strategy where a key driver is the development of non-audit services to be provided to audit clients"*⁴⁹. In 2011, the UK inspection report confirmed the conflict of interest problem: *"It is clear from the AIU's review of appraisals and partner admission procedures that senior audit staff at some firms continue to believe that success in the selling of non-audit services to audited entities is a significant contributory factor to promotion and remuneration decisions"*⁵⁰. Recently, the US oversight body's reviews found examples of *"seemingly unrestrained enthusiasm...for selling services to audit clients"*. Those examples were *"in a sufficient number to raise troubling questions"*⁵¹.

ii) Conflicts of interest are intrinsic in the audit firm selection and remuneration mechanism ("auditee selects and pays the auditor"). Auditors are appointed and paid by the entity that needs to be audited. The auditor's responsibility is to the shareholders of the audited company and other stakeholders, but the auditor is often *de facto* selected and paid by the management of the audited company (Chief Financial Officer and/or Chief Executive Officer). In fact, shareholders have little or no impact on the selection of the auditor and the choice of auditors is at best validated by

with a significant peak for Santander: 46% in 2009 and 40% in 2010 (AMF (2010) and AMF (2011)). Recent data on distressed banks around the world show similar trends (see [Annex 5](#)).

⁴⁵ For example, data from the German market shows that while the total Big Four firm revenues from audit services was static between 2004/05 and 2009/10, the revenues from non-audit services increased by 59% over this period (see [Annex 5](#)). Data on Big Four audit firms in the UK shows that audit and other related services represented only 33% of total revenues (cf. Accountancy Magazine, January 2011). Moreover, Big Four audit firms have outlined ambitious expansion plans for their consultancy arms in the UK: KPMG announced plans to treble its consulting revenues by 2013; PWC also plans to treble its fees from management consulting by 2013 and to double its consulting staff in the same period; Ernst & Young plans to double its revenues in the next three years; and Deloitte also intends to increase its activity. See Huber (March 2011).

⁴⁶ Casta et Mucol (1999) explain that the big audit firms, which initially have focused on their audit mission, have progressively developed consulting services creating conglomerate corporate structures like real multi-professional teams associated to the audit service. This repositioning regarding the profession itself has not been done without creating potential ethical problems.

⁴⁷ House of Lords (March 2011), p. 24.

⁴⁸ House of Commons (2009).

⁴⁹ FRC (July 2010).

⁵⁰ FRC (July 2011), p. 21.

⁵¹ See Doty (2011a), section II.

them at the annual general meeting⁵². This fact creates a serious distortion within the system in that it undermines auditor independence in reporting findings and providing negative feed-back about the performance of the management (CFO and /or CEO) of the audited company.

In this framework, Audit Committees are expected to counter-balance the influence of management, acting as independent agents of investors within the audited entities. However, the current practices and functioning of Audit Committees across the Union raise doubts about their effectiveness⁵³. This in turn has a negative impact on their independence from the management of the company⁵⁴. Moreover, the Statutory Audit Directive does not require complete independence of the Audit Committee members and leaves discretion for Member States to impose additional independence criteria⁵⁵. The feed-back from all stakeholders to the Green Paper consultation clearly supports the need to strengthen both the level of competence as well as the structure of the Audit Committee.

iii) Potential conflict of interest due to the "Threat of Familiarity". Just the rotation of key audit partners, which is required by EU legislation, and self-regulation regarding the organisation of audit firms does not address the threat of familiarity⁵⁶ that results from the audited company often appointing and re-appointing the same audit firm for decades. For example, a new audit partner of the same audit firm will likely feel obliged to live with the decisions and agreements made by the former partner; he may have little flexibility to reopen them⁵⁷. Only in Italy the situation is different⁵⁸.

In a 2006 study, more than half of the respondent companies reported that their auditor had served the company for more than 7 years, and 31% reported that the auditor had served for more than 15 years: the general tendency was that the bigger the audited company, the lower the switching rate⁵⁹. According to a recent report in the UK, a FTSE 100 auditor remains in place for about 48 years on average; for the FTSE 250 the average is 36 years. It is noteworthy that Barclays has been audited by PWC or its predecessors since 1896⁶⁰. In Germany, two thirds of the DAX 30 companies have not changed their auditor for the last 20 years, including leading financial services entities⁶¹. At global level, nearly 60% of all Fortune 1000 public companies have had the same auditor for more than 10 years and 10% for 50 years or more⁶².

⁵² In accordance with the Statutory Audit Directive, the appointment of the auditor(s) in a PIE must be made by the general meeting of shareholders, upon a proposal by the board based on the audit committee recommendation.

⁵³ See European Commission (June 2010) and European Commission (April 2011b), section 1.1.1. on Professional diversity.

⁵⁴ An interesting recent example: the CFO of a large listed German company expressed his views on the expectation of an international group towards its auditor during a conference (Schmalenbach-Tagung) stating that he would fulfil the dominant role in the selection of the auditor. Moreover, he stated that he would 'examine' the auditor and expect that the auditor be available 24 hours a day, seven days a week; and have a global right to issue instructions and to discipline the auditor in case of an unsatisfactory result of the audit. Cf. Börsen-Zeitung, 04.05.2011.

⁵⁵ Article 41 of the Statutory Audit Directive requires that "*at least one member of the audit committee shall be independent and shall have competence in accounting and/or auditing*", allowing Member States discretion to decide on stricter independence/competence rules for the remaining members.

⁵⁶ Familiarity threats, which may occur when, because of a close relationship, a professional accountant becomes too sympathetic to the interests of others (IFAC code of ethics).

⁵⁷ Doty (June 2011b), section II.

⁵⁸ Italy enforces the mandatory rotation of audit firms every 9 years, in order to enhance the independence of the auditor from the audited PIE. See [Annex 11](#) for further detail on this issue.

⁵⁹ See London Economics (September 2006).

⁶⁰ See House of Lords (March 2011).

⁶¹ Source: German public register of companies.

⁶² Aubin (2011).

This lack of change in auditors creates a perverse pressure on the incoming partner not to lose long standing 'audit clients'⁶³. Recent data from the US⁶⁴ outlines that "*as in other professions, auditors want to advance in their chosen profession which often means keeping the client happy and growing their business.*" Indeed, research on the subject shows that audited entities who received an emphasis of matter/qualified audit opinion on the financial statements from their auditors changed auditors more often than entities that received audit opinions with no observations⁶⁵.

Cause	Barriers to entry into the statutory audit market for PIEs
Effect	Limited effective choice of auditor for large PIEs

Changing the auditor could contribute to addressing some of the threats to independence described above. However, in responses to the recent Green Paper, companies reported that the effective choice in the market for audits of large listed companies and large financial institutions has been progressively limited to the Big Four audit firms. In some cases, the choice for the audited entity is limited to less than four firms: i.e. to avoid potential conflicts of interest if one of the Big Four audit firms is already providing other services to the entity.

This limited choice is the consequence of a number of barriers preventing new audit firms from entering (or existing ones from growing within) the audit market for large PIEs⁶⁶: (1) there is asymmetric information related to the quality of auditors in the market⁶⁷, which results in, the reputation of the Big Four audit firms becoming the most important factor for auditor choice; (2) contract clauses that effectively require Big Four audits; (3) companies rarely change their audit firm and there is hardly any opportunity to compete for new audit assignments, which has led to market stagnation; and (4) restrictive ownership rules have led to distortions in the market by creating a competitive advantage for audit firms even in NAS on one hand and by creating de facto barriers to the growth of smaller audit firms on the other hand, therefore protecting large audit firms from competition from medium-sized firms. These barriers also affect the extent to which the market can penalise audit firms producing low quality audits. See [Annex 6](#) for further details on these barriers⁶⁸. A study in 2006 concluded that "*only if the existing barriers, in terms of perception/reputation and low switching rates, could be reduced might substantial market entry by mid-tier firms become feasible*".⁶⁹

These barriers result in high concentration in the vast majority of audit markets⁷⁰, even at the global level (see [figure 4](#))⁷¹.

⁶³ See for instance FRC (August 2010), p.10: "*it is also clear that audit firms place considerable importance on retaining their client base. Emphasis on client service planning and relationship management within the firms may act as a disincentive for auditor scepticism if audit teams believe that by demonstrating scepticism they risk having an 'unhappy client'*".

⁶⁴ See Doty (2011a), section II.

⁶⁵ Prat et Hauret (2003).

⁶⁶ Other factors could also influence the inability of audit firms to grow: insufficient trained or qualified staff, lack of sufficiently developed international network etc.

⁶⁷ Inspections reports are not disclosed to those charged with the governance of the audited entity. As a result, the audited entity has insufficient information on this point. Only in the UK do audit committee receive some information on inspection findings.

⁶⁸ See also OFT (2010). The OFT has provisionally decided that there are competition problems in the audit market that pass the statutory test for referral to the Competition Commission.

⁶⁹ Oxera (April 2006), page i.

⁷⁰ See London Economics (September 2006), table 5, pages 22-23.

⁷¹ For more information on the history of market concentration see [Annex 7\(1\)](#).

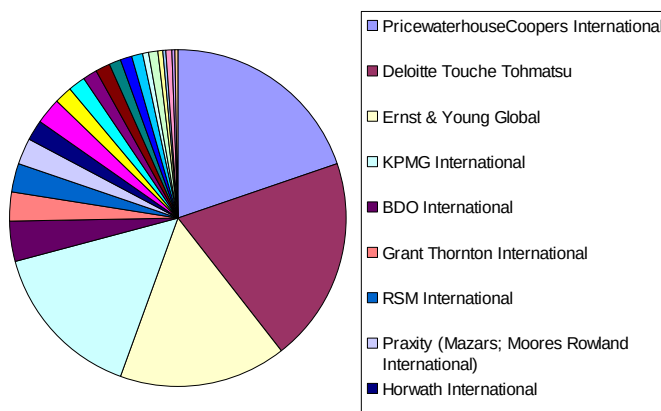


Figure 4. Relative market shares (in terms of global revenues) of 24 international audit firm networks/associations in 2009

0. In 2009, the 24 biggest international audit firm networks generated more than \$130 billion revenue world-wide with the Big Four audit firms market share at 71%^{72 73}.
1. There has been practically no change between 2004 and 2009 in the revenue shares among the ten biggest audit firm networks. In terms of revenues, every non-Big Four audit firm network lagged at least four times behind the smallest Big Four audit network (See [Annex 7\(1\)](#) for the historical overview of market concentration).
2. The market concentration among audit firms is much higher than in the markets of other professional services providers. (See [Annex 7\(2\)](#) for comparison between audit and law firms).
3. In terms of the individual size of the Big Four audit firms, it has been observed that the Big Four international networks are the biggest providers of professional services in the world ([figure 5](#)).

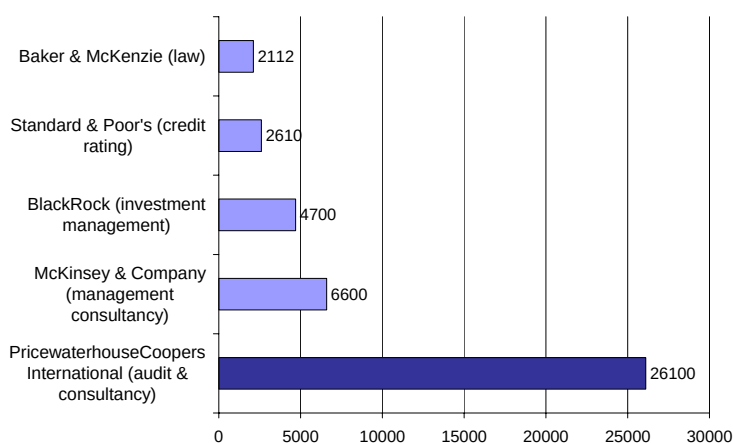


Figure 5. Global revenues of biggest service providers in 2009 (in million USD)⁷⁴

⁷² Accountancy Magazine, June 2010, page 37, table Top 25 international networks.

⁷³ Total revenues from audit and non-audit services provided to public interest entities and other individuals or companies.

⁷⁴ Sources: Accountancy Magazine June 2010; http://www.forbes.com/lists/2010/21/private-companies-10_McKinsey-Co_IPPW.html; [http://www.wikinest.com/stock/BlackRock_\(BLK\)/Filing/10-K/2010/F46751551](http://www.wikinest.com/stock/BlackRock_(BLK)/Filing/10-K/2010/F46751551); <http://www.standardandpoors.com/about-sp/key-statistics/en/us>; <http://www.law.com/jsp/tal/PubArticleTAL.jsp?id=1202448484841>

As regards the Union, high concentration⁷⁵ is observed in national markets for audits of listed companies⁷⁶ as well as financial institutions⁷⁷. The market share of the Big Four audit firms for listed companies exceeds 85% in the vast majority of Member States⁷⁸ (see Annex 7(3) for additional data). For example, all EUROSTOXX 50 companies were audited by the Big Four in 2009 and 2010⁷⁹. In the UK, not only did the Big Four audit firms audit 99% of the FTSE 100 index companies, they also audited more than 95% of the FTSE 350 companies and represented 99% of audit fees in the FTSE 350 (data covers the period 1995-2004)⁸⁰. Moreover, they also had about 80% of the FTSE small capitalisation audits. In some important market segments, the degree of concentration is even greater: for example, only three of the Big Four audit firms audit banks in the UK⁸¹. In Germany, two audit firms (KPMG and PWC) have the audit mandates for 90% of the companies listed on the DAX 30⁸². In Spain, where all IBEX 35 companies are audited by the Big Four audit firms, Deloitte audits 15 of those companies (corresponding to 46% of the IBEX 35) as well as all major banks⁸³. In France, joint audit is mandatory. As a result, although all CAC40 company are audited by at least one Big Four audit firm, a fifth audit firm has been able to gain some market share by providing audit services to several CAC 40 companies⁸⁴.

A particular feature to underline is the policy of Big Four audit firms to absorb smaller competing audit firms: e.g. in France, competing local networks were taken over by KPMG in 2004 (Salustro Reydel) and Deloitte in 2006 (acquiring Marque et Gendrot which was before associated to BDO) and in 2008 (Constantin); in Denmark, PwC has announced its intention to take over the local firm affiliated to Grant Thornton International in 2011.

This high concentration is leading to an important risk affecting society at large: the risk of failure of a large audit firm and the "too big to fail" phenomenon is creating a risk of moral hazard⁸⁵. A negative side effect of the structure of the audit market is that on the one hand there is either the risk (or at least the perception) of serious possible disturbance in the case of a large

⁷⁵ It should be noted that high concentration, *per se*, does not result in an infringement of EU antitrust rules. Currently, the UK competition authority (Office of Fair Trading) has come to the preliminary conclusion that there are reasonable grounds for suspecting that there are features of the market that restrict, distort or prevent competition in the UK. See OFT (2011).

⁷⁶ London Economics (September 2006), table 5, pages 22-23.

⁷⁷ London Economics (September 2006), table 12, pages 32.

⁷⁸ For some commentators, we are facing an oligopoly situation. See Billard et al. (2011).

⁷⁹ AMF (2010), p.8 and AMF (2010), p. 9. It should be noted that Mazars also audit 6 of these companies, as joint auditor.

⁸⁰ Oxera (April 2006), p.i. See also Chambers (2011).

⁸¹ House of Lords (March 2011), Chapter 3.

⁸² For the information on Germany, see London Economics (2006), table 5, p. 22.

⁸³ CNMV (2009), p.34.I In 2010, Deloitte audited 39 of the 92 smaller listed companies in Madrid (excluding IBEX 35). See Expansión, 23 May 2011, p.13.

⁸⁴ In France, two additional firms held 13 (joint) mandates (Mazars [12] and Corévisie [1]) out of the 79 mandates in CAC 40 companies (three of the CAC 40 companies are non-French companies and do not have joint audit, while two companies, BNP Paribas and GDF Suez have 3 auditors). The Big Four held the remaining 66 (83%). In terms of fees, Big Four firms accounted for 92% of the audit fees of CAC 40 companies.

The joint audit rule in France was not designed to address market concentration and therefore does not establish any restriction on the selection of the audit firms. However, the implementation of the joint audit rule shows that it may have effects on the market structure. This rule has in particular allowed a fifth player to have an important presence (compared to other markets) in the market for the statutory audit of large PIEs. See Annex 12.

⁸⁵ See European Parliament (2011), §49.

firm failing⁸⁶ and on the other hand the "too big to fail" phenomenon that the risk of serious disturbance perversely perpetuates⁸⁷. The current structure induces a moral hazard whereby public authorities could be required to save an audit firm or, at least, to display regulatory forbearance. The experience of US public institutions in dealing with US based KPMG LLP regarding its sale of tax shelters⁸⁸ may indicate such a problem.

2.4. Moreover, such market concentration also results in high prices⁸⁹: one of the notable phenomena of the current market structure is that Big Four audit firms generate higher profit margins than other international networks. 2010 data from the UK market shows that the average profit margins in Big Four audit firms were 50% higher than the next four audit firms (27% versus 18%). The levelling out of Big Four profit margins to those of the next four, in the UK alone, would lead to annual savings of more than £600 million to companies⁹⁰. These findings are consistent with the conclusions that "in the period 2002-2006 the premium paid for being audited by a top-tier auditor was around 20%".⁹¹ Problems affecting auditors of PIEs and other entities that are required to have an audit

Cause	Burdens resulting from fragmented national regulation
Effect	Additional compliance cost for auditors and audit firms

i) Provision of statutory audits in a different Member State is possible only if the auditor passes an aptitude test. Auditors and audit firms should be approved in all Member States in which they want to carry out statutory audits. Such approval entails a bureaucratic process. For natural persons, the procedure also requires passing an aptitude test in the Member State of the audited entity (Article 14 of the Statutory Audit Directive). The approval and aptitude test requirements result in additional compliance costs across the Union.

ii) Cost-burden to auditors and audit firms resulting from a lack of common standards across the Union on audit practice, independence and internal control of audit firms. Each Member State has the discretion to design and enforce the rules as regards practice standards (auditing and independence standards) and internal controls for audit firms. Public oversight and quality assurance practices are also different from one Member State to another. This environment entails compliance costs (e.g. becoming familiar with a different legal framework) to audit firms if they or their networks wish to operate in more than one Member State and may be disproportionate to the size of the businesses, thus being a bigger hurdle to small and medium

⁸⁶ E.g. resulting from a liability problem. There is also a reputational problem, as underlined by the European Parliament (2011), §48: "[...] in view of the current configuration of the audit market, [...] the collapse of one of the Big Four firms would undermine the credibility of the auditing profession as a whole."

⁸⁷ The effects would not be comparable, it is true, to a similar situation in the banking sector.

⁸⁸ The US Justice Department and the Internal Revenue Service in 2005 announced that KPMG LLP (KPMG) had "admitted to criminal wrongdoing and agreed to pay \$456 million in fines, restitution and penalties as part of an agreement to defer prosecution of the firm. <...> KPMG has admitted that it engaged in a fraud that generated at least \$11 billion dollars in phony tax losses which, according to court papers, cost the United States at least \$2.5 billion dollars in evaded taxes". See US IRS (2005).

⁸⁹ See Oxera (April 2006), p. v, explaining that the results of an econometric analysis on the relationship between market structure and audit fees show that market concentration (as measured by the HHI per sector in any given year) and the market share of a given auditor in a given sector/year both have a statistically significant and positive impact on audit fees.

⁹⁰ Calculations made on the basis of data published in: Accountancy Magazine, January 2011; Baker Tilly UK Audit LLP Report and Financial Statements for the year ended 31 March 2010.

⁹¹ See Kittsteiner and Selvaggi (April 2008), Chapter 4.6 "Big-N premium", p. 26.

sized practitioners. In addition, the lack of common standards has a negative impact on the credibility and quality of financial statements as well as on the acceptance of audit reports from other jurisdictions. A study commissioned by the European Commission⁹² has assessed and compared the costs and benefits of applying international standards, the so-called 'clarified ISAs'⁹³ as common standards throughout the Union. The study estimates the total recurring net benefits of 2 billion euros per year from the expected reduction in the cost of capital for audit clients as a result of the application of common standards.

iii) Auditing standards, both national and international, do not take into account the size of the audited companies in particular SMEs. The fact that audit standards are not simplified to take into account the smaller size of the audited entities⁹⁴ creates an unnecessary cost burden for the small and medium sized audited entities (e.g. excessive time spent on audit compared to the complexity of the company), without necessarily contributing to a better quality of audits. This view has been confirmed by some SME respondents to the Green Paper.

2.5. Problems in relation to the supervision of compliance by auditors with their obligations

This section concerns auditors of PIEs as well as other entities that are required to have an audit.

Cause	Representatives from the audit profession and/or practicing auditors are actively involved in the public auditor oversight in many Member States
Effect	Public oversight authorities are not "genuinely" independent from the profession in many Member States

The presence of practicing auditors in the governance of the public oversight authorities is currently allowed by the legal framework. This, however, undermines the whole concept of independence and effective public oversight for statutory auditors and audit firms⁹⁵. Some Member States like, Austria, Bulgaria, Denmark, France, Greece, Italy, Luxembourg, the Netherlands, Spain, Sweden and the UK have independent inspections systems which are run and executed by the staff of the public oversight authorities, at least with regard to the audit of PIEs⁹⁶. However, in most Member States, professional associations and/or practicing auditors are still involved in the execution of external quality assurance reviews. Also, there were instances where the system of investigations and penalties was run under the substantial influence of the profession and failed to implement its mandate⁹⁷.

⁹² Köhler et al. (June 2009).

⁹³ Clarified Standards (IFAC)- The final set of clarified standards comprises 36 International Standards on Auditing (ISAs) and International Standard on Quality Control (ISQC) 1, including: One new standard, addressing communication of deficiencies in internal control; 16 standards containing new and revised requirements (these have been referred to as "revised and redrafted ISAs"); and 20 standards that have been redrafted to apply the new conventions and reflect matters of general clarity only (these have been referred to as "redrafted ISAs and redrafted ISQC 1").

⁹⁴ In France, the need to adapt the application of the auditing standards to the size of small companies has been recognised. See [Annex 16](#).

⁹⁵ Competent authorities for the tasks provided for in the Statutory Audit Directive (2006/43/EC): http://ec.europa.eu/internal_market/auditing/docs/dir/100201_competent_authorities_SAD_en.pdf

⁹⁶ These authorities may delegate their inspection tasks to the professional bodies, even with regard to the audit of PIEs, considering notably the low number of full-time inspectors they have.

In the other Member States, inspections are generally not carried out by the authorities.

⁹⁷ See IAASA (2010). Following the completion of a Preliminary Enquiry and the subsequent initiation of a Full Enquiry under section 23 of the Companies (Auditing and Accounting) Act 2003, the Authority and

Cause	Underfinanced and/or weak structures of national and EU-wide auditor supervision
Effect	Lack of effective national and EU-wide supervision of audit network firms

There are many differences among the national audit regulators in terms of the structures, mandate or administrative capacities. The Commission Recommendation on *external quality assurance for statutory audits and audit firms auditing public interest entities* has not achieved its objective of reducing the gap between audit regulators. Some Member States have devoted considerable resources to an effective public oversight over the profession. This is the case of the Netherlands, France or Bulgaria, where inspections are carried out by bodies both independent from the profession and from political influence. In other Member States, the oversight bodies are relatively weak due to either budgetary constraints or to weak oversight structures in certain Member States. Economies of scale could be generated if merged with other authorities, such as market regulators.

The current EU-wide cooperation mechanism under the aegis of the European Group of Auditors' Oversight Bodies (EGAOB), an expert group chaired by the European Commission, does not have appropriate means to ensure the convergence of supervisory rules, powers and the system of investigation and penalties. The supervisory framework is not commensurate with the integrated structures of audit firms that go beyond national borders. At present, the cross-border management entities that cover an audit network's operations in various Member States are not supervised (only the "national" component of the network is supervised at a national level).

With respect to effective supervision, the empirical evidence (feed-back received from EU MSs supervisory bodies) shows that some of the national banking supervisory authorities have the right under national law to "veto" the appointment of statutory auditors for financial institutions, although information is not publicly available as to how frequently this right has been exercised by supervisors. Also, to-date, no auditor of the failed banks been sanctioned for issuing clean audit reports to banks, which failed shortly after the report has been delivered (though a number are currently being investigated).

3. BASELINE SCENARIO AND SUBSIDIARITY

3.1. Baseline scenario

If no change in policy occurs, statutory audit will be performed on the basis of the existing obligations under the Statutory Audit Directive and other related legal acts (see [Annex 2](#) for the existing legal framework), respective national legislation, as well as self-regulatory codes.

Continuing under the existing framework would preserve the expectation gap regarding the role and value of audit. Maintaining the current format of the audit report risks exacerbating the uncertainty among market agents about the real contribution of auditors as well as the capacity of the audited entity to continue as a going concern, in particular for PIEs.

the Institute of Chartered Accountants in Ireland have agreed Terms of Settlement ('Settlement') on the basis that it has been determined that the Institute failed to comply with its approved investigation and disciplinary procedures. The Settlement details the Authority's findings and the associated sanctions.

Furthermore, the lack of a streamlined and well developed dialogue between auditors and supervisors, especially in the case of systemic financial institutions will be a missed opportunity to use the auditor's work as a tool for financial stability.

The provision of NASs by audit firms will continue to compromise the full independence of statutory audit providers. At the same time, the Audit Committee in its current structure will not be in a position to perform its independent monitoring function due to a lack of sufficient technical expertise as well as independence from management. Just the mandatory rotation of key audit partners and self-regulation on the organisation of audit firms do not address the threat of familiarity resulting from the audited company often appointing and re-appointing the same audit firm for decades.

The different market entry barriers (see [Annex 6](#)) will continue to prevent non-Big Four audit firms from entering the audit market for large listed companies and financial institutions. The absence of any requirement to change auditor after a certain period will further entrench the *statu quo*.

This situation is not likely to improve in a significant manner across the Union in the absence of a legislative intervention at Union level⁹⁸. Self-regulation will hardly be a solution. In the aftermath of the crisis, as shown by the debate launched by the Commission Green Paper, most of the audit profession has reverted to a "defensive reflex"⁹⁹, justifying their role¹⁰⁰ or denying any wrongdoing during the crisis¹⁰¹. Complacency has also been observed. For the profession, the answer will be "back to business as usual", as soon as possible.

Developments in national legislation may be expected in the absence of an intervention at the level of the Union. But such developments would inevitably lead to an even greater unlevel playing field, to the detriment of the internal market. The lack of harmonised application of clarified ISAs in the internal market will continue to generate a cost burden for audit firms, which combined with the requirement of an aptitude test in each Member State for access to a national statutory audit market will further prevent SMPs from providing cross-border audit services.

Considering the findings on audit quality, national supervisors should have an interest in addressing the deficiencies revealed. However, the supervision of audit firms at national and European levels is not independent enough from the profession and its current effectiveness is questionable. Moreover, individual recommendations after inspections can supplement but not replace a modern legal framework for auditing services. As a result, supervisory action under the current circumstances is likely to exacerbate the problems of patchy audit quality in the internal market.

⁹⁸ See for instance Chambers (2011), p.33: "*Measures to address the folly of an oligopoly that has monopoly rights to practice upon a captive client base are overdue.*"

⁹⁹ Expression borrowed from Bos (2011).

¹⁰⁰ See for instance the following extract from the FEE (the Federation of European Accountants) reply to the Green Paper (p.2): "[...] *evidence to date suggests that, despite very challenging economic circumstances and the financial market crisis, auditors have, overall, been performing their role as requested with diligence [...]*"

¹⁰¹ See for instance Valukas (2011) on the role of the auditor in the events preceding the collapse of Lehman Brothers: "*So to review the bidding, Lehman's senior executives weren't responsible because they relied on the auditors and other executives. The auditors weren't responsible because they relied on the executives and the lawyers. And the lawyers relied on the executives. But the public – who relied on the financial statements – who do they get to rely on?*"

3.2. The EU's right to act and subsidiarity

EU rules have partially regulated statutory audit since 1984, when a directive (Directive 1984/253/EEC) harmonised the procedures for the approval of auditors. That directive was replaced in 2006 by the Statutory Audit Directive, which expanded the scope to also cover some principles concerning the carry out of statutory audit and related supervision and a few specific provisions on the audit of PIEs. The Statutory Audit Directive is based on the freedom of establishment provisions of the Treaty¹⁰². Moreover, the EU has enacted ample legislation regarding the financial markets, in many cases using the general internal market legal basis¹⁰³, either alone or in combination with the freedom of establishment provisions. Therefore, the EU has a right to act in this area, covering both the rules on the access to the profession as well as the rules on the provision of the statutory audit service to audited entities in the wide context of the financial markets.

EU rules have always left large discretion to Member States, which in turn relied on self-regulation by the profession. Even after the adoption of the Statutory Audit Directive in 2006, self-regulation continued to exist in most of the Member States in the areas covered by the Directive, including the statutory audits of PIEs. The crisis has shown that self-regulation is not sufficient when looking towards the future. These objectives cannot be achieved by the Member States either as important differences would continue to exist in the regulatory framework put in place by them, which would undermine the single market.

Concerning the problems that affect PIEs (see [section 2.3](#)), given the interconnected nature of securities markets and financial actors, it is important that there is a harmonised framework within which audit is conducted across the Union. It is critical that the role, independence of auditors and the market structure are dealt with at the level of the Union as PIEs in Europe often have cross-border activities. Legislation on protection of investment in issuers of securities or regarding conduct of business of financial institutions is also enacted at European level.

Maintaining different approaches in Member States' audit regulation will not eliminate the problems discussed in the sections above. The need for market initiatives to be coordinated at Union level was broadly acknowledged in the UK where the UK House of Lords recently organised a hearing regarding the audit market. A coordinated approach at the level of the Union, supplemented by international support, would also lower the risk of regulatory arbitrage.

¹⁰² Article 50(2)(g) of the Treaty on the Functioning of the European Union, TFUE (ex Article 44(2)(g) of the Treaty on the European Community, TEC). Article 50 TFUE states:

"1. In order to attain freedom of establishment as regards a particular activity, the European Parliament and the Council, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, shall act by means of directives.

2. The European Parliament, the Council and the Commission shall carry out the duties devolving upon them under the preceding provisions, in particular:

[...]

(g) by coordinating to the necessary extent the safeguards which, for the protection of the interests of members and others, are required by Member States of companies or firms within the meaning of the second paragraph of Article 54 with a view to making such safeguards equivalent throughout the Union; [...]."

¹⁰³ Article 114 of the TFUE (ex Article 95 TEC). Article 114 TFUE states: *"1. Save where otherwise provided in the Treaties, the following provisions shall apply for the achievement of the objectives set out in Article 26. The European Parliament and the Council shall, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, adopt the measures for the approximation of the provisions laid down by law, regulation or administrative action in Member States which have as their object the establishment and functioning of the internal market."*

The Commission also endeavours to co-ordinate its work and that of Member States' with its international partners. To get international solutions to global problems it is therefore necessary to get a robust solution at the level of the Union and not just at the level of the Member State.

The problems described in [section 2.4](#), which affect both auditors of PIEs and other entities (procedures for the approval of auditors and audit firms of other Member States and the use of auditing standards), also call for harmonisation as they have a cross-border dimension. Action at Union level is therefore necessary and justified.

4. OBJECTIVES

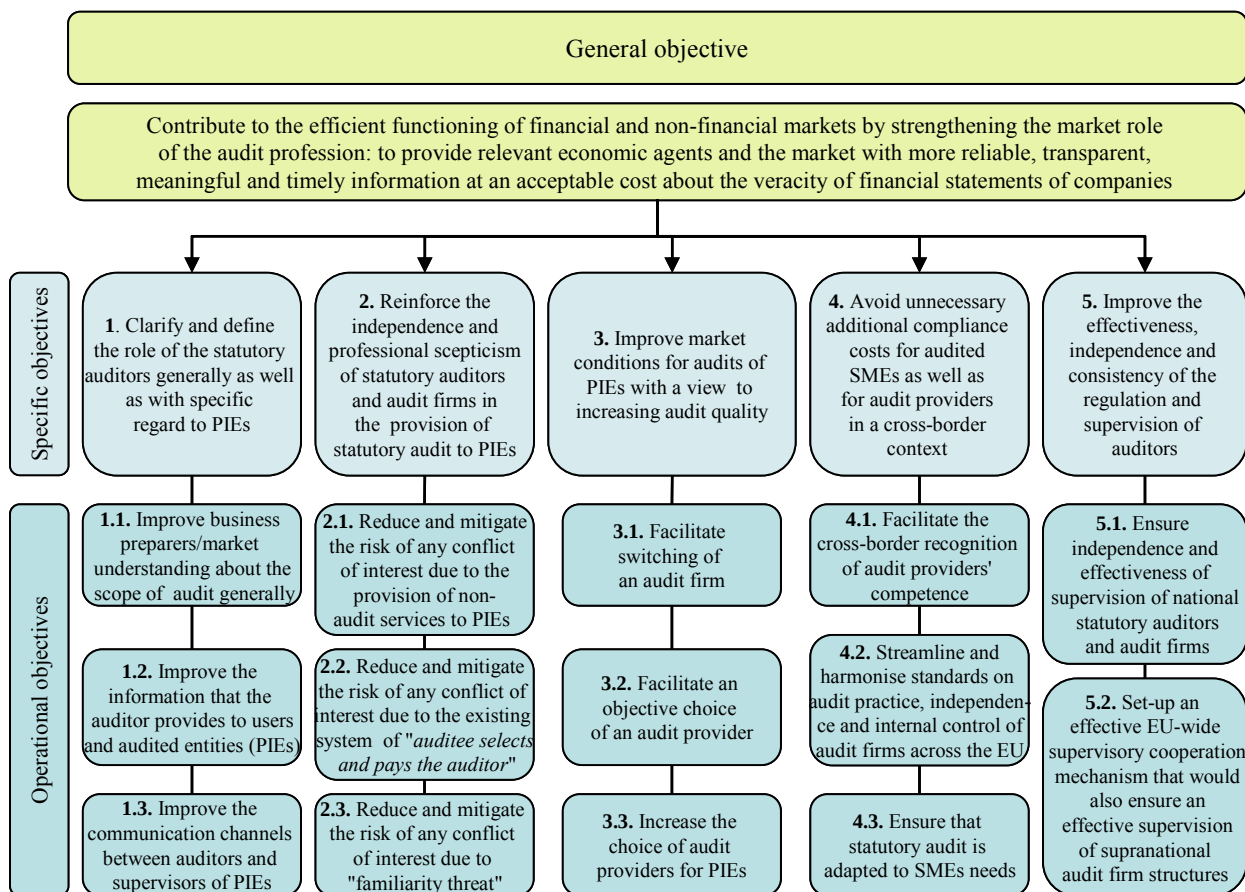


Figure 6. Objectives.

5. IDENTIFICATION OF POLICY OPTIONS

The set of policy options on substantive requirements presented in this section aims at addressing the problems analysed in the problem definition section. They are presented in accordance with the objectives set out in [section 4](#) above. A more detailed description of each policy option is found in [Annex 8](#).

The inherent complexity of the audit market and the important role audit plays for the market as a whole has been taken into account in the selection of options. In this analysis, the existing business model for the provision of statutory audit services has also been challenged, and possible options for changing this business model have been assessed. As a starting point, three alternatives have been discarded. Firstly, it could be conceivable to require that the statutory

audit service is provided by a public authority (e.g. a court of auditors or similar) rather than by regulated (private) professionals. This could effectively address the problem of lack of independence. However, the practical implementation of such an alternative model present doubts as to the capacity of public national bodies to undertake the huge task of providing statutory audit services to thousands of audited entities and the desirability to create a public monopoly for the provision of statutory audit services to companies. It would also raise questions as to who would supervise such body (the "*Quis custodiet ipsos custodes?*" problem).

A second alternative business model, which has been analysed is the option to abandon the requirement to have the companies' accounts audited and to replace it with an obligation to insure the financial statements¹⁰⁴. Under this option, insurance companies could provide coverage for investors in the audited company against losses suffered as a result of problems with the company's published financial statements. Insurance companies, in order to lower their own risk, would then appoint and pay audit firms to certify the accuracy of the financial statements. Thus, the auditor would no longer provide a direct service to the audited entity, which would reinforce his/her independence. The auditor's opinion would assist the insurance companies in setting future premiums and coverage levels. The practical implementation of this alternative business model, however, is not without difficulties. It would imply creating a new insurance market which currently does not exist. Doubts have been expressed about the capacity of insurance companies to insure financial statements in this way¹⁰⁵. As a result, this option would present several uncertainties as to its real practicability.

As a third alternative model, merely strengthening the sanctioning regime has also been considered. However, it is estimated that if this were done in isolation and without changes to the legislative framework, it would be insufficient to address the identified problems and achieve the described specific objectives. As shown in [section 2.5](#), the national supervisory authorities are not always sufficiently independent from the profession, in particular as regards inspections. Also, the number of sanctions is modest (see the description of the baseline scenario for objective 5.1 in [Annex 8](#)). The need to reinforce the sanctioning regime, as a complement to the policy options proposed, is examined below in [section 8](#).

Specific objective 1: Clarify and define the role of the statutory auditors generally as well as with specific regard to PIEs

1.1 Policy options to improve business preparers/market understanding of the scope of audit generally

0. Baseline scenario. No definition at EU level on the scope of audit.
1. Clarify and specify the scope of statutory audit in the EU rules (without enlarging it) to reduce the expectation gap. Auditors/firms will be required to apply their professional scepticism throughout the performance of the audit. Requirements will be established regarding the important tasks to be undertaken when performing the audit work: i.e. appointment of adequate staff; organisation of audit file; market integrity and fraud prevention; responsibility of group auditors; internal quality control or record keeping.
2. Redefine the scope of statutory audit to fill the expectation gap. The auditors will be required to assess forward looking information provided by the company, particularly in the context of "going concern".

1.2 Policy options to improve the information that the auditor provides to users and audited entities (PIEs)

0. Baseline scenario. Minimum requirements for the audit report result in very short reports with standard language, no requirements for the provision of additional information to the audited entities.

¹⁰⁴ This option is examined in US GAO (2008), p. 58. See also House of Lords (2011), §74 and Chambers (2011), p.33.

¹⁰⁵ See also House of Lords (2011), §74, *in fine*.

1. Improve and expand the content of the audit report disclosed to the public. Set additional requirements for the audit report so it provides more information to the public.
2. Require the preparation of a longer and more detailed report for the audited entity. An additional internal report providing detailed information on the audit carried out to the audit committee and management.
3. Increase the communication between the auditor and audit committee. Articulating relations between the auditor and audit committee as regards reporting, regular dialogue and subsequent information to management.
4. Combination of options 1 to 3.

1.3 Policy options to improve the communication channels between auditors and supervisors of PIEs

0. Baseline scenario. Beyond the obligation to report breaches of rules in certain cases, no requirement for auditors to regularly engage with supervisors of the PIEs.
1. Enabling (in law) and recommending regular dialogue between auditors and supervisors of PIEs (banks and insurance companies). No breach of confidentiality rules if auditors engage in a regular dialogue with the supervisors of PIEs.
2. Requiring the establishment of regular dialogue between auditors and supervisors of PIEs (banks and insurance companies). Requiring that such dialogue takes place effectively in all circumstances.

Specific objective 2: Reinforce the independence and professional scepticism of statutory auditors and audit firms in the provision of statutory audit to PIEs

2.1 Policy options to reduce and mitigate the risk of any conflict of interest due to the provision of non-audit services to PIEs

0. Baseline scenario. General criteria on independence applicable, but no direct prohibition of the provision of additional non-audit services to the audited entity.
1. Prohibition of the provision of certain non-audit services to the audited entity (blacklisting certain services).
2. Prohibition of the provision of any non-audit services to the audited entities. But the provision of non-audit services to entities which are not audited would remain possible.
3. Pure audit firms. Approved audit firms will only be allowed to provide statutory audit services and be unconnected to firms providing certain non-audit services to audited entities.

2.2 Policy options to reduce and mitigate the risk of any conflict of interest due to the existing system of "auditee selects and pays the auditor"

0. Baseline scenario. Companies continue to appoint auditors with a light intervention of the audit committee.
1. Stricter rules on the procedure for the appointment of auditors with an increased role for a strengthened audit committee. Its recommendation for the appointment of the auditor shall be discussed at the general meeting of shareholders. Reinforcement of the independence and technical competence of the committee: at least two of its members must be independent and at least one have knowledge on audit.
2. Appointment of auditor by a third party. A third party (i.e. a regulator) appoints the auditor.

2.3 Policy options to reduce and mitigate the risk of any conflict of interest due to a "familiarity threat"

0. Baseline scenario. Restrictions on the duration of audit engagements only apply to the key audit partner; no specific requirements at EU level, except regarding ethics and the prohibition of contingent audit fees.
1. Mandatory rotation of an audit firm. Audit firms will step down after a certain number of years of engagement and would only be allowed to take a new engagement with the same audited entity after a cooling-off period.
2. Strengthening the role of the audit committee in overseeing the work of the statutory auditors/audit firms.
3. Establishing additional requirements on the internal organisation and governance of audit firms.
4. Combination of options 1 to 3.

Specific objective 3: Improve market conditions for audits of PIEs with a view to increasing audit quality.

3.1 Policy options to facilitate switching of an audit firm¹⁰⁶

0. Baseline scenario. Companies do not want to spend management time to organise tenders and are ready to pay a premium to Big Four auditors as audit costs are relatively low compared to total turnover for most of PIEs. If the issue of "low switching" is not tackled, all other measures to improve the market functioning (objective 1.2 and objective 1.3) are likely to fail to achieve specific objective 1.
1. Regular tendering. Audited entities will invite a minimum number of auditors/firms to participate in a tendering procedure, including an audit firm which is not among the four biggest players in the market.
2. Mandatory rotation. The statutory auditor/audit firm will not be allowed to audit the same company after a certain number of years and an appropriate cooling off period (the same as option 1 under objective 2.3).
3. Mandatory rotation of an audit firm via tendering (combination of option 1 and option 2).

3.2 Policy options to facilitate an objective choice of audit provider

0. Baseline scenario. Due to the lack of sufficient information and criteria to assess and compare the quality of audits, the reputation of Big Four audit firms will remain the most important proxy of audit quality and audit firms will continue to be selected on the basis of reputation rather than on the basis of more objective criteria of audit quality/price. In addition, in certain cases the objective selection of the auditor is also hampered by contractual clauses, which predetermine the choice of the auditor.
1. Prohibit contractual clauses limiting the choice of audit firms (e.g clauses between the audited entity and a third party (such as a bank) requiring that the statutory audit is performed by a "Big-Four firm" only).
2. Increase transparency on audit quality and on audit firms. Audit firms auditing PIEs will disclose their financial statements and more information in their transparency reports that they are currently required to publish annually. They will also report information on fees to supervisors. Competent authorities will disclose the results of inspection reports by firm.
3. Establish an audit quality certification. A pan-European system that certifies that an auditor or firm meets some quality requirements enabling them to carry out high quality statutory audits of PIEs.
4. Combination of options 1 to 3.

3.3 Policy options to increase the choice of audit providers for PIEs

0. Baseline scenario. PIEs continue to face the issue of limited perceived choice of audit firms with the capacity to perform high quality statutory audits, in particular in the segment of large and systemically important PIEs.
- 1.1 Pure audit firms. PIE audits will be performed by firms who will be allowed to provide only audit services (same as option 3 under objective 2.1).
- 1.2 Joint audits: obligation for large PIEs to have more than one audit firm, at least one of which is not among the largest four audit firms. In the tendering process for their selection, the scope and responsibility of each auditor should be clearly defined. Both audit firms will have joint responsibility for the audit.
- 1.3 Joint audits: obligation only for Large PIEs in the Financial sector to have more than one audit firm, at least one of which is not among the largest four audit firms. In the tendering process for their selection, the scope and responsibility of each auditor should be clearly defined. Both audit firms will have joint responsibility for the audit.
- 1.4 Joint audits for all large PIEs conducted by pure audit firms.
- 1.5 Mandatory joint audit only to FIs by pure audit firms
- 1.6. Voluntary joint audit to all PIEs: creates incentives for audit providers and audited entities alike to use joint audit on a voluntary basis.
2. Lift restrictions on the ownership of audit firms. Lifting any restrictions currently preventing investors from non-audit backgrounds to buy shares and invest in audit firms. But holders of voting rights in an audit firm shall be independent of the audited entity and not involved in the decision-taking of the audited entity.
3. Establish market share ceilings for large audit service providers. No audit firm shall be allowed to have more than 20% of the market share regarding the statutory audit of PIEs (which would ensure at least five players in the market).

¹⁰⁶ Some of the policy options in 3.1 are closely connected to the objective identified in 2.3 (mitigate the risk of familiarity threat). As explained in section 2.3, there is a link between the lack of effective choice of auditor for large PIEs and the independence problems.

Specific objective 4: Avoid unnecessary additional compliance costs for audited SMEs as well as for audit providers in a cross-border context

4.1 Policy options to facilitate the cross-border recognition of audit providers' competence

0. Baseline scenario. Auditors and audit firms shall be approved in all MS in which they wish to carry out statutory audit. Auditors are required to pass an aptitude test in each Member State in which they want to perform audits.
1. Mutual recognition of audit firms. An audit firm approved in a MS will automatically be approved in all MS, provided that the key audit partner leading the audit is approved as an auditor in the concerned MS.
2. Mutual recognition of statutory auditors approved in a Member State.
3. Introduction of an adaptation period scheme and increased convergence, transparency and predictability in the aptitude test.

4.2 Policy options to streamline audit standards on practice, independence and internal control of audit firms across the EU

0. Baseline scenario. Auditing standards may differ in Member States.
1. Introduction of clarified ISAs. With possible national add-ons but no carve-outs
2. Introduction of clarified ISAs. With possible national carve-outs by Member States.

4.3 Policy options to ensure that statutory audit is adapted to SMEs needs

0. Baseline scenario. Same auditing standards apply irrespective of size of audited entity.
1. Adapt audit standards to the size and complexity of the business of the audited entity. Request Member States to ensure a proportionate and simplified audit for SMEs.
2. Introduce limited reviews for SMEs instead of statutory audit. Audits could be replaced by "limited reviews", which are less costly, but provide a lower level of assurance compared to a statutory audit.

Specific objective 5: Improve the effectiveness, independence and EU-wide consistency of the regulation and supervision of auditors

5.1. Policy options to ensure independence and effectiveness of supervision of national statutory auditors and audit firms

0. Baseline scenario. The current legislative framework does not prohibit the close involvement of the audit profession through their professional bodies in audit supervisory matters.
1. **Establishment of an independent EU oversight authority.** This authority will be responsible for the supervision of national audit firms auditing PIEs with a cross-border impact for stakeholders.
2. Strengthening national audit supervisory authorities. The mandate, powers and independence requirements for audit supervisors will be set at EU level, but supervision carried out nationally.

5.2 Policy options to set up an effective EU-wide supervisory cooperation mechanism that would also ensure an efficient supervision of supranational audit firm structures

0. Baseline scenario. Commission services continue to lead a group of experts composed of representatives of national public oversight authorities.
1. Cooperation within a level-3 Lamfalussy-type committee. Independent legal status and EU-wide structure which would decide on its own work, with the Commission as observer only.
2. EU-wide cooperation within ESMA. In cooperation with EBA and EIOPA, ESMA takes the responsibility for EU-wide cooperation on auditor supervision matters for audits of PIEs.
3. New European Authority of audit supervisors. New authority specifically devoted to the supervision of the audit market.

6. ANALYSIS OF POLICY OPTIONS

Sections 6.1 to 6.5 show the analysis of the policy options¹⁰⁷: sections 6.1 to 6.3 deal with objectives 1 to 3 and only concern the statutory audit of PIEs; while sections 6.4 and 6.5 address statutory audit in general. Annex 20 provides specific information on the costs associated with the preferred policy options. Annex 9 summarises the stakeholder views with regard to the preferred policy options.

Summary tables measure the comparative advantages and disadvantages of the different possible solutions against three criteria:

- (1) effectiveness (the extent to which the option is likely to fulfil the objectives formulated in section 4);
- (2) convergence (the extent to which the framework for the conduct of statutory auditors and audit firms is governed by the same requirements in all Member States and a level playing field created; and
- (3) cost-effectiveness (the extent to which the objectives are likely to be met having considered the costs of implementing the option).

The tables present the magnitude of impact as compared with the baseline scenario (indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

Section 6.6 analyses the policy options from the perspective of the coherence criterion (the extent to which options are coherent with the overarching objectives of EU policy). Finally, section 6.7 discusses the choice of legal instrument.

6.1. Policy Options to deal with the role of the auditor and the scope of audit

Objective 1.1: Sub-policy options to improve business preparers/market understanding of the scope of audit generally

Figure 6

Policy option	Effectiveness	Convergence	Cost-effectiveness
	Objective 1.1		
0. Baseline scenario	0	0	0
1. Clarify and specify the scope of statutory audit to reduce the expectation gap	+	+	≈
2. Redefine the scope of statutory audit to fill the expectation gap	-	+	-

Under the baseline scenario the expectation gap would remain. Existing legislation and self-regulatory standards (developed by the profession) on the scope of statutory audit do not provide enough clarity to stakeholders. Option 1 would not change the scope of the statutory audit. It would clarify the scope of the audit without enlarging it and specify the role of the auditor by requiring that auditors/ firms apply their professional scepticism throughout the performance of the audit. Establishing clear rules and disclosing more information on the scope would contribute to increased clarity and certainty on the audit scope – and as a result audit quality – as well as the convergence of legislation across the EU; currently the scope of statutory audit is largely dependent on self-regulatory audit standards. Furthermore, by disclosing further information on the work carried out by auditors, it would enable a broader public to better understand this scope and therefore, provide a measure to close the expectation gap. However, the scope of an audit would not include the assurance on the future viability of the audited entity. Nevertheless, this does not exclude an assessment of the "going concern" as part of the opinion. This option is

¹⁰⁷

The European Federation of Accountants (FEE) has prepared, for its conference of 30 June 2011, five briefing papers addressing some of these options. They deal with: Developing the Role of the Auditor and Auditor's Communication; Appointment of the Auditor; Provision of Non-Audit Services to Audit Clients; European Passport for Auditors and Audit Firms; and Future Supervision of the Audit Profession – Further Cooperation. The briefing papers are available at FEE website (http://www.fee.be/news/default.asp?library_ref=2&content_ref=1363).

largely supported by the majority of the respondents to the Green Paper¹⁰⁸. The European Parliament underlines that "*professional scepticism is vital in auditing*"¹⁰⁹. Option 2, on the contrary, is controversial: it would enlarge the scope of statutory audit to encompass the assessment of forward looking information provided by the company and to provide an economic and financial outlook for the company beyond the examination of the "going concern". This option is supported by some representatives of the profession, whereas public authorities and preparers strongly disagree¹¹⁰. Although option 2 would contribute to the convergence of rules, it is generally perceived, (at least by many respondents to the Green Paper), as not adding value to stakeholders. Management is primarily perceived as being responsible for forward-looking information and other market actors such as equity analysts or credit rating agencies, are already processing and assessing the reliability of that information. Hence, option 2 would duplicate efforts and generally increase costs for audited entities without any clear benefit. As a result, option 1 is the preferred policy option.

Objective 1.2: Sub-policy options to improve the information that the auditors provide to users and audited entities (PIEs)

Figure 7

Policy option	Objectives	Effectiveness		Convergence	Cost-effectiveness
		Objective 1.2	Objective 5		
0. Baseline scenario		0	0	0	0
1. Improve and expand the content the audit report disclosed the public		+	+	+	≈ / +
2. Preparation of a longer and more detailed report for the audited entity		++	++	++	≈ / +
3. Increase the communication between the auditor and the audit committee		++	++	++	≈ / +
4. Combination of options 1 to 3.		++	++	++	≈ / +

Current practice (baseline scenario) is to prepare template audit reports, so investors have no means to understand what is behind the audit work¹¹¹. In the absence of legislative developments at EU level it is unlikely that objective 1.2. would be achieved through voluntary efforts by auditors and audited entities to prepare more meaningful audit reports¹¹² or to present an additional longer and more detailed report to the audited entity for internal purposes¹¹³. Also, the current flexibility in the relations between auditors and supervisors of PIEs, although valuable, does not guarantee sufficient engagement between these actors. Therefore, the value added of statutory audit is likely to continue to be perceived as low by stakeholders. The expanded and improved content of the audit report (option 1) would provide greater incentives for higher quality audits¹¹⁴. Moreover, option 1 will also facilitate greater engagement by the investors who would attach greater value to the statutory audit. The longer report (option 2) and the increased communication between the auditor and the audit committee (option 3) would also result in

¹⁰⁸ Including professional bodies, associations linked to the profession, investors, public authorities, preparers and others (some representatives of the profession, however, maintain that the expectation gap is unlikely to be closed). There is wide support as well for reinforcing professional scepticism.

¹⁰⁹ See European Parliament (2011), §16.

¹¹⁰ The European Parliament suggests studying this issue. See European Parliament (2011), §10.

¹¹¹ Only in France, due to a legislative requirement, do audit reports systematically provide more information than the current minimum requirement in the EU rules.

¹¹² Despite the integrated networks of audit firms, this has not resulted in this best practice being extended. Fear of possible liability implications appears as a strong deterrent for auditors/audit firms to provide more information.

¹¹³ This longer internal report is mandatory in Germany, Austria and Switzerland. Despite the integrated networks of audit firms, this best practice has not been extended.

¹¹⁴ This option would also help to reduce the expectation gap on the scope of the audit. As described above, the audit report is a proxy to the scope of the audit.

greater incentives for higher quality audits since it would facilitate the monitoring of statutory audit work and an assessment of quality by the audit committee. This should facilitate the tasks of audit supervisors thus also contributing to achieving the objective of improving audit supervision in the EU (objective 5). These options have received large support from many categories of stakeholders, as outlined in the replies to the Green Paper. The European Parliament is also in favour of providing more information in the audit report, of auditors focusing more on substance rather than on form and of enhanced dialogue between the auditor and the audit committee¹¹⁵. The additional costs¹¹⁶ resulting from these options are estimated to be moderate (see Annex 20). Options 1 to 3 are not mutually exclusive. Indeed, the combination of the three (option 4) would result in positive synergies, in particular as regards the incentives to improve audit quality, facilitate the monitoring tasks of the audit committee and the supervision of auditors' performance. Enhanced monitoring and supervision of the audit work would lead to improved quality and added value of the statutory audit. Therefore, option 4 is the preferred option.

Objective 1.3: Sub-policy options to improve the communication channels between auditors and supervisors of PIEs

Figure 8

Policy option	Objectives	Effectiveness		Convergence	Cost-effectiveness
		Objective 1.3	Objective 5		
0. Baseline scenario		0	0	0	0
1. Enabling (in law) and recommending regular dialogue between auditors and supervisors of PIEs (banks and insurance companies)		+	++	+	+
2. Requiring the establishment of regular dialogue between auditors and supervisors of PIEs (banks and insurance companies)		++	++	+	+

The current situation and financial crisis (baseline scenario) shows that structured dialogue between regulators/supervisors of PIEs, in particular financial institutions (such as banks), and their auditors does not appear to be sufficiently developed¹¹⁷. However, research underlines the benefits of establishing such structured dialogue¹¹⁸, thus meeting the objectives of improving the communication channels between auditors and supervisors (objective 1.3) and EU-wide supervision over auditors (objective 5). Establishing dialogue between supervisors of banking and insurance supervisors and the auditors of banks and insurance companies received substantial support in the public consultation. The European Parliament also supports two-way

¹¹⁵ See European Parliament (2011), §§9, 11 and 18.

¹¹⁶ The additional costs for options 1 and 2 are the additional time spent in drafting the expanded audit report and the additional internal report. Concerning option 3, additional costs for the audited entity would result from the increased engagement of audit committee members and key audit partners (e.g. hourly fees of key audit partners and the compensation for the audit committee members). This increase may vary largely from company to company.

¹¹⁷ See for instance Dewing and O’Russell (2011), explaining that in the UK, the banking supervisor prior to the crisis did not really engage in any structured dialogue with the auditors of banks.

¹¹⁸ *Ibid.* Since 1934 auditors have had a role in regulating banks in Switzerland – in a so called 'dualistic' or 'two-tiered' system. All auditors in Switzerland get a normal audit licence from the audit oversight authority, but to audit banks they must also obtain a special licence from the banking supervisor. Only a small number of auditors are licensed to undertake bank audits. The banking supervisory has power to observe the audit on-site during the audit. Auditors of banks undertake normal statutory audits and report to the shareholders under company law. They also undertake risk-based financial and regulatory audits, including direct supervisory tasks, and report to the banking supervisor under banking law. For large banks (e.g. Credit Suisse and UBS), the banking supervisor carries out additional direct supervisory activity. It is the banking supervisor who inspects the auditors work with regard to the audits of banks.

communication between auditors and supervisors of financial institutions¹¹⁹. Of the two options presented, option 1 has the advantage of giving supervisors more flexibility as to whether they should hold such dialogue or not depending on the different size and nature of audited entities involved. The disadvantage is that it may lead to no dialogue at all if the auditor decides not to engage. Option 2, however, ensures that the dialogue will effectively take place and, at the same time, allows for sufficient flexibility to be built into the system so as to avoid the requirement becoming a meaningless bureaucratic obligation. The expected benefits for the supervisory system from both options would outweigh the expected moderate costs (e.g. meetings)¹²⁰. The preferred option is option 2.

6.2. Policy Options to deal with conflicts of interest

Objective 2.1: Sub-policy options to prevent any conflict of interest arising from the provision of non-audit services to PIEs

Figure 9

Policy option	Objectives	Effectiveness		Convergence	Cost-effectiveness
		Objective 2.1	Objective 3.3. Increase the choice of audit providers for PIEs		
0. Baseline scenario:		0	0	0	0
1. Prohibition of the provision of certain non-audit services to the audited entity		+	≈	+	+ / ≈
2. Prohibition of the provision of any non-audit services to the audited entities		++	-	+	+ / ≈
3. Pure audit firms		++	+	+	+

A significant proportion of the profession consider that the existing situation (baseline scenario) is sufficient to avoid or mitigate any threat to independence. However, the existing rules allow for a “case-by-case” examination of potential conflicts of interest¹²¹, giving a large interpretation margin to auditors. As a result, it is likely that the audit of PIEs will continue to be potentially compromised due to the 'business potential' of providing NAS. Option 1 (blacklisting)¹²² would have a positive effect on streamlining and harmonising policies among Member States¹²³, creating a level playing field for all audit providers in the EU. It would also eliminate the legal uncertainties and potential conflicts of interest¹²⁴ due to discrepancies in the blacklisting among Member States on the one hand and the global geographical coverage of big audit firms on the other hand. This is the option supported by the European Parliament¹²⁵. Some stakeholders (authorities, investors) could also accept it. This option could be supplemented with a cap on the

¹¹⁹ See European Parliament (2011), §§13 and 42 to 44).

¹²⁰ See Annex 20 for the cost estimates for this option as well as the cost estimates for such meetings – FSA (2011).

¹²¹ Only France and Belgium have developed lists of authorised and non-authorised services.

¹²² The blacklist could include services such as preparing accounting records and financial statements, bookkeeping services, designing and implementing financial information technology systems, etc. See Annex 8.

¹²³ Belgian and French lists are not identical, for instance.

¹²⁴ For instance, an audit firm providing the same NAS to several entities of the same group in different MSs may be in a situation of conflict of interest in one and in not in the other MS due to the differences in the way NASs are treated. In such a case in order to provide the audit service to the parent undertaking of the group, the audit firm may apply the more lenient rules on independence of the country of the parent undertaking in the assessment of potential conflict of interests at the level of a given subsidiary, even if the legislation in the country of the subsidiary is stricter.

¹²⁵ European Parliament (2011), §29 and seq. The European Parliament also suggests that the role of the audit committee in deciding whether the provision of NAS is possible should be reinforced.

NAS fees compared to the total audit fees for a given client¹²⁶. However, recent evidence from the US¹²⁷ shows that it is unlikely that option 1 would be sufficient to fully address the issue of audit firm independence¹²⁸. Option 2 would prevent a potential conflict of interest and would preserve professional scepticism¹²⁹. This would be similar to the previous option but would have a greater positive effect on independence because no NAS could be provided to the audit client¹³⁰. This option is supported by investors and accepted by some representatives of the profession, provided it applies to PIEs only¹³¹. A drawback, however, is that if the audit firm provides NAS to a particular client, it would no longer be able to provide audit services to that client, which could *de facto* reduce the number of audit firms eligible to audit large PIEs in the short term¹³². At the same time, this option should facilitate the growth of mid-size audit firms focusing on audit services. As a result, option 2 does not integrate well with the policy options regarding objective 3.3. Option 3 (see Annex 10 on this option) would also solve the issue of the potential conflict of interest, as the audit firm would only be allowed to provide audit services. Audit firms consider that this option might deprive them of the knowledge and understanding of their clients' businesses which they deem necessary for the provision of good quality audit services. However, contrary to this perception, this option would create incentives, on both the demand and the supply sides, to focus on audit quality: PIEs would have to select an auditor purely on the basis of their audit capabilities and audit firms would have to focus on audit services, which would significantly reinforce audit quality and the perception of the independence of the auditor. At the same time, this option would not result in a reduction of eligible audit firms¹³³ and therefore, has positive effects regarding the audit of large PIEs, particularly from the perspective of objective 3.3 (see below, also regarding the proportionality assessment and the need to adapt this option to the size of audit firms). From the point of view of

¹²⁶ An option that would be based, however, only on a cap on NAS fees (without blacklisting certain services) would not be practicable because of the risk of self-review.

¹²⁷ This option is currently the situation in the US after the enactment of the Sarbanes-Oxley Act. In the US, the blacklist is combined with a cap on the maximum amount of NAS fees compared to the audit fees for a given client.

¹²⁸ See Doty (2011a): "*Despite those requirements [blacklisting of the provision of certain non-audit services], PCAOB inspection reviews of partner evaluation and compensation processes find examples of seemingly unrestrained enthusiasm – in partners' self-evaluations, in their supervisors' evaluations of their performance, and in agreed performance goals – for selling services to audit clients.*"

¹²⁹ For instance in the EU, credit rating agencies are not allowed to provide consultancy or advisory services to the rated entity or a related third party regarding the corporate or legal structure, assets, liabilities or activities of that rated entity or related third party. See Regulation (EC) No 1060/2009.

¹³⁰ The incentive for the audit firm to rename a non-audit service so as to avoid being captured by the black list would disappear.

¹³¹ On the contrary, audit firms fear the weakening of the range of skills they can offer and anticipate difficulties in attracting talented staff. It may be argued, however, that if talented staff is recruited to provide NAS rather than audit services, this would have no direct effect in raising audit quality.

¹³² For instance, information provided by Assonime, the association of Italian listed companies, suggests that large Italian PIEs, when implementing the rotation of audit firm rule, find themselves faced with a very limited choice. Sometimes, only one audit firm (a Big-Four audit firm) is available to provide the statutory audit service (the outgoing audit firm being prevented from providing the service during the cooling-off period; the two other large audit firms being prevented from providing the service because of independence rules either in Italy or with regard to subsidiaries in other countries, and smaller audit firms are not always able to cope with the geographical coverage of the group of the PIE). This implies a shift of bargaining power to the detriment of the PIE. It also effectively results in rotation between two Big-Four audit firms. Chambers (2011) also points at this idea: "*In several sectors only three firms are active auditors. It may be impossible for a large bank to change to another Big Four auditor due to conflicts [...]*".

¹³³ Under options 1 and 2, an audit firm providing a blacklisted NAS or simply NAS to a client is *de iure* not eligible to provide audit services to that client. If such firm is a Big Four audit firm, it would significantly reduce the number of available providers of audit services to large PIEs, at least in the short term. On this issue, see US PCAOB (August 2011), p. 21.

convergence, it has similar positive effects as the other two options. In terms of the costs, there is likely to be an increase in the costs of audit, in particular for PIEs, due to lost synergies derived from the provision of both audit and NAS by the auditor. A combination of options 2 and 3 could be possible, depending on the size of the audit firm, and is the preferred policy option.

Objective 2.2: Sub-policy options to mitigate the risk of any potential conflict of interest due to the existing system of "auditee selects and pays the auditor"

Figure 10

Policy option	Objectives	Effectiveness		Convergence	Cost-effectiveness
		Objective 2.2:	Objective 3: improve market conditions for audits of PIEs		
0. Baseline scenario		0	0	0	0
1. Stricter rules on the procedure for the appointment of auditors with an increased role for a strengthened Audit Committee		++	+	+	≈/+
2. Appointment of auditor by a third party		++	+	≈/+	≈/-

Under the baseline scenario, the inherent conflict of interest would remain, as would the different independence requirements in Member States. Option 1¹³⁴ would positively contribute to ensuring better monitoring of the independence of auditors. Improving the capacity of the audit committee to take informed decisions during the selection process for the statutory audit provider would also facilitate the entry of new statutory audit providers into the market (counterbalancing the company's overreliance on the continuing provision of audit services by the same Big Four audit firm). Such selection processes would be based on streamlined criteria across the Union. There may be additional costs for PIEs in recruiting Audit Committee members with relevant technical profiles as well as remuneration for their greater involvement as experts. Option 2 as a general rule was not supported by the vast majority of respondents to the Green Paper as this option might be costly and difficult to enforce¹³⁵. It would also take away the discretion of the Audit Committee and the shareholders. Convergence would remain challenging as the selection process would be difficult to streamline across the EU. Option 2 could be considered for PIEs with systemic importance (e.g. some financial institutions), where the choice and performance of the statutory auditors could have a big influence on preserving market stability and where banking and insurance supervisors have an interest in closely monitoring the audit work. However, it is questionable whether it would add any value compared to a solution that currently exists in several Member States¹³⁶: the possibility for banking supervisors to veto the appointment of an auditor. A veto possibility appears sufficient to allow the banking supervisors to exercise influence on the appointment of the auditor while integrating within the mechanisms and dynamics of option 1, thus preserving the rights of the PIE shareholders. The introduction of such a veto at a Union level appears to be a preferable approach¹³⁷. Option 1, maintaining the

¹³⁴ Strengthening the requirements for the selection of audit committee members would mean that at least one member shall have an audit qualification and at least two members shall have competence in accounting and/or auditing. In addition, the committee members as a whole should have experience in the sector of operation of the company. In terms of independence, the majority of the members should be independent (including the chairman).

The European Parliament supports this option. See European Parliament (2011), §§ 15, 22 and 23.

¹³⁵ It received, however, some support from public authorities for certain specific situations.

¹³⁶ Veto rights exist in at least the following countries: AT, BE, BU, CZ, DE, FR, IE, LT, LV, MT, PT, RO and SK. A pre-approved list of bank auditors exists in BE. In EE, the authority can appeal to the courts if unsatisfied with the auditor appointed. There is not enough public evidence on the formal use of these rights in most of these countries. It appears that authorities use soft powers in this regard.

¹³⁷ This option could be accepted by some stakeholders, including investors, authorities and the profession.

possibility for banking and insurance supervisors to veto the appointment of an auditor, is the preferred policy option.

Objective 2.3: Sub-policy options to mitigate the risk of any potential conflict of interest due to a "familiarity threat"

Figure 11

Policy option	Objectives	Effectiveness		Convergence	Cost-effectiveness
		Objective 2.3	Objective 3.1: facilitate switching of an audit firm		
0. Baseline scenario		0	0	0	0
1. Mandatory rotation of an audit firm		++	++	+	+
2. Strengthening the role of the audit committee in overseeing the work of the statutory auditors/audit firms		+	+	+	≈/+
3. Establishing additional requirements on the internal organisation and governance of audit firms		+	n.a.	+ / ≈	≈
4. Combination of options 1 to 3		++	++	+	+

The European Parliament seems satisfied with the *statu quo* on this point (baseline scenario): while it regards external rotation as a means of strengthening the independence of auditors, it reiterates its view that *"the existing partner rotation arrangements provide the independence necessary for audits to be effective"*¹³⁸. This view is also supported by the majority of the profession, who refer to academic research showing that rotation of audit firms would harm audit quality and increase costs. The Italian experience is not considered to have had positive effects (see Annex 11 for a description of the main arguments for and against the rotation of audit firms, including the Italian experience). The baseline scenario, however, risks perpetuating the syndrome of decades-long audit engagements, where the partner of a firm's long standing (sometimes over a hundred years) audit client naturally remains under pressure not to lose the client¹³⁹. The audit committee, at its current level of low effectiveness (cf. respondents to the Green Paper) would continue to have little impact on the elimination of the 'familiarity threat'.

Limiting the duration of the audit engagement and requiring the rotation of audit firms (option 1) is likely to have a positive effect on mitigating potential conflicts of interest due to the "familiarity threat"¹⁴⁰. Furthermore, having a uniform rule across the Union will create a level playing field in the internal market. It will have a certain cost for both PIEs (assigning resources to help the new auditor in the first year) and audit firms (more resources needed to cover the learning curve in the first year of the assignment). These costs could, however, be contained by enforcing clear rules on access to information and the transfer of knowledge about the audited entity from the previous audit firm¹⁴¹. It would be crucial to find the right balance between the

¹³⁸ See European Parliament (2011), §26. On the contrary, the US has recently launched a reflection on *"whether mandatory audit firm rotation would help address the inherent conflict created because the auditor is paid by the client"* (see Doty (2011a), section III.B). A consultation paper was published in August 2011. See US PCAOB (August 2011).

¹³⁹ See above Section 2.3.2.

¹⁴⁰ In the words of the US audit oversight body: *"[b]y ending a firm's ability to turn each new engagement into a long-term income stream, mandatory firm rotation could fundamentally change the firm's relationship with its audit client and might, as a result, significantly enhance the auditor's ability to serve as an independent gatekeeper."* See US PCAOB (August 2011), p. 9.

¹⁴¹ This cost may diminish if a specific and detailed handover file is provided by the outgoing auditor to the incoming one. Article 23(3) of the Statutory Audit Directive sets a general principle that the former statutory auditor has to provide the incoming audit firm with all relevant information concerning the audited entity. However, this general principle is not further specified.

Interestingly, Assonime (the Italian association of listed companies) suggest a different solution to this problem of potential loss of knowledge. Assonime suggests that audited companies could be allowed to

appropriate duration of the mandate of the auditor to ensure that disproportionate costs due to very short mandates are avoided and ensure that the "familiarity threat" is addressed. Indeed, given that such switching will only occur periodically, the cost will effectively be spread over several years. Therefore, a 9 year maximum duration appears proportionate¹⁴². Strengthening the role of the audit committee¹⁴³ as a more independent body to oversee the work of the statutory auditors/audit firms (option 2) will have an overall positive effect (see also previous section). However, option 2, in isolation, would not achieve the same positive effects that rotation achieves in addressing the familiarity threat: its effectiveness could be affected depending on the quality of the audit committee members and their engagement¹⁴⁴. The cost-effectiveness of this option, due to the additional cost resulting from the enhanced engagement of the audit committee, might be only slightly positive. Establishing additional requirements for the internal organisation and governance of audit firms (option 3) will have a positive impact on the performance of audit work so as to avoid conflicts of interest. Since such policies/procedures already exist in a number of audit firms, mainly resulting from self regulation or national standards, option 3 would streamline good practice at almost no cost for audit service providers.

The combination of these options (option 4) has potential positive synergies, specifically because the strengthened audit committee would be better placed to play an active role in the selection process. Option 4 is the preferred policy option. In terms of proportionality, it is necessary to adjust options 2 and 3 to the size of PIEs and audit firms respectively.

6.3. Policy Options to improve market conditions for audits of PIEs with a view to increasing audit quality

The conflict of interest problem leading to undermined independence of the auditor is directly addressed by objective 2. However, as described in the problem definition, the conflict of interest problem cannot be solved if there is a limited choice of auditors in the market. Hence, the need to pursue objective 3.

Objective 3.1: Sub-policy options to facilitate switching of an audit firm¹⁴⁵

Figure 12

Policy option	Objectives	Effectiveness		Convergence	Cost-effectiveness
		Objective 3.1:	Objective 2.3: mitigate the risk of any potential conflict of interest due to "familiarity threat"		
0. Baseline scenario		0	0	0	0
1. Regular tendering		+ / ≈	+ / ≈	+ / ≈	≈

appoint the new audit firm during the 12 months before the expiry of the previous audit firm engagement. In this way, the incoming auditor could have the possibility to gain an understanding of the company in advance and to start the audit work on day 1 of the financial year that he/she will audit. Currently, audited entities would typically appoint the new auditor in the annual general meeting approving the accounts of the previous financial year, which usually takes place in April. Therefore 4, months are lost for the new auditor. See the reply of Assonime to the Green Paper.

¹⁴² This is the maximum duration of audit engagements in Italy, where the rotation rule is mandatory. In Brazil, where rotation of audit firms currently takes place every 5 years, there stock exchange supervisor is considering to extend this period to 10 years. See CVM (2011).

¹⁴³ On the audit committee, see generally ECODA (2011).

¹⁴⁴ Investors, public authorities and academics are split on this issue. For some, regular tendering of audit contracts (see section 6.3) with greater involvement of audit committees and shareholders would be enough to address the familiarity threat. For others, rotation of audit firms would be necessary.

¹⁴⁵ Some of the policy options in 3.1 are closely connected to the objective identified in 2.3 (mitigate the risk of familiarity threat). As explained in section 2.3, there is a link between the lack of effective choice of auditor for large PIEs and the independence problems.

2. Mandatory rotation of an audit firm	+	++	+	+
3. Mandatory rotation of an audit firm via tendering	++	++	+	+ / ++

Under the baseline scenario, auditors will continue to enjoy long continuous engagements and companies will remain reluctant to spend management time to organise tenders. Companies are ready to pay a premium to Big Four audit firms as audit costs are relatively low compared to total turnover (see [figure 13](#)) for most of PIEs.

Turnover bracket (£m) ¹		Big Four	Non Big Four	Differential (absolute)	Differential (relative)
≤50	Average audit fee, % of turnover	0.59	0.56	+0.03	5.36%
	Number of clients	1,477	602		
50–100	Average audit fee, % of turnover	0.15	0.14	+0.01	7.14%
	Number of clients	548	195		
100–500	Average audit fee, % of turnover	0.10	0.07	+0.03	42.86%
	Number of clients	1,726	295		
500–5,000	Average audit fee, % of turnover	0.06	0.05	+0.01	20.00%
	Number of clients	1,499	44		
>5,000	Average audit fee, % of turnover	0.04	–	n/a	n/a
	Number of clients	237	0	n/a	

Note: ¹ Based on average company turnover, 1995–2004, in 1995 prices.
Source: Oxera's calculations based on Oxera panel dataset.

Figure 13. Indication of the differential in audit fees between the Big Four and mid-tier audit firms.
Source: Oxera (April 2006), table 5.2, page 71.

If the "low switching" issue is not addressed, all other measures to improve the market functioning (e.g. with regard to objectives 1.2 and 1.3) are likely to fail. Infrequent changing of audit firm – "low switching" – is one of the most important barriers to entry into the market for audits of large and listed companies, and is thus an obstacle to enhancing competition in the audit market. Option 1 (the company regularly tenders for a new auditor and considers several audit providers) is broadly supported by stakeholders¹⁴⁶ and also by the European Parliament¹⁴⁷. However, this option provides less certainty than option 2 to audit firms. There is no guarantee that the audited entity will change its audit firm as it could decide to continue to engage the same auditors after completing the tendering procedure for reasons other than quality or price. Less certainty would also mean less willingness for audit firms to invest resources in participating in tendering procedures. In terms of the costs, mandatory retendering will increase the cost for audited entities without providing any certainty on the achievement of this objective. Option 2 (mandatory rotation of an audit firm – see above the analysis regarding the policy options for objective 2.3) will ensure that a certain number of new audit contracts would become available in the market¹⁴⁸. Requiring mandatory rotation of audit firms on its own would not ensure that non-Big Four firms would gain a higher market share¹⁴⁹, but it would increase competition both

¹⁴⁶ There is strong support among professional bodies and associations linked to the profession for tendering on a regular basis. Mid-tier firms, many investors as well as some public authorities are also in favour.

¹⁴⁷ See European Parliament (2011), §59, supporting tendering with a strong role for the audit committee in the tendering procedure and the requirement to invite at least two non-Big Four audit firms.

¹⁴⁸ Audited entities insist that the company should decide in certain circumstances to keep the same auditor if benefits of continuity are demonstrable.

¹⁴⁹ This is evidenced by the Italian experience.

among Big Four audit firms and also with other existing or potential non-Big Four entrants into the market. Mandatory rotation of audit firms would also address the "familiarity" threat, which stems from the long tenure of the same audit firm. Mandatory rotation of audit firms faces opposition from the profession and has not been supported by the European Parliament¹⁵⁰, although there are arguments supporting its enforcement (see [Annex 11](#)).

Option 3 (the combination of mandatory rotation with tendering) is the most effective option for the market of audits of PIEs: (i) mandatory rotation of audit firms will ensure that new audit contracts will be available in the market for audits of PIEs. The change of an audit firm after a fixed duration will provide certainty to market participants that every year a certain percentage of PIE audit mandates will be subject to competition; (ii) the tendering rules will require that non-Big Four audit firms are also invited to tender and that a transparent process is ensured; and (iii) mandatory rotation with tendering will ensure that consistent policies will be applied across the Union. There will be also a strong positive impact on mitigating the "familiarity threat" (see option 1 under objective 2.3): audit quality should improve due to the absence of familiarity and the enhancement of auditor independence.

In terms of costs, there would be additional costs on both sides- PIEs (preparation and selection of the successful bidder) and audit firms (preparation of the bid and participation in the tender process). There could also be an additional initial cost, for audit firms and PIEs alike, in the first year of a statutory audit mandate. In the case of audit firms, those costs would cover expenditure on additional investment to better understand their new audit client, although there are mitigating factors¹⁵¹. In the case of PIEs, these costs would be opportunity costs due to the need to reallocate resources in the first year of the mandate to assist the new auditor. Concerning the direct costs for audit firms, the impact of the tendering rule could be high, especially in jurisdictions where there has been no statutory requirement to have regular tendering. It has been particularly difficult to gather information from audit firms and audited companies since they are reluctant to unveil what they consider sensitive commercial information. However, we were provided informal information that, for example, responding to the tender for the audit of a large PIE (with a market capitalisation above €1 billion) cost €1 million; for a particularly complex and geographically extended company with a market capitalisation in excess €40 billion, the cost reported was in excess of €5 million. In the case of medium-sized PIEs, tender costs would be significantly lower: on average €160 thousand (roughly €18 thousand per annum). On the assumption that companies would have to organise a tender periodically (given that a tender for a given company would take place every 9 years, costs would be amortised to almost a tenth of the above amounts), the annual tendering cost would be less than 1% of the total audit fees¹⁵². On

¹⁵⁰ See European Parliament (2011), §59, supporting tendering but not rotation of audit firms. It is noted that the *rapporteur* of the EP report expressed his favourable position on rotation of audit firms, for instance in the Conference organised by the Commission in February 2011 and in the conference organised by FEE on 30 June 2011. In the latter, the *rapporteur* distanced himself somewhat from the EP report. Subsequently, Mr Masip explained at an EP meeting that he has received threats from a member of a Spanish audit firm. See the minutes of the meeting of the EP Committee on Legal Affairs of 11 July 2011 (JURI_PV(2011)0711-1), point 17 *in fine*.

¹⁵¹ See the analysis regarding the policy options under objective 6.2.

¹⁵² Of course not all responses to a tender would result in a mandate and to this extent some of these costs would prove fruitless. This may sound like a step increase in jurisdictions with little tendering over the past decades but will in effect only be bringing the audit world into line with normal business practice in other fields including other financial services. In any case, marketing costs such as tendering costs have to be seen in the context of the potential reward: in France, the average annual audit fees for CAC40 companies for 2009 / 2010 were around €17 million. For the most complex companies, audit fees were above €40 million. In the UK, the average audit fees for FTSE 100 companies in 2008/2009 were around £5.5 million;

the side of PIEs, the feed-back from stakeholders shows that costs would range from 150 to 200 working days for the majority of PIEs, while in the case of larger PIEs this could increase to 1.000 working days. The above indication of costs does not take into account any mitigating aspects for both 'clients' and auditors: tendering will obviously result in competitive bidding; this may in turn temper any additional costs for audited entities. For firms, increased and repeat experience with tenders will streamline and institutionalise the process thus lowering the costs of preparing tenders (see [Annex 20](#) for more details on costs and benefits).

One could expect that, over time, tendering procedures for audit services would result in lower audit fees. If this happens, the savings in audit fees for the audited entity may be higher than the costs incurred in organising the tender. However, since one of the objectives of the tendering procedure is to ensure that the selection of the auditor is based on expected audit quality, it cannot be assumed that audit fees will systematically be lower. In any case, in terms of proportionality, it is important to ensure that rotation and tendering do not lead to disproportionate costs for audited companies or to a loss of audit quality.

Therefore, the period after which an audit firm should rotate must be carefully considered: considering the costs that tendering would entail (see [Annex 20](#)), a period of 9 years between tendering procedures (and implying rotation of the audit firm) appears reasonable. It would be appropriate to adjust the tendering obligation to the size of PIEs (see [Annex 19](#)). Option 3 is the preferred policy option.

If incentives will be created for PIEs/ audit firms to use joint audits (see also analysis under objective 3.3), this would have a further positive impact on the effectiveness of option 3 due to the fact that auditors in a joint audit scheme could rotate at different points of time, which would ensure a smooth transition of the audit engagement from one audit firm to another. However, joint audits would have a negative impact on the cost of audit and thus option 3 would be a cost-effective only in the case of large PIEs or systemically important financial institutions (SIFIs) where audit costs are relatively low (e.g. 0,04% of the total turnover¹⁵³) compared to turnover (for more details on additional costs of joint audits see [Annex 20](#)).

Objective 3.2: Sub-policy options to facilitate the objective choice of an audit provider

Figure 14

Policy option	Objectives	Effectiveness (objective 3.2)	Convergence	Cost-effectiveness
0. Baseline scenario		0	0	0
1. Prohibit contractual clauses limiting the choice of audit firm		+ / ≈	+	+
2. Increase transparency on audit quality and on audit firms		+	+	+
3. Establish a pan European audit quality certification		+	+	++
4. Combination of options 1 to 3		++	+	++

Under the baseline scenario, it is anticipated that there will not be sufficient information on audit quality available to the public. Therefore, auditors will continue to be selected more on the basis of reputation rather than on the more objective criteria of audit quality/price. There are different options to increase the market transparency with a view to facilitating the objective choice of an audit provider. Option 1 would have a preventive role, to avoid this practice (the so-called “big four only” clauses) to spread. This option would be integrated with the appointment procedure

the fees for some companies exceeded £30 million. For medium-sized PIEs, the average audit fees are £766 thousand (FTSE 250 companies in 2009) in the UK and €700 thousand for French listed companies in the B and C segments of the French stock exchange (2010).

¹⁵³

Oxera (April 2006), figure 5.2, page 71.

described under objective 2.2: indeed, any private contractual clause of this type would *de facto* deprive the shareholders of the right to select the auditor on the proposal of the audit committee and therefore jeopardise its effectiveness. The concrete significance of this option cannot however be assessed due to the confidentiality of contracts including this type of clause. This option would not be costly and has been supported by respondents to the Green Paper as well as by the European Parliament¹⁵⁴. Under option 2, more information would be available on the audit quality and financial health of audit firms. The Statutory Audit Directive required the establishment of independent auditor supervisors and inspection systems. While there are some imperfections in the regime (see above section 2.5), reinforced inspection mechanisms would allow strengthened national audit supervisors (see below section 6.5) to monitor the actual, rather than perceived, quality of audits. The information resulting from reinforced inspections systems would be better disclosed by competent authorities and used by the relevant parties such as audit committees in the selection of an audit firm. Moreover, the disclosure of financial information by statutory auditors and audit firms (in addition to the existing obligation to publish a transparency report)¹⁵⁵ would facilitate the audited entity's evaluation of whether an auditor or firm is in a position to devote sufficient resources to the statutory audit in question. A voluntarily pan-European audit quality certification (option 3) would be a cost-effective option to increase the visibility, recognition and reputation of all audit firms having the capacity to conduct high quality audits of PIEs¹⁵⁶. The certificate would be delivered by ESMA¹⁵⁷, in cooperation with national competent authorities. Specific secondary legislation (i.e. technical standards prepared by ESMA) would be necessary to develop the details of the certificate. Additionally, such a voluntary system would avoid creating a barrier to entry for small audit firms with a small base of PIE clients¹⁵⁸. The question of visibility, recognition and reputation of audit firms cannot readily be addressed by national licences or the cross-border recognition of national licences (see objective 4.1)¹⁵⁹. The likely positive impact of strengthened national supervision (see option 2¹⁶⁰) could contribute to improving the reputation and recognition of firms. The certification system would be expected to take the results of inspections into account. Therefore, it will consolidate the inspection findings (and other information), also on a cross border basis. There will be additional costs for audit firms in applying for and obtaining the certificate, but these will be negligible for any audit firm network operating across the Union since there will be the possibility of issuing one certificate for the whole audit firm network.

The combination of options 1, 2 and 3 (option 4) is the preferred option. All are individually cost effective and are complementary to each other in achieving objective 3.2 by making more information on audit quality and audit firms available to market participants. This would in turn facilitate the objective choice of the statutory audit provider¹⁶¹.

¹⁵⁴ European Parliament (2011), §§56 and 57.

¹⁵⁵ This option is supported by the European Parliament. *Ibid.*, §35.

¹⁵⁶ This option is supported by the European Parliament. *Ibid.*, §58.

¹⁵⁷ See objective 5.2.

¹⁵⁸ A compulsory certification system, or even more, a special licence for the audit of PIEs would result in a barrier to entry or to growth for small firms that have a few PIE clients or could have. Such firms may refrain from providing audit services to PIEs so as to avoid the organisational requirements and/or administrative burden that they may associate with a compulsory certification or licence.

¹⁵⁹ This certification should not be assimilated to a national licence or to the recognition of a national licence. The mutual recognition of a national licence will not address the reputational problem, in the same manner as the national licence does not address it either. It is not because a firm is allowed to provide services in more than one country that the perception of the quality of its services will necessarily increase.

¹⁶⁰ See objective 5.1.

¹⁶¹ See also European Parliament (2011), §§53 on the need to better judge the quality of audit services.

Objective 3.3: Sub-policy options to increase the choice of audit providers for PIEs

Figure 15

Policy option	Objectives	Effectiveness			Convergence	Cost-effectiveness
		Objective 3.3:	Objective 2.1: prevent any conflict of interest arising from the provision of non-audit services to PIEs	Objective 2.3: mitigate the risk of any potential conflict of interest due to "familiarity threat"		
0. Baseline scenario		0	0	0	0	0
1.1. Pure audit firms		+	++	≈	+	+
1.2. Mandatory joint audit applied to all large PIEs		+	≈	≈/+	+	+/-
1.3. Mandatory joint audit applied only to large PIEs in the financial sector,		+	≈	≈/+	+	+/-
1.4. Mandatory joint audit to all large PIEs by pure audit firms		+	++	≈/+	+	+≈
1.5. Mandatory joint audit only to large PIEs in the financial sector by pure audit firms						
1.6. Voluntary joint audit to all PIEs: creates incentives for audit providers and audited entities alike to use joint audit on a voluntary basis.		+	≈	≈/+	+	++
1.7 Voluntary joint audit to all PIEs by pure audit firms		+	++	≈/+	+	+
2. Lift restriction on ownership of audit firms		+	-/≈	≈	+	+
3. Establish market share ceilings for large audit service providers		+/-	≈	≈	+	--

Under the baseline scenario the choice of auditors for PIEs would remain limited. Option 1 is composed of six sub-options. Sub-option 1.1 (pure audit firms, the same as option 3 under objective 2.1: see above for the position of stakeholders as well as the discussion on independence; see also [Annex 10](#)) would introduce more dynamism and choice in the upper segment of the market, as all the Big Four audit firms would be available to supply audit services to any client¹⁶². However, it is likely to present difficulties for smaller firms which mainly provide audit (and non-audit) services to non-PIEs. The obligation to convert to pure audit firms might deter these firms from entering into (or remaining in) the PIE audit market¹⁶³, which would be in contradiction with the intended objective to enlarge the choice of auditors. Therefore, in terms of proportionality, option 3 does not appear the most suitable in all circumstances (see [Annex 19](#)): it would be necessary to at least provide exemptions from the pure audit firm obligation to take account of the size and dimension of the activities of the audit firms. In terms of costs, further to the synergies lost (see above), there would be costs resulting from the need to split audit firms. While this option is effective in ensuring auditor independence and audit quality, the potential downsides mentioned above should be carefully considered. Under sub-option 1.2, (the obligation for PIEs to have more than one auditor at least one of which is not among the largest audit firms¹⁶⁴), will provide opportunities for smaller firms¹⁶⁵ to get exposure, demonstrate their capability and build up a reputation over time so that they may become real

¹⁶² This is highlighted, for instance, by Chambers (2011): "Pure audit firms would turn the Big Four into a Big Eight for some purposes as clients could look to the non-audit spin-offs for advice on non-audit matters."

¹⁶³ E.g. the provision of NAS might constitute a very significant proportion of their revenues.

¹⁶⁴ This sub-option differs from the French joint audit. While it also combines at least two audit firms, it would require that at least one of them should not have a substantial market share in the top listed company market segment in a Member State. In other terms, a joint audit carried out by two large audit firms together would not be possible.

¹⁶⁵ Not unsurprisingly, this option is supported by mid-tier firms and SMPs.

competitors to the current Big Four audit firms both in size and in expertise¹⁶⁶. The French experience shows that joint audits (despite the fact that the French model does not intend, and therefore it is not designed, to address market concentration) could facilitate the growth of non-Big Four audit firms by giving them access to a new market segments previously covered only by Big 4 audit firms¹⁶⁷. The European Parliament has recognised that "*the implementation of joint audits could have positive effects on the diversification of the audit market*".¹⁶⁸ There would be a tendering process (see policy options for objective 3.1) for the selection of joint auditors where the scope and responsibility of each auditor is clearly defined. In addition, joint audits would contribute to higher audit quality through complementary and combined audit work, applying the four-eyes principle in the strategic preparation of the joint audit as well as in the analysis of the findings. This is, in particular, one of the strengths of the French joint audit model¹⁶⁹, although it must be underlined that the Danish experience was not very positive¹⁷⁰ (see [Annex 12](#) for further detail on joint audit, including the French and Danish experiences). Public authorities generally support the introduction of joint audits provided that there are clear rules as to how it will work in practice. There is a risk of coordination failures between the two audit firms (considering that in the joint audit model the firms would not necessarily present joint bids) and/or of dominance by the larger firm of the consortium (thus, weakening the four-eyes principle). Indeed, one of the lessons of the French experience is the need to structure and allocate the audit tasks between the two firms and the audited PIE. For the audited entities joint audit, if required by legislation, should be well balanced. In the replies to the Green Paper they raised cost considerations were raised. Indeed, concerning the additional costs resulting from joint audit, two factors should be considered. On the one hand, it is estimated, assuming that the two audit firms charge an identical level of audit fees, that the additional work that joint audit entails could result in audit costs increasing from 5% to 10% of total audit fees¹⁷¹. On the other hand, large audit firms are generally more expensive than other networks (see [section 2.3, in fine](#)). Therefore, if a mid-size audit firm is part of the audit consortia, the audit fees charged by such a firm could be lower than those that would be otherwise charged by a large audit firm. The possible savings from lower fee rates are, however, difficult to estimate.

Sub-option 1.3. is expected to have all the described characteristics presented above with the only difference that it will have a more limited scope since it will be only applied to large PIEs in the financial sector. This option could be considered as being more proportionate to the problem tackled taking into account that it will be applied on the most systemically important entities, representing a higher risk for the whole economy as shown by the financial crisis (for more information on enforcement, possible exemptions and the role of ESMA see [Annex 8](#)).

¹⁶⁶ This is particularly important for sectors such as financial services, where there are few audit firms providing services. Additionally, sufficient safeguards would be needed so that competition is not distorted.

¹⁶⁷ Chambers (2011) also outlines the efforts by the Big Four audit firms to "eliminate" competitors by acquiring them. "*Evidence to the UK House of Lords claimed that the experience of, for instance, France did not suggest joint audits reduced audit concentration as there was only a Big Five there. [...] The limited success of joint audits in widening choice is related to the absorption by the Big Four over the past 15 years of three firms that were each No 6 in France when they were acquired, with only Mazars holding out. The same pattern can be seen elsewhere. In 2010, the fifth and sixth Brazilian firms joined forces with members of the Big Four firms, depriving Grant Thornton and BDO of their network partners. Grant Thornton's Danish partnership has just fallen to one of the Big Four. It is hard to think of any market behaviour less conducive to widening competition.*" It should be noted that in Brazil the mandatory rotation of audit firm rule applies.

¹⁶⁸ See European Parliament (2011), §54.

¹⁶⁹ Joint audit is currently required in France for the audit of consolidated accounts, whether PIEs or not.

¹⁷⁰ Joint audits were recently abolished in Denmark.

¹⁷¹ See [Annex 20](#).

Sub-option 1.6 considers the introduction of joint audit as a voluntary measure by only creating incentives for audited entities to use it as a way to increase audit quality and auditors' independence. This sub-option takes into account the existing uncertainty among market operators and regulators alike about the real cost of this measure compared with its potential value-added (one of the reasons for which joint audits have been abolished in Denmark). The lack of sufficient and comprehensive data on the cost side of the joint audit does not provide sufficiently strong arguments justifying its mandatory introduction, since it could result in an excessive cost burden for certain PIEs. Therefore, also considering that joint audit is used by PIEs in the financial sector on a voluntary basis in certain countries like Austria and Sweden, it could be considered more economically prudent and proportionate to test the viability of this measure by only creating incentives for its use on a voluntary basis, while leaving to the discretion to PIEs to test it and decide about its use on an individual basis.

The respective combination of sub-options 1.1/ 1.2, 1.1/ 1.3, and 1.1/ 1.6 (sub-options 1.4, 1.5, and 1.7) maintains the positive impacts of both sub-options in each case. In addition, joint audit would help smaller audit firms to compete against large pure audit firms focusing on audit services only. In terms of proportionality, however, joint audit and pure audit firms would need to be limited to large PIEs only in the case of sub-option 1.4 (see Annex 19).

Removing restrictions on the ownership structures of audit firms (option 2) will eliminate the privileged position held by statutory auditors regarding the ownership of audit firms: currently, audit firms can expand into non-audit business but non-auditors cannot easily enter the statutory audit market¹⁷². It will also allow smaller and medium-sized firms to rapidly grow and take up the challenges and opportunities created by the mandatory rotation, tendering and joint audit rules. While the provision of statutory audit services is not a capital intensive business activity, organic growth through capital injections by partners does not ensure, on its own, that small and medium-sized audit firms will have enough means to grow. A vast majority of investors supported a review of the ownership structures. The replies to the Green Paper¹⁷³ noted that changes in ownership structures might facilitate greater competition and choice in the market. A few investors made the Commission aware that changes might increase the risks relating to independence and audit quality and asked for appropriate safeguards on independence¹⁷⁴. The European Parliament also believes that the partnership model is the appropriate one for audit firms, since it protects their independence¹⁷⁵. Many other investors believed these risks could be addressed satisfactorily. Option 2 takes account of those risks and, therefore, does not waive the requirement that an audit firm should be managed by statutory auditors. Imposing a market share ceiling for audit services providers (option 3) would immediately reduce the market share of large audit providers. Over a period of time, however, this option is likely to lead to less competition since those who reach the limit would be banned from competing for other available audit engagements. Companies might be faced with further limitation of choice. Moreover, due to the fact that audit markets are national and market shares will have to be applied nationally, in those Member States with a small audit market (=small number of PIEs), individual audit firms would have to become very small and the economies of scale would be lost, suggesting that option 3 is not likely to be proportionate.

¹⁷² At the same time, it should be taken into account that if the pure audit firms option is introduced (see policy options under objective 2.1), this would bar the audit firms concerned from accessing the market for consultancy services, thus eliminating the problem of regulatory asymmetries explained in Annex 6.

¹⁷³ See also IOSCO (2010), p. 16 and seq. for stakeholders' views on this issue.

¹⁷⁴ For a critical view against lifting the restrictions on ownership rules, see also Jean (2011).

¹⁷⁵ European Parliament (2011), §37.

Options 1 (sub-option1.7) and 2 are individually cost effective, complementary and proportionate to each other in achieving objective 3.3. They are the preferred policy options. Option 3 is less effective and may present some additional implementation difficulties in terms of legal certainty¹⁷⁶.

6.4. Policy Options to deal with / avoid unnecessary additional compliance costs for auditors/audit firms in a cross-border context

Objective 4.1: Sub-policy options to facilitate the cross-border recognition of audit providers' competence

Figure 16

Policy option	Objectives	Effectiveness		Convergence	Cost-effectiveness
		Objective 4.1:	Objective 5.2: Set-up an effective EU-wide supervisory cooperation mechanism		
0. Baseline scenario		0	0	0	0
1. Mutual recognition of audit firms		++	≈	++	++
2. Mutual recognition of statutory auditors		++	-	++	++
3. Introduction of an adaptation period scheme and increased convergence, transparency and predictability in the aptitude test		+	≈	+	+

If the current regime remains in place (baseline scenario): the additional costs and barriers for auditors and firms would remain since they will continue to require approval in all Member States in which they wish to undertake statutory audits¹⁷⁷. Option 1 would be effective in immediately alleviating the administrative burden that a multitude of approval procedures entails¹⁷⁸. At the same time, it would allow for the emergence of real pan-European audit firms without an organisational structure in every Member State and therefore lower operating costs. It should be neutral concerning the quality of the statutory audit work, since locally approved auditors would carry out the work in any case. This automatic recognition of firms should not result in a reduction of supervisory quality: on condition that the local competence of the key audit partner representing the audit firm in the statutory audit is maintained and supervisors will not be prevented from overseeing audit work carried out in their respective Member State¹⁷⁹. However, this option will reinforce the need for greater cooperation between supervisors. A similar option for statutory auditors (option 2) would be effective as regards the reduction of costs associated with the approval of the auditor and would facilitate the emergence of cross-border competition. Indeed, the European Parliament is favourable towards a "*European passport for auditors*"¹⁸⁰. This is also supported by many stakeholders (profession, investors). However, most public authorities are reluctant to accept the passport. Such a mutual recognition

¹⁷⁶ It is not evident that a valid legal basis in EU law could support such an option. Therefore, it could be subject to legal challenges, which may in turn result in legal uncertainty.

¹⁷⁷ This results in few auditors seeking approval in other Member States. For instance, according to the reply of the Belgian public oversight authority to the Green Paper, only 36 Belgian auditors are approved in other Member States (namely, 21 in LU, 7 in NL, 2 in FR, 4 in UK, 1 in DE and 1 in RO). It should be noted that Belgian auditors normally have fewer linguistic barriers and can speak fluently the official language of at least one of its neighbouring countries. However, 36 auditors is a very low figure compared to the 1044 approved auditors in Belgium.

¹⁷⁸ The European Parliament considers that "*easier access to the market and the removal of obstacles for firms wishing to enter the market are vital if a larger number of market participants is to be attracted on to the auditing market.*" See European Parliament (2011), §53.

¹⁷⁹ Supervision is, in principle, based on the principle of home-country regulation and oversight by the Member State in which the statutory auditor or audit firm is approved and the audited entity has its registered office.

¹⁸⁰ See European Parliament (2011), §61.

system for individuals qualified as statutory auditors would raise questions on how to guarantee audit quality in the absence of a procedure to verify the auditor’s knowledge of and/or familiarity with those areas that require national knowledge/expertise. Figure 17 provides the views of stakeholders on the need for further harmonisation before introducing a European passport for auditors. It also illustrates where the national knowledge/expertise is important.

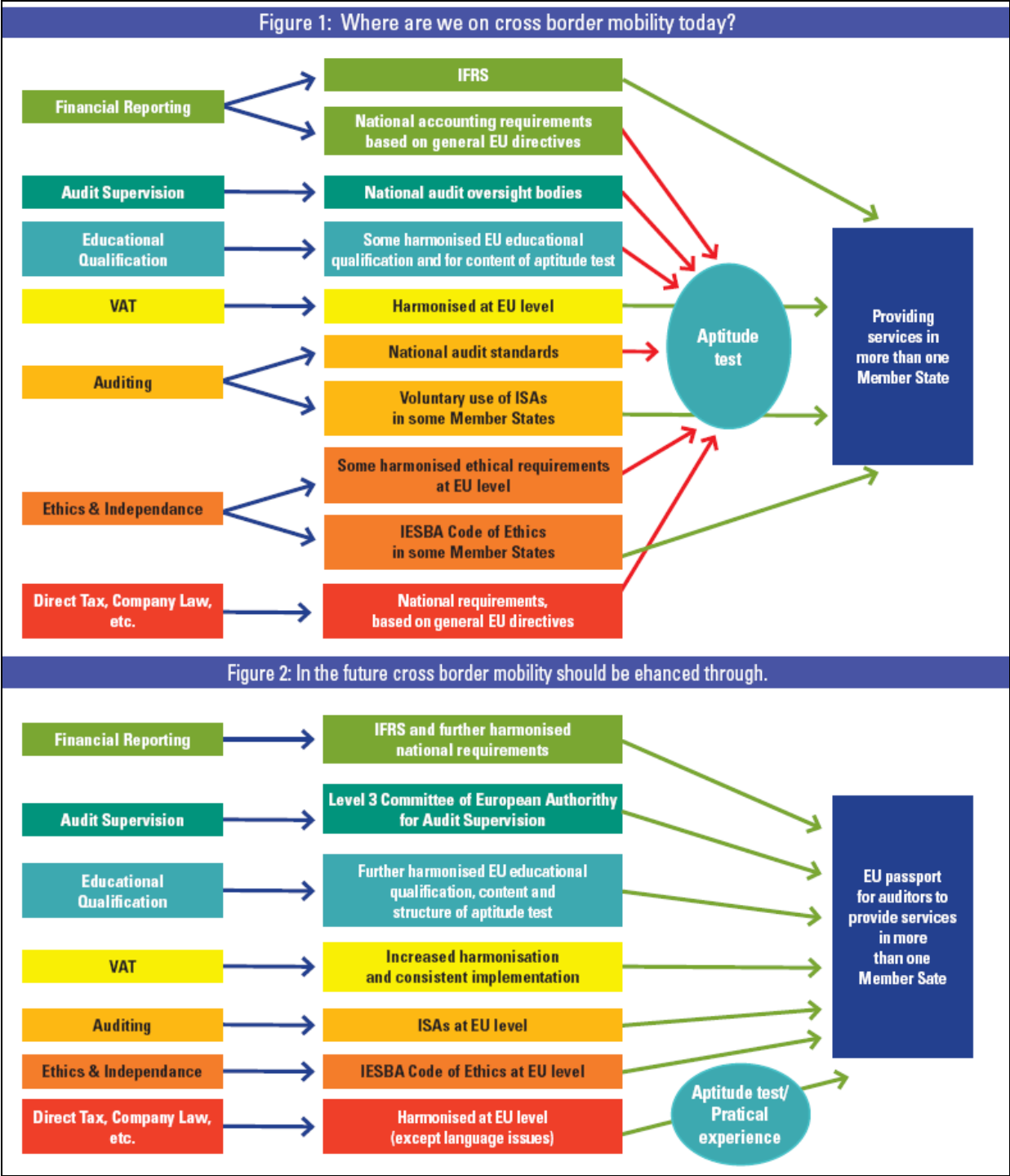


Figure 17. Source: FEE briefing paper *European Passport for Auditors and Audit Firms*, June 2011

Those arguments against the mutual recognition system are, however, weaker in the case of the occasional cross-border provision of services. In this case, the auditor concerned could easily fill the "national knowledge" gap¹⁸¹ by relying on *ad hoc* services provided by a local auditor. Thus, the principles of Directive 2005/36/EC on professional qualifications could, *mutatis mutandis*, be applicable. This option could result in initial operational difficulties for the supervisor of the host Member State¹⁸². At the same time, it will trigger the need for reinforced cooperation between supervisors at EU level both as regards the exchange of information on supervisory matters but also as regards the convergence on the conditions for access to the profession¹⁸³. Under option 3, auditors would be allowed to choose their preferred method, a 3-year adaptation period under the supervision of a locally approved auditor or an aptitude test, to obtain approval in another Member State. Using the option of adaptation period would largely facilitate such approval. The adaptation period scheme would facilitate the cross-border approval of experienced auditors who would become familiar with local requirements through regular practice rather than through formal tests. Concerning the supervision of auditors approved under an adaptation period, changes would be neutral since contrary to option 2, the adaptation period acts as a procedure to verify the auditor's knowledge of and/or familiarity with specific national requirements and it is particularly suited for the case in which the auditor wishes to establish itself in another Member State. Option 3 also has positive impacts regarding the aptitude test, if this is the method preferred by the applicant auditor. More transparent national requirements should result in more predictable aptitude tests. Options 1, 2 and 3 are the preferred policy options. In the case of options 2 and 3, their individual scope would need to be reduced to avoid overlapping: they are compatible with each other as long as each addresses a different scope: establishment under option 3 and cross-border provision of services under option 2¹⁸⁴.

Objective 4.2: Sub-policy options to streamline and harmonise standards on audit practice, independence and internal control of audit firms across the EU

Figure 18

Policy option	Objectives	Effectiveness		Convergence	Cost-effectiveness
		Objective 4.1. Facilitate the provision of cross-border audit services	Objective 4.2		
0. Baseline scenario		0	0	0	0
1. Introduction of clarified ISAs with possible national add-ons but no carve-outs		++	++	++	++
2. Introduction of clarified ISAs with possible national carve-outs from MS		+/~	+/~	+	+/~

Under the baseline scenario, there is no guarantee of convergence in audit standards: Member States will continue to be free to require an audit in accordance with the national auditing standards. On the contrary, the introduction of the clarified ISAs¹⁸⁵ appears to be a plausible solution to ensure harmonisation and therefore objectives 4.1 and 4.2: the adoption of clarified

¹⁸¹ Adoption of the clarified ISAs (see policy options regarding objective 4.2) and the use of international accounting standards by the audited entity would contribute to closing the national knowledge gap.

¹⁸² In the cross-border provision of services situation, the supervisory authority of the host Member State (where the service is provided) would be in a position to supervise the quality of the audit carried out, since the audited entity would be a host Member State entity. However, the host Member State supervisor would not be in a position to exercise oversight over the statutory auditor him/herself as far as the conditions for access to the profession and organisational requirements are concerned. Hence, it would need to rely on the home Member State supervisor (of the country from which the service is provided).

¹⁸³ More convergence on these issues will increase the trust among supervisory authorities.

¹⁸⁴ This is, *mutatis mutandis*, the regime for the recognition of professional qualifications in Directive 2005/36/EC.

¹⁸⁵ See FEE (September 2011).

ISAs implies the substitution of various national auditing standards by a uniform set of auditing standards within the Union and their consistent application, which would lead to total recurrent net benefits of €2 billion to the EU economy as a whole due to a reduction in the cost of capital¹⁸⁶. The introduction of clarified ISAs receives very broad support among stakeholders¹⁸⁷ and also from the European Parliament¹⁸⁸, although there is not always consensus on the legal instrument¹⁸⁹. In order to achieve a maximum degree of harmonisation, under option 1 Member States would not be allowed to carve-out provisions from the clarified ISAs. However, in order to accommodate other reporting and audit requirements based on national corporate governance rules, the possibility to impose additional national audit procedures or requirements could be maintained only if these stem from specific national legal requirements relating to the scope of the statutory audit of annual or consolidated accounts, meaning that those requirements are not covered by the ISAs.¹⁹⁰ Option 2 would be less effective regarding the convergence objective. Allowing Member States to freely adapt and modify the clarified ISAs to the specificities and the requirements of individual jurisdictions or to carve-out from the clarified ISAs would better respect the specificities of the different audit markets and the requirements of individual jurisdictions. In the eyes of supporters of carve-outs, the Member States may use these to enhance the standards or tailor them to certain situations. However, this could lead to different sets of auditing standards and reduce the effect of harmonisation. This could also result in confusion for companies, investors and auditors in understanding what an audit comprises (because carve-outs would severely undermine the comparability of audits). Allowing for national carve-outs would be detrimental to EU policy towards third countries. Finally, most of the benefits expected from a harmonisation at EU and international levels in terms of transnational audit costs and credibility of the financial statements would be lost. Option 1 and 2 could also be combined to form a new option giving Member States complete freedom in the way they adopt the clarified ISAs but this option has been discarded as it risks reducing the harmonisation effect expected from the adoption of a sole set of auditing standards. The preferred option is option 1.

Objective 4.3: Sub-policy options to ensure that statutory audit is adapted to SMEs needs

Figure 19

	Objectives	Effectiveness		Convergence	Cost-effectiveness
		Objective 4.3:	Objective 5: Improve the effectiveness, independence and EU-wide consistency of the regulation and supervision of auditors of PIEs		
Policy option					
0. Baseline scenario		0	0	0	0

¹⁸⁶ Köhler et al. (June 2009).

¹⁸⁷ Many stakeholders (users, investors, regulators...) generally support this option because it best advances transparency and consistent audit quality throughout the EU, enhances confidence in the reliability of financial reporting and so contributes to a greater acceptance of audit reports outside of their home jurisdictions within and outside of the EU. Audited companies express less enthusiasm for ISAs. Some SMPs, however, requested sensitivity to the administrative burden involved in the adaptation to the standards. Audited companies expressed less enthusiasm about the adoption of the ISAs. The main reasons were that the ISAs do not take account of the diversity of the audit model in Europe and that there is an important cost dimension associated with the adoption of the ISAs.

¹⁸⁸ See also European Parliament (2011), §§21 and 61.

¹⁸⁹ The European Parliament would favour the adoption of the standards by a European Commission regulation. Other stakeholders prefer a non-binding approach.

¹⁹⁰ Supporters of add-ons to the ISAs believe that national authorities should retain the right to introduce add-ons only to meet national regulatory/legal obligations, in particular regarding company law. This implies that Member States may, for example, prescribe other reporting and audit requirements based on national corporate governance rules.

1. Adapt audit standards to the size and complexity of the business of the audited entity	++	≈	≈	+
2. Introduce limited reviews for SMEs instead of statutory audit	+	≈	-	≈
3. Combination of options 1 and 2	+	≈	≈ /-	≈ /+

The Commission proposal replacing the 4th and 7th Company Law Directives¹⁹¹ proposes that small companies shall no longer be subject to the obligation to have their accounts audited under EU law.¹⁹² Therefore, the Union statutory audit requirements would only apply to medium-sized and larger companies (although Member States would remain free to require the audit of the accounts of small companies)¹⁹³. Voluntary efforts by auditors or governments to adapt audit work to medium-sized companies needs are unlikely. Thus, the baseline scenario would remain: audit work will more than likely continue to be disproportionate compared to the size and complexity of the business of many medium-sized companies, ultimately resulting in higher administrative burden and costs. Option 1 appears plausible in achieving the objective of adapting statutory audit¹⁹⁴ to the needs of medium-sized companies¹⁹⁵, building upon national experiences, notably in France, with small companies¹⁹⁶. It is supported by the European Parliament¹⁹⁷ and by stakeholders, particularly SMEs and SMPs. It maintains the value of the audit in requiring the same level of assurance on the medium-sized companies' financial statements¹⁹⁸ (compared to the larger companies) and, at the same time, it results in cost reductions since the hourly engagement fee of auditors will probably diminish¹⁹⁹. In so far as the level of assurance remains identical to that in a normal audit, a proportionate audit would be neutral from the perspective of the cost of capital for a medium-sized company. Additionally, this option allows for its voluntary extension, at national level, to the audit of accounts of small companies²⁰⁰, which although not required by EU law, may be carried out voluntarily by the

¹⁹¹ European Commission (October 2011b).

¹⁹² Small companies are those which do not exceed two of the following criteria: balance sheet total (€5M), net turnover (€10M) and average number of employees (50).

¹⁹³ In the case of PIEs, the requirement to have the accounts audited applies irrespective of size.

¹⁹⁴ Since the ISAs are scalable to size, it is technically possible for a statutory auditor/audit firm to issue a valid audit opinion ("an audit is an audit") while limiting the audit work to the essential steps that are meaningful to the dimension and complexity of the business of SMEs.

¹⁹⁵ Medium sized companies are those which do not qualify as small companies and do not exceed two of the following criteria: balance sheet total (€20M), net turnover (€40M) and average number of employees (250).

¹⁹⁶ Recent experience in France shows that it is possible to apply the auditing standards in a proportionate manner to small companies without resulting in a reduction of the value attached to the audit of SMEs. The positive experience results from the combined effect of a legislative empowerment to carry out proportionate and simplified audit and a substantial effort from the audit profession to provide operational guidance and training to auditors auditing SMEs (see Annex 16 for further detail). It should be noted that the French experience is with regard to smaller companies than those targeted by option 1 and is relatively recent (since 2009).

¹⁹⁷ European Parliament (2011), §21.

¹⁹⁸ Indeed, stakeholders are generally attached to the level of assurance of an audit ("an audit is an audit") and, as outlined by the replies to the Green Paper, there is little support for any auditor opinion that would give a lower level of assurance than statutory audit. See also FEE (2006).

¹⁹⁹ The experience with small companies goes into that direction. For instance, the French standard (*norme petite entreprise*) is modelled to carry out the statutory audit in 40 hours; and a Canadian estimation considers it possible to undertake a statutory audit of a small company in 12 hours – cf. Cowperthwaite (2011). These examples, however, are for small companies and would not be fully transposable, in terms of hours needed for an audit, to a medium-sized company,

²⁰⁰ Therefore guaranteeing that "an audit is an audit".

small company or upon request by national legislation²⁰¹. In order to ensure coherence with the preferred policy option under objective 4.2 (introduction of ISAs with national additions but no carve outs), this option should not result in the enactment of specific national standards derogating from the ISAs, but rather in ensuring that the ISAs, which are scalable by nature²⁰², are applied in a proportionate manner (following professional guidance)²⁰³ and that the audit oversight bodies accept the proportionate and simplified audits as a valid application of the auditing standards. Since this option grants certain discretion to Member States in how the standards should be applied, it will not lead to increased convergence of rules. At the same time, it should not result in an unlevel playing field: on the one hand, the Member States discretion is limited by the ISAs framework; on the other hand, the discretion granted to Member States takes into account the fact that small and medium-sized companies generally have, contrary to PIEs, a national dimension and usually apply the national accounting rules. Option 1 is neutral as regards the possibility of statutory auditors/audit firms to provide NAS to the audited entity²⁰⁴. The introduction of proportionate/simplified audits should also be neutral as regards supervision. It may lead to an initial investment for supervisors (e.g. training of inspectors/reviewers) to understand the particularities of the proportionate audit of medium-sized companies, but in any event this investment would be marginal (considering that inspectors/reviewers are already knowledgeable on the subject) and limited in time. Option 2, on the contrary, would be less effective. In terms of scope, it could only be applicable to small companies (for which an obligation to carry out a statutory audit is not required under EU law) but not to medium-sized companies (which are obliged under EU law to have their accounts audited). Additionally, requiring Member States to introduce a “limited review” for small companies²⁰⁵, would introduce uncertainty as to the actual level of assurance provided (cf. replies to the Green Paper): a limited review is an assurance service, less exhaustive than a statutory audit, which provides some assurance as to the reliability of the financial data of the company²⁰⁶. Such uncertainty would impact on the credibility of the accounts subject to a “limited review”. Also, the concept of “limited review” is not harmonised and international standards on this issue are not widely applied²⁰⁷. Therefore, in the absence of substantial harmonisation, its cross-border value would

²⁰¹ The cost advantage of the proportionate audit is particularly important from the perspective of maintaining the attractiveness of statutory audit for small companies that will no longer be obliged by EU law to have a statutory audit, but would nevertheless be interested in voluntarily having their accounts audited.

²⁰² See IAASB (2009).

²⁰³ There is already international guidance on this matter. See IFAC (2010).

²⁰⁴ The possibility to provide NAS to the audited entity would depend on the general application of Article 22 of the Statutory Audit Directive and the national legislation implementing it, including in the future the adopted ISAs.

²⁰⁵ The limited review could be an alternative to any possible statutory audit of small companies required by national law. Alternatively, the requirement to have a limited review of the accounts of small companies at national level could be construed as preventing Member States from requiring the statutory audit of the accounts of those companies.

²⁰⁶ An audit generally implies that the auditor has obtained “reasonable assurance” as to whether the financial statements are free from material misstatement. Auditors express a positive opinion (“...in our opinion the financial statements give a true and fair view...”) and should perform sufficient work to reduce the risk of a material misstatement so as to support a positive form of conclusion.

On the contrary, the International Standard on Review Engagements (ISRE) 2400 explains that the objective of a review of financial statements is to enable a practitioner to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the practitioner’s attention that causes the practitioner to believe that the financial statements are not prepared, in all material respects, in accordance with the applicable financial reporting framework (negative assurance).

²⁰⁷ See FEE (2009) explaining the difference between two sets of international standards on this issue and its limited application in EU Member States. See [Annex 16](#) for a description of the voluntary limited review/assurance service for SMEs available in the UK and Switzerland.

be limited. From the perspective of supervision, the issues would be similar to the ones mentioned in option 1. The combination of a proportionate/simplified audit for medium-sized companies with a limited review for small companies ([option 3](#)) would create the risk of confusion between the two levels of assurance, in particular if the same company could make the choice between the two. This may in turn impact on the reputation of, and therefore the value attached to, the proportionate/simplified audit. As a result, [option 1](#) is the preferred option²⁰⁸.

6.5. Policy Options to improve the effectiveness, independence and EU-wide consistency of the regulation and supervision of auditors

Objective 5.1: Sub-policy options to ensure the independence and effectiveness of supervision of national statutory auditors and audit firms

Figure 20

Objectives Policy option	Effectiveness				Subsidiarity respected	Costs	Cost-effectiveness
	Consistency of supervision of audit firms of PEs	Independence from the audit profession	Ensuring a level playing field for audit firms	Coherence with other supervisory structures			
0. Baseline scenario	0	0	0	0	Yes	0	0
1. Establishment of an EU oversight authority	++	++	++	--	No	-	+
2. Strengthening national audit supervisory authorities	+	++	+	0	Yes	--	+

The [baseline scenario](#) has so far failed to ensure the robustness and independence of all national audit supervisors. The external quality assurance and supervisory practices are still very divergent between Member States: this does not ensure a level playing field for audit firms. Both [option 1](#) and [option 2](#) are effective in achieving objective 5.1. [Option 1](#) would entail some initial direct costs (setting up the structure), but would over time be less expensive than having 27 national competent authorities. However, option 1 does not meet the subsidiarity criteria: currently, supervisory powers lie with Member States and given the number of auditors and firms (see [Annex 3](#)), an EU oversight authority would be disproportionate in this regard. Thus, it will not be analysed further. Under [option 2](#), more specific Union level requirements (i.e. in the areas of independence, mandate and powers²⁰⁹) on the functioning of national supervisors would ensure a higher quality and more consistent supervision of audit in Member States. Overall, strengthening the national audit oversight authorities would make them more coherent with other national supervision structures in the field of financial services. In terms of the costs, while no significant cost would be expected for those Member States which have established robust and independent (from the profession) oversight systems, other Member States will have to invest time and resources to upgrade their audit supervision systems. However, these costs should be proportional to the size of the audit market. For example, Member States with smaller audit markets could consider integrating their auditor supervisor into the existing structures of

²⁰⁸ However, considering that there would no longer be a requirement for the statutory audit of small companies under EU law, it would be appropriate in the light of the subsidiarity principle that, should a Member State wish to introduce a mandatory “limited review” as an assurance service for small companies instead of a full audit, the Member State would be allowed to do so.

²⁰⁹ The European Parliament particularly supports the preparation of contingency plans and living wills to address risks arising from the market concentration. See European Parliament (2011), §49 and seq. It is noted that the policy response in this regard is integrated within this option. See [Annex 8](#) for further detail.

financial supervision in order to obtain economies of scale and synergies. Option 2 is therefore the preferred option.

Objective 5.2: Sub-policy options to set-up an effective EU-wide supervisory cooperation mechanism that would also ensure an efficient supervision of supranational audit firm structures

Figure 21

Policy option \ Objectives	Effectiveness				Costs	Cost-effectiveness
	Convergence in supervisory practices	Independence from the European Commission	Supervision of supranational audit firms structure	Coherence with other supervisory structures		
0. Baseline scenario	0	0	0	0	0	0
1. Level 3 Lamfalussy Committee type structure	+	+	+	≈	-	-
2. EU-wide cooperation on auditor oversight within ESMA	+	+	++	++	≈/-	++
3. New European Authority of Audit Supervisors	++	+	++	+	--	+ / ≈

The continuation of the status quo (baseline scenario) on EU-wide cooperation poses a threat to the development of effective cooperation at EU level. The current structure, an expert advisory group to the Commission (the European Group of Auditors' Oversight Bodies (EGAOB)) is not aligned with the interests of both the Commission and national oversight authorities and cannot ensure supervisory convergence across the Union. Option 1 would give an independent legal status to the EGAOB, but it would not have the same legal powers as those of the European Supervisory Authorities (ESAs), which are European regulatory agencies. The Level 3 Lamfalussy committee-type structure would be costly to establish: it would require the setting up of a specific administrative structure (a small secretariat) and specific *ad hoc* premises. The funding would need to be granted by its Members, while the contribution of the EU budget would not be guaranteed²¹⁰. While a Level 3 Lamfalussy committee-type structure constitutes an improvement compared to the existing situation, it does not easily fit with the new supervisory architecture for financial markets, which relies on the newly created European authorities rather than on hybrid Level 3 Lamfalussy committee-type structures. Option 2 would benefit from the experience and resources of ESMA (and generally the ESAs). ESMA is already working in the field of auditing (and accounting) regarding PIEs. Additionally, the legal framework foresees the cooperation of ESMA, EBA and EIOPA, within their joint committee, on auditing matters²¹¹. The main limitation of ESMA (or generally the ESAs) option is that any cooperation at the level of ESMA (or ESAs) would be largely limited to public interest entities (listed companies and financial institutions). At the same time, it is at this very level that cooperation is most needed (see Annex 8, in fine for a more detailed description of the advantages of ESMA (and ESAs generally). From the perspective of audit supervision, taken in isolation, option 3 would be the most effective proposal. A European Supervisory Authority specifically devoted to the audit market would ensure that cooperation on the oversight of the audits of non-listed companies is strengthened and streamlined. It would have similar a mandate and powers to those of the ESAs,

²¹⁰ In the past, initiatives for Lamfalussy Committee type structures, such as CESR, CEBS and CEIOPS, came from the Member States and the European Parliament and were subsequently established by Commission decision. So far, however, Member States have not shown any initiative and support for this type of structure for EU-wide cooperation on auditor supervision.

²¹¹ Article 54(2) of the ESMA Regulation.

thus enlarging the number of European supervisory authorities in financial markets. However, compared to the ESMA (ESAs) structure (option 2), option 3 presents the disadvantage that it would require a high level of coordination with the existing ESAs as auditing is already within the scope of their activities and they have the other PIE supervisors as members. Therefore, option 2 would facilitate more coherence among the different supervisory obligations regarding the financial markets. In terms of costs, option 3 would be disproportionately costly compared to option 2. In the case of ESMA (ESAs), the administrative structures and premises are already in place: only the staff resources devoted to policy development would be needed (these staff resources may be reallocated from other activities). In the case of a new Authority, the cost would be significantly higher: specific premises and an administrative organisation (e.g. board, chairman, executive director, administrative staff) would be required in addition to the staff in charge of policy development. This does not seem to be justified having regard to the scope of work envisaged: cooperation on statutory audit. Hence, option 2 would be the most appropriate structure to enhance EU-wide cooperation on audit supervision. This is supported by the European Parliament²¹². Option 2 is the preferred policy option.

6.6. Analysis of coherence with other policy initiatives

In the wake of the crisis, the Commission has worked on a number of domains with a view to strengthening the regulatory framework and, in doing so, enhancing financial stability in the Union. Any initiative in the domain of audit will have to complement what is being pursued in other domains of financial regulation. That being said, it is important to distinguish audit from other domains to the extent that audit is a statutory obligation for companies; moreover, this statutory function can be performed by a select group of competent people who have qualified as statutory auditors.

As audit provides comfort on the veracity of financial statements, it is one of the primary building blocks of financial stability. Other general initiatives, i.e. initiatives that are not specific to any sector (banking, insurance, securities, etc), that are currently being worked on are corporate governance, accounting and credit ratings. All these initiatives are complementary. They neither duplicate nor overlap with each other. The following explains the coverage of each initiative.

Internal to the Company

Corporate Governance: relates to the internal management and supervisory structure of the day to day running of the company.²¹³

Accounting: relates to the recording of financial information and the use of appropriate internal controls and accounting systems to ensure that accurate financial statements are produced.²¹⁴

External to the Company

²¹² See European Parliament (2011), §45: "*Points to the need to harmonise audit supervisory practices and asks the Commission to consider integrating the European Group of Auditors' Oversight Bodies into the European System of Financial Supervision, possibly through the ESMA.*"

²¹³ When preparing this impact assessment, account has been taken of the on-going work on corporate governance regarding financial institutions and listed companies. See European Commission (June 2010) and European Commission (April 2011b).

²¹⁴ When preparing this impact assessment, account has been taken of Commission proposal to replace the 4th and 7th Company Law Directives. See European Commission (October 2011a) and European Commission (October 2011b).

Credit rating: for issuers of 'tradeable' debt an external rating agency examines the potential of the issuer to service its debt over the period of issuance. Issuance could be at any point in time depending on market conditions and investor appetite and the duration of the issuance would run from that point in time.

Auditing: is the verification of the veracity of historical financial statements; such verification determines that the assets and liability at the reporting date, normally the (accounting) year end, are not misstated. Auditing also covers the 'going concern' principle to ensure that the company can meet its financial obligations over the twelve months following the year end. Although such a 'going concern' review will examine the ability to service the debt obligations arising over the twelve month period, audit reports are not a basis for the issuance of long term debt issuance; that is the domain of credit rating.

Although the above four areas are distinct, they are complementary and to some extent interconnected. Any failure in corporate governance, for example, would raise doubts about the integrity of the accounting function and would in turn create problems for auditing and eventually credit rating.

In this context, it is legitimate to consider whether the existing concept of "public-interest entity" should be extended beyond banks, insurance companies and issuers of securities admitted to trading in regulated markets to also encompass other financial institutions. The importance of the shadow financial system for financial stability has grown in recent years. This has been reflected in new (e.g. directives on alternative investment funds, payment institutions, e-money institutions) or modernised (e.g. UCITS directive or MIFID as regards investment firms) rules. Therefore, it appears appropriate that auditors conducting the statutory audit of the financial statements of certain types of financial institutions be subject to the stricter requirements applicable to the audit of PIEs (see [Annex 13](#) for more information).

6.7. Choice of legal instrument

A non-binding legislative instrument would not be appropriate to implement the policy options described before. As explained in [section 3.2](#) there is a need for a more harmonised legal framework within which statutory audit is conducted across the Union, in particular as regards the audit of PIEs. The current legal framework (a principle-based directive) which allows a large margin of self-regulation by the profession has proved inadequate to address all the problems described above. The objectives presented in [section 4](#) can only be achieved with a legally binding instrument, either a regulation or a more detailed directive. The advantages and disadvantages of a regulation or a directive have been examined (see [Annex 14](#) for the detail of the examination) on the basis of 3 criteria: (1) effectiveness (the extent to which the measure fulfils the objectives in [section 4](#)), (2) certainty (highest possible confidence of the relevant stakeholders as to the content of the rules to be respected and that the rules followed in practice are closely aligned with the objectives of the framework) and (3) common framework (the same requirements applying in all Member States).

The conclusion of this examination is that: (i) a regulation is a suitable and proportionate solution for the policy options relating to the audit of PIEs, including the supervision of compliance with the obligations as long as the rules on supervision are ancillary to the main substantive rules. Indeed, the policy options are sufficiently detailed, the population concerned by the rules is relatively small (PIEs, auditors of PIEs) and a high level of harmonisation possible; (ii) a modification of the existing directive is a suitable and proportionate solution for the policy options relating to the approval and registration of statutory auditors and audit firms (a regulation would not be an appropriate legal instrument because of the lack of a valid legal basis: Art. 50 TFUE would require a directive in this case) and those connected with the audit of SMEs, which are less detailed and need to be framed at the national level; (iii) both instruments are equally effective, certain and provide a similar harmonisation level concerning the adoption

of international auditing standards; and (iv) both a directive or a regulation would need to be completed with additional secondary legislation, either normal delegated or implementing acts or technical standards developed by ESMA.

Figure 22

Objectives	effectiveness	certainty	common framework
Policy option			
<i>Policy options relating to the audit of PIEs, including supervision</i>			
Regulation	++	++	++
Directive	+	+	+
<i>Policy options relating to the audit of SMEs</i>			
Regulation	≈	+	+
Directive	++	+	+
<i>Policy options relating to the approval and registration of statutory auditors and audit firms</i>			
Regulation	--	--	--
Directive	+	+	+
<i>Policy options relating to the adoption of auditing standards</i>			
Regulation	+	+	+
Directive	+	+	+
<i>Policy options in connection to the supervision of the audit of non-PIEs</i>			
Regulation	≈	≈	≈
Directive	+	+	+

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; -- strongly negative; - negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

7. ANALYSIS OF IMPACT ON STAKEHOLDERS

Annex 15 provides a summary analysis of the main impacts of the each of the preferred policy options on different stakeholders: users of audited accounts (e.g. investors, analysts etc); audited entities (PIEs and SMEs); and providers of statutory audit services (i.e. Big Four firms, mid-size audit firms and smaller firms/auditors, referred to as small and medium-size practitioners, or SMPs). Audited entities and providers of statutory audit services are the stakeholders most directly concerned by the policy options. SMEs, are hardly affected by these policy options, unless they are also PIEs. In any event, the impact of these policy options on smaller companies (SMEs and small caps) has been taken into account in their design (see the specific analysis in Annex 16). The impact of these policy options on governments, employment and financial stability are jointly considered for each of the five general objectives in the analysis contained in Annex 15. Concerning the impact on third countries, the measures proposed are rather neutral, but are expected to have an indirect positive impact on global economy (see a specific analysis in Annex 17). Section 8 provides an overview of the impacts on the different stakeholders.

8. OVERALL IMPACT OF THE PACKAGE

8.1. Cumulative impacts and synergies

This section presents the cumulative impacts and synergies from the implementation of the package of preferred policy options (see Annex 18 for an overview of the cumulation of the measures). The package of preferred policy options has been developed in a way to ensure the achievement of the overall objective to "contribute to the efficient functioning of financial and non-financial markets by strengthening the market role of the audit profession to provide relevant economic agents and the market with more reliable, transparent, meaningful and timely information at an acceptable cost about the veracity of financial statements of companies".

It is expected that some of the measures (mandatory rotation of audit firms, restriction on the provision of NAS and joint audits) will result in higher audit quality, a sustainable audit market structure and more choice in the audit market. This would encourage statutory audit firms to focus on the subject of their statutory entrustment - statutory audit. Furthermore, this would have an indirect effect on the markets for NAS. The providers of NAS would no longer have to compete with firms with captive audit clients. It is expected that the overall package would make the market structure more dynamic.

The policy options of mandatory rotation and joint audit will create genuine healthy competition in the statutory audit market; mid-tier audit firms will be encouraged to build up additional capacity and will eventually be able to serve the upper segment of the market (listed and large companies).

As an additional positive side effect, the increased number of statutory audit providers will contribute to financial stability by progressively reducing the risks in the statutory audit market of a "too big to fail" firm.

Independent and effective national audit supervisors and their coordination at EU level, as well as the regular dialogue between auditors of large financial institutions and their supervisors, will ensure a more efficient flow of information, thereby increasing the quality of audit.

As these measures will have a positive impact on the quality of audit, the audit practices in the Union will become the benchmark for global practice.

In terms of **proportionality**, the proposed policy options address particularly the problems affecting the audit of PIEs, especially for large PIEs in the financial sector; it is at this level that the impact of negligently or poorly audited financial statements would be most severe on investors, on financial stability and on the broader society. It thus follows that the proposed actions are more detailed for this segment of the market. The proposed policy options appear necessary to achieve the identified objectives, both individually²¹⁵ and in combination (see [Annex 19](#) for a more detailed examination of the proportionality of the measures). Conversely, actions will be adjusted to the size and dimension of the "smaller" actors, be it auditors/firms or PIEs (see [Annex 16](#)). Regarding the measures that would apply to both the audit of non-PIEs and of PIEs, the proposed actions remain principle-based, building on existing legislation and continuing to grant discretion to Member States in adjusting rules to the national situation.

8.2. Impact on different stakeholders groups

i) Investors and other users of financial statements. Investors will benefit substantially from the implementation of the preferred measures. The benefits will result from the enhanced role of auditors in meeting the expectations of relevant stakeholders, in particular, the availability of more information on the audit findings as well as the rationale for confirming the "going concern" hypothesis underlying the audit opinion. Investors as well as other users of financial statements, such as analysts or employees will benefit from higher audit quality. The latter will be enhanced by fostering audit firms that will compete more, adhere to stricter independence rules and be effectively supervised. A strong enforcement mechanism would be critical to ensure that the benefits of changes are realisable.

²¹⁵ See above for each policy option.

ii) Public interest-entities. Ensuring auditor accountability towards shareholders and those who are charged with the governance of the entity will help refocus statutory audit as a “service” provided not only to the entity, but also to its investors, lenders and other stakeholders. Combined with robust and clear independence rules, this refocused accountability shall increase audit quality.

The requirement for pure audit firms would ensure that PIEs, especially large ones, will benefit from an increased choice of audit firms, since currently some cannot become their auditors as they already provide non-audit services. The ban on the provision of a range of non-audit services by the audit firm will result in the audit committee focusing on audit quality issues rather than on ensuring that no conflicts of interest arise because of the provision of non-audit services. However, due to the split of audit and non-audit services, the audited entity will no longer be able to avail of the “one stop shop” they are frequently offered at present.

iii) Small and medium size enterprises (SMEs). SMEs will not be affected by the new measures regarding the audit of PIEs, unless they are PIEs themselves. In any event, these measures are adapted to size: PIEs of smaller dimension (including SMEs) will benefit from derogations or lower requirements (e.g. on the audit committee, tendering procedures or the provision of joint audit). Where SMEs which are not PIEs are audited²¹⁶, Member States will be required to ensure that the application of the audit standards is adapted to the size of the audited entity, which should result in better targeted audit services provided to SMEs. An analysis of the impact on SMEs, including SMPs, is provided in [Annex 16](#).

iv) Big Four audit firms. If the Big Four audit firms were to stand still, they would be negatively affected in the short term due to the opening-up of the market for large and listed companies to more competition. Big Four audit firms may be under pressure to reduce their profitability levels in line with the levels of other internationally operating audit firm networks. However, the changes would create real incentives for restructuring at the top end of the market, whereby “off-shoots” from the Big Four audit firms may become feasible and even attractive. Given that the audit business is essentially a “people business” where highly qualified and intellectually nimble people are employed, it is expected that such changes will be seen as an opportunity rather than a threat. Mandatory rotation via tendering will create the right incentives for “new” firms and other mid-tier firms to invest and emerge as real contenders for the very top segment of the PIE market. In any case, the risks of failure of a “major” firm and the impact thereof will be substantially mitigated. In the short term, Big Four audit firms may suffer if the requirement to become pure audit firms is enforced as some economies of scale and synergies would be lost due to the split between audit and non-audit services. However, incentives for cross-subsidiation between audit and non-audit services will be removed. The Big Four audit firms will certainly benefit from the measures to facilitate the cross-border recognition of auditors' and audit firms' competence (e.g. possibility to provide services in a cross-border context in all 27 Member States with a single licence or to move employed auditors within the network), from more coordinated and effective supervision as well as the application of common standards on audit practice, independence and convergence of firms' internal controls. Big Four audit firms will also benefit from enhanced trust in statutory audit through better audit reports and explanations of how they conduct their audits.

²¹⁶ It must be noted that, according to European Commission (October 2011b), only “medium-sized” (but not “small” ones) undertakings would be subject to the obligation to have their accounts audited. The medium-sized undertakings (with limited liability) subject to the audit obligation are a minority of SMEs.

v) Non-Big Four audit firms. In addition to the emergence of new players, a large number of internationally operating non-Big Four audit firm networks will be given a real possibility to compete for audit engagements of large PIEs due to the requirement for the mandatory rotation of audit firms and the tendering procedures. To mitigate the companies' bias towards Big Four audit firms, the market participants will be provided more with information on audit quality and audit firms, confirming that non-Big Four audit firms have the capacity to perform audits of PIEs. The incentives to apply joint audits by all PIEs could also be beneficial for the building up of reputation for non-Big Four audit firms. Like the Big Four audit firms, these firms will also benefit from the measures to facilitate the cross-border recognition of auditors' and audit firms' competence.

vi) Small and medium size practitioners (SMPs). SMPs are occasionally present in the market for the audit of listed companies and other PIEs (they are more present in France, where they may be the small partner in an audit consortium), so the impact of most of the proposals on them is limited. In any case, account of their size has been taken for the more demanding measures, such as the conversion into pure audit firms which would not be required for SMPs²¹⁷. See also [Annex 16](#). They will also benefit from the reduction of administrative burden resulting from the removal of cross border obstacles and the introduction of common standards within the Union (see below).

vii) Audit regulators. Audit regulators will benefit from the clarification of their mandate and the increase of their supervisory powers. Due to the ban on the provision of non-audit services, the oversight and enforcement of independence rules would become easier and less costly. When performing inspections of PIEs audits, adequate coordination would be needed to ensure that audits throughout the Union are conducted in compliance with auditing standards and other applicable rules. The clear cooperation mechanism within ESMA should facilitate cooperation at the level of the Union.

8.3. Other impacts

(i) Social impacts. There will be no direct social impact at a macro level, such as on the national employment levels, of the preferred options. Indirectly, however, all the measures would lead to a more efficient functioning of the market, which in turn may enhance confidence, foster more investment and thus positively affect the level of employment.

Discussions at the EESC have highlighted the importance of robust financial information with regard to the solidity of the entity from the perspective of employees. It is important for employees and their representatives to receive an audit report that is more meaningful; equally, it is critical for them to know if there are any immediate risks to the continuation of activity and any threat to their employer's ability to meet its obligations towards its staff.

(ii) Environment. Although robust audits do not have a direct environmental impact they are extremely useful in providing assurance that any liabilities related to environmental remedial work or claims have been adequately identified as well as quantified. The quantification of environmental claims against BP as a result of the oil spill in the Gulf of Mexico is a noteworthy example.

²¹⁷ The imposition of the pure audit requirement with respect to audits of PIEs would, however, make the entrance of SMPs into this market more difficult. In this regard, a derogation for SMPs would be required to avoid perverse effects when SMPs would have to decide whether to join larger audit firms or to quit this segment of the audit market. This derogation would cease to apply should the SMP grow sufficiently.

(iii) Administrative burden. Only some of the proposed measures would result in additional administrative burden to either audited entities or audit firms/statutory auditors. Annex 20 presents a table with a description of these burdens. On the other hand, the removal of cross border obstacles and the introduction of common standards within the Union will reduce existing administrative burdens for the provision of audit services in other Member States. Administrative burden at the level of SMEs will also be reduced, not least because Member States will have to adapt audit standards to the size of the audited entity and ensure a proportionate and simplified audit for SMEs.

(iv) Impacts on third Countries. The proposed measures are rather neutral regarding their effects on third countries: (1) there is no change regarding the scope of application of Union audit rules or the possibility for third country nationals to become statutory auditors in the EU; (2) there are marginal improvements regarding the audit of consolidated accounts (i.e. with a view to facilitating the audit of consolidated financial statements when either an EU company has subsidiaries in third countries or a third country company has subsidiaries in the EU); (3) supervisory cooperation with third country authorities is encouraged, but the rules on such cooperation (e.g. transfer of audit working papers) remain largely untouched. See Annex 17 for further detail.

v) Other impacts. There will be a positive impact on providers of non-audit services, including SMEs, since audit firms will no longer be able to provide those services to their audit clients. The providers of NAS would no longer have to compete with firms with captive audit clients.

8.4. Transposition and compliance aspects

Some of the policy choices envisaged require the adoption of national transposition measures²¹⁸. Other policy options would be directly applicable (i.e. those containing obligations for PIEs and for auditors of PIEs), but a *vacatio legis* period should be established, matching the transposition period (2 years) so as to ensure effective supervision. Additionally, it is anticipated that compliance with some of the proposed measures may not be easy in the short term. Firstly, the conversion of audit firms into pure audit firms may require the granting of a specific transitional period to guarantee that existing firms are able to appropriately prepare such conversion: i.e. 3 years after the adoption of the legislative measure. Secondly, the rules on tendering and rotation should be introduced in a way that would ensure that all changes of auditors do not occur at the same time. Also, account needs to be taken of the contracts for audit services which are effective at the moment of the entry into force of the legislative measures. See Annex 21 on transposition issues. Thirdly, beyond empowering competent authorities in national law, the challenge is to ensure that national competent authorities and ESMA will be provided with sufficient resources within a relatively short time (see Section 9).

In terms of compliance with the rules, the preferred policy options imply a reinforcement of the national supervisory authorities. This should facilitate the monitoring of compliance with the rules by the statutory auditors/audit firms and also the audited entities. Considering, however, the level of detail of the preferred policy options that apply specifically to the audit of PIEs and which would be set out in a directly applicable legal instrument, it appears appropriate to provide for a clear and specific sanctioning regime as regards those specific measures²¹⁹. Such a regime

²¹⁸ i.e. the requirements regarding access to audit markets in different Member States; the audit standards to be used, including when auditing SMEs; and the supervisory issues.

²¹⁹ This would be consistent with European Commission (December 2010).

would include rules on: the identification of the key infringements, the minimum level of the maximum amount of the administrative fines, the publication of sanctions and minimum powers for competent authorities on supervisory measures. See [Annex 22](#) for further detail.

9. MONITORING AND EVALUATION

The monitoring and evaluation of the preferred policy options will be carried out in 3 steps (see [Annex 23](#) for further details on this issue): (1) a transposition/transitional period plan, in cooperation with ESMA, preparing for the application of the rules; (2) the regular monitoring activity by the Commission, as guardian of the Treaty (focusing on the empowerment of national supervisors) and the national authorities (on quality assurance reviews of auditors/firms; market monitoring, in particular of market concentration levels; and threats to the continuity of operations of audit firms). ESMA would prepare a report on supervisory issues; and (3) the evaluation of the policy.

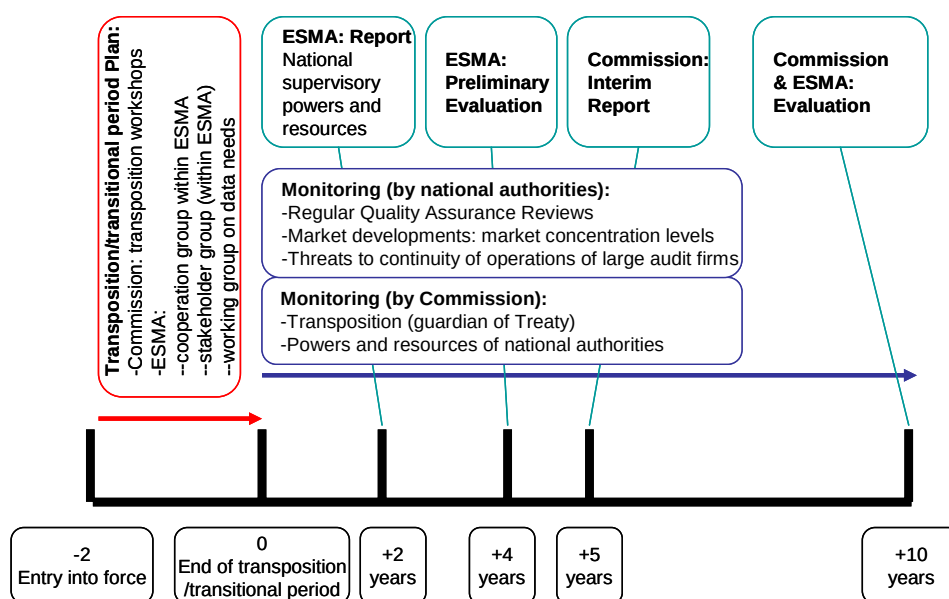


Figure 23

A full evaluation of the effects of the policy choices could, however, only be undertaken in the longer term. Some of the important policy choices will take time to have any impact e.g. conversion of audit firms into pure audit firms, mandatory rotation of audit firms after 9 years; joint audits etc.). It would be necessary therefore to carry out such evaluation in two steps: (i) first a preliminary examination by ESMA (possibly followed by an interim report by the Commission), on selected issues: e.g. changes in audit market structure; changes in the patterns of cross-border activity; interim assessment of the improvement in audit quality; impact of the changes regarding audit of SMEs; (ii) the full evaluation, 10 years after the end of the transposition/transitional period (to measure the effects of mandatory rotation). The full evaluation could be undertaken by ESMA or conducted externally. This choice could be made after the results of the first step (the preliminary examination) are known.

ANNEX 1. SUMMARY OF RESPONSES TO THE GREEN PAPER "AUDIT POLICY: LESSONS FROM THE CRISIS"

This annex reproduces the summary of responses to the Green Paper "Audit Policy: Lessons from the Crisis" published²²⁰ the 4 February 2011 by the Commission services at: http://ec.europa.eu/internal_market/consultations/2010/green_paper_audit_en.htm

The summary presents the following structure

- Background
- General Views
- 1. Role of the Auditor
- 2. International Standards on Auditing (ISAs)
- 3. Governance and independence of audit firms
- 4. Supervision
- 5. Concentration and market structure
- 6. Creation of a European Market
- 7. Simplification: small and medium-sized enterprises and practitioners
- 8. International Co-operation

²²⁰ Individual responses are also published on the same website.

Background

The Commission published a Green Paper on the 13th of October 2010 seeking views from stakeholders and the broader public on a range of issues related to the statutory audit ('audit'). The consultation closed on the 8th of December although certain responses came in after the deadline.

In all, almost 700 responses were received. This is the highest level of responses of any consultation in the Internal Market and Services area since the completion of the public consultation on Solvency II in February 2008 and is certainly the widest consultation response coming out of the financial crisis. The responses have come from various stakeholders; these include members of the profession, supervisors, investors, academics, companies, government authorities, professional bodies and individuals. Although the majority of the responses are from within the European Union, there have been a number of responses from third countries.

This summary has been prepared to provide a qualitative synthesis of the analyses carried out of the various responses. Although there are some very detailed responses, not all respondents have replied to all the questions. In fact, there are certain responses that are very short and some that make a statement without responding to any particular question.

Through this summary, our endeavour is to provide an accurate depiction of the broad spectrum of responses. As for any public consultation, there are some responses at the extremes of the opinion spectrum with outright rejection of almost everything on the one hand and unflinching support for most ideas at the other. We have tried to provide an idea of the different levels of support and rejection as well as the stakeholder groups concerned. The stakeholder groupings used throughout the summary emanate from the procedures used by us to process all the replies; they are not intended to 'club' any particular respondent in a category as there may well be instances where the respondent could have been included in another category. In any case, in order to facilitate a trail back to the individual responses, the latter will be published using the same categories as those appearing in this summary. For ease of reference back to the Green Paper we have also used the same section headings as in the Green Paper.

It is worth noting that the four biggest audit networks ('Big Four') have each submitted one response on behalf of the whole network. The summary often refers to the Big Four and endeavours to represent a 'collective' position although there are nuances and differences on certain issues; to get a clearer detailed view of their response we would refer the reader to the individual responses that have been published along with this summary.

It is also important to highlight that 42% of all responses have originated in Germany. A noteworthy aspect of the responses is the substantial interest expressed by the small and medium sized audit practitioners from Germany as well as other Member States.

In various instances, for the purposes of accuracy as well as in recognition of the clarity of certain messages, we have reproduced the text provided in the response. The variation in the length of the various sections is a reflection of the number of questions posed in the Green Paper as well as the level of interest elicited amongst respondents.

Stakeholders

87% of replies (from the total of 688 replies) were received from the European Union Member States (see figure 1). The consultation attracted groups representing either pan European (19 replies) or worldwide (22 replies) interests. Respondents representing world-wide interests included internationally operating audit firm networks and associations. Among the EU wide stakeholders (19 replies), these were primarily European associations representing the interest of companies (preparers). There was also considerable interest in the consultation from non-EU countries (49 replies).

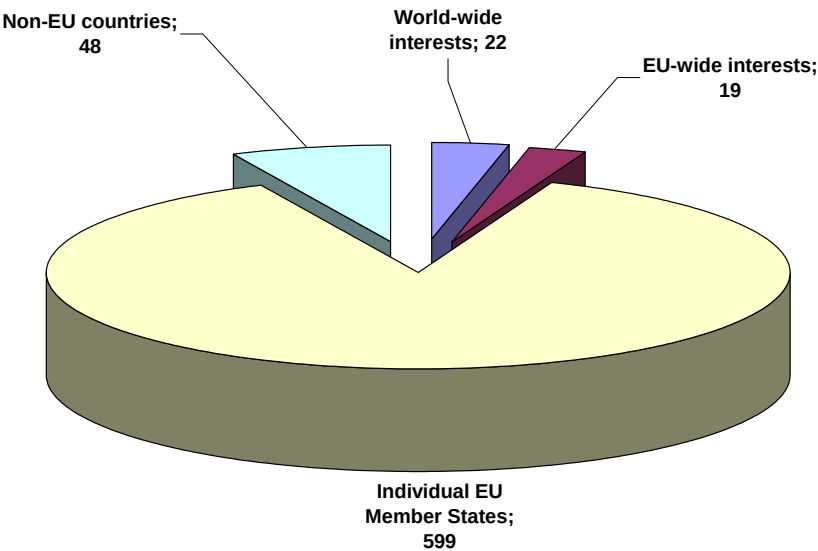


Figure 1. Geographical distribution of the replies to the Green Paper

There were 599 replies received from individual EU Member States (see figure 2). The replies from Germany, UK, France and Spain made up more than 2/3 of all replies received from individual Member States. The replies from the international audit firm networks have not been included under replies from member states.

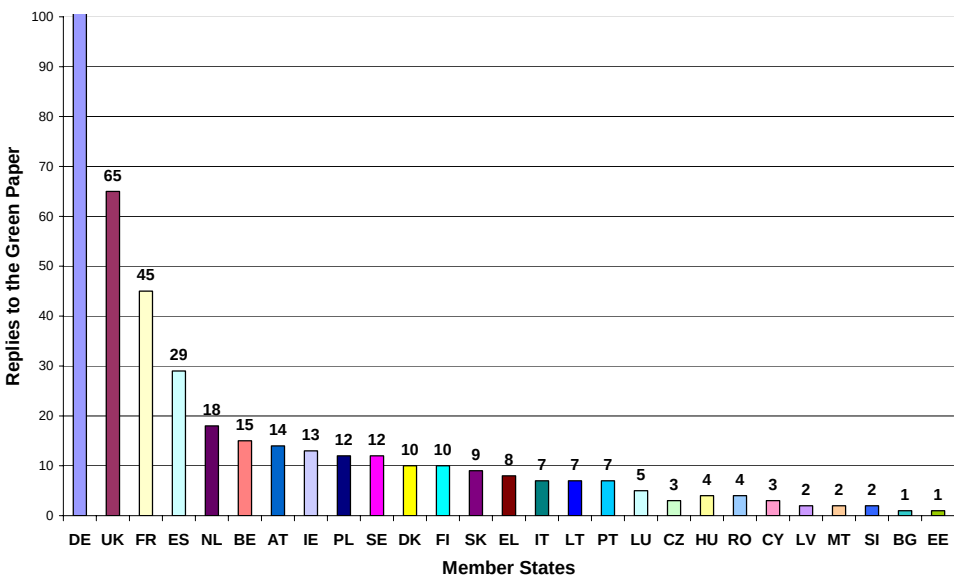


Figure 2. Distribution of replies by a Member State [DE: 291 replies]

Figure 3 presents more detailed information on the replies received from other non-EU countries. Almost half of the non-EU replies have been received from the United States.

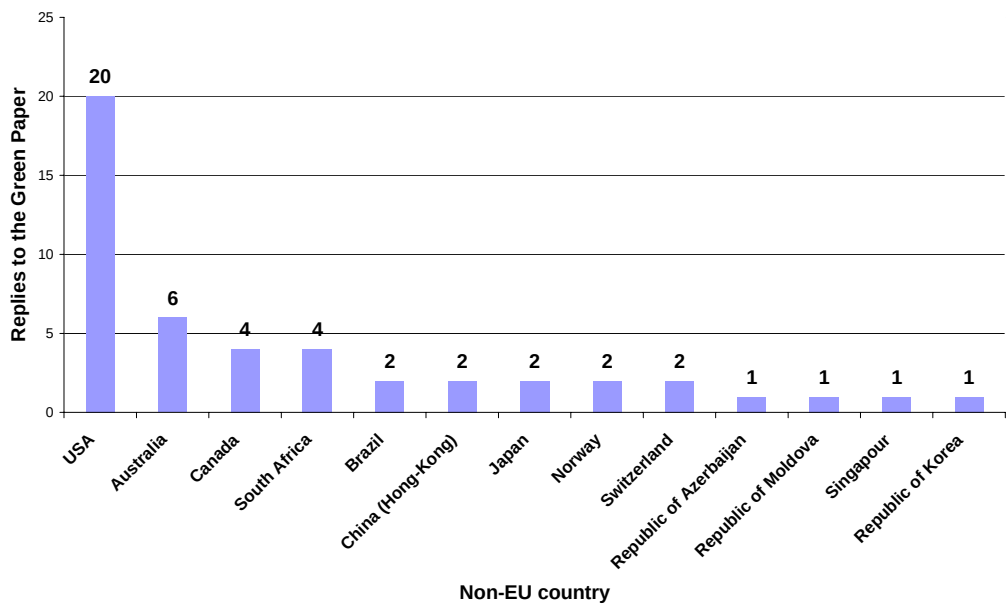


Figure 3. Responses from non-EU countries

In terms of the interest groups, a majority of responses represented the interests of the audit profession – 59% of the total number of responses (see figure 4). It should however be noted here that there were more than 200 replies identical in their content; these were all received from the German audit profession. The second biggest group of respondents were the preparers of the accounts and businesses in general (21% of the total number of responses). There has also been good representation of public authorities and users, respectively 57 and 22 responses. The remaining replies included academia (28 replies), audit committees (9 replies) and other replies (20 replies), of which the majority came from private persons.

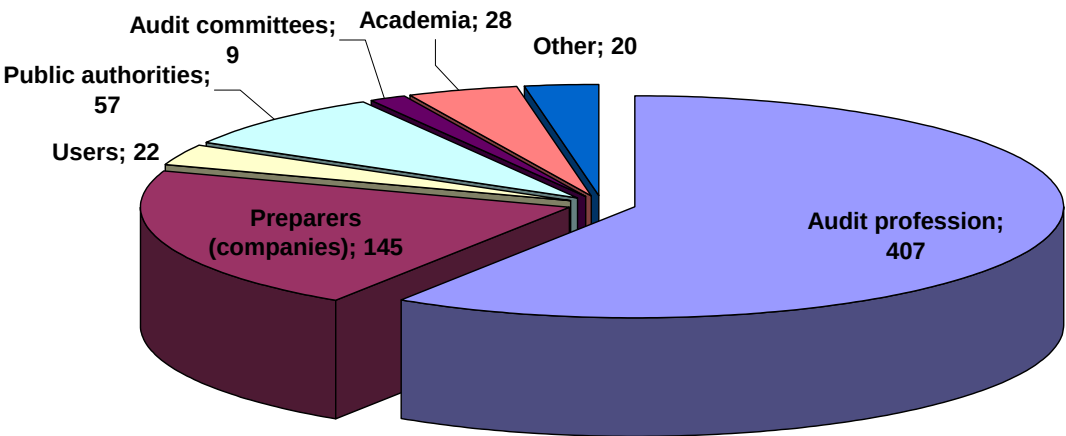


Figure 4. Responses by interest groups

Among the representatives from the audit profession, sole practitioners and other small audit firms were the most responsive amounting to 286 replies (see figure 5) with German small and medium practitioners being particularly active. There were 94 replies from the professional associations. The Big Four networks provided their replies on behalf of all their respective members. Other international networks, a vast majority of which form part of the European Group of International Audit Firms (EGIAN) or/and of the Forum of Firms, were also well represented.

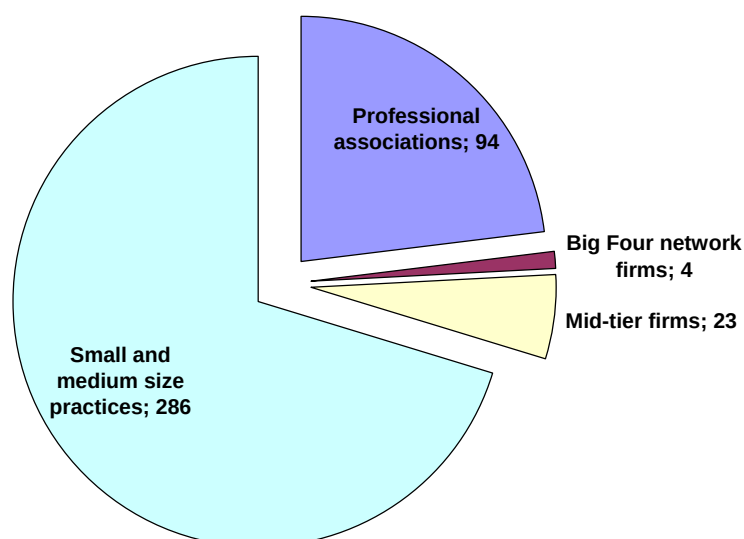


Figure 5. Responses representing the interests of the audit profession

The interests of the preparers of financial statements have been represented well by various business associations – 49 replies out of 145 (see figure 6). The financial industry has been the most responsive economic sector (20 replies). There were only two companies identified as SMEs, though their views were also reflected by some professional associations.

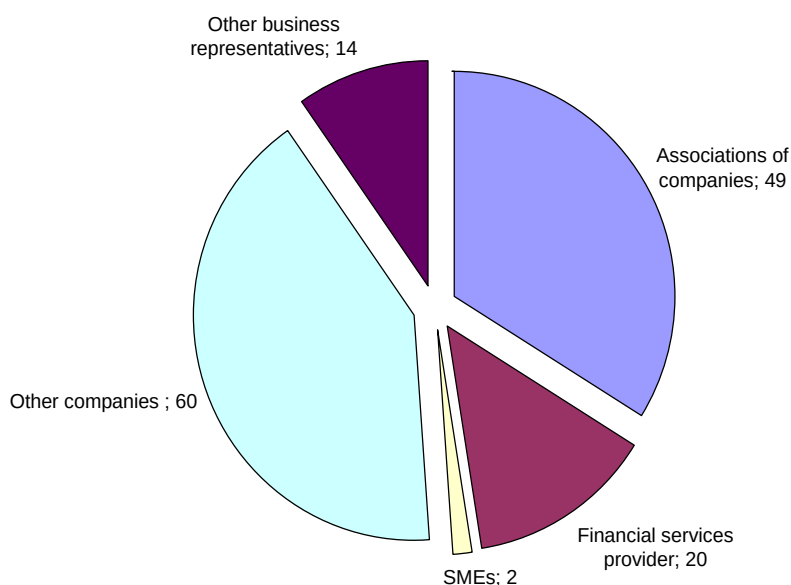


Figure 6. Responses representing the interests of preparers of the audited financial accounts

When it comes to the user stakeholder group, most of them represented investors (figure 7), but there were also replies representing the interests of employees and analysts, respectively 3 and 1 replies.

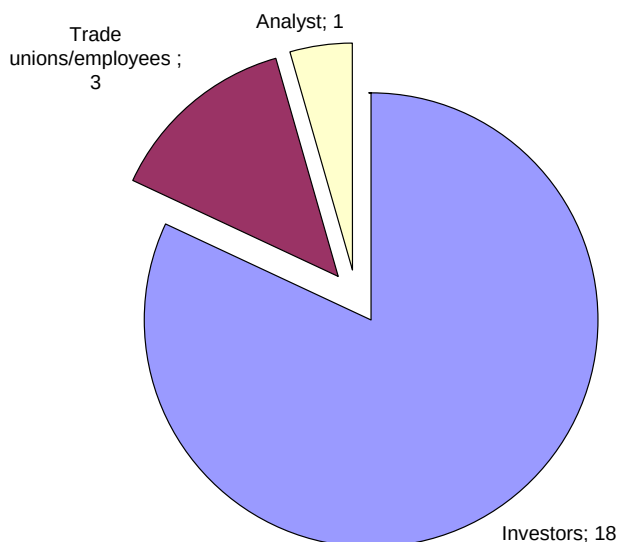


Figure 7. Responses representing the interests of the users of audited financial accounts

GENERAL VIEWS

There is general acceptance of the Green Paper. The issues raised, despite having been discussed before, are of particular interest in light of the recent financial crisis – a crisis that is still affecting the economies of many nations.

There persists an expectation gap between the actual scope of audit and the public perception of what audits are intended for. It is thus important to improve transparency on the conduct and outcome of the audit to narrow that expectation gap. It is equally important to 'adjust' the work carried out in function of the requirements of the main stakeholders.

It has been indicated that the societal role of auditors is clear, but clarification or better articulation could be helpful.

Academics suggest that there is a need to align the role of auditor more with expectations of the general public by enhancing audit reporting and disclosure to add more value to the audit. The current legal framework is not sufficient to safeguard auditor independence and structural changes are needed. Inspections in some countries show that 'big' is not equal to 'high quality'.

Although, the majority of individual business preparers do not see a real need to redefine the scope or role of auditors, some of them also agree that improvements could be achieved by redefining the role of audit regarding the veracity of financial statements as well as an increase in the quality of audit. Some respondents find audit too focused on tax issues rather than on a true and fair view of the financial statements.

1. ROLE OF THE AUDITOR

The Profession

Professional bodies and associations linked to the profession

The majority reply that reporting on the financial health is not the purpose of an audit and that, currently, audits are not fit for this purpose. The current role is to express an opinion on the financial information provided by management i.e. to give reasonable assurance on the true and fair view of the financial statements.

The respondents generally confirmed that more information could be provided but many maintain that the expectation gap is unlikely to be closed. Nonetheless, what an audit does and does not do should be clearly spelt out especially with more disclosures on the work conducted on key areas of judgement, the major queries raised and management explanations thereto, issues of material concern and models/techniques used for valuation, etc. Some suggested more disclosures on risk, judgements and estimates. Another suggestion was to ask the users what information they would require.

The vast majority of respondents do not consider that more substantive testing or 'going back to basics' will automatically result in higher assurance.

The majority of respondents replied that qualifications should remain 'negative'; they should not be graded as they are binary in nature. Although some did suggest that qualified opinions could be better explained in the audit report.

There were also suggestions that the audit committees could report more on discussions with auditors, e.g. key areas of judgements and audit issues in the financial statements. Some also suggested strengthening the independence of the audit committee and internal audit.

The replies were mixed as regards the role for an auditor in CSR. Caution was urged as key aspects of this area require further clarification and now may not be the right time to introduce CSR requirements. In any case, a prohibition on non-audit services could affect CSR.

The majority of respondents think that the time gap between the year end and the date of the audit report cannot be shortened without damaging audit quality. A few suggested more interim reporting.

Suggestions to enhance audit quality include enhancing auditor involvement with the front end of the annual report, providing greater assurance outside the report and improving communication between auditors, regulators & company.

Quite a number of respondents feel that the role of the auditor could be expanded if those charged with governance were to provide more information in the annual report (e.g. assumptions underlying going concern and the key risks associated with the entities' business model) and the auditor could then provide assurance on this information.

One respondent proposed an explicit provision in EU Regulation that EU auditors act in the public interest when performing statutory audits.

The majority of respondents believe there is a need to better set out the role, purpose, scope and limitations of audits. The interaction of audit with other functions in the corporate governance framework should be better understood and awareness of concepts such as going concern and emphasis of matter should be enhanced. Moreover, audit oversight has an important role in audit quality.

Big Four

On the specific questions, the Big Four are of the opinion that although some measures may be helpful in strengthening the role of audit, several topics run the risk of negatively impacting audit quality, imposing disproportionate costs on business and affecting shareholder's rights. They also alert the Commission on the global implications, including potential unintended consequences of any EU proposals. The Big Four remind the Commission that the auditor's mandate is to issue an opinion as to whether the financial statements give a true and fair view in accordance with the relevant reporting framework.

Mid Tier Firms and Small and Medium Sized Practitioners (SMPs)

The non Big Four believe that audit quality is not an 'absolute' but rather a state of incremental attainment at any given time. A view has been expressed that 'audit quality' may be adversely affected by the pressure, in many countries, to reduce audit fees.

German replies draw the attention to the point that the German "Lagebericht" (management report), which has to be audited as well, already includes forward looking information. In order to enhance the value of audits, it is proposed that the German long form report could be a basis to provide further information.

Some SMPs point out that the standardisation of the auditors' report has deprived the auditor's opinion of any meaningful content.

Investors

Most investors believed that auditors should also provide comfort regarding the financial health of companies, but only within their current remit and without any extension of the auditors' role. Specifically, investors underline the importance of the going concern assumption, both in terms of its disclosures by the company and its validation by auditors, as well as the correct valuation of assets. Moreover, investors suggested that auditors should improve their reporting by explaining what they have done during an audit.

All investor representatives agree that professional scepticism should be reinforced. Investors would like to see audit firms ensuring a stronger and more visible "tone from the top" as well as the consistency of key judgments across clients. Mentoring, junior staff training, continuing education, reducing the amount of junior staff per audit partner should also be seen as crucial to developing and reinforcing scepticism. The promotion system should also be well adapted to support the use of professional scepticism. Investors also think that independent inspections should focus more on the use of professional scepticism and in this regard it is important that review notes are retained by auditors. An audit committee should also be in a position to assess the professional scepticism applied by auditors. Fair value valuation and going concern validations are specific areas where investors believe the use of professional scepticism should be improved.

Most investors were of a view that audit reports should be more qualitative and the negative perception towards audit qualifications should be reconsidered. As a solution, investors propose more informative auditor opinions, more frequent use of the "emphasis of matter" statements or even the review of the audit terminology used in audit reports, such as "emphasis of matter", "true and fair override". Some investors pointed out that if the audit report gave an indication on the quality of financial statements, i.e. how far the company is pushing the boundaries of accounting standards, it would provide much more useful information to investors, and would dissuade companies from taking an aggressive stance.

The audit profession needs to more actively consider the 'true and fair override' such that auditors do not sign off simply because statements comply with accounting standards. The 'true and fair override' is required under accounting standards, but seems never to be applied in practice.

While few thought audit firms could be in a position to also audit CSR, others believed that non-audit firms may be better specialised to provide assurance on such matters.

Public Authorities

Most respondents argue that the current role of an auditor is an assurance concerning historical information, not forward looking information. Auditors should not replace the role of rating agencies and analysts, nor of those entrusted with governance. Still, there were some public authorities that were more open to an analysis of the benefits of such a change in the current role of the auditor.

Most respondents agreed that it is important to bridge the expectation gap, to the extent possible, by explaining the methodology used by auditors to users. More detailed suggestions on the matter included: the auditor should explain the purpose of performing risk assessment procedures and of obtaining an understanding of the entity, the entity's environment and internal controls, as well as the purpose of evaluating the design of those controls. Auditors could also explain how they have arrived at certain judgments, evaluations and decisions. It was also suggested that an "extended" audit report, which contains further description of the methodology applied and which is made available to the audited entity and relevant supervisory authority, could be helpful to reduce the expectation gap.

Most respondents agree that professional scepticism should be reinforced.

Some respondents proposed greater transparency by audit committees on the outcome of the audit together with improved engagement with investors; this should help minimise the shortcomings in a binary audit opinion and the implementation of a "graduated ladder" of reporting options which would help auditors express their views regarding the company's finances more specifically (rather than just having the sole option of 'qualification').

Most respondents agreed that there should be more regular communication by the auditor to the stakeholder but that the time gap between the year end and the issue of the audit opinion should not be reduced. Reducing the time available for the auditor to gather and analyse audit evidence would present a risk to audit quality. It was also argued by some that it is vital that any changes to audit regulation at EU or Member State levels are evidenced by an assessment of the economic impacts that demonstrates that the benefits exceed the costs.

CESR, CEIOPS and CEBS do not think that the role of the auditor should be extended to provide comfort on the financial health of companies. Auditors are not (and should not become) credit rating agencies predicting or assessing the future solvency of companies. However, they support improving the communication of the auditor towards stakeholders on this issue: further discussion on improving the explanatory notes to the going concern assessment would be welcomed.

There could be benefits in auditors better explaining audit methodology to users, but this may not necessarily reduce the expectations gap. They agree that there is room for improvement on professional scepticism. CEIOPS would encourage experts to start a debate on whether different categories of qualifications in audit reports could be feasible.

They agree that there is a need for better communication between auditors, audit committees and external stakeholders. Improved communication, inside or outside the audit report, would be beneficial and might help diminish the expectations gap of stakeholders.

Academics

Apart from adding reasonable assurance and protection with respect to the reliability of the accounts, academics who responded to the consultation generally think that the substantive added value of audit reports is very limited. Form dominates over substance.

More transparency is needed on audit quality, and the reporting of it by regulators and oversight bodies. Expanding the content of the auditor's report is critical not only to reduce the expectations gap but also to provide greater incentives for high quality audits. A qualified audit report should send a clear and important message to the market place; this is not the case at the moment. Fraud detection should be indispensable as it's invariably linked to the major disappointments with the present system.

Additional information should give more prominence and visibility on work performed by the auditor (also linked to the expectation gap), consider the use made of the annual report by stakeholders and where additional information can help, avoid an information overload (as is already the case in annual reports) and have more explicit and informed professional judgements explained in the financial statements.

Professional scepticism can be achieved through rotation after fixed (8 year) periods as the auditor would be sure in this case that another audit firm will be engaged and that the incoming auditor will review the previous auditor's work.

The Green Paper does not sufficiently analyse the position of the auditor in a company: "giving credibility to the accounts that are presented by the management and the board as these would not be considered reliable without the external, expert and independent opinion of the auditor". In reality, auditors are nominated and their remuneration is fixed by management. To give power back to shareholders, a shareholder committee as tested in Sweden should be considered. There is a need to align the role of auditor more with expectations of the general public by enhancing audit reporting and disclosure on audit. The current legal framework is not sufficient to safeguard auditor independence and structural changes are needed. Inspections in some countries show that 'big' does not necessarily equal 'high quality'.

Society would benefit if it were to view and treat the auditor as a potential whistleblower, accompanied by appropriate rewards and incentives. Especially as the overall incidence rate of fraud was recently estimated to be in the 7%-13% range of all publicly held organisations, i.e. detected fraud could well be the proverbial tip of the iceberg.

Preparers, businesses and organisations of companies

There is strong support from business respondents that audits should never be considered to provide comfort on the financial health of companies since this would transform audit opinions into credit ratings. There is also strong support for enhancing the communication between auditors and supervisors (specifically in the banking sector), while lifting any restrictions on auditors to share client-specific information with the supervisors.

Auditor's role should be to give assurance on the financial statements based on historical data. If users require more information, they would be able to form their opinion on the health of the company, based on the financial statements, possibly guided by rating agencies or other professionals in assessment (e.g. equity analysts).

Over the past years, one can see a shift in the focus of audit. Typically auditors want to secure completeness, correctness and timeliness of the financial data (balance sheet, P&L, cash flow overview and notes) of a company. Respondents have noticed a shift from this focus to examining compliance with IFRS.

With regard to the ideas of the Commission to come back to a more basic and substantive test of the balance sheet, they can only support them in relation to the audit of small entities for which a system-based approach does not make sense (too limited number of staff). In contrast, respondents are not in favour of this idea for medium-sized, larger entities and large groups. A 'risk based approach' (i.e. an approach based on the risks of material misstatements in the financial statements) is more efficient. It should be maintained with possibly extensive feedback on effectiveness of internal controls. However, even with a risk based approach, it might be useful to limit the focus of the audit to financial data and not broaden its scope to auxiliary areas and reports.

Although, the majority of individual business preparers do not see a real need to redefine the scope or role of auditors work, some of them agree that some improvements could be envisaged by redefining the role of audit with regard to the veracity of financial statements as well as improving quality. These discussions should be on a level of materiality and scope of audit programmes; this in turn would help closing the expectations gap. Some respondents also find audit too focused on tax issues rather than on a true and fair view of the financial statements.

On the specific questions, business respondents are of the opinion that although some measures may be helpful in strengthening the role of audit, several topics run the risk of negatively impacting audit quality, imposing disproportionate costs on business and affecting shareholder's rights. The role of the regulators should also be revisited because many auditors have increased their focus on checklists in order to meet the demand of audit inspection units. This situation can distort the quality because it has led to a 'perceived degeneration' of an audit into a review on IFRS compliance instead of providing a professional judgment.

On the audit methodology issue, all respondents admitted that the audit methodology should be better explained to the public and the users but this explanation should not be included within the audit opinion.

On the audit report, the preparers seem to agree that their language should be revisited (very defensive and difficult to understand). The opinion should clearly state the responsibility of the auditor and the work performed. Auditors should provide more detailed information as well as more information on key judgments. They can also justify their opinion as is currently the case in France.

Finally, regarding the qualified audit report, there is a general belief that its current form is satisfactory but it might be beneficial to look into further explanations on the reasons for qualification. If the signal is changed to for example “nearly qualified” the value of audit might decrease as a mixed signal does not make sense. Conversely, if the auditor fails to qualify his opinion when it should have been qualified, audit regulators or inspectors should be able to file law suits or impose disciplinary sanctions. A potential solution could be the introduction of several categories of opinions.

Finally on the question to know whether a short or long report should be put in place, the respondents do not seem very concerned as most people do not read the audit report as such. They only focus on the ‘qualification’ status or ‘emphasis of matter’ paragraphs. But what should really matter in the report is how the auditor has planned and conducted the audit (i.e. the audit methodology).

To reinforce professional scepticism, audit regulators should be able to refer the auditor to a disciplinary tribunal.

Nobody believes that the auditor should play a role in the field of CSR. The objective is not to give new markets to auditors. Moreover, auditors often do not have the skills to understand CSR reports (often qualitative information). Companies should use specific experts if they seek some sort of assurance in this field.

2. INTERNATIONAL STANDARDS ON AUDITING (ISAS)

Views are mixed on the possible adoption of ISAs in the EU.

The Profession

Professional bodies and associations linked to the profession

There is very broad support for binding ISA adoption. Some professional bodies, however, suggested that Member States should be allowed to introduce modifications to ISAs which would be needed because of national legislation/practice (e.g. company law). It was also suggested that ISAs should include the international standards on quality control (ISQC1), widely applied by firms. Concerning the role of the IAASB, professional bodies also explained that currently auditors are not sufficiently represented in the IAASB.

Big Four, Mid Tier Firms and SMPs

There is broad support for the adoption of ISAs in the EU as binding instruments and without any further adaptation for SMEs and SMPs; the latter are catered for already in the standards

themselves as well as the guidance provided. However, there are a number of responses from SMPs requesting sensitivity to the additional administrative burden.

Investors

Most investors supported application of consistent auditing standards not only in the EU, but also globally. Most respondents rather support a flexible non-binding approach, such as a recommendation, which could also be subject to a form of review in order that the Commission and other relevant stakeholders can reasonably satisfy themselves that standards are proving to be 'fit for purpose'. It was believed that the non-binding approach would not reduce an impetus to higher audit quality by making auditors more focused on the overall purpose of the audit to ensure a 'true and fair view' rather than following compliance-focused audits.

Some investors also raised an issue on the governance of the auditing standard setter IAASB. This body may be potentially conflicted as it is part of IFAC which is funded by the professional associations and large audit firms. In this respect, investors asked for a review of the IAASB governance so that a broader constituency including investors are involved in the development of ISAs.

Public Authorities

There is broad support for ISAs albeit not always for a binding approach. CESR, CEIOPS and CEBS support the adoption of ISAs in the EU as binding instruments (by Regulation, through comitology). CEBS would be opposed to adaptations and carve outs, but could accept national additions. CESR suggests, however, that it would be beneficial to retain an ability to amend standards prior to endorsement, should the European public interest so require.

Academics

There is support for ISAs in the EU through regulatory binding standards. The risk of non-application of ISAs by the US should, however, be taken into account.

Preparers, businesses and organisations of companies

Companies, nevertheless, expressed less enthusiasm for ISAs. Companies are not opposed to the application of ISAs by EU binding instruments for medium, large and listed entities provided that their reservations are addressed. These reservations relate firstly to the need to reinforce the governance and due process of IAASB with participation of all interested parties. At the moment the composition of the board is unbalanced (mainly accountants) which may lead to conflicts of interest. Secondly, these reservations relate to the need to put in place a specific assessment and adoption approach in the EU with appropriate guarantees:

- The approach should not be similar to the one existing for enforcement of IFRS. The new approach should be more flexible especially in a context where ISAs were drawn up by a body which is not accountable to European institutions.
- Explicitly allow amendment of standards that would include requirements on companies.
- The adoption procedure should be in direct cooperation with stakeholders (in particular companies) to make sure that ISAs do not set up new corporate

responsibilities. The ISAs should remain 'legal environment-neutral' to facilitate the international convergence of external auditing standards towards ISAs.

- The adoption procedure of the ISA should not limit the responsibility of auditors.

Some companies have also expressed their concern about the risk of ISAs pushing the core of audit into being even more "compliance-driven" as opposed to focusing on the veracity of financial statements. ISAs, as they stand now, would inappropriately describe the role of auditors and not take sufficiently into account the diversity of the audit model in Europe. In addition, there would be an important cost dimension associated to the adoption of ISAs.

For SMEs and SMPs, there is a willingness to further explore this area. Some of the replies express concerns that ISAs should be further developed to be better suited for SMPs and SMEs.

3. GOVERNANCE AND INDEPENDENCE OF AUDIT FIRMS

3.1. Appointment of auditors (Q.16/17)

Profession

Professional bodies and associations linked to the profession

Although most respondents replied that the Code of Ethics and/or effective audit committees are sufficient to address any potential independence risk, others acknowledge the conflict in the current status quo. Although the vast majority rejects appointment by third parties, some did state that in very exceptional cases (systemically important entities) there could be some third party involvement e.g. the right of a supervisor to veto the appointment of the auditor, governmental involvement where companies are in receipt of public funding or where an entity has no auditor or refuses to appoint one.

Big Four

There is strong endorsement of the fundamental premise that 'independence should be the unshakeable bedrock of the audit environment.'

On the appointment of auditors the Big Four do not believe there is a conflict and believe that the current system works well, in particular relying on the existence of an effective audit committee. The Big Four believe that appointment by a third party would disenfranchise shareholders and audit committees. Some believe that there may be certain instances where a regulator could be involved in the appointment of auditors; one Big Four, however, limits this to specific circumstances where a prudential supervisor or stock market regulator may need to appoint an audit firm to perform specific procedures in relation to the audited entity. The same network also explains that such an arrangement would expose such regulator (third party) to a much greater level of risk because they would be held accountable by shareholders for every perceived audit failure.

It has also been suggested that where the previous auditor has resigned due to disagreement with the entity then there may be some justification for third party appointment of the replacement auditor.

The Commission has also been requested to investigate the possibility of establishing an independent body to work with Audit Committees in reviewing their audit appointment procedures, with an explicit agenda for ensuring: regular and open tendering, independence from management in setting audit remuneration and reduction in market concentration.

Mid Tier Firms and SMPs

The non Big Four believe that the main conflict to be avoided is that of management having a role in the appointment of the auditor. There is a submission that in the case of large banks which benefit from the 'too big to fail' public guarantee there may be a case for regulatory appointment of the auditors.

Mid tier firms are of the opinion that the role of the audit committees should be strengthened with regard to the appointment of auditors. There is also strong support for regular tendering through a fair process. Mid tier networks do not support a prohibition of non audit services.

On the other hand, some SMPs point out that it is critical that the auditor is appointed and remunerated by the audited entity. Therefore, they call for a fixed scale of fees. Moreover, this group is of the opinion that in the segment of listed companies a third party, maybe a regulator integrated within a European supervisory body, could appoint the auditor at least as long as a sufficient number of SMPs have access to the listed company segment. The appointment and remuneration by a third party in the sector of SMEs is not seen as justifiable mainly due to the administrative burden.

Investors

Most investors agree that there is an inherent potential conflict of interest where the auditor is appointed by the audited entity, but believed that a number of measures already exist to mitigate that risk and that further measures could be invoked if necessary.

Most investors oppose "a scenario where the audit role is one of statutory inspection wherein the appointment, remuneration and duration of the engagement would be the responsibility of a third party, perhaps a regulator, rather than the company itself" as referenced in the Green Paper. In the view of investors, such a scenario would seriously undermine the accountability of auditors and their relationship with shareholders. However, some investors noted that in some specific cases the intervention of a third party, such as a supervisory authority, in the appointment of a new auditor might be necessary, such as in the situation where the auditor report and the financial statements are found to be misleading by a group of shareholders or the supervisory authorities.

As possible ways to deal with these conflicts, the following measures were pointed out:

- (a) Shareholders should always approve the auditor. Specifically, the appointment or re-election of the auditor should always be subject to annual approval by the shareholders, whereas appointment should be made by the independent members of the audit committee. As a reappointment of the auditor often hinges on the quality of their long-term relationship with the management board, the responsibility to decide on the auditor's (re)appointment should no longer, formally, or in practice, be with the management board.
- (b) The Commission should take steps to empower shareholders and to make the auditor more accountable, whereas an independent audit committee must be independent and

fully engaged in the audit process. It should provide a check and balance not only to prevent the conflict being abused, but also to improve their reporting to shareholders.

- (c) There should be minimum standards of transparency regarding the relationship between the company and its auditors. This will ensure that shareholders make appropriately informed voting decisions. Such disclosures might, for example, include the amounts paid to the auditor in respect of audit and non-audit fees for, say, the last three years, the length of tenure of the audit firm, the date the audit was last put out to tender, and the company specific reasons why the Board is recommending election/re-appointment.
- (d) There should be more transparency regarding the change in auditor and the views of the out-going auditor, which is a major weakness in European corporate governance. Too often, companies and the out-going auditor cite reasons of confidentiality as justification for not disclosing the reasons for the change such that there is no meaningful transparency, which is most unsatisfactory. This is a governance-critical change on which there should be effective accountability. Changes in auditors should be better explained and that auditors and companies should not be able to use commercial confidentiality as a reason to opt out of a more meaningful statement. Shareholders need to be assured that there are no relevant matters that they should take into account when assessing the change and voting on the appointment of the new auditor.
- (e) The remuneration of employees and partners in audit firms should be more aligned with ensuring high quality audits, rather than their contributions to turnover and profit.
- (f) An independent regulator should have a power to disagree on the entity's selection of an auditor and consequently the entity should appoint another auditor.

Public Authorities

The majority of respondents agreed that there is an inherent conflict of interest, which arises due to the fact that auditors are appointed and remunerated by the same entity. While Public Authorities were reluctant to suggest that a unified approach should be adopted, prohibiting the appointment and remuneration of auditors by the audited entity in every case, they did suggest that in certain situations, it should be forbidden. As an alternative to the current situation they suggested the following:

- auditors should be appointed and remunerated by the audit committee of the audited entity, as this committee is independent from the executive of the entity;
- appointment of the auditor by a third party could be justified in the case of certain public interest entities. It is already a practice in some Member States that a regulatory authority has the "right of veto", which is regarded as an efficient way to control the procedure of auditor's appointment.

Academics

The company's audit committee should consist entirely of independent directors. The audit committee should be responsible for setting the auditor's remuneration. Some competition on

fees should exist, but one should avoid other services being used to make up for lower audit fees. A floor for fees, checked by supervision could be a way forward; the fees in the public sector are sometimes ridiculously low.

The appointment of the auditor by the company is usually influenced by management. This can lead to "lowballing" (a low price for audit in order to have profitable consulting assignments) but lowballing can be addressed by more transparency on fees paid, limited non-audit services, fixed period appointment of auditors and approval of non-audit services by shareholders or non-executive directors or supervisory boards. If non-audit services were limited, this would no longer be the case.

Preparers, businesses and organisations of companies

Many businesses think the appointment by a third party is not feasible and should be limited to very rare cases (e.g. co-operatives' practices in some Member States²²¹) but in general the designation should remain the task of the general assembly. They nevertheless believe that there may be certain instances where a regulator could require the company to elect a new auditor in the case that the current auditor was proved to be unable to perform any audits.

3.2 Rotation (Q18)

Profession

Professional bodies and associations linked to the profession

There is a general rejection of mandatory firm rotation. A few respondents consider that there should be a limitation of engagement for Public Interest Entities (PIEs) (a 10 year limitation was suggested).

Big Four

The Big Four oppose limitation of continuous engagement of audit firms. They claim that studies have proven that mandatory rotation of firms harms audit quality and in any case such ideas are premature as the statutory audit directive is still being implemented with regard to partner (as opposed to firm) rotation.

Mid Tier Firms and SMPs

Mainly, mid tier firms do not support mandatory rotation explaining that it will increase costs, impair audit quality without any certainty on being able to address concentration.

Investors

With respect to limitation in time of the continuous engagement of an audit firm and mandatory rotation, investors had divergent views. Some investors did not support mandatory rotation, but supported mandatory re-tendering after a specific period of time. Investors

²²¹ As regards auditing practices in some co-operatives, one respondent recalls that in Austria, Germany and Italy for cooperative banks, which are members of a national/regional cooperative association, the auditor may be appointed by this association and not by the audit cooperative. According to their members, this appointment model preserves the independence of the auditor.

believed that more transparency from companies and audit committees on audit appointments, re-tendering and other information is needed, with the greater involvement of shareholders.

Public Authorities

Many public authorities did not support the introduction of mandatory rotation. Others stated, however, that such a measure would be beneficial, some suggesting that the audit firm should rotate at the same time as an audit partner. One of the recommendations concerning the issue was to allow the audit committee to decide whether the firm needs to be rotated, as this would enable committee members to apply their minds to real threats to independence, instead of applying rotation of firms in compliance with a rigid rule.

Academics

On rotation, there is support from some. A possible way forward may be a maximum period together with a period of overlap between the old and new firms so that information and knowledge can be transmitted from the previous auditor to the new auditor. If all auditors were to be submitted to the same discipline, there would be no losers as in principle all candidates would be able to find other mandates. It would also enlarge the expertise in the firms.

There could be a combination of internal and external rotation. The cost of rotation should be examined in the context of the period as well as in terms of the (societal) costs caused by lack of trust in audited accounts due to impaired auditor independence. Rotation combined with fixed period appointment would decrease any bias in the auditor's judgement to please management/shareholders to assure reappointment. Also, as the incumbent auditor knows that a new audit firm would come into the company, there would be more pressure to do 'proper' audits. Mere internal rotation does not contribute to independence; it's surprising that this route was chosen in the Directive.

Auditor appointment for a fixed 5-7 year period, with mandatory rotation of both audit firm and auditor after that period combined with limiting the dismissal of an auditor to cases of material reasons and with the approval of Courts will reinforce the independence of auditors. This should at least be obtained for PIEs such as banks and insurance companies (systemic).

Theoretical and experimental research suggests that mandatory audit firm rotation may be beneficial but only under very specific circumstances, e.g., when the cost to changing auditors is low, the market for audit services is not competitive, and reputation has limited effect on auditor performance. Other research has indicated that audit failures are likely to occur in short tenure cases as well as long tenure cases, although the causes may differ, i.e., when an auditor's tenure is short they are less likely to detect fraud but when an auditors' tenure is long they are more susceptible to forces that motivate management to manage earnings.

3.3 Non-Audit services (Q.19)

Profession

Professional bodies and associations linked to the profession

The vast majority also say no to the prohibition of non-audit services. A few respondents indicated that perhaps there could be some restrictions for PIEs. In any case, the audit committee should have more input in the area of non-audit services.

Big Four

The Big Four generally oppose a prohibition on non audit services although there is some appreciation for considering / restricting non audit services to audit clients. Moreover, the Big Four believe that any such provision would weaken the general economic independence of audit firms and the range of skills they can offer; they also believe that adding new limits would run against the grain of the Commission's aims to remove administrative and legal burdens to encourage the service sector, a growth area for Europe. It has also been argued that the provision of services to a non audit client has no impact on the statutory audit of a totally unrelated entity.

The Big Four believe that there are already rigorous requirements on independence while non Big Four support more disclosure from, in effect, the Big Four. The Big Four support EU adoption of the International Standard on Quality Control 1. Another measure could be a requirement for audit committee approval for non audit services. It has also been suggested that there may be a public interest in having stricter rules in the case of systemic financial institutions in order to enhance general confidence in the audit of such companies. One view is: 'Accordingly, we would support a review of the position in respect of 'systemic companies' as part of a comprehensive set of measures addressing this segment of the market.'

Disciplinary sanctions have also been raised in the context of a firm providing services that are proven to conflict with independence standards. Moreover, it is considered that audit committees should ensure that fees for non audit services do not contain a hidden subsidy for a low audit fee and there is a call for greater transparency from the audit committees on fees and on appointment decisions.

Mid Tier Firms and SMPs

The prohibition of non-audit services by audit firms is considered an important measure to maintain independence by some SMPs. However, they state that such prohibition should only be applied to PIEs and that systemic financial institution should be included in any prohibition any case. This group, however, appeals for "safe harbours" regarding the prohibition of non-audit services for there 'smaller' clients; they point out that especially for SMPs it is important to perform such services otherwise their existence could be threatened.

Investors

On the basis of the majority of the replies, the following could be noted:

Those non-audit services which have no natural connection with the audit must be discouraged or even forbidden as they are the main source of conflicts of interest and provide the audit firm with a competitive advantage which is unwarranted.

- (g) There should be requirements to establish appropriate protections to mitigate the risks of some non-audit services.
- (h) There should be much better disclosure of the non-audit services carried out by the auditor so that shareholders can raise concerns with auditors and audit committees on

the basis of useful and relevant information. Companies should provide enhanced disclosure about the quantity and type of services provided. Audit committees should also play a role in the assessment of non-audit services and the reporting to shareholders.

Some investors requested more clarity and consistency on what non-audit services are and suggest developing a list of non-audit services that are allowed and those that are prohibited. As regards specific examples of non-audit services, investors referred to internal audits where they noted with concern that "the provision of both internal and external audit services by the same firm has obvious implications for audit independence in that the external audit firm will in effect audit its own work and may be taking on management functions. Some investors noted the importance of uniformly implementing the independence requirements throughout the EU.

Public Authorities

It was argued that the provision of non-audit services increases the auditor's knowledge of the company and thus also increases audit quality. The provision of non-audit services should thus not be prohibited for all clients. It is an issue that needs to be judged on a case by case basis. It was, however, noted that agreeing on the list of prohibited non-audit services could be a way forward.

In the case of listed companies, PIEs and financial institutions it would be appropriate to allow the audit committee to take responsibility for taking the decision regarding the provision of non-audit services for a company that is already an audit client. Their decision should be based on known facts and not necessarily by applying a specific rule.

Academics

There is broad support for either a full cessation of non-audit services, as the best guarantee for independence, or the prohibition of non-audit services to audit clients. The latter would allow the audit firm to keep the necessary expertise without losing appearance of being biased.

In any case, audit and non-audit services should be pre-approved by the audit committee. A ban on the provision of non-audit services by audit firms would no doubt have a positive effect on third parties' perception of auditor independence. Research shows, however, that not all non-audit services have a negative effect on the perception of independence.

For certain non-audit services, however, a ban appears inevitable. Knowledge spillovers from consulting services are not used to increase audit quality but to reduce audit costs. Consulting services may be beneficial to the auditor and client, but the ensuing lack of independence harms the interests of external stakeholders. A lack of independence can neither be justified by efficiency arguments nor by the chance of increased effectiveness in the auditing and consulting areas.

Auditor independence should be monitored and violations should be published. The provision of non-audit services impairs independence in appearance. The recipient of financial reports (such as investors) must believe in the auditor's independence, i.e. independence in appearance is required. For most advisory services, but not all, a significant impairment of

perceived auditor's independence was found. Internal separation of audit and non-audit services within an audit firm does not increase the perceived independence.

The maximum percentage of non-audit services acceptable to investors is 25% of fees paid by the audited company to its auditor. There is also broad support for the US Securities and Exchange Commission's principle based approach: (1) an auditor should not audit his or her own work; (2) an auditor should not function in the role of management and (3) an auditor should not serve in an advocacy role for his or her client.

The prohibition of all or many non-audit services to an audit client would lead to a decrease of the total remuneration received by an audit firm from a single customer. This side effect is seen positively.

Providers of non-audit services

Competitors such as lawyers and tax advisors do not believe that auditors should be providing non audit services.

Preparers, businesses and organisations of companies

They cannot support an EU-wide prohibition of non-audit services; from the perspective of audit quality, it appears important to maintain the diversity of skills (multidisciplinary) in audit firms. Some, however, suggest exploring prohibition on the combination of audit and non-audit services to the same clients.

3.4. Maximum level for fees (Q.20)

Profession

Both Big Four and non Big Four support a limit on the fees from any one client as a percentage of the total fees. They also support transparency although not necessarily new rules.

Academics

The maximum limits for remuneration from any one client (in Denmark 20%, in Germany 30 or 20%) are not enough to exclude the risk of economic dependence. The loss of such a large client could threaten the existence of the audit firm seriously, and thus undermine independence significantly. For this reason, a limit of 10% is considered adequate. In addition, it has been pointed out that the risk of economic dependence not only exists at the level of the audit firm, but also at the level of the local office or even the partner concerned. In this respect it is also proposed that the Commission addresses the question of whether maximum compensation limits need to be introduced at these lower levels.

3.5. Transparency, governance and structure of audit firms (Q.21, 22, 23)

Profession

Professional bodies and associations linked to the profession

Many respondents consider that alternative structures could be explored but the independence of auditors should be safeguarded and auditors' liability regimes would need to be revised.

Big Four

Both Big Four and Mid Tier Firms support the exploration of alternative structures on a voluntary basis. On alternative structures, especially with regard to access to third party capital there is recognition that the capital would flow to the dominant firms. One non Big Four firm suggests a radical review of rules relating to the ownership and funding of audit firms, with a view to encouraging new investment in audit firms outside of the Big Four.

Mid Tier Firms and SMPs

A vast majority of SMPs, especially those in Germany, speak out against allowing audit firms to raise capital from external resources; external interests could threaten the independence of auditors.

Investors

A vast majority of investors agreed that it is in the public interest, particularly for larger audit firms and irrespective of their ownership arrangements, to have audit firms' financial information available to the public. Among other things, financial information, including information on legal claims, should help to evaluate the soundness of the financial position of a given audit firm, which might have implications on the audit quality. Some also believe that the improved transparency should help to disaggregate "audit and other assurance business and the performance and the capital devoted to the auditing business". Moreover, publication of financial statements would make companies and investors better informed and thus would help them to 'distinguish between audit firms and not necessarily prefer one from the Big Four'.

All investors shared the view that the governance of audit firms could be further improved.

A vast majority of investors supported a review of the ownership structures that limit external capital investment in the business. The replies noted that changes in ownership structures might facilitate greater competition and choice in the market.

Academics

Essential information, regarding internal quality review procedures, partner remuneration, promotions is often missing from transparency reports. There should be transparency regarding the composition of audit networks, ownership in networks and legal structures.

3.6 Group auditors (Q.24)

Profession

Big Four. They also support the access to documents of Group auditors. One Big Four firm points out that joint audits and mandatory rotation would have a fundamental (negative) impact on the ability of the group auditor to manage the group audit on a coordinated basis.

Investors

Investors supported Commission views and suggestions regarding group audits that would make sure that there are no barriers or constraints for the group auditor for the purpose of a group audit to have access to the information of auditors of subsidiaries. However, some

emphasized that "it needs to be handled carefully to avoid further entrenching the position of the Big 4".

Academics

Group auditors should have access to the reports and other documentation of all auditors of components of the group.

4. SUPERVISION

The Profession

Professional bodies and associations linked to the profession

The vast majority of those who commented on the future structure of the EGAOB favoured a level three authority.

There should be appropriate enforcement of EU requirements for auditors of financial institutions to alert authorities if they become aware of certain issues; this has also been suggested for all PIEs; increased communication is favoured especially for banks and large financial institutions.

Big Four

There is support for EU wide co-ordination of audit oversight bodies although the Big Four do not support integrating them into the new European Supervisory Authorities as this could lead to divisions within the audit profession and variation in oversight practices and ultimately audits.

There is also support on strong two way communication between auditors and regulators for the audit of systemically important financial institutions. There is a suggestion that auditors could contribute to discussions at the newly created European Systemic Risk Board.

Mid-Tier Firms and SMPs

There is support for EU wide co-ordination. Some SMPs welcome the approach of creating a European Supervisory Authority.

Investors

There was wide support that the supervision of audit firms in the EU should be performed on a more integrated basis. To increase consultation and communication between the auditors of large listed companies and the regulators, the dialogue should be a two-way process so that supervisors also alert auditors regarding particular areas of concern.

Public Authorities

There should be agreements with third countries to share information, subject to adequate confidentiality requirements, and reliance on countries' inspections processes, formation of a college of regulators, and the transformation of EGAOB into a level three authority for audit supervision.

Academics

One could follow the scheme developed for the new European Supervisory Authorities, except that the European body should have inspection powers on the national supervisors and if needed also on the firms supervised by the latter. For multistate auditing firms, a system of supervisory colleges could usefully be developed to especially deal with the cross border links in auditor networks.

For international purposes the European body would be the direct interlocutor for non-EU supervisory bodies, and would channel their questions and coordinate the answers of the national supervisors.

One member of audit committee should be nominated by a regulator.

Preparers, businesses and organisations of companies

There is support for EU wide co-ordination of audit oversight bodies.

5. CONCENTRATION AND MARKET STRUCTURE

5.1 Systemic risk? (Q.27)

The Profession

Professional bodies and associations linked to the profession

The majority of respondents consider that there is no systemic risk. The market could cope in the event of a collapse of a Big Four. A number suggest that addressing the liability issue would reduce the risk of a collapse. A small number, however, consider that the current configuration presents a systemic risk.

Big Four

They believe that failure of one or more of the largest firms could under rare circumstances cause a temporary disruption in capital markets and although the risk is not similar to that presented by banks there is risk, in such an instance, to the continuity of audit services and to the choice of auditor in the market. The Big Four believe that this risk emanates from the litigation environment coupled with the lack of effective liability limitations for statutory audit work, in the UK and the US.

Mid Tier Firms and SMPs

They consider that the current configuration of the audit market poses a systemic risk to market stability. They go on to say that the choice is often even less than four as a company may not wish to appoint its competitor's auditor. Also, another auditor may be providing non audit services and may thus not be eligible to provide audit services. Should one of the four dominant networks leave the market for any reason, there is a real likelihood of severe disruption in the audit and capital markets resulting in some of the largest companies being unable to find a suitable auditor in the short term, with a consequent adverse effect on the capital markets. It is likely that such effect would be greater than previous withdrawals from the market.

They also highlight the problems associated with the 'too big to fail' moral hazard.

On top of the risks indicated in the actual 'oligopoly' structure, there is an additional risk of undue influence by this 'oligopoly' on regulators, be it national or international.

Investors

The degree of concentration in the audit market and the Big Four dominance of the audits of most international companies are not good for competition and choice. If the Big Four were to be reduced to the Big Three this could undermine financial stability and market confidence, though not necessarily cause an economic crisis. Investors considered that a more open and vibrant audit market would serve the public interest better. The Commission was urged to move with a greater sense of urgency and 'provide bold leadership in order to make serious headway towards a sustainable audit market, which would be consistent with maintaining financial stability and strengthening market confidence.'

Public Authorities

Most of the Public Authorities agreed that the current market configuration does present a systemic risk. Those against structural measures explained that there is the possibility of increased cost and the objective of raising the profile of the small and medium firms does not necessarily mean that the 'big four' firms should be 'diluted'. Among the positive side of joint audits, there would be benefits to non big four firms such as:

- Obtaining necessary experience for audit of public interest entities, large corporations, audits in specific areas, etc.
- Getting the opportunity to prove competence for audit of public interest entities, large corporations, audits in specific areas, etc.
- Getting the opportunity to gain the trust of the biggest audits clients, financial institutions, etc.
- Reducing negative results in the case of "systemic firm" collapse.

A **competition authority** explains that the limited choice of auditors and existing competition problems in the market mean that if one of the Big Four audit firms were to exit the market for auditing large companies, existing competition problems in the market could be exacerbated. High barriers to expansion might make it difficult for smaller firms to step up to replace it. There might also be a short-term risk of some companies being unable to purchase audit services, leading to a loss of confidence in the financial status of large listed companies and/or high-risk companies and possibly among investors more generally. Thus the existing high barriers to entry, leading to high market concentration, can be seen as contributing to the risk of wider, systemic failure whereby the failure of a network could have substantial negative effects on the wider economy.

An **independent regulator** believes that the degree of concentration represents a systemic risk to capital markets. It suggests that public and investor confidence would be undermined and equity, bond and lending markets would fall significantly as a result: 'In the longer term, existing problems around lack of choice would be exacerbated. Additionally, if the event were audit-related, the remaining firms may become reluctant to audit companies in high risk industries and may even begin to withdraw from certain sectors of the market. At a minimum, a market with three or fewer large firms capable of auditing the largest and most complex clients is likely to require a significantly more intrusive regulatory environment and therefore cost.'

CESR, CEIOPS and CEBS agree that the current level of concentration in the audit market presents risks for financial markets, as a failure of one of the largest audit firms could cause

severe market disruption. However, they do not see such risks as being the same as those posed by the banking sector during the financial crisis. When identifying appropriate measures to mitigate the risks posed by the structure of the audit market, the distinctive characteristics of the audit sector need to be taken into account. Any action in this area should be taken at the international level.

Academics

Concentration is a risk, though whether or not systemic is open for discussion. But regardless of this, the concentration issue has to be dealt with also for reasons of adequate competition, diversity of practices and opinions and the effectiveness of supervisory action (a supervisor confronted with unacceptable behaviour by a major audit firm would be very hesitant to take action against that firm if that action could trigger a crisis, possibly with systemic consequences). This might also create "moral hazard" on behalf of audit firms.

Preparers, businesses and organisations of companies

There is no clear consensus that the failure of one or more of the largest firms could present a systemic risk but they all recognise that the situation might create serious difficulties for the certification of the annual account of multinational listed entities (three global networks is not enough). Amongst the reasons pinpointed is that the firms cannot themselves be considered as systemic but they recognise that the situation can contribute to dysfunctions of systemic importance. According to some of them, the current configuration does not present insurmountable difficulties which cannot be handled. Preventive actions should include 'contingency plans'.

5.2 Audit firm consortia (Q.28)

The Profession

Professional bodies and associations linked to the profession

On joint audits, there are mixed responses. A leading body feels that this could dynamise the audit market but very rigorous tests regarding audit quality, costs and liability issues should be undertaken before making it mandatory. There should also be objective research on the experience in France.

Big Four

On mandatory joint audits and consortia, the Big Four are negative as they believe it will impair audit quality and will cause co-ordination problems. They also believe that such an artificial attribution to smaller firms of a share in the market for larger audits could risk becoming a disincentive to them to grow.

Mid Tier Firms and SMPs

Mid tier firms and SMPs strongly support joint audit and consortia where at least one non-systemic firm is included. They also highlight that joint audits are tried and tested and have worked in keeping concentration lower in France than in other Member States; they explain that in France there is currently an additional firm at the top end of the market. There have been other players but they were acquired by the Big Four. They also indicate that concentration is also lower in France at the next level of the market than in other Member

States. Some believe that the participation of more networks and audit firms in the larger as well as public interest audits will enhance competition and can potentially raise quality.

It has been submitted that consortia should not be fixed between any specific firms but should be put together on a case by case basis.

It has also been submitted that the main benefit of consortia is that more firms are able to directly demonstrate high quality in a range of services to a wider range of companies which in turn bolsters the firms' credibility. Greater understanding of more firms delivering high quality services becomes a virtuous circle leading over time to more firms with a meaningful share of a larger company audit market; in spite of the requirement for compulsory joint audit in Denmark being lifted five years ago, 16 of Denmark's 64 largest public companies still use joint audit voluntarily. One major non Big Four firm claims to have gained important joint audit assignments in France, Denmark, Cyprus and Belgium where it believes it would otherwise have had limited chance of winning the sole audit.

Investors

There are divergent views among investors regarding the mandatory formation of consortia with the inclusion of at least one smaller, non systemic audit firm. Many investors did not support this proposal, mainly fearing an increase of costs of audits, the dilution of responsibility or the lack of beneficial effects. Other investor representatives however did "not fear the use of audit firm consortiums on a more formal basis, provided that the company audit committees properly own the relationships and offer appropriate and effective challenge to the auditors such that the firms in the consortium each deliver a quality audit and challenge each other to improve their approach".

Public Authorities

If joints audit were introduced in the EU, the Commission should establish clear lines of responsibility for the joint audit opinion as well as to consider a resolution mechanism for differences in opinion between consortium members.

For CESR and CEIOPS, joint audits should not be considered as a means for dealing with audit market concentration or making the market more dynamic. Joint audits might pose a number of issues in terms of responsibilities, differences in the level of workload and audit approach. In addition to this, the issues might be more complex when referring to joint audits between Big Four and mid-tier or small audit firms (e.g. this will only lead to the audit work being performed by the big audit firm, which can rely on its network and workforce to look at the firm as a whole, especially for cross-border activities; in such circumstances, this would reduce the benefit of having a joint audit).

Academics

Making joint audits mandatory seems excessive, but as an optional solution it should be welcomed. In general, radical remedies should be avoided in favour of gradual improvement.

Preparers, businesses and organisations of companies

On the joint audit concept, preparers are not opposed to its principle if it is well balanced, well-framed and with very strict requirements. Whilst some companies consider that the appointment of more than one auditor has some benefits (e.g. collusion with the management

would be more difficult), for a majority of companies, the benefits do not outweigh its disadvantages (e.g. costs incurred 15-20% higher than for conventional audit, overlapping of audit parts, etc.).

The pros of the French joint audit are that they enhance audit quality: four eyes are better than two. The negatives relate to the 'burdensome nature' of the process. The French model works well because the joint audit is balanced and profitable. If the Commission goes for the French model, it should apply only to listed companies, as the additional costs would be hardly 'bearable' for smaller entities. In any case, companies always have the choice of two auditors.

5.3 Mandatory rotation and retendering (Q.29)

The Profession

Professional bodies and associations linked to the profession

There is strong rejection of mandatory rotation but support for tendering on a regular basis (e.g. every 3 or 5 years mentioned) or even mandatory tendering; the audit committee should review appointment on a regular basis and should have a policy for re-tendering and clear criteria for selection, more transparency on reappointment.

Big Four

The Big Four oppose limitation of continuous engagement of audit firms. They claim that studies have proven that mandatory rotation of firms harms audit quality and in any case such ideas are premature as the statutory audit directive is still being implemented with regard to partner (as opposed to firm) rotation.

Mid Tier Firms and SMPs

Mainly, mid tier firms do not support mandatory rotation explaining that it will increase costs, impair audit quality without any certainty on being able to address concentration. On tendering they are more supportive, provided such tendering is not mandatory. They are open to the possibility of at least one non Big Four firm being able to participate in a transparent tendering process in which quality should be a key criterion. It has also been suggested that tendering could be mandatory for listed companies every 5 to 7 years. Some SMPs, however, are of the opinion that mandatory rotation will increase competition amongst auditors and is an important tool to strengthen independence. Six years is to be considered as an appropriate period of time. However, this group also states that this should be considered in any case for all public interest entities.

There is also support for regular and fair tendering suggesting a two stage short listing and full proposal process, drawing on the practice in the public sector. There is a submission that shareholder involvement in the process is critical because the current practice of seeking shareholder approval at the AGM is usually too late to have sufficient influence on the decision. An example of the UK public sector audit market has been provided where independent bodies representing the 'owners' monitor audit appointments, audit quality, value for money and tenders.

Public Authorities

Mandatory rotation of audit firms may have the opposite effect to saving cost and enhancing audit quality. It might also increase the probability of collusion among audit firms in order to coordinate acquisition of clients. However, there were some who supported mandatory audit firm rotation, suggesting that the maximum period of engagement should be the same as for audit partners.

There is broad support for mandatory re-tendering.

None of CESR, CEIOPS and CEBS see mandatory rotation of audit firms as a significant measure that would substantially open up the audit market, although they see value in debating its possible contribution to auditor's independence.

Academics

A key instrument has not been worked out in the Green Paper: the nomination procedure for the auditor, apart from involving shareholder committees, should include strict internal rules (call for candidates, independent selection, objective comparative analysis, selection on stated reasons submitted to shareholders).

Preparers, businesses and organisations of companies

On rotation, preparers cannot support the mandatory rotation of audit firms. Regarding the tendering process, they are in general in favour but insist that the company should decide in certain circumstances to keep the same auditor if benefits of continuity are demonstrable. The selection criteria should be defined ahead of the tendering process in order to justify the decision and this information should be communicated to make sure that some of potential candidates are not discriminated against. Finally, audit fee should not be decisive in the choice of auditors. Selection criteria should also include a mix of parameters that are individually decided from company to company: for example, expertise in a specific domain, the geographical coverage, strong foothold in some regional markets, the network, size of specific audit team and audit fees. Re-tendering should also be a matter of vigilance by strong, independent Audit Committees who monitor the performance, quality, independence and objectivity of their auditors. Last but not least, a mandatory rotation of firms is incompatible with a joint audit regime at the moment as the offer is not sufficient.

5.4 "Big Four bias" (Q.30)

The Profession

Professional bodies and associations linked to the profession

There is support for ideas such as the prohibition of Big Four clauses, publication of inspection reports, open tendering procedures, transparent selection and (re)appointment criteria.

Big Four, Mid Tier Firms and SMPs

Firms believe that 'Big Four only' clauses should be discouraged or prohibited and non Big Four firms believe that such clauses should be eliminated. The Big Four point out, however, that reputation is built-up over a long period of time, through consistent high quality performance, which implies huge investments in human resources and enabling technology and lack of circumstances that endanger a reputation.

There is support for some sort of European certification of quality.

Investors

Most investors believed that greater transparency was needed to address the issue of a Big Four bias:

- (i) companies and their audit committees should report their policy approach towards audit tendering;
- (j) audit committees and/or the board should make themselves available to explain to major investors any changes of auditor. This should provide a useful ‘check and balance’ in the process and assist in ensuring a mutual understanding of the circumstances and the process outcome. Any covenants restricting a company's choice of auditor should be disclosed.

Public Authorities

CESR explained that greater transparency on audit quality, both by auditor oversight bodies and from the audit firms themselves, could help to address the Commission’s question about whether the perceived extra level of comfort in appointing a Big Four firm is due to “perceptions” rather than “merit”. CEIOPS sees value in the European quality certificate but warns about the possible creation of entry barriers for smaller firms.

Academics

Audit quality for the Big Four and mid-tier is comparable, but investors perceive the Big Four as providers of better quality. However, one possible reason for investors trusting Big Four more could be that Big Four would have "deeper pockets" should something go wrong.

Preparers, businesses and organisations of companies

Whilst preparers recognise that the use of Big 4 only clauses can constitute a barrier to entry, one of the reasons of this bias is the use of the IFRS as only the Big Four firms today may be able to maintain sufficient knowledge of these standards although even in these networks the local offices sometimes struggle to maintain sufficient knowledge.

5.5 Contingency plans (Q.31)

The Profession

Professional bodies and associations linked to the profession.

Many respondents agreed that regulators could prepare contingency plans. There is no support for living wills.

Big Four

The Big Four do not all support living wills along the lines of banks because of the non-systemic risk posed. The ones that do support such considerations are of the view that audit firms may work with their regulators to develop contingency plans to address concerns of a disorderly failure.

Investors

Most investors agreed that it would be sensible for audit firms or regulatory authorities to develop contingency plans, including living wills, to help address the impact of a firm failure on the audit market. Some suggested that such plans should be made public, in order that shareholders and other parties can study them. It was conceivable that the contingency plans might be included in the annual financial statements of the audit firm.

Public Authorities

Most of the Public Authorities agreed that contingency plans would be key in the future.

It has been submitted that: 'Contingency plans should be developed that, as a minimum, seek to:

- reduce the risk of a firm leaving the market without good reason;
- reduce uncertainty and disruption in the event of a firm leaving the market;
- ensure that, in the event of a firm failure, the future audit market is not dominated by three or fewer firms.

In order to accomplish these objectives, the contingency plan will need to include:

- A mechanism whereby firms inform regulators of any emerging issues which could threaten a national firm and/or its network.
- Arrangements aimed at stabilising the firm and preventing immediate collapse through the exodus of clients and staff while an investigation is carried out.
- An objective incident assessment to understand the root cause of the incident, whether the issue is systemic to the firm and/or network and whether the firm in part or in whole is worth saving. The assessment should be independent of any subsequent regulatory or disciplinary action.
- A response plan, which would include a decision on whether the relevant regulator(s) felt able to provide continued support to the firm and on what terms. If continued support was considered inappropriate, or if it was clear that the firm would not survive because of the actions of clients and other market participants, then the plan would need to include provision for an orderly transition of clients and staff to one or more other firms.'

CESR, CEIOPS and CEBS agree that contingency planning should be developed to mitigate these risks. CESR suggests that planning should be done at sector level and by individual audit firms and audited companies. As the largest audit firms are part of international networks international co-ordination might be necessary.

5.6 Rationale for consolidation (Q.32)

The Profession

Professional bodies and associations linked to the profession

A few comments were made on possible actions that could be taken instead of seeking a reversal of the past consolidation; promote growth of mid-tier firms, confine consolidations in the future.

Big Four

On the consolidation over the past two decades, the Big Four believe that the rationale is still valid and point to the fact that the 1998 merger between Price Waterhouse and Coopers and Lybrand and the 2002 takeover by Deloitte and Ernst and Young of certain Andersen partners and activities were approved by the European Commission.

Mid Tier Firms and SMPs

They do not believe that the consolidation was necessary. Although a break up is considered complex and difficult, there is a suggestion that the Big Four should not be allowed to further acquire significant firms e.g. in Brazil the largest non Big Four firm was recently acquired by a Big Four firm.

It is pointed out that that it is difficult to imagine a situation where any member of the Big Four would voluntarily restructure itself into two or more smaller entities, or where the directors of large entities and advisers would turn away from the Big Four and appoint smaller firms in the current configuration.

There is a radical suggestion to impose restrictions on market share: a monitoring group comprised primarily of investors, and possibly regulators, could place tapered limits on the absolute number of audits that any one firm can carry out for defined sectors e.g. largest 100 companies ranked by market capitalisation over say a five year period.

Investors

Some investors contest the decision allowing certain mergers of audit networks. Most investors did not, however, agree that there should be a reversal or a forced break up of the Big Four, which in itself could disrupt the market and cause additional problems.

Nevertheless, some investors claimed that market forces failed to deliver meaningful solutions and thus radical measures should be sought. They believed that there should be an "unambiguous encouragement to the larger audit firms to restructure their operations - possibly by demerger or other strategic combinations. This should be combined with an undertaking by the Commission to conduct a further review of the audit market structure in, say, 2-3 years time with terms of reference that will require it to mandate structural changes to the firms if it is not satisfied that the structural issues have been addressed. This approach of an "iron fist in a velvet glove" would rightly give the audit firms the opportunity to shape their own destiny within a reasonable time period whilst at the same time provide clarity of intent on the part of the Commission to intervene if the major audit firms fail to respond constructively to its initiative. One should not be prescriptive as to how many firms and networks there should be but eight or more feels like a sensible benchmark to use. To achieve this objective the Commission should co-ordinate its efforts with its global counterparts."

Some respondents also suggested creating "pure" audit firms by the splitting up of audit and non-audit services.

It has been submitted that investors and regulators have consistently identified the risks associated with concentration in the large corporate audit market. They seek a larger pool of quality providers with a meaningful share of the large corporate audit market to address the issues of concentration risk, market stability and innovation.

Public Authorities

On the consolidation over the past two decades, CESR believes that it may be appropriate for national competition authorities to consider whether measures might be taken to address market structure in specific jurisdictions, taking into account the specificities of each national market and industry sector. CEBS outlines that it has no view on optimal market structure, but that any proposal on this issue should be carefully assessed to ensure that neither the quality nor the efficiency or the availability of statutory audit work is reduced.

6. CREATION OF A EUROPEAN MARKET

Profession

A number of respondents cautioned that from a practical perspective auditors must know local tax and legal requirements as well as language. Responses are generally quite positive to a European passport if more harmonisation is achievable. However, even those who favour 'maximum harmonisation' see difficulties in this area. Time is needed to assess implementation of the directive; moreover, education, qualifications and training should be harmonised. Those in favour of the European passport state that differences in national laws, tax rules and language remain problematic. This could, however, be a long term project.

There is broad support for closer alignment of examination and training requirements and maximum harmonisation across the EU.

Investors

While some investors supported a single European market for the provision of audit services, others believed that a European passport would be detrimental to audit quality, where cross-border liability issues may also arise. Some investors were sure that the cross-border mobility is not an issue for Big Four audit firms but could be increased for the others by encouraging auditors to gain competence in one or more other languages. Finally, most investors supported harmonisation of qualification and training requirements, whilst "avoiding a rush to the bottom".

Public Authorities

Many respondents stated that co-operation between professional bodies on auditor qualifications should be encouraged. On the issue of the European Passport many Public Authorities were reluctant to embrace this proposal as they argued that such a measure might harm quality and would be difficult to implement. Still, many respondents argued that maximum harmonisation is a measure that will help the audit market as long as quality is preserved.

CEBS believes that a European market for auditors would require harmonised auditing and independence standards across the EU, including a code of ethics. However, one would also need to take into account the differences in national legal systems which are relevant for auditors (e.g. company law etc), which could make it hard to move to maximum

harmonisation in the short term. CEBS also questioned whether a large EU market would benefit SMPs; most of the benefits of a more integrated audit market would accrue to larger firms only. CEIOPS underlined that a European quality certificate (recognising aptitude to perform audits of large listed companies) could be of interest, but the requirements should be designed to avoid the creation of entry barriers.

Academics

Harmonisation has an important role but Member State differences should not be overlooked.

Preparers, businesses and organisations of companies

Although some support the idea of a single passport, they do not believe a single passport could be put in place because they find it difficult to remove the aptitude test as it focuses on national legislations (national corporate law, social, taxation, civil law, national accounting principles, language, etc.). When auditors issue an opinion, it is important to make sure that they are familiar with the domestic laws.

7. SIMPLIFICATION: SMALL AND MEDIUM SIZED ENTERPRISES AND PRACTITIONERS

The Profession

Professional bodies and associations linked to the profession

A majority do not support a limited audit. 'An audit is an audit' and should not be diluted. Exempted companies should be free to choose a statutory review on a voluntary basis. Confusion should be avoided when mentioning 'limited' audits.

Big Four

The Big Four do not support the development of less stringent rules of internal control and suggest that the oversight of firms could be provided by local professional bodies. The non Big Four believe that the rules and oversight could be less stringent. Amongst this Group of respondents, one large firm is, however, more closely aligned with the Big Four with regards to this section.

Mid Tier Firms and SMPs

Some SMPs feel that they are surrounded by an ever growing regulated environment which may not necessarily suit their practice or the immediate needs of their SME clients. To ensure appropriate conditions for the development of such firms, the "limited audit" or "statutory review" referred to above could be accompanied by proportionate rules on quality control and oversight by audit regulators. This would allow SMPs to reduce their administrative costs while helping them to service their clients better.

Others support exemption thresholds but remain reserved about a second tier audit, especially if any alternative assurance implies a de facto audit, albeit under another name. On the question of a 'safe harbour' there are mixed views as independence should remain the pillar of all audits, big or small.

Investors

Among those who responded, there was a general understanding that "an audit is an audit" and that there is no value for investors in having a 'less than true and fair view' audit for SMEs. Some also raised doubts if limited audit would be able to provide the necessary assurance for the purposes of compiling the parent's (non-SME) audited consolidated accounts. Nevertheless, some investors thought that a limited review could be possible for SMEs. There was no appetite among investors to support "safe harbours" or less strict internal quality control or oversight rules.

Professional bodies and associations linked to the profession

A majority do not support a limited audit. 'An audit is an audit' and should not be diluted. In any case, ISAs are scaleable. Exempted companies should be free to choose a statutory review on a voluntary basis – it should not be regulated at EU level. Confusion should be avoided when mentioning 'limited' audits.

A few respondents stated that if the EC were to prohibit non audit services, SMPs should have a "safe harbour". Very few supported a less burdensome quality control/oversight although one replied that it should be less burdensome and could be done by the local professional body.

CESR believes that international cooperation with audit oversight bodies in third countries is fundamental to addressing the issues arising from the supervision of large groups which operate in multiple jurisdictions and from the supervision of global audit networks. CEBS supports discussion with international partners and suggests that an international solution could be the most appropriate to address many of the issues raised by the Green Paper. CEIOPS made no comments.

Public Authorities

The views of the public authorities on this issue were split between those in favour of a limited audit and those arguing that a limited audit is unnecessary and might cause confusion amongst the stakeholders. Most respondents agreed that the provision of non-audit services to SME audit clients poses less of a risk than for larger public interest entities, and might be beneficial to SMEs from a cost and time perspective. Thus, they did not object to auditors of such companies being permitted to provide a wider range of non-audit services than may be provided to listed companies, provided that the degree of the auditor's objectivity is clear.

The more general view of the majority of respondents was that all audits should be conducted using the same auditing standards (for the avoidance of confusion). Some also argued that it might be good to exempt from audit a wider group of entities than is currently the case. It was, however, noted that internal control rules should stay the same.

CEBS noted that audited financial statements are currently used by banks as part of the credit granting process. Any proposal to reduce the level of assurance given on SMEs financial information could have unintended consequences for the availability of credit for such business. CESR and CEIOPS made no comments.

Academics

There is no real reason to require a statutory audit for all corporations. Most SMEs don't need one. For private entities, the users (banks, lenders, other users) should decide what type of service is needed.

Preparers, businesses and organisations of companies

SMPs feel that they are surrounded by an ever growing regulated environment which may not necessarily suit their practice or the immediate needs of their SME clients. To ensure appropriate conditions for the development of such firms, the "limited audit" or "statutory review" referred to above could be accompanied by proportionate rules on quality control and oversight by audit regulators. This would allow SMPs to reduce their administrative costs while helping them in servicing their clients better.

Some preparers think that audits adapted to the needs of SMEs would decrease the cost of audits, but at the same time they have concerns related to the fear that such adapted audit formats would not be taken seriously by banks for example thus losing credibility.

8. INTERNATIONAL CO-OPERATION

Profession

There is broad support for continuing efforts on mutual recognition and more co-operation and information exchange.

Investors

The Commission should make a clear commitment and secure political support at the highest possible level to enhancing the quality of global audit oversight. This could involve championing the commitment at G8 and G20 levels as well as securing the support of relevant bodies entrusted with financial stability responsibilities.

Professional bodies and associations linked to the profession

There should be enhanced mutual reliance (recognition) at both EU & global level; more convergence in standards, ethics and public oversight practices.

Public Authorities

There was support for agreements with third countries in respect of information sharing and international collaboration.

Academics

There should be international co-operation

Preparers, businesses and organisations of companies

Preparers fully support any initiatives that would lead to increase international cooperation between audit regulators as this is obviously the only efficient way to conduct audit inspections of large networks. However, they recognise the difficulty of the task as it concerns the flow of sensitive business and commercial data.

ANNEX 2. EXISTING EUROPEAN UNION LEGAL FRAMEWORK ON STATUTORY AUDITS

This annex describes the existing European Union legal framework on statutory audits:

- (1) Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts²²². Directive 2006/43/EC is the most important piece of EU legislation regarding the conduct of statutory audits in the EU.
- (2) the EU legal texts that require a statutory audit. Directive 2006/43/EC does not establish when the statutory audit of annual and consolidated accounts should be undertaken.

(1) Directive 2006/43/EC

This Directive establishes a minimum level of harmonisation concerning: (a) rules on the approval, continuing education, mutual recognition and registration of statutory auditors and audit firms; (b) the professional ethics principles to be applied by statutory auditors and audit firms to guarantee their objectivity and independence; (c) the audit standards to be applied and the reporting obligations; (d) principles of oversight of statutory auditors and audit firms' compliance with their obligations; (e) the rules on the appointment of auditors; (f) the special provisions for the statutory audits of public-interest entities and (g) relations with third countries. Finally (h), this Directive is complemented by two important Commission Recommendations on external quality assurance and civil liability.

(a) Approval, continuing education, mutual recognition and registration of statutory auditors and audit firms

The Directive establishes that a statutory audit may only be carried out by statutory auditors or audit firms which are approved by the Member State requiring the statutory audit.

- Statutory auditor: a natural person who is approved in accordance with the Directive by the competent authorities of a Member State to carry out statutory audits.
- Audit firm: a legal person or any other entity, regardless of its legal form, that is approved in accordance with the Directive by the competent authorities of a Member State to carry out statutory audits. The auditors carrying out the statutory audit on behalf of the audit firm should be "statutory auditors" approved in the Member State concerned.

It also sets some conditions regarding good repute and educational qualifications for statutory auditors and on ownership restrictions for audit firms.

The Directive contains rules on the type of educational qualifications and professional training auditors must follow. An auditor may be approved to carry out a statutory audit only after having attained university entrance or equivalent level, following which he or she has

²²² OJ L 157, 9.6.2006, p. 87.

completed a course of theoretical instruction, undergone practical training and passed an examination of their professional competence.

A statutory auditor approved in one Member State may follow a specific procedure to obtain approval in another Member State. This procedure requires passing an aptitude test which is subject to some conditions. It must be conducted in one of the languages permitted by the language rules applicable in the Member State concerned and must cover only the statutory auditor's knowledge of the laws and regulations of that Member State in so far as they are relevant to statutory audits.

The Member States must ensure that all approved statutory auditors and audit firms are recorded in a register which is accessible to the public and which contains certain minimum information concerning the statutory auditors and audit firms. They must also ensure that statutory auditors and audit firms notify the competent authorities in charge of the public register without undue delay of any change of information contained in the public register.

(b) Professional ethics principles to be applied by statutory auditors and audit firms to guarantee their objectivity and independence

The Directive sets out some general principles concerning professional ethics, independence, objectivity, confidentiality and professional secrecy.

All statutory auditors and audit firms are subject to principles of professional ethics, covering at least their public-interest function, their integrity and objectivity and their professional competence and due care.

Member States must ensure that, when carrying out a statutory audit, the statutory auditor and/or the audit firm is independent of the audited entity and is not involved in the decision-taking of that entity. A statutory auditor or an audit firm must not carry out a statutory audit if there is any direct or indirect financial, business, employment or other relationship between the statutory auditor, audit firm or network and the audited entity.

All information and documents to which a statutory auditor or audit firm has access when carrying out a statutory audit must be protected by adequate rules on confidentiality and professional secrecy.

Audit fees should not be influenced or determined by the provision of additional services to the audited entity or based on any form of contingency.

(c) Auditing standards and reporting obligations

The Directive does not directly prescribe the auditing standards to be applied by statutory auditors or audit firms when carrying out a statutory audit. It empowers the Commission to decide on the applicability of international auditing standards within the EU. However, the Commission has not yet taken a decision on this issue. As a result, at present, Member States are free to determine the applicable audit standards; these may be international auditing standards or other.

The outcome of the audit process is the audit report prepared by the statutory auditor or the audit firm. Where an audit firm carries out a statutory audit, the audit report must be signed at

least by the statutory auditor carrying out the audit on behalf of the audit firm. This report shall contain the following information²²³:

- (a) an introduction, which shall at least identify the annual accounts that are the subject of the statutory audit, together with the financial reporting framework that has been applied in their preparation;
- (b) a description of the scope of the statutory audit which shall at least identify the auditing standards in accordance with which the statutory audit was conducted;
- (c) an audit opinion, which shall state clearly the opinion of the statutory auditors as to whether the annual accounts give a true and fair view in accordance with the relevant financial reporting framework and, where appropriate, whether the annual accounts comply with statutory requirements; the audit opinion shall be either unqualified, qualified, an adverse opinion or, if the statutory auditors are unable to express an audit opinion, a disclaimer of opinion;
- (d) a reference to any matters to which the statutory auditors draw attention by way of emphasis without qualifying the audit opinion;
- (e) an opinion concerning the consistency or otherwise of the annual report with the annual accounts for the same financial year.

(d) Principles of oversight of statutory auditors and audit firms' compliance with their obligations;

The Directive establishes some obligations regarding the supervision of statutory auditors and audit firms.

Concerning quality assurance, Member States are obliged to organise a system of quality assurance for statutory audits that must meet the criteria laid down in the Directive. This system shall have sufficient funding and resources and be independent from the reviewed auditors and firms. The scope of the quality assurance review, supported by adequate testing of selected audit files, shall include an assessment of compliance with applicable auditing standards and independence requirements, of the quantity and quality of resources spent, of the audit fees charged and of the internal quality control system of the audit firm. Quality assurance reviews shall take place at least every 6 years.

Also, effective systems of investigations and penalties must be put in place in order to detect, correct and prevent inadequate execution of statutory audits.

In addition, Member States must organise an effective system of public oversight for statutory auditors and audit firms, governed by non-practitioners who are knowledgeable in the area of statutory audit. The system of public oversight shall have the ultimate responsibility for the oversight of: (a) the approval and registration of statutory auditors and audit firms; (b) the adoption of standards on professional ethics, internal quality control of audit firms and

²²³ The content of the audit report is governed by Article 51a of Directive 78/660/EEC (Fourth Council Directive of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies)

auditing, and (c) continuing education, quality assurance and investigative and disciplinary systems.

National competent authorities are required to cooperate at EU level.

Supervision is based on the principle of home-country regulation and oversight by the Member State in which the statutory auditor or audit firm is approved and the audited entity has its registered office.

(e) Rules on the appointment of auditors

The Directive requires that the general meeting of shareholders appoints the auditor and that statutory auditors and audit firms are dismissed only where there are proper grounds.

(f) Special provisions for the statutory audits of public-interest entities

Each public-interest entity must have an audit committee responsible for, among other things,:

- (a) monitoring the financial reporting process;
- (b) monitoring the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
- (c) monitoring the statutory audit of the annual and consolidated accounts; and
- (d) reviewing and monitoring the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity.

This committee shall also make a recommendation to the board of the company on the choice of auditor.

Statutory auditors and audit firms of public-interest entities are required to publish an annual transparency report. They are also subject to stricter independence requirements, including the obligation to rotate the key audit partner responsible for the audit of a particular entity every 7 years. The quality assurance reviews must place at least every 3 years.

(g) Relations with third countries

The competent authorities of a Member State may approve a third-country auditor as a statutory auditor if that person has furnished proof that he or she complies with requirements equivalent to those laid down in the Directive.

The Directive also establishes rules concerning the cooperation between national competent authorities and authorities of third countries concerning the supervision of auditors and firms, notably regarding the transfer of audit working papers.

(h) Commission Recommendations.

Commission Recommendation of 6 May 2008 on external quality assurance for statutory auditors and audit firms auditing public interest entities²²⁴ provides guidance to Member States on establishing an independent and effective system of inspections on the basis of the Directive on Statutory Audit. In essence, this Recommendation gives more responsibilities to the public oversight bodies, strengthens the independence of inspection teams and enhances the transparency of the results of inspections of individual audit firms.

²²⁴ OJ L 120, 7.5.2008, p. 20.

The main purpose of the Commission Recommendation of 5 June 2008, concerning the limitation of the civil liability of statutory auditors and audit firms²²⁵, is to encourage the growth of non-Big Four audit firms assuming that auditor liability is a major barrier to entry into the markets for audits of large and listed companies. This Recommendation leaves it to Member States to decide on the appropriate method for limiting liability, and introduces a set of key principles to ensure that any limitation is fair for auditors, the audited companies, investors and other stakeholders.

(2) EU legal texts establishing the obligation to have a statutory audit

The obligation to have a statutory audits is established in different legal texts. A first group of texts requires certain types of legal entities (depending of their legal form) to have their accounts audited. A second group of texts address public-interest entities depending on their activity: i.e. financial institution or listed company. These legal texts are briefly described in the following table ([figure A2.1](#)).

Figure A2.1 – Existing legal framework

Existing legal framework	Main features
Companies required to have their accounts audited under EU legislation	
1. General requirements according to the legal form (harmonisation of company law)	
4 th Company Law Directive (78/660/EEC) on the annual accounts of certain types of companies	Requires the audit of annual accounts of limited liability companies (approx 7.3 million). Member States may exempt small companies from statutory audit requirement. There is no harmonised threshold for exemption from audit.
7 th Company Law Directive (83/349/EEC) on consolidated accounts	Requires the audit of 'consolidated accounts' of limited liability companies (approx 150,000).
Council Regulation 1435/2003 on the Statute for a European Cooperative Society (SCE)	Requires the drawing-up, auditing and disclosure of the annual accounts, and the consolidated accounts if any, of the SCE, subject to the law of the State in which it has its registered office, giving effect to the EU legislation in force.
Council Regulation 2157/2001 on the Statute for a European company (SE)	Requires the preparation of the annual and, where appropriate, consolidated accounts including the accompanying annual report and the auditing and publication of the accounts of the SE, subject to the rules applicable to public limited-liability companies, under the law of the Member State in which its registered office is situated (exceptions when the SE is an insurance undertaking or credit or financial institution)
11 th Council Directive 89/666/EEC concerning disclosure requirements in respect of branches opened in a Member State by certain types of company governed by the law of another State	The branch no longer needs to publish branch accounts but it must publish the annual accounts and annual report of the company as audited and published in accordance with the law of the Member State by which the company is governed, in accordance with Directives 78/660/EEC, 83/349/EEC and 84/253/EEC.

²²⁵ OJ L 162, 21.6.2008, p. 39.

Existing legal framework	Main features
2. Specific Requirements for public-interest entities	
2.1. Listed companies	
Directive 2004/109/EC on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market	Requires the audit of the annual financial statements and of the consolidated accounts of issuers whose transferable securities (including any class of shares and debt) are admitted to trading on a regulated market and whose home state is a Member State of the EU.
Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and Commission Regulation (EC) No 809/2004 implementing Directive 2003/71/EC as regards information contained in prospectuses as well as the format, incorporation by reference and publication of such prospectuses and dissemination of advertisements	Requires the audit of the financial statements that form part of the prospectus published when issuing securities.
2.2. Insurance undertakings	
Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II)	Requires the audit of annual and consolidated accounts of direct life and non-life insurance and reinsurance undertakings. Some undertakings are excluded from the scope due to their size or type of operation or activity of the undertaking.
<i>Directive 2005/68/EC on reinsurance</i>	<i>Requires the audit of annual and consolidated accounts of reinsurance undertakings. The Directive will be applicable until 31/10/2012, as it has been repealed by Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).</i>
<i>Directive 2002/83/EC concerning life assurance</i>	<i>Requires the audit of annual and consolidated accounts of life assurance undertakings. The Directive will be applicable until 31/10/2012, as it has been repealed by Directive 2009/138/EC on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II).</i>
<i>Council Directive 92/96/EEC on the coordination of laws, regulations and administrative provisions relating to direct life assurance</i>	<i>Partially repealed by Directive 2002/83/EC.</i>
Council Directive 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings	Adapts the 4 th and 7 th Company Law Directives to the annual and consolidated accounts of insurance undertakings.
2.3. Credit institutions	

Existing legal framework	Main features
Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions	Requires the audit of annual and consolidated accounts of business of credit institutions. Excluded from the scope of the Directive are the central banks of Member States and some specific credit institutions in a number of Member States.
Council Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions	Adapts the 4 th and 7 th Company Law Directives on the annual and consolidated accounts of banks and other financial institutions. Possibility for Member States not to require statutory audit of public savings banks where the statutory audit of the documents of those undertakings is undertaken by an existing supervisory body for those savings banks at the time of the entry into force of this Directive and where the person responsible complies at least with the minimum conditions set out in the Statutory Audit Directive.
2.4. Other financial institutions: investment firms, payment institutions, UCITS and e-money institutions	
Directive 2004/39/EC on markets in financial instruments	Requires the audit of annual and consolidated accounts of investment firms.
Directive 2007/64/EC on payment services in the internal market	Unless exempted under Directive 78/660/EEC and, where applicable, Directives 83/349/EEC and 86/635/EEC, the annual accounts and consolidated accounts of payment institutions shall be audited by statutory auditors or audit firms within the meaning of Directive 2006/43/EC.
Directive 2009/65/EC on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)	Requires the audit of annual and consolidated accounts of undertakings for collective investment in transferable securities (UCITS). Excluded from the scope of the Directive are several forms of collective investment undertakings.
Directive 2009/110/EC on the taking up, pursuit and prudential supervision of the business of electronic money institutions	Article 3(1), by references to Directive 2007/64/EC, requires the audit of accounts of e-money institutions.

ANNEX 3. APPROVED STATUTORY AUDITORS AND AUDIT FIRMS

This annex presents an estimation of the number of statutory auditors and audit firms approved in EU Member States.

Figure A3.1

Member State	Statutory Auditors	Audit Firms	Source of data	Date
Belgium	1044	513	Belgian public oversight authority	April 2010
Bulgaria	636	94	Bulgarian Commission for public oversight of statutory auditors (CPOSA).	June 2011
Czech Republic	1338	357	Ministry of Finance	June 2011
Germany	13866	2631	WPK	January 2011
Denmark	4479	1835	Danish Commerce and Companies Agency	June 2011
Estonia	344	200	Estonian Auditors Activities Register http://www.audiiitortegevus.e	March 2010
Greece	977 (4 operating as sole practitioners)	24	Greek oversight body	June 2011
Ireland	see below UK for combined figures			
Spain	5655	1354	Spanish Registry	December 2010
France	14500	4500	CNCC	June 2011
Hungary	3324	2000	Chamber of auditors	2011
Italy	140000	21 audit firms registered with Consob (for PIEs). Approximately 300 audit firms registered with CCRC.	CNDCEC (for auditors) CONSOB	May 2011 June 2011
Cyprus	450	250	FEE	July 2006
Latvia	173	160	LACA	2011
Lithuania	397	189	Chamber of auditors (LCA)	2011
Luxembourg	421	100	CSSF	2011
Malta	967	36	Ministry of Finance	March 2011
Netherlands	15 audit firms registered with AFM for audits of PIEs 466 auditors or firms registered with AFM		AFM	June 2011
Austria	156	378	QKB	June 2011
Poland	3529 (practicing)	1804	Ministry of Finance	March 2011
Portugal	1159	189	CMVM & Ordem dos Revisores Oficiais de Contas	December 2010

Romania	3241	851	Chamber of auditors	December 2009
Slovak Republic	818	237	FEE	June 2006 (auditors)
			Udva.sk	June 2011 (firms)
Slovenia	219	52	Anr.si	December 2009
Finland	1448	74	AB3C	January 2011 (auditors)
				August 2009 (firms)
Sweden	4100	125	Supervisory Board of public accountants	June 2011
United Kingdom	27050	7843	Auditregister.org.uk	June 2011
			Joint register IE/UK	

ANNEX 4. OVERVIEW OF RECENT INSPECTION REPORTS OF AUDITOR OVERSIGHT BODIES

This annex presents an overview of recent inspection reports of Auditor Oversight Bodies from 5 of the 6 biggest EU economies²²⁶; France, Germany, Italy, the Netherlands and the UK. These reports show that audit quality is not a given and that it must be considerably improved.

(1) France

The inspections carried out by the French Public Oversight Body in 2009, "*Haut Conseil du Commissariat aux Comptes*" (H3C), revealed deficiencies in the way statutory audits are currently carried out in the French market for audit services. As a general point, the H3C noted that there is a lack of formalisation and documentation in the performance of statutory audit:

*"Ce défaut est patent en ce qui concerne l'analyse des risques d'audit, leur évaluation ainsi que les réponses qui sont apportées en termes de procédures d'audit mises en œuvre. Dans une moindre mesure, il a été noté que la détermination du seuil de signification n'était pas suffisamment explicitée, formalisée, voire pertinente."*²²⁷

During the inspections carried out in 2009, 272 audit engagements for PIEs were examined and for more than 12% (35 audit engagements for listed companies and financial institutions) concerns were raised regarding the lack of sufficient information to support the audit opinion, the incoherence of the audit opinion itself and errors in the financial information of the audited entity that were not detected by the statutory auditor or audit firm:

*"Tout d'abord, le secrétaire général a relevé pour 54 mandats, dont quatre relatif aux sociétés cotées, que les diligences réalisées par le signataire du rapport d'audit n'étaient pas suffisantes pour étayer l'opinion émise et que seul l'accomplissement d'un nouvel audit aurait permis aux contrôleurs de conclure sur la pertinence de l'opinion délivrée, ce qui n'entre pas dans leur mission. Il a été constaté pour trois mandats concernant des sociétés cotées des insuffisances dans la documentation fournie et la démarche d'audit telle qu'elles ressortaient du dossier contrôlé. Concernant quatre mandats, le commissaire aux comptes n'a pas relevé lors de l'exécution de sa mission légale des erreurs dans l'information financière fournie par l'entité et n'en a pas tiré les conséquences quant à l'opinion émise. Enfin il a été noté pour six mandats dont deux concernant des sociétés cotées que l'opinion émise n'était pas, au vu des diligences mises en œuvre par les commissaires aux comptes, cohérente avec les éléments relevés par ces derniers".*²²⁸

The H3C insisted that in order to improve the quality of the audits and to reinforce the audit of the financial statements of the audited entities, it is important that the audit firms keep more records and information about the way the audit is performed. Thus, the recommendations

²²⁶ Concerning Spain, there is no publicly available information concerning the findings of the Spanish oversight body.

²²⁷ Haut Conseil du Commissariat aux Comptes (2009), p. 54.

²²⁸ *Ibid.* p. 56.

directed at those audit firms with systemic deficiencies in the quality of their audits, were focused, among others, on the respect of the rules on independence, on the need to develop a better methodology to audit the consolidated accounts and on the transparency report.

(2) Germany

The German Auditor Oversight Commission (*AbschlussPrüferAufsichtskommission*) published a report in 2010 presenting the results of the inspections carried out for the years 2007-2010²²⁹. In this three year inspection cycle, at least one inspection of all auditors and audit firms subject to the procedure had been carried out. In general, *"the inspection findings in this report show that there is still room for improvement in terms of audit quality."*²³⁰

The report presents findings regarding (i) the system of quality control, (ii) the performance of audit engagements in the context of the financial markets and economic crisis as well as (iii) other findings.

The main relevant findings are presented below.

i). Findings on the system of quality control

Concerning *client acceptance procedure and independence*, the following findings (objections), were made²³¹.

- *"conclusive assessment of the client and engagement risk only after submission of the offer to the company to be audited or only after the firm was chosen as annual auditor at the shareholders meeting of the company to be audited;*
- *dispatch of the engagement confirmation letter to the chairman of the supervisory board of the company to be audited only after the start of the audit process;*
- *the completeness and up-to-datedness of the ownership structure of the company to be audited recorded in the systems of the firm, which are necessary in the case of complex group structures to check the independence and to identify possible conflicts of interest, are not consistently guaranteed.*
- *breach of internal firm policies on the possession and disclosure of securities investments and on maintaining data in the systems set up to record corresponding transactions through individual employees;*
- *completeness and correctness of the information in the databases set up for monitoring the obligations for internal rotations not guaranteed for all clients and professionals subject to rotation requirements."*²³²

²²⁹ Abschlussprüferaufsichtskommission (2010).

²³⁰ *Ibid.*, p.3.

²³¹ The assessment of the risks associated with the engagement during the client acceptance and continuing process as well as the measures and systems to ensure the independence of the firm and the personnel entrusted with performing an engagement are checked during all inspections because of their special significance for the public's trust in the auditor's work. Large firms must maintain comprehensive systems and internal controls due to the size and international network of their organisations in order to ensure the adherence to national and international requirements in relation to client acceptance and independence.

Concerning *partner evaluation and remuneration*, it was observed, in individual cases, that **"the partner appointment, assessment and remuneration systems did not provide for any sufficient performance incentives to secure the audit quality. Instead, economic and acquisition aspects were put to the foreground. There was also, partly, a lack of consistent sanctioning of revealed quality defects."**²³³

Concerning *engagement quality control review*, it was repeatedly observed that the required engagement quality control review was not made at suitable points in time during the engagement process or did not include all audit steps. Furthermore, there were some indications that the engagement quality control review was not always carried out with sufficient professional due care. In individual cases, the engagement quality control review was also carried out by persons who were themselves involved in conducting the audit.

ii) Findings on the performance of audit engagements in the context of the financial market and economic crisis

Concerning the *assessment of the risks of breaches and irregularities (fraud)*, it was frequently observed that the necessary interviews with the management, the supervisory bodies and other persons regarding the risk of errors and fraud were either not documented by the auditor or it was apparent from the documentation that merely a formulaic interview which was not tailored to the company's individual circumstances had taken place. In many cases, the risk that the management may suspend control measures that appear effective was not counteracted with suitable audit procedures.

Concerning the *audit of the Going Concern assumption*, repeatedly, a lack of sufficient and appropriate audit procedures was recognisable with regard to the assessment of the forecast procedure and the underlying assumptions which the management had made as a basis for its positive going concern assumption, although the client's economic situation would clearly have required this.

Concerning the *audit of the measurement of goodwill and other assets as well as the review of accounting estimates*, it was observed, in many cases, that *"the auditor had not performed a sufficient evaluation of the measurement methods applied by the audited company and the underlying significant assumptions and data or at least had not documented their evaluation comprehensibly in the working papers"*²³⁴. When checking the recoverable amount of goodwill, it was frequently observed that the business plans had not been recognisably assessed in terms of its plausibility. Furthermore, there was often a lack of a comprehensible assessment of the used discount rate.

iii) Other findings

The German Audit Oversight Commission found, with regard to the implementation of a risk-based audit approach, that in some cases there was a lack of appropriate risk assessment at the beginning of the audit, making it impossible to plan the audit properly.

Other findings referred to the assessment of the company's internal control system. In a series of audits, no assessment of the design of control activities which were relevant for the audit

²³² Abschlussprüferaufsichtskommission (2010), p.6.

²³³ *Ibid.* p. 7. Emphasis added.

²³⁴ *Ibid.* p. 9.

was performed. In other cases, insufficient understanding of the control measures of the company was gained during the assessment of the internal control system.

Consequently, essential information on the controls was not documented in the working papers. Likewise, errors occurred in the conduct of the effectiveness test of the internal controls; among others, insufficient and inappropriate evidence had been obtained for the implementation of the controls by the responsible persons in the audited company, and the scope of random tests was not sufficient to be able to derive a conclusion on the efficiency of the controls.

In a series of inspected audit engagements, the connection between the risk assessment and the result of the audit of the internal control system on the one hand and the determination of the type, scope and timing of the substantive audit procedures on the other hand were not coherent on the basis of the audit working papers. This was particularly significant in situations where the result of the audit of the internal control system should have led to an extension of the substantive audit procedures initially planned. The inspection of substantive audit procedures repeatedly revealed findings with regard to obtaining and evaluating confirmations of balances. Concerns were also raised on the fact that the selection, dispatch and response to inquiries were not under the auditor's control, no additional audit evidence was obtained in cases of a confirmation date deviating from the balance sheet date and no appropriate alternative audit procedures were performed for unanswered confirmation requests.

In some cases, it was also not comprehensible that the auditor had achieved sufficient appropriate audit evidence in the inspected audit area on the basis of the tests of controls and substantive audit procedures undertaken.

Following these findings, the Audit Oversight Commission decided in several cases, depending on the circumstances of the individual case, to take measures against the owner of the firm or the responsible professionals to ensure the enforcement of professional standards, in particular disciplinary proceedings. **On average, 25% of the completed inspections between 2007 and 2010 led to disciplinary proceedings²³⁵.**

(3) Italy

In Italy, Consob supervises the activity of 21 audit firms that are registered to carry out audits of PIEs²³⁶.

A major part of Consob's supervision relates to the internal organisation of audit firms, in particular internal **quality control**.

- **In 2009**, the Italian supervisor, Consob, supervised the statutory auditors and audit firms of PIEs through systematic preventive quality control action and enforcement in specific cases. With regard to the quality controls, to verify the existence and correct application of the internal control procedures, 3 inspections were launched in 2008. For these firms, Consob has already formulated specific recommendations on the action to be taken to remedy shortcomings discovered during the inspections and the related implementation

²³⁵ *Ibid.* p. 11 and seq.

²³⁶ See Consob (2010) and Consob (2011).

deadlines.

Follow-up action was also taken in relation to a further 3 independent auditors subject to verification in 2007-2008, regarding the assessment of organisational remedies adopted by the firms to correct shortcomings emerging during investigations.

In 2009 a further 8 inspections of independent auditors were launched, 2 of which were completed during the year. The aim of the supervision concentrated on assessing the adequacy and correct application of quality control procedures pursuant to Document no. 220, recommended by Consob, on "Quality control of independent auditing".²³⁷

- **In 2010**, Consob checked, in respect of 7 audit firms, the internal control procedures set out in Legislative Decree no. 39/2010 and provided the firms concerned with the final reports containing measures to be put in place in order to overcome the deficiencies identified. In 2010, Consob ensured the follow-up of the actions taken against 3 large audit firms which were inspected in 2008-2009. Also in 2010, five inspections were initiated to assess audit firms' organisational structure and quality control procedures. The aspects verified were the adequacy, efficiency and the effective implementation by the audit firms of their quality control procedures, and the firm's relations with their own international networks in order to analyse the process of implementation of guidelines and standards issued by the global network. For the audit firms with a limited scale of operations, the inspections also covered the examination of some selected audit engagements.²³⁸

Consob also examined the **network dimension of audit firms**.

- Thus controls in 2009 covered relations with firms in the respective international networks, also with the aim of rebuilding the process of local implementation of guidelines and standards issued by the networks at global level.
- In 2010, concerning the Big Four audit firms, **Consob found it difficult in some cases, based on the existing legislation, to identify what constitutes a "network":** *"Rispetto alle "big four", in alcuni casi è emersa la difficoltà ad accertare l'esistenza di una "rete", così come definita sulla base delle disposizioni di legge e regolamentari, ovvero la mancanza di consapevolezza dell'appartenenza a una rete".* **This has consequences for the auditor independence as it leads to an under-estimation of the risk of conflict of interest arising from the fact that the same audit firms that perform the audits provides other services to other entities belonging to the same network.** Therefore, Consob recommended measures to strengthen procedures for the verification of declarations of independence.

Consob has also identified cases of **irregularities regarding audits of financial statements**:

²³⁷ Consob (2010), p. 111.

²³⁸ Consob (2011), p. 175.

- In 2009, letters of notice were issued to 2 auditors after confirmation of audit irregularities concerning the 2006 and 2007 financial statements of a listed issuer and the 2007 annual report of an issuer of widely-distributed financial instruments.
- In 2010, Consob sent 4 letters of complaint to three audit firms on the Special Register following the identification of serious irregularities related to the audits of the accounts of three listed companies and a broker: *"Per quanto concerne l'attività di enforcement, nel corso dell'anno sono state trasmesse 4 lettere di contestazioni nei confronti di 3 società iscritte nell'Albo Speciale, ai sensi dell'art. 163 del Tuf, a seguito dell'accertamento di gravi irregolarità sui lavori di revisione relativi ai bilanci di 3 emittenti quotati e di un intermediario finanziario"*.²³⁹

The allocation of work has resulted in some problems:

- In 2010, the proper allocation of resources to the tasks was identified as a problem in some cases. The persons composing the team werenot selected according to the nature and risks of the tasks. In such cases, it was recommended that the workforce be supplemented with staff having the appropriate professional qualifications and experience.
- Deficiencies were identified in the process for the appointment of the second or independent partner reviewer whose responsibility is to review the work of the team, before an opinion is issued: *"Inoltre, sono state generalmente riscontrate carenze nel processo di nomina del cosiddetto second partner reviewer o independent reviewer e nella documentazione dell'effettivo riesame svolto da tale figura professionale indipendente, incaricata di riesaminare il lavoro svolto dal team, prima dell'emissione dell'opinione."*²⁴⁰

Also, Consob raised some **concerns regarding the audit of accounts in the context of the crisis**²⁴¹.

In 2009, in relation to audits of the financial statements as at 31 December 2008, statutory auditors were called upon to comply with the rules of Document no. 570 on "Going concern" (recommended by Consob in November 2007), which governs auditors assessments of going concern assumptions and provides useful indications on the correct application of this principle in the specific context of the financial crisis.

The financial crisis had considerable effects on Italian listed companies, leading to tension and going concern difficulties that called for an increase in the content of the accounting and financial disclosures made by listed companies.²⁴²

In 2009, the Italian supervisor, Consob, noted an increase in the number of requests to publish accounting disclosures by listed companies²⁴³ compared to previous years

²³⁹ *Ibid.* (2011), p. 176.

²⁴⁰ *Ibid.* (2011), p. 50

²⁴¹ Consob (2010), p. 112.

²⁴² *Ibid.*, p. 96.

²⁴³ *Ibid.*, p. 95.

when the number of requests to publish supplements to periodic financial reports was 6 in 2006, 1 in 2007 and 21 in 2008,. In 2009, the number of such requests was 59²⁴⁴.

(4) The Netherlands

The Netherlands Authority for the Financial Markets (AFM) published in September 2010 a report on the general findings regarding the quality of audits and quality control monitoring at the four largest audit firms in the Netherlands: Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers (the Big Four audit firms). In this report²⁴⁵, the AFM highlighted the need for the fundamental improvement of audits²⁴⁶.

The inspections carried out: in 2009 and 2010, the AFM carried out regular inspections of audits of 2008 financial statements of companies and institutions in sectors particularly affected by the crisis, including the financial, construction/real estate and automotive sector. The audits reviewed by the AFM were conducted by the Big Four audit firms, which have a total market share of about 80 percent in terms of revenue from statutory audits conducted in the Netherlands. As part of its regular inspections, the AFM also focused on quality control monitoring at the Big Four audit firms, including engagement quality control reviews, internal quality reviews and the compliance function. In addition to its regular inspections, the AFM investigated a number of incidents.

Findings

The AFM found **positive elements** and thus: "*established that quality has been given a higher priority by the Big 4 firms compared with the outcome of previous inspections. Awareness has clearly increased, as has the readiness to take action to improve quality. Partly as a result of the AFM's supervision, progress has been made in these areas*"²⁴⁷.

At the same time, the AFM's review findings **highlighted systemic deficiencies in the quality of audits of more than one Big Four audit firm**²⁴⁸.

Main conclusions of the report

The main conclusions of the report are the following:

"The key deficiencies identified at several Big 4 firms were as follows:

- *External auditors failing to exercise sufficient and appropriate professional skepticism in the conduct of their audits. If audits are not conducted with professional skepticism, there is a risk of material errors in the financial statements going undetected and of incorrectly issuing an unqualified audit opinion. In the case*

²⁴⁴ *Ibid.*, p. 96.

²⁴⁵ AFM (2010a).

²⁴⁶ AFM (2010b).

²⁴⁷ AFM (2010a).

²⁴⁸ The deficiencies were not restricted to audits in the financial sector; they also occurred in the construction/real estate, automotive and public sector (municipalities and housing corporations). The AFM published the results of its earlier credit crisis inspections in December 2009, revealing that the quality of audits in the financial sector required improvement. The recent inspections show that the deficiencies are more widespread and systemic.

of such uncertainties in an audit, there is insufficient assurance that the financial statements are free from material misstatement.

- *External auditors failing to apply, or apply sufficiently, auditing standards in too many cases. The AFM identified relevant weaknesses in 29 of the 46 audits reviewed in the context of its regular inspections. The most important findings related to insufficient and inappropriate audit evidence due to, among other things:*
 - *performing insufficient audit procedures to verify the existence and valuation of financial assets, work in progress, vehicles and property in the balance sheet;*
 - *performing insufficient procedures to assess whether there are indications of fraud or other non-compliance with laws and regulations;*
 - *performing insufficient procedures required when reliance is placed upon work carried out by another auditor, an internal audit department or expert;*
 - *performing insufficient procedures to assess whether the client's going concern assumption is valid;*
 - *performing insufficient procedures to ascertain the completeness of revenue.*
- *Quality control monitoring at several Big 4 firms falling short in certain respects, resulting in situations where there were insufficient safeguards to ensure that audit opinions issued or to be issued were correct and sufficiently and appropriately supported.*
- *Audit firms accepting audit quality falling short within their own organisation, and failed to take appropriate action against infringements of laws and regulations by their staff. As a consequence, audit firms failed to adequately fulfil their duty of care regarding the quality of audits.*
- *Insufficient involvement of and direction by the external auditor in the conduct of the audit by the team".²⁴⁹*

The AFM explained that the degree to which these deficiencies occurred varied both per Big four audit firm and per audit. There were therefore differences in audit quality across the audit firms reviewed.

The AFM also explained that at several Big four audit firms, the ‘tone-at-the-top’ and its impact on the firm’s behavior regarding quality could be improved (emphasis added):

*"The senior executives at the audit firm, the audit firm's policymakers and co-policymakers and the external auditors in charge of audit teams set an important example in this respect. They will have to take the lead in order to bring about the necessary change in behavior at the audit firms. In this context, **the AFM noted that the supervisory boards and audit committees of audit clients can also make a contribution to improving audit quality.** For example, they can draw attention to the*

²⁴⁹ AFM (2010a). See also AFM (2010b), p. 11 and seq.

quality of the audit by asking their own auditor for the AFM's inspection findings or by initiating a discussion on issues raised. The AFM is not allowed to share its findings with audit clients due to its duty of confidentiality"²⁵⁰.

Follow up to the report

Following the AFM's inspection reports, several Big Four audit firms took or announced measures²⁵¹.

The AFM announced that it intends to:

- monitor whether the measures taken or announced by audit firms are actually implemented;
- take formal enforcement measures against one or more Big Four firms²⁵²;
- submit one or more disciplinary complaints to the Disciplinary Court for Auditors against one or more external auditors employed or previously employed by one or more of the Big Four audit firms reviewed²⁵³; and
- carry out, in the second half of 2010 and in 2011, inspections of the Big Four audit firms focusing on *"financial incentives and their impact on the quality of audits. The AFM will focus particularly on compliance with independence rules and policies regarding appraisals, remuneration, appointments and sanctions at the firms. The AFM expects to publish its inspection findings in 2011"*²⁵⁴.

(5) United Kingdom

The 2009/2010 annual report of the Audit Inspection Unit (AUI) of the UK's Professional Oversight Board ("the Oversight Board") underlines several instances of insufficient audit quality²⁵⁵. The AUI completed full scope inspections regarding the Big Four audit firms and a fifth firm for this period²⁵⁶ and published individual inspection reports on these 5 audit firms.

The AUI report contained some **key messages to the audit profession**²⁵⁷ regarding **audit quality** of major firms²⁵⁸ (emphasis added).

<i>"Audit quality: major firms</i>

²⁵⁰ AFM (2010a).

²⁵¹ See AFM (2010b), p.19.

²⁵² AFM (2010b), p. 21. See also AFM (2010a). Formal enforcement measures may include an instruction, an order for incremental penalty payments or an administrative penalty.

²⁵³ AFM (2010b), p. 21.

²⁵⁴ AFM (2010b), p. 22.

²⁵⁵ FRC (July 2010).

²⁵⁶ Deloitte, Ernst & Young, KPMG, PKF and PwC.

²⁵⁷ FRC (July 2010), p. 2 and seq.

²⁵⁸ Major firms in the UK are those auditing more than ten entities within AUI' scope. There are 9 such firms: Baker Tilly, BDO, Deloitte, Ernst & Young, Grant Thornton, Horwath Clark Whitehill, KPMG, PKF and PwC.

The report also contains information regarding inspections of smaller firms.

The AIU's inspections in 2009/10 confirm that major firms have policies and procedures in place to support audit quality that are generally appropriate to the size of the firms and the nature of their client base. Nevertheless, improvements to these policies and procedures have been recommended at all firms.

*Notwithstanding the quality of firms' policies and procedures, **the number of audits assessed as requiring significant improvement at major firms (eight audits or 11 % of audits reviewed at major firms excluding follow up reviews) is too high.** Firms are therefore not always consistently applying their policies and procedures on all aspects of individual audits.*

Policies and procedures however can only go so far in supporting and encouraging desirable behaviours to deliver audit quality. While firms are willing to change these and to provide additional training to staff, such actions will be insufficient without effective behavioural change which is more difficult to achieve."

Other key messages related to professional scepticism, quality of audit evidence, going concern, use of specialists and provision of non-audit services to audit clients were (emphasis added):

"Professional scepticism

*Firms sometimes approach the audit of highly judgmental balances by seeking to obtain evidence that corroborates rather than challenges the judgments made by their clients. **The AIU has identified situations where differing and conflicting judgments are accepted by the same firm for clients operating in similar industries.** Some firms have processes designed to confirm consistency of key judgments across their client base; these could be considered by all firms, but they also need to be applied effectively. **Auditors should exercise greater professional scepticism particularly when reviewing management's judgments relating to fair values and the impairment of goodwill and other intangibles and future cash flows relevant to the consideration of going concern.***

Quality of audit evidence

Auditing Standards recognise that third party evidence is generally the most reliable form of audit evidence and it should be obtained wherever practicable in relation to important matters. Firms should revisit their audit approaches to ensure that appropriate consideration is given to the availability of such evidence, particularly independent confirmations of balances and that these are more frequently sought.

Going concern

Firms have responded positively to the challenges arising from the economic downturn by issuing a significant amount of guidance to audit teams to assist in their evaluation of going concern. The APB has also been active in the provision of additional guidance to assist auditors in this area.

*Notwithstanding this, **a number of shortcomings relating to the audit of going concern were identified at both major and smaller firms.** While acknowledging that much of the work in this area is done well, audit teams need to ensure that the key*

factors material to the going concern assessment in each individual case are appropriately considered and resolved.

Use of specialists

The increasing use of internal specialists, especially by major firms, to evaluate valuations performed by client specialists and to assist in the audit of other complex audit areas such as taxation and pension balances contributes to improving the quality of audit evidence obtained in these areas. Where firms make use of internal specialists they must ensure that this work is properly integrated with the work of the main audit team. In particular, it should be clear from the audit files how the audit team has responded to any matters arising from the work of specialists.

Provision of non-audit services to audit clients: Ethical Standards

Ethical Standards require firms to identify areas of potential risk to independence such as the provision of services other than the audit to an audit client. Firms need to embrace more fully the principles underlying the Ethical Standards which require threats to be mitigated by appropriate safeguards if the work is to be undertaken.

Firms are perhaps too ready to conclude that existing procedures, required in any event in the audit, provide that necessary degree of safeguard. They must accept that non-audit services should not be provided where safeguards cannot appropriately mitigate threats to their independence.

*Surveys of fee income show that the ratio of non-audit fees to audit fees for audit clients in the UK has declined over the years. However the rate of decline has been small in recent years and **the AIU is concerned that one major firm has embarked on a growth strategy where a key driver is the development of non-audit services to be provided to audit clients.***

ANNEX 5. REVENUES FROM AUDIT AND NON-AUDIT SERVICES

Changes in the revenues from audit and consultancy services between 2004/05 and 2009/10 for the Big Four audit firms in Germany.

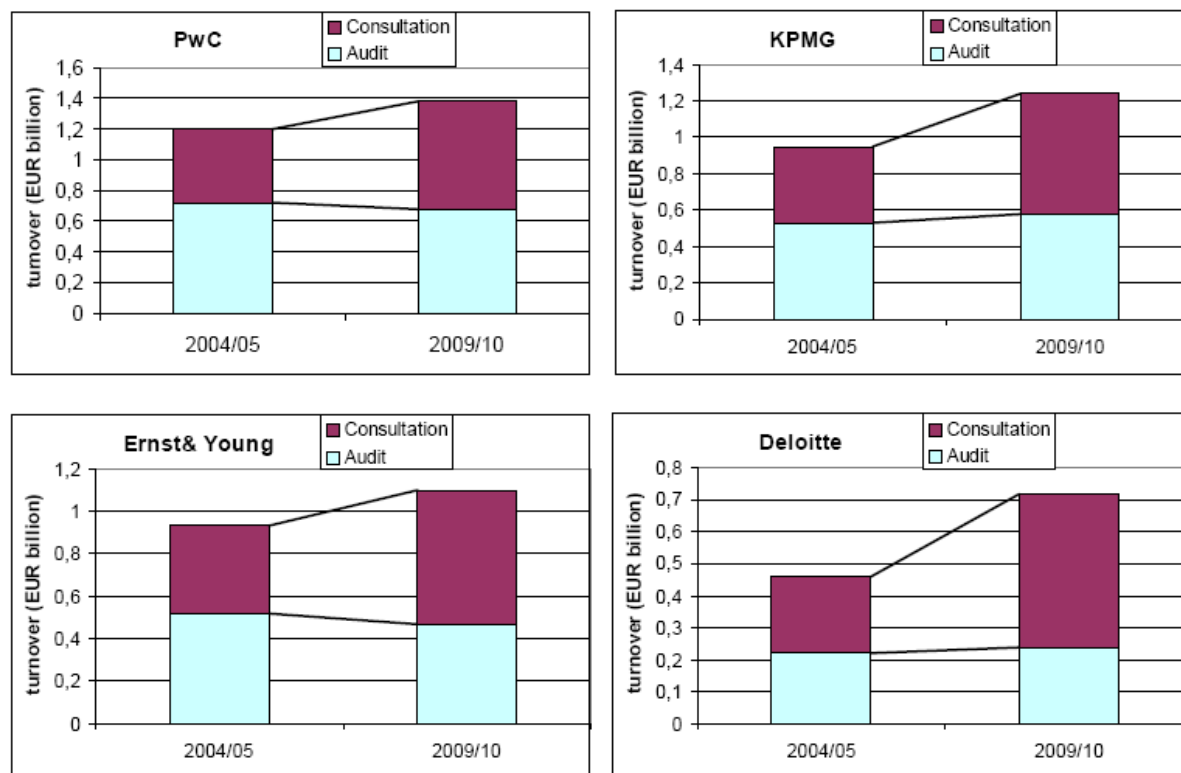


Figure A5.1. Source: Calculations made on the basis of data published in Handelsblatt, "Preiskampf im Dax: Die Branche rangelt um Mandate mit Renomme", 19 January 2011

Audit and non-audit fees in selected distressed banks in France, Iceland, Netherlands, Switzerland, UK and US.

Company	Country	Year end	Auditor	Date of audit report	Audit opinion	Fee (millions)	
						Audit	Non-audit
Abbey National	UK	31 December 2007	D and T	4 March 2008	Unqualified	£2.8	£2.1
Alliance and Leicester	UK	31 December 2007	D and T	19 February 2008	Unqualified	£0.8	£0.8
Barclays	UK	31 December 2007	PwC	7 March 2008	Unqualified	£29	£15
Bear Stearns	USA	30 November 2007	D and T	28 January 2008	Unqualified	\$23.4	\$4.9
Bradford and Bingley	UK	31 December 2007	KPMG	12 February 2008	Unqualified	£0.6	£0.8
Carlyle Capital Corporation	Guernsey	31 December 2007	PwC	27 February 2008	Unqualified	N/A	N/A
Citigroup	USA	31 December 2007	KPMG	22 February 2008	Unqualified*	\$81.7	\$6.4
Dexia	France/ Belgium	31 December 2007	PwC + Mazars and Guérard	28 March 2008	Unqualified	€10.12	€1.48
Fannie Mae	USA	31 December 2007	D and T	26 February 2008	Unqualified	\$49.3	–
Fortis	Holland	31 December 2007	KPMG + PwC	6 March 2008	Unqualified	€20	€17
Freddie Mac	USA	31 December 2007	PwC	27 February 2008	Unqualified*	\$73.4	–
Glitnir	Iceland	31 December 2007	PwC	31 January 2008	Unqualified	ISK146	ISK218
HBOS	UK	31 December 2007	KPMG	26 February 2008	Unqualified	£9.0	£2.4
Hypo Real Estate	Germany	31 December 2007	KPMG	25 March 2008	Unqualified	€5.4	€5.7
Indymac	USA	31 December 2007	E and Y	28 February 2008	Unqualified*	\$5.7	\$0.5
ING	Holland	31 December 2007	E and Y	17 March 2008	Unqualified	€68	€7
Kaupthing Bank	Iceland	31 December 2007	KPMG	30 January 2008	Unqualified	ISK421	ISK74
Landsbanki	Iceland	31 December 2007	PwC	28 January 2008	Unqualified	ISK259	ISK46
Lehman Brothers	USA	30 November 2007	E and Y	28 January 2008	Unqualified	\$27.8	\$3.5
Lloyds TSB	UK	31 December 2007	PwC	21 February 2008	Unqualified	£13.1	£1.5
Northern Rock	UK	31 December 2006	PwC	27 February 2007	Unqualified	£1.3	£0.7
Royal Bank of Scotland	UK	31 December 2007	D and T	27 February 2008	Unqualified	£17	£14.4
TCF Financial Corp	USA	31 December 2007	KPMG	14 February 2008	Unqualified	\$0.97	\$0.05
Thornburg Mortgage	USA	31 December 2007	KPMG	27 February 2008	Unqualified	\$2.1	\$0.4
UBS	Switzerland	31 December 2007	E and Y	6 March 2008	Unqualified	CHF61.7	CHF13.4
US Bancorp	USA	31 December 2007	E and Y	20 February 2008	Unqualified	\$7.5	\$9.6
Wachovia	USA	31 December 2007	KPMG	25 February 2008	Unqualified	\$29.2	\$4.1
Washington Mutual	USA	31 December 2007	D and T	28 February 2008	Unqualified	\$10.7	\$4.3

Figure A5.2. Source: Sikka (2009), Table 1: Auditors and distressed Banks.

Notes: Data as per financial statements and statutory filings shown on the respective company's website. 'Audit fee' also includes 'audit related fees'.

* Denotes that audit report draws attention to some matters already contained in the notes to financial statements

ANNEX 6. BARRIERS TO MORE COMPETITION IN THE AUDIT MARKET FOR LARGE PIES

There are a number of barriers preventing new audit firms from entering the audit market for large and listed companies. A study in 2006 concluded that "*only if the existing barriers, in terms of perception/reputation and low switching rates, could be reduced might substantial market entry by mid-tier firms become feasible*"²⁵⁹.

Barrier 1. There is asymmetric information related to the quality of auditors in the market. As a result, the selection of auditors is not based on fully informed decisions, which has made the reputation of the Big Four audit firms the most important factor for auditor choice

A study had shown that reputation is the most important factor that determines a company's choice of a provider of audit services²⁶⁰. Moreover, there is an inertia that perpetuates the effective bias towards the Big Four. This is particularly important in view of the fact that the impact on the reputation of the Big Four of the recent inspection reports that highlight fundamental weaknesses has still not resulted in any tangible shift in attitudes.

Investors and regulators underlined the need for greater transparency on audit quality. With respect to individual audits inspected, the information on the quality of these audits is not divulged to those charged with the governance of the audited company. Only in the UK, is the audit committee sent a report which contains inspection findings on audits of their company.

Barrier 2. Contract clauses effectively requiring Big Four audits

Although there is no comprehensive information on this issue, it was one of the problems mentioned during the discussions at the conference on audit organised by the Commission. The discussion revealed that on some occasions (specifically when companies apply for a bank loan) a specific clause is imposed on the company, stipulating that audits should be carried out by one of the Big Four audit firms. Furthermore, in their feed-back to the Green Paper, some investors expressed the view that audit committees should reveal to shareholders any covenants limiting the choice of the auditors.

The confidential character of such contracts has prevented any material evidence from being presented to the Commission. It is worth noting that this issue has also been mentioned in a recent report ordered by the House of Lords in the UK, while further investigation on the issue of restrictive bank covenants has been requested from the Office of Fair Trading (OFT)²⁶¹

Barrier 3. Companies rarely change an audit firm

²⁵⁹ Oxera (April 2006), page i.

²⁶⁰ Source: Study on the Economic Impact of Auditors' Liability Regimes (MARKT/2005/24/F); Final Report To EC-DG Internal Market and Services By London Economics in association with Professor Ralf Ewert, Goethe University, Frankfurt am Main, Germany; table 30, page 50; September 2006.

²⁶¹ Auditors: Market concentration and their role - Economic Affairs Committee, Report ordered by House of Commons (March 2011). CHAPTER 3: Changes to the Legislative/Regulatory Framework Governing Audit,
<http://www.publications.parliament.uk/pa/ld201011/ldselect/ldconaf/119/11906.htm#a6>

From the demand side, the rarity of instances where auditors are changed is one of the most critical deterrents to other potential market participants to enter the market for audits of listed and large companies²⁶². The available empirical evidence proves a very low level of auditor switching among Union companies. 31% of EU surveyed companies indicated that their audit firm had served them for more than 15 years²⁶³.

In relation to the UK, a recent report also shows that a FTSE 100 auditor remains in place for about 48 years on average; for the FTSE 250 the average is 36 years. Nearly all these companies have Big Four auditors. For example, Barclays has used PwC or its predecessors since 1896 and since 1978 as sole auditor²⁶⁴.

No or low level of switching leads to market stagnation (see figure A6.1). Even if other measures are taken to increase competition, any possible structural changes in the audit market would be delayed due to the low rate of switching.

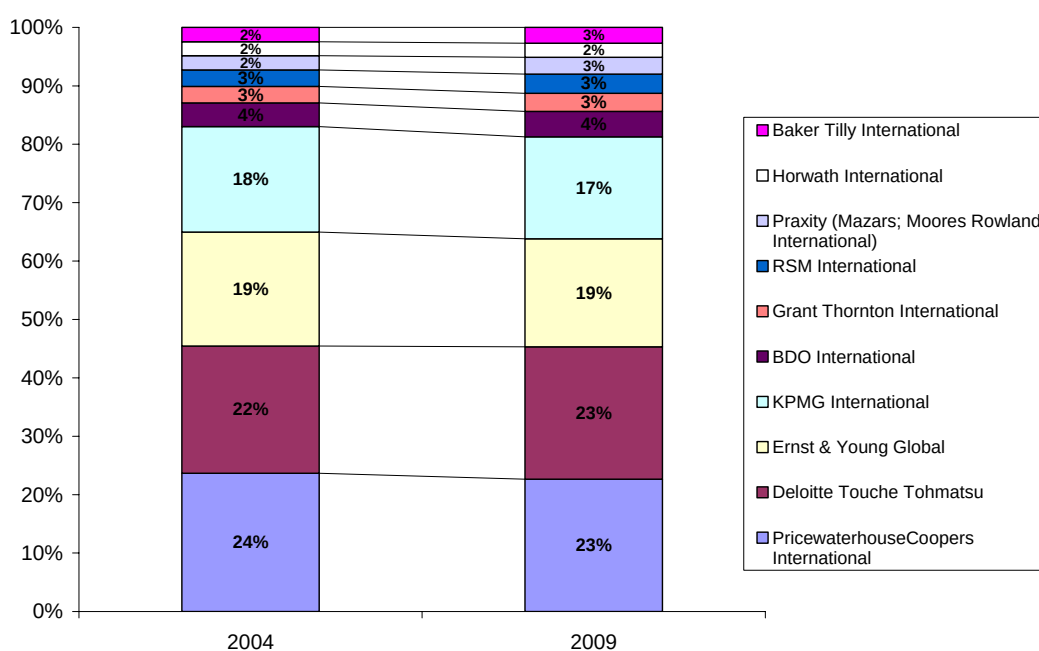


Figure A6.1. Developments in the relative market share of largest audit firm networks in terms of total world-wide revenues

Currently, there is no requirement at EU level for the rotation of audit firms. Article 42 of Directive 2006/43/EC requires Member States to "*ensure that the key audit partner(s) responsible for statutory audit rotate(s) from the audit engagement within a maximum period of seven years from the date of appointment*". Some Member States however go further requiring the mandatory audit firm rotation. It is currently present in Italy with respect to

²⁶² Source: Study on the Economic Impact of Auditors' Liability Regimes (MARKT/2005/24/F); Final Report To EC-DG Internal Market and Services By London Economics in association with Professor Ralf Ewert, Goethe University, Frankfurt am Main, Germany; table 19, page 41; September 2006

²⁶³ Study by London Economics on the Economic Impact of Auditors' Liability Regimes; September 2006, table 22, pages 43. http://ec.europa.eu/internal_market/auditing/liability/index_en.htm

²⁶⁴ Economic Affairs Committee - Second Report Auditors: Market concentration and their role (report ordered by the House of Lords 15 March 2011); <http://www.publications.parliament.uk/pa/ld201011/ldselect/ldconaf/119/11905.htm#a3>

audits of listed companies (audit firm should change after 9 years) and in Poland with respect to audits of insurance companies (after maximum 5 years with a cooling off period of 3 years). The auditor oversight authorities from both countries have not reported any difficulties with implementing this provision.

This lack of change of audit firms perpetuates and even aggravates the risk of over familiarity between auditor and 'auditee'; this in turn impairs professional scepticism, the sine qua non of an adequate audit opinion.

As regards the reasons for rare switching, companies that responded to the Green Paper expressed satisfaction with their audit firm and were unwilling to change their auditors. They justify their unwillingness by citing high costs in organising a tender or spending management time to become familiar with new auditors. When citing such 'difficulties', little or no consideration is given to the fact that such tenders would not be annual but periodic. It is also important to consider whether the management should have an opinion at all in terms of expressing satisfaction with their auditors or whether it should be a demonstrably independent body that should express an opinion on the performance of the auditor.

The information below (figure A6.2) provides more accurate information on the factors discouraging audit committee chairs from changing the company's auditor²⁶⁵. The time required from management in the event of switching auditor appears to be the most significant barrier.

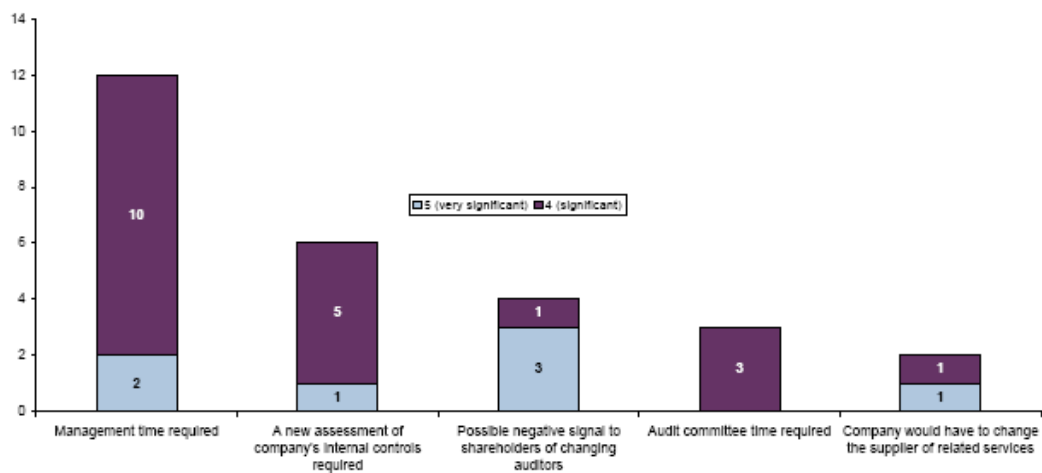


Figure A6.2. Significance attached by audit committee chairs to factors that might discourage switching (number of respondents; base: 50 respondents)

Barrier 4. Restrictive ownership rules

The Directive requires that the majority of the voting rights in a firm be held by those permitted to undertake statutory audits. The rationale for this rule is that if an audit firm were publicly owned, a danger would exist that its shareholders could include persons affiliated with the firm’s audit clients, creating conflicts of interest and damaging the independence of audit.

²⁶⁵ Competition and choice in the UK audit market, prepared by Oxera for Department of Trade and Industry and Financial Reporting Council, April 2006, figure 3.12, page 48.

The restrictive ownership rules however have led to distortions and asymmetry in the markets for statutory audit and other services. Audit firms instead of focusing mainly on audit – the very purpose of the restrictive ownership rules – have instead expanded to a plethora of non-audit services:

Example of services from PWC's website_ <http://www.pwc.com/gx/en/global-business-services>

Audit and assurance: Actuarial insurance services, Assistance with capital market transactions, Corporate reporting improvement, Financial accounting, **Financial statement audit**, Sustainability reporting, IFRS reporting, Independent controls & systems process assurance, Internal audit, Regulatory compliance and reporting, Sarbanes-Oxley compliance

Consulting: Strategy, Finance, Technology, Governance, risk and compliance, Operations, People & change, Revenue growth, Shared services and outsourcing, Sustainability, Delivering deal value, Investigations

Deals: Business recovery services, Corporate finance, Delivering deal value, Post deal services, Structuring services, Financial due diligence, Strategy, Valuations and economics, Valuation consulting, Tax valuations, Economics, Independent expert opinions, Accounting valuations, Modelling and business planning, Post deal services, Structuring services

Human resources: International assignments, Reward, HR management

Legal: Asset management, Corporate and commercial, Corporate secretarial, Dispute resolution, Employment, Financial services, Immigration, Public law, Real estate, Middle market and private companies

Tax: Global compliance services, Indirect taxes, International tax services, Mergers & acquisitions, Sustainability & climate change tax, Tax accounting services, Tax function effectiveness, Transfer pricing

Despite different reporting styles used by international audit firm networks, it could be estimated that around 40 – 50% of their revenues come from statutory audit and audit related services. The rest includes mainly advisory and tax-related services (see figure A6.3). Figures on Big Four audit firms in the UK show that audit and other related services represented only 33% of total revenues²⁶⁶.

Additionally, the restrictive ownership rules create de facto barriers to the growth of smaller audit firms. While the provision of statutory audit services is not a capital intensive business activity, organic growth through capital injections by partners does not ensure, on its own, that small and medium-sized audit firms will have enough financial means to grow.

This contributes to protecting large audit firms from competition from medium-sized firms.

²⁶⁶

Accountancy Magazine, January 2011

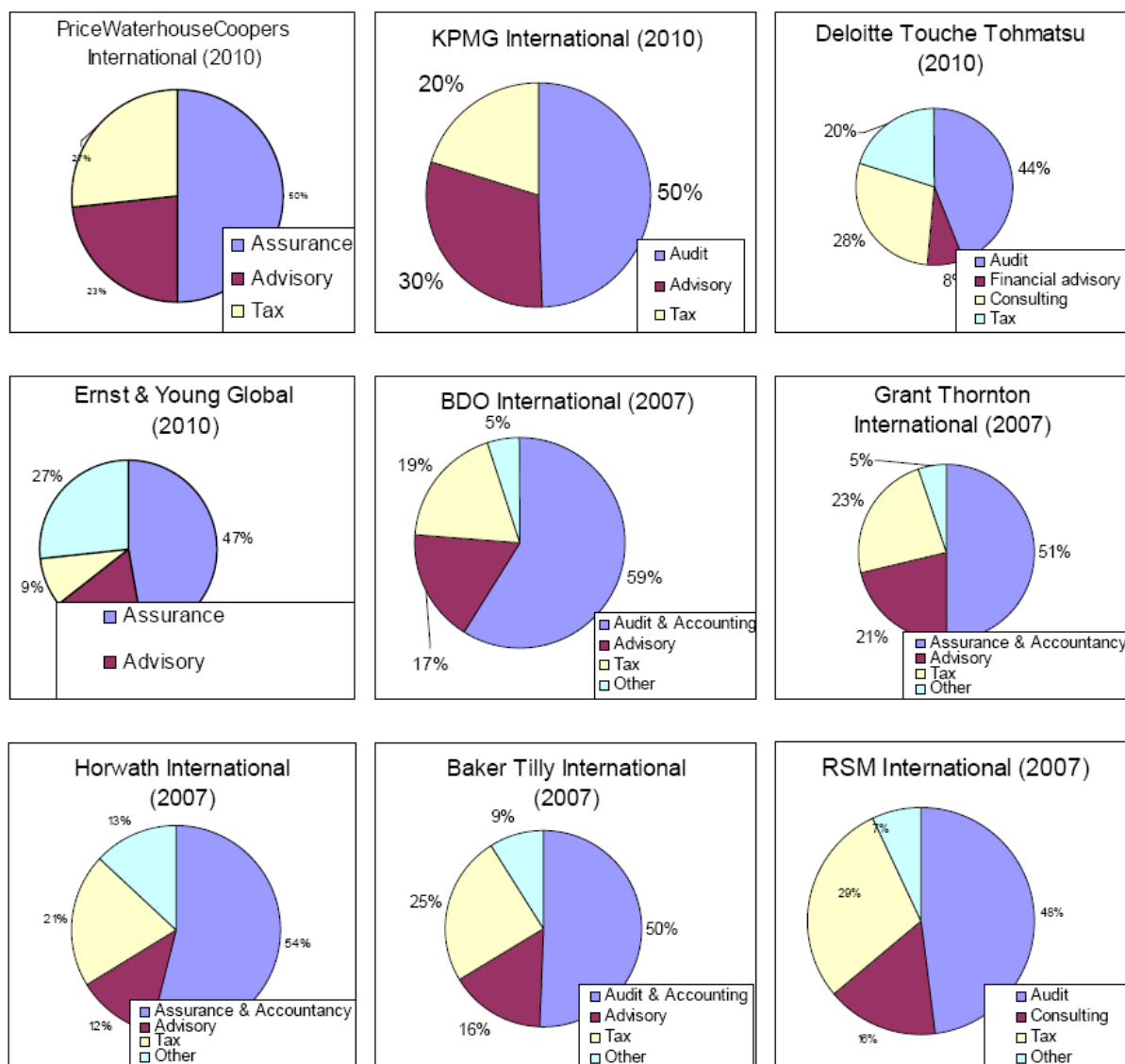


Figure A6.3. Source: audit firms' annual reports

By being able to provide both audit and NAS, audit firms (mainly the Big Four) have a competitive advantage over other providers. Audit firm capacities to cross-subsidise audit or non-audit services are an additional deterrent to enter the market for listed and large companies. For example, this practice creates significant market distortion by preventing other potential service providers of non-audit services from serving clients, to whom the Big Four are providing statutory audit, but also may deter the entry of non-Big Four firms that have less developed NAS into the statutory audit market.

ANNEX 7. MARKET CONCENTRATION

(1) History of market concentration

The past two decades have seen a process of market consolidation of large firms into even larger firms. In the late 1980s there were eight major audit firms but since 2003 there have been only four firms that audit the majority of large public companies and that derive significant income from non-auditing services. The consolidation also allows big audit firms to take advantage of economies of scale, expand industry-specific knowledge and technical expertise, and potentially increase the capital base in order to spread risk.²⁶⁷

Significant mergers of the 1980s and 1990s

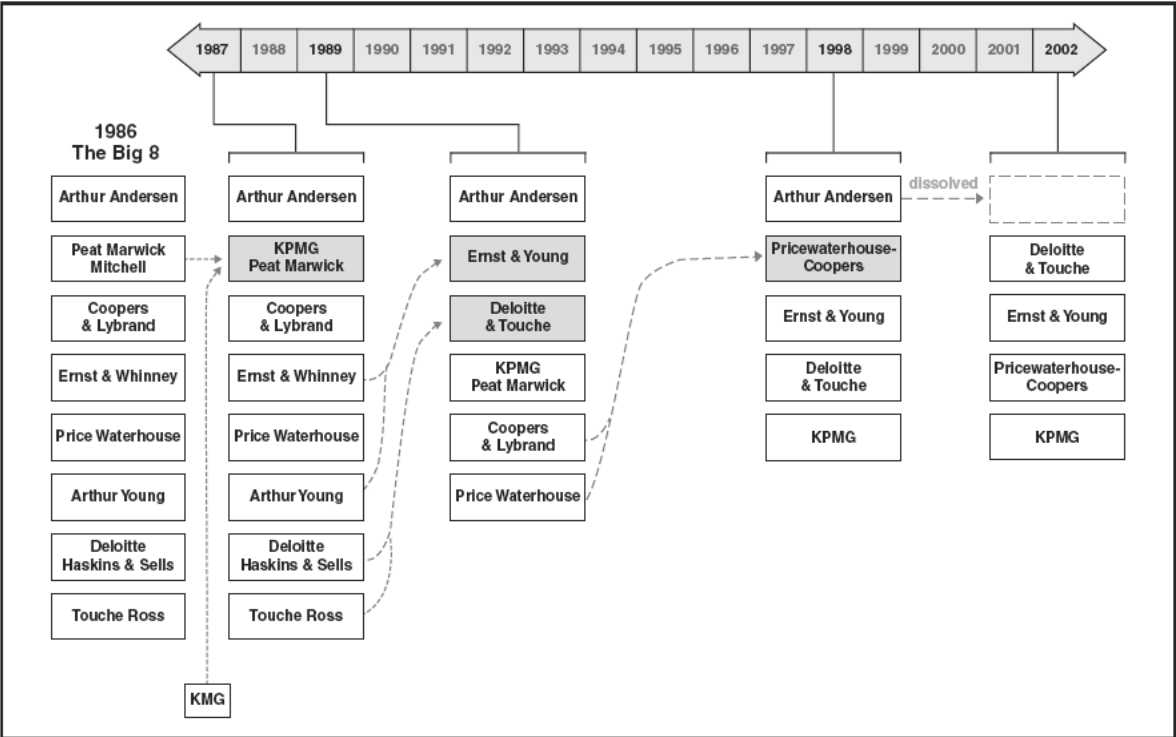


Figure A7.1. Source: US GAO (2008), p.9.

267

OECD (2009).

(2) Comparison between audit and law firms

In comparison with legal services, the audit market appears more concentrated. The figure below shows that the five largest audit firm networks represent 75% of the total revenues of the top 24 global audit firms whereas the five largest global law firms have only 19% of the total revenues (of the global law firms)²⁶⁸.

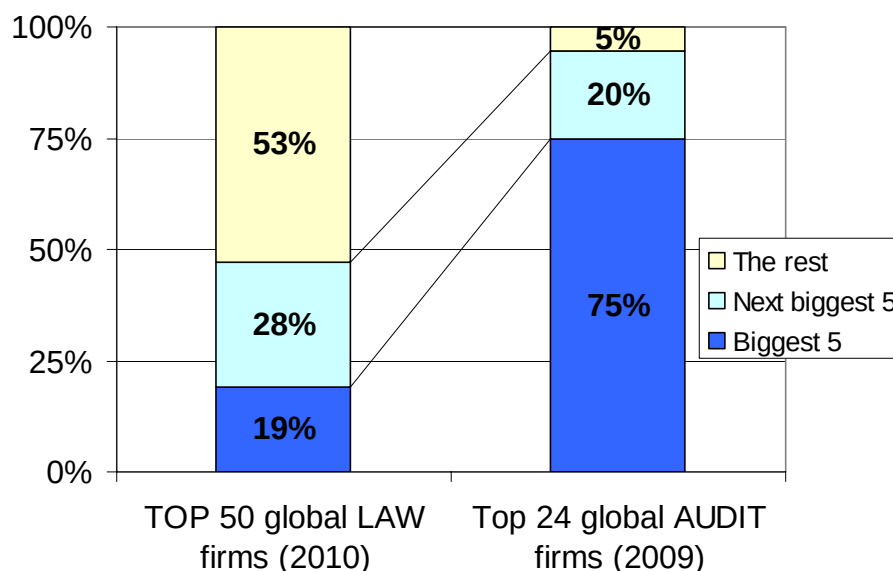


Figure A7.2 - Comparison between the revenue shares of five biggest market players among audit firms and among law firms²⁶⁹.

²⁶⁸ The data is available for 24 global audit firms and 50 global law firms. Even if the data were available for the 50 biggest audit firms, the figure would change only slightly due to the very small size of the remaining audit firms: the revenue share of the smallest audit firm within the 24 global audit firm networks is less than 0,3% of the total revenues.

²⁶⁹ Source: Data on legal firms: TheCityUK, report on Legal Services 2011, page 5, chart 7 Concentration of legal services: <http://www.thecityuk.com/what-we-do/reports/articles/2011/february/legal-services-2011.aspx>; Data on audit firms: Accountancy Magazine, January 2011

(3) Market concentration

For the majority of EU Member States, the market share of the Big Four audit firms exceeds 85% as regards the audit of large listed companies (FTSE 350 equivalent market capitalisation).

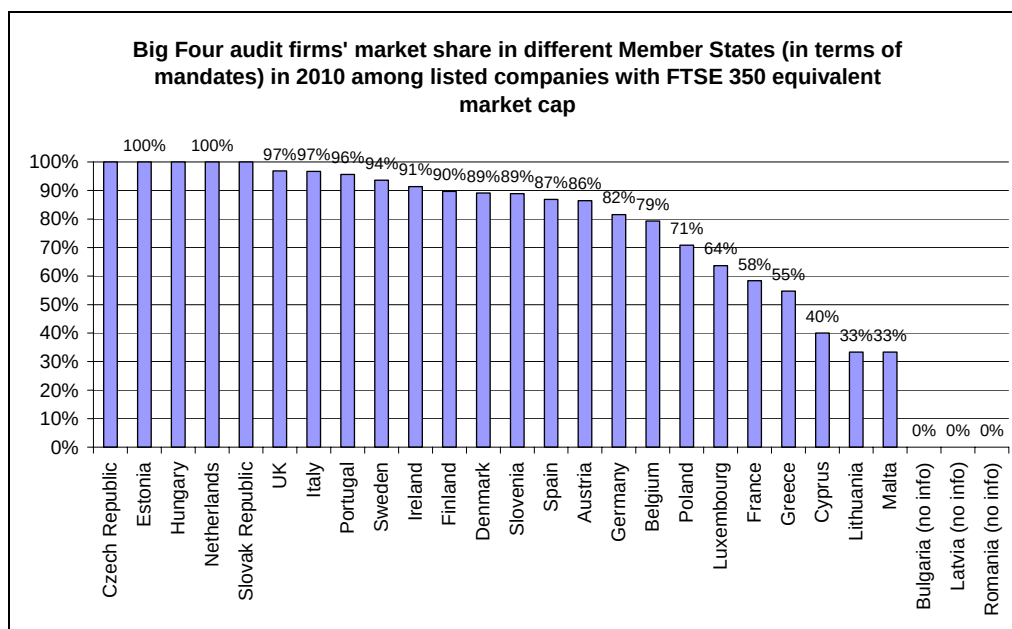


Figure A7.3 – Source: data extracted from Huber (May 2011).

This market share relates to the number of audit engagements. It may be different if audit fees are considered instead. For instance, if one looks at the French market, the market share of the Big Four firms is significantly higher when audit fees (90% in 2009) rather than number of audit engagements (73% in 2009)²⁷⁰ are compared: figures A7.4 and A7.5 comparing data from the largest 120 listed companies in France.

²⁷⁰

It should be noted that in figure A7.3, data for France concerns 468 audit engagements, therefore including more firms than figure A7.4.

	2009		2008		2007		2006		2005		2004	
Name	No	C(i)	No	C(i)	No	C(i)	No	C(i)	No	C(i)	No	C(i)
Ernst & Young	56	23.5%	56	23.5%	55	23.5%	57	24.3%	62	26.5%	64	27.4%
Deloitte	46	42.9%	46	42.9%	43	41.9%	39	40.9%	35	41.5%	36	42.7%
KPMG	40	59.7%	40	59.7%	39	58.5%	41	58.3%	38	57.7%	27	54.3%
PWC	32	73.1%	32	73.1%	34	73.1%	31	71.5%	31	70.9%	30	67.1%
Mazars	29	85.3%	29	85.3%	28	85.0%	25	82.1%	26	82.1%	25	77.8%
Grant Thornton	5	87.4%	5	87.4%	5	87.2%	4	83.8%	3	83.3%	3	79.1%
BDO	0	87.4%	0	87.4%	0	87.2%	4	85.5%	4	85.0%	2	79.9%
Constantin	0	87.4%	1	87.8%	1	87.6%	2	86.4%	1	85.5%	2	80.8%
Others	30	100.0%	29	100.0%	29	100.0%	32	100.0%	34	100.0%	45	100.0%
TOTAL	238		238		234		235		234		234	

Note.: The C(i) index shows the cumulated percentage of market share, the companies being ranked by decreasing number of mandates.

Figure A7.4 – Source: Billard et al. (2011), p. 12; table 2: number of audit missions and market concentration (2004 to 2009); data collected from the annual financial information of SBF120 companies.

	2009		2008		2007		2006		2005		2004	
Name	F	C(i)	F	C(i)	F	C(i)	F	C(i)	F	C(i)	F	C(i)
Ernst & Young	313.58	30.5	331.96	31.6	318.51	32.2	298.86	29.8	295.13	32.8	297.07	35.1
Deloitte	251.55	55.0	247.37	55.2	203.23	52.7	215.34	51.2	203.72	55.4	177.60	56.1
PWC	208.23	75.3	206.35	74.9	204.89	73.5	222.13	73.4	183.67	75.8	176.43	76.9
KPMG	154.65	90.3	164.91	90.6	166.73	90.3	172.71	90.6	139.56	91.3	110.61	90.0
Mazars	85.17	98.6	82.85	98.5	81.45	98.6	73.40	97.9	60.83	98.1	45.72	95.4
Grant Thornton	4.52	99.1	4.33	98.9	4.89	99.0	4.16	98.3	3.77	98	4.43	95.9
BDO	0.00	99.1	0.00	98.9	0.00	99.0	1.38	98.5	1.14	98.6	0.53	96.0
Constantin	0.00	99.1	3.40	99.2	1.60	99.2	3.18	98.8	0.97	98.7	1.54	96.2
Others	9.43	100.0	8.11	100.0	7.80	100.0	12.14	100.0	11.45	100.0	32.45	100.0
TOTAL	1027.13		1049.29		989.10		1003.32		900.23		846.38	

Note.: The C(i) index shows the cumulated percentage of market share, the companies being ranked by decreasing number of mandates. F is the amount of fees in millions of euros.

Figure A7.5 – Source: Billard et al. (2011), p.12; table 3: market share and concentration in terms of audit fees from 2004 to 2009; data collected from the annual financial information of SBF120 companies.

The EU27 average (excluding 3 Member States for which no data is available) of the Big Four market share for the audit of those large listed companies is 83% (see [figure A7.6](#)). This market share diminishes when the audited listed company is of smaller size. If all companies with a market capitalisation above £50M are considered, the combined market share of Big Four firms goes down to 63%.

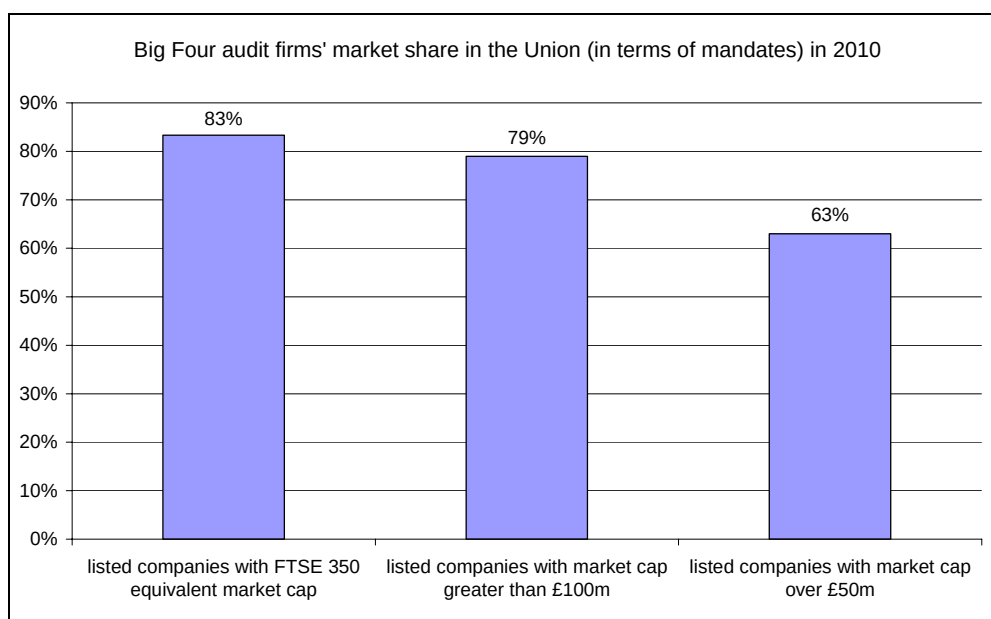


Figure A7.6 - Source: data extracted from Huber (May 2011).

When compared to the main international trading partners, it can be noted that the trends are similar regarding the US and the combined G8 countries. However, the position of Big Four audit firms in China is significantly weaker: they audit only 14% of the listed companies considered. Their position in India, Russia and some other G20 countries is not as strong as in western economies, which explains the lower figures for the combined G20 countries.

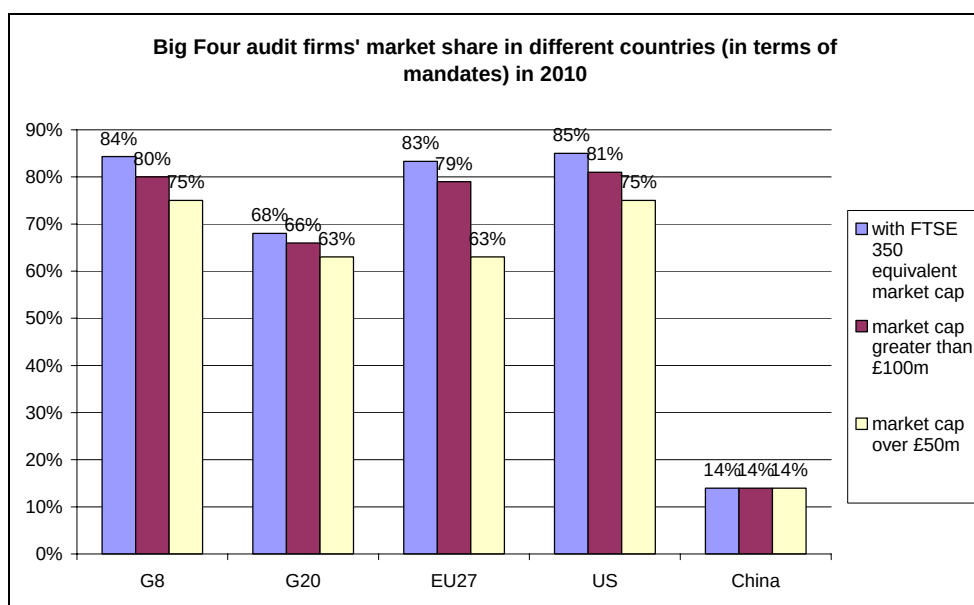


Figure A7.7 - Source: data extracted from Huber (May 2011).

ANNEX 8. DETAILED POLICY OPTIONS

(1) OBJECTIVE 1: POLICY OPTIONS TO DEAL WITH THE CLARIFICATION AND DEFINITION OF THE ROLE OF THE STATUTORY AUDITORS GENERALLY AS WELL AS WITH SPECIFIC REGARD TO PIES

Objective 1.1: Sub-policy options to improve business preparers/market understanding of the scope of audit generally

Baseline scenario. The existing EU rules do not clearly define what the scope of the statutory audit is. The requirements on the minimum content of the audit report²⁷¹ act as proxy to the scope of the audit. Indeed, auditors are requested to provide, in the audit report, a "*description of the scope of the statutory audit which shall at least identify the auditing standards in accordance with which the statutory audit was conducted*" as well as "*an audit opinion which shall state clearly the opinion of the statutory auditors as to whether the annual accounts give a true and fair view in accordance with the relevant financial reporting framework [...]*". When reporting that the accounts give a true and fair view in accordance with the relevant reporting framework, auditors provide "reasonable assurance" that the financial statements as a whole are free from material misstatements, whether due to fraud or error. The fact that the companies' accounts are audited does not mean that there is an obligation on the auditor to ensure that the audited accounts are entirely free from misstatements, but this is not clearly explained in the EU rules. Additionally, EU rules do not require that the audit opinion will give assurance as to the future of the audited company, but the requirement on the auditor to provide an opinion on the audited company as a "going concern" creates some confusion about the scope of this assessment, which helps to explain the expectations created among shareholders on this issue.

EU rules do not explain either how the auditor is expected to carry out his/her tasks in relation to the statutory audit. For instance, there is no requirement in the legislation that the auditor applies professional scepticism when carrying out the statutory audit work²⁷². The requirements on the minimum content of the audit report do not provide an indication of the scope of the audit nor the tasks carried out. This is "delegated" to the professional standards that auditors generally apply on the performance of the audit work.

Option 1: Clarify and specify the scope of statutory audit to reduce the expectation gap. This option consists in (a) clarifying the scope of the audit of PIEs in the EU rules, without enlarging it; and (b) specifying the role of the auditor by requiring that auditors/firms apply their professional scepticism throughout the performance of the audit and establish requirements regarding the important audit work tasks (e.g. organisation of the work, market integrity, group auditors and internal quality control).

(a) Clarifying the scope of statutory audit in the EU rules. This clarification would consist in explicitly stating that

- (i) the role of the auditor is to provide an opinion on whether historical financial information is misstated and whether the going concern basis is valid; and

²⁷¹ Cf. Article 51a of Directive 1978/660/EEC and 37(2) of Directive 1983/349/EEC.

²⁷² With the exception of some requirements for group auditors. Cf. Article 27 of the Statutory Audit Directive.

- (ii) such scope does not include the assurance as to the future viability of the audited entity (beyond the assessment conducted to establish the validity of the going concern basis²⁷³), nor the efficiency or effectiveness with which the management has conducted or will conduct the affairs of the audited entity.

(b) *Specifying the role of the auditor in connection with that scope.* This would consist in explicitly requiring that auditors apply professional scepticism throughout the performance of the audit²⁷⁴. Professional scepticism refers to "*an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatements due to error or fraud and a critical assessment of audit evidence*"²⁷⁵. The auditor would be required to, in particular, maintain professional scepticism when reviewing management values relating to fair values and to the impairment of goodwill and other intangible assets and future cash flows relevant to the consideration of the going concern.

Specifying the role of the auditor would also include a description of important tasks to be undertaken when performing the statutory audit work. The following requirements form part of this option:

- requirements on the the appointment of adequate staff – including a key audit partner – and sufficient resources to carry out the work;
- requirements on the organisation of a client account record and the composition of the audit file;
- requirements in relation to market integrity and fraud prevention²⁷⁶ with a view to preventing the involvement of the auditor/firm and his/her/its employees in any criminal offence or breach of the law that would be detrimental to public confidence in statutory audit or financial markets. Those requirements include procedures for the transmission of relevant information to competent authorities;
- requirements in relation to the responsibility of group auditors when auditing consolidated accounts. These requirements expand those of Article 27 of the Statutory Audit Directive;
- requirements in relation to the internal quality control review to be conducted by the audit firm before issuing the audit report; or
- requirements in relation to record keeping.

²⁷³ As such, there is no change in the going concern examination.

²⁷⁴ See generally FRC (August 2010) explaining that the application of an appropriate degree of professional scepticism is a crucial skill for the auditor, outlining the importance of scepticism in practice and providing some ideas on what can be done to promote auditor scepticism. The FRC paper contains a review of academic research (essentially of US-related studies) on the characteristics underlying auditor scepticism and the degree to which it is likely to be exhibited in practice.

²⁷⁵ Definition of the International Auditing Standards. According to FRC (August 2010), this definition suggests that "*scepticism influences the scope of the work, helps the auditor evaluate audit findings and ultimately conclude whether sufficient appropriate audit evidence has been obtained to enable a 'true and fair view' opinion to be expressed on an entity's financial statements*".

²⁷⁶ A recent survey places honesty and integrity of financial reporting generally as a key ethical issue for the integrity of global markets in 2011. See CFA (January 2011).

Option 1 should be read in connection with option 1 regarding objective 1.2 on the content of the audit report. The requirement on the content of the audit report will continue to act as a proxy to the scope of audit.

Option 2: Redefine the scope of statutory audit to fill the expectation gap. Auditors would be required to assess forward looking information provided by the company, and given privileged access to key information, provide an economic and financial outlook of the company beyond the context of the examination of the "going concern".

Objective 1.2: Sub-policy options to improve the information that the auditor provides to users and audited entities (PIEs)

Baseline Scenario. Under the existing EU requirements, auditors only communicate a short (one or two pages) audit report to the public, which often contains standard language²⁷⁷. In the case of PIEs, the standard report does not reflect the complexity of the audit work carried out or the methodology used. Concerning the communication between the auditors and the audited company, there are no specific requirements for the provision of additional information to the audited entities; the practice is that auditors do not share their audit working papers with them. Concerning the relationship with the audit committee, the current rules empower the audit committee to "*monitor the statutory audit of the annual and consolidated accounts*"²⁷⁸, but the rules do not specify how such monitoring shall be conducted. As a result, the practice differs from company to company. Auditors are not required to engage in regular communication and discussion with the audit committee. Nor are they required by law to provide a more detailed report on the audit work to the audit committee or the audited company²⁷⁹.

The audit committee (article 41 of the Statutory Audit Directive)

Each PIE (with some exceptions) must have an audit committee.

In PIEs which are SMEs, Member States may permit the functions assigned to the audit committee to be performed by the administrative or supervisory body as a whole, provided at least that when the chairman of such a body is an executive member, he or she is not the chairman of the audit committee

Member States may also allow or decide that the requirement to have an audit committee do not apply to PIEs having a body performing equivalent functions to an audit committee, established and functioning according to provisions in place in the Member State in which the entity to be audited is registered. In such a case the entity shall disclose which body carries out these functions and how it is composed.

Composition of the audit committee

²⁷⁷ In France, the audit report is generally longer because auditors are required to publicly justify their audit opinion. This includes their appreciation of a company's choices or use of accounting methods, of material or sensitive accounting estimates, and also, if necessary, of elements of internal control.

²⁷⁸ Cf. Article 41(2)(c) of Directive 2006/43/EC.

²⁷⁹ The German legislation requires the auditor to submit a "long-form report" to the management and where the auditor was appointed by the supervisory board, it is submitted to it. Such a report, which is not available to the public, summarises in greater detail than the auditor's report the fundamental findings of the audit on the going concern assumption and associated monitoring systems, future development and risks facing the company, material disclosures, irregularities encountered, accounting methods used or any "window dressing" transactions.

Member State determine whether audit committees are to be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity. At least one member of the audit committee shall be independent²⁸⁰ and shall have competence in accounting and/or auditing.

*Functions of the audit committee*²⁸¹

Without prejudice to the responsibility of the members of the administrative, management or supervisory bodies, or of other members who are appointed by the general meeting of shareholders of the audited entity, the audit committee must, *inter alia*:

- (i) monitor the financial reporting process;
- (ii) monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
- (iii) monitor the statutory audit of the annual and consolidated accounts;
- (iv) review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity;

The proposal of the administrative or supervisory body for the appointment of a statutory auditor or audit firm of a PIE must be based on a recommendation made by the audit committee.

The statutory auditor or audit firm must report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process.

Option 1: Improve and expand the content of the audit report disclosed the public. Under this option, the content of the audit report disclosed to the public would be expanded and improved. The audit report should include the following information:

- explanations on the methodology used (e.g. especially how much of the balance sheet has been directly verified and how much has been based on system and compliance testing; describing the levels of materiality used);
- more qualitative information (e.g. identify key areas of risk of material misstatement of the accounts, including critical accounting estimates or areas of measurement uncertainty, the assessment of the internal control system and to what extent the audit was designed to detect fraud);
- explanations on violations of accounting rules or violations of laws or the articles of incorporation, significant business transactions, accounting policy decisions and other matters that are significant for the governance of the entity;

²⁸⁰ See European Commission (2005).

²⁸¹ See also European Commission (2005).

- explanations on the variations in the weighting of substance and compliance testing when compared to a previous accounting year, even if the statutory audit in the previous year was conducted by a different auditor.

Option 2: Require the preparation of a longer and more detailed report for the audited entity. The auditor would be required to prepare a longer and more detailed report for the benefit of the audited entity (this is part of the "internal communication" between the auditor and the audited entity). This additional "internal report" would provide more detailed information (and justify it) on the audit carried out. It would in particular:

- provide a statement on the situation of the audited entity or in case of the statutory audit of consolidated accounts of the parent company and the group, especially an assessment of the going concern and the future development of the entity or the parent company and the group;
- indicate and explain judgments about material uncertainty that may cast doubt on the entity's ability to continue as a going concern;
- determine in detail whether the book-keeping, the accounting, all audited documents, the annual or consolidated accounts and possible additional reports show appropriateness;
- indicate and explain all instances of non-compliance, including non-material instances as far as it is considered to be important to the audit committee in order to fulfil its tasks;
- assess the valuation methods applied to the various items in the annual or consolidated accounts including any impact of changes of such;
- provide full details of all guarantees, comfort letters, undertakings of public intervention and other support measures that have been relied upon when making a going concern assessment;
- confirm the attendance at stock-takes as well as other instances of physical verification, in case such stock-takes or verifications took place;
- indicate and explain the principles of consolidation in the case of a statutory audit of consolidated accounts; and
- indicate which audit work is performed by third-country auditor(s), statutory auditor(s), third-country audit entity(ies) or audit firm(s) in case of a statutory audit of consolidated accounts.

In terms of procedure, this longer report would be submitted by the auditor to the audit committee and to the management of the audited entity, but not to the public (given that the content of the additional report would contain business secrets and possibly price sensitive information).

Option 3: Increase the communication between the auditor and the audit committee. This option articulates the relationship between auditors and a strengthened audit committee (part of the "internal communication": between the auditor and the audited entity) in three steps:

- (i) auditors would be clearly required to report to the audit committee on key matters arising from the statutory audit and in particular on material weaknesses in internal control in relation to the financial reporting process;
- (ii) both parties would be required to engage in regular dialogue; and
- (iii) the audit committee would be required to inform management of the outcome of the statutory audit, how the statutory audit contributed to the integrity of the financial reporting and what was the role of the audit committee in this process.

It should be noted that option 1 (tendering) regarding objective 3.1 would have an indirect impact on this option. The presentation of a more detailed methodology by the auditor in the tendering process should also contribute to facilitating the communication between the audit committee and the auditor.

Under this option, stricter requirements would apply to the structure and the technical competence of the members of the Audit Committee. Currently only at least one member has to have an audit qualification and be independent. Strengthening the requirements for selection of audit committee members would mean that at least one member has to have an audit qualification and at least two members have to have competence in accounting and/or auditing. In addition, the committee members as a whole should have experience in the sector of operation of the company. In terms of independence, the majority of the members should be independent (including the chairman). The concept of independence should be understood in the "corporate governance" context.

Option 4: Combination of options 1 + 2 + 3.

Objective 1.3: Sub-policy options to improve the communication channels between auditors and supervisors of PIEs

Baseline Scenario. Auditors of most financial institutions regulated at EU level²⁸² are already required under EU law to report promptly to the supervisors of those institutions any fact that is liable to bring about a material breach of the laws, affect the ability of the audited entity as a going concern or lead to a qualified audit report. The real enforcement of those early warning obligations was not evident during the crisis; the lack of such communication may be attributable to the absence of any sanctions²⁸³ and/or the fear of potentially infringing the professional secrecy principle when making a report to the authorities. Beyond this reporting obligation, there is no requirement for auditors to regularly engage with supervisors of PIEs.

Option 1. Enabling (in law) and recommending regular dialogue between auditors and supervisors of PIEs. This option would consist in empowering auditors and supervisors of PIEs to engage in regular dialogue. It would guarantee that auditors do not breach their confidentiality rules when they engage in such dialogue. Such dialogue would be recommended but auditors and supervisors would be free to organise it or not.

²⁸² i.e. investment firms, credit institutions, insurance undertakings, payment institutions, e-money institutions or UCITS. However, auditors of alternative investment funds (AIF) and AIF managers as such, as well as auditors of issuers of securities which are not part of the above categories are not subject to the obligation.

²⁸³ Directive 2006/48/EC (banking directive) does not foresee any sanction of the auditor in case of the infringement of Article 53.

Option 2. Requiring the establishment of regular dialogue between auditors and supervisors of PIEs. This option would require that such dialogue takes place effectively in all circumstances. The dialogue should be adapted to the size and nature of the companies involved. This would be achieved by setting a general principle in legislation and empowering EBA and EIOPA to prepare guidance on how to enforce it²⁸⁴. Such dialogue could be associated with a clarified text on the early warning obligation to make sure that there are no gaps in legislation, particularly as regards the sanctions for lack of compliance.

(2) OBJECTIVE 2: POLICY OPTIONS TO REINFORCE THE INDEPENDENCE AND PROFESSIONAL SCEPTICISM OF STATUTORY AUDITORS AND AUDIT FIRMS IN THE PROVISION OF STATUTORY AUDIT TO PIEs

Objective 2.1: Sub-policy options to prevent and mitigate any conflict of interests due to the provision of non-audit services to the PIE

Baseline Scenario: No change. Although the current EU regulatory framework establishes a general principle requiring Member States to ensure the independence of auditors (cf. Article 22) and, in a 2002 Recommendation, the Commission set some additional fundamental principles; there is no direct prohibition on the provision of non-audit services to audit clients. In this scenario, Member States will continue to be responsible for ensuring the independence of auditors, namely avoiding situations that may pose a threat of self-review, self-interest, advocacy, familiarity or trust or intimidation. In line with the Commission Recommendation, the audit firm should neither take any decision, nor take part in any decision making on behalf of the audit client or its management while providing a non-audit service. It also suggests that even if not involved in the decision-making of the audit client, the auditor should consider applying particular safeguards to mitigate any independence threat. Specifically, the Recommendation provides some examples analysing specific situations, which may give rise to (*inter alia*) a self-review threat, in relation to: preparing accounting records and financial statements, designing and implementing financial information technology systems, valuation services, participation in the audit client's internal audit, acting for the audit client in the resolution of litigation and recruiting senior management.

The current system relies on the role of the audit committee to take decisions regarding the provision of NAS by the statutory auditor or audit firm. It must review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity. For this, the statutory auditor or audit firm is required to (a) confirm annually in writing to the audit committee their independence from the audited public-interest entity; (b) disclose annually to the audit committee any additional services provided to the audited entity; and (c) discuss with the audit committee the threats to their independence and the safeguards applied to mitigate those threats.

However, existing disparities in the implementation of the Directive and the 2002 Recommendation will persist. Moreover, due to its limited technical resources the Audit Committee will not be in a position to effectively monitor the independence of the auditors once appointed. The system over-relies on the capacity of the audit committee to take decisions on a

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For instance, a code of practice for the relationship between the external auditor and the supervisor has been published in draft by the FSA, supported by the Bank of England, in February 2011 for a public consultation period. The code provides guidance on the nature of the relationship between supervisors and external auditors for all UK regulated firms. See FSA (2011).

case-by-case basis as to whether there are threats to independence arising from the provision of NAS.

Option 1: Prohibition of the provision of certain non-audit services to audit 'client' (black-listing)

Audit firms providing statutory audit and financial audit services²⁸⁵ would not provide certain non-audit services to an audit client. This amounts to "black-listing" certain non-audit services namely:

- preparing accounting records and financial statements;
- bookkeeping services;
- designing and implementing financial information technology systems;
- valuation services (including appraisal or valuation services, fairness opinions or contribution-in-kind reports);
- actuarial services;
- participation in the audit client's internal audit and the general provision of services related to the internal audit function;
- design and implementation of internal control or risk management procedures related to the preparation and/or control of financial information included in the financial statements;
- acting for the audit client in the resolution of litigation;
- legal services and expert services unrelated to the audit;
- tax advice/consultancy services;
- recruiting senior management and human resources generally;
- broker or dealer, investment advisor, or investment banking services;
- risk advice;
- due diligence services to the vendor or the buy side on potential mergers and acquisitions;
- providing assurance on the audited entity to other parties at a financial or corporate transaction;
- providing comfort letters for investors in the context of the issuance of an undertaking's securities;
- general management consultancy services; and
- any partial or total outsourcing of the above tasks.

²⁸⁵ Financial audit services include the audit of interim accounts and accounting review services.

It would also require adding a general catch-all clause for non-audit services modelled on the existing Article 22(2).

The prohibition would be extended to the parent company of the audit client and its material subsidiaries. In addition, for the provision of other services which are not part of the audit mandate and are not included in the black-list:

- the audit firm should request the approval of the audit committee of the client for the provision of such additional service. The audit committee should approve the provision of the service and justify the absence of any threat to the independence of the auditor;
- the fees for the non-audit service in question should not be higher than 10% of the audit fee;
- shareholders should be informed of the provision of non-audit services in the annual report.

Option 2: Prohibition of the provision of any non-audit services to the audited entity (PIE)

The second option is the prohibition of the provision of any non-audit services to the audited entity (PIE): statutory auditors or audit firms providing statutory audit to a PIE would not provide any non-audit service to this audited entity. However, the provision of non-audit services to entities which are not audited by the statutory audit or audit firm would not be prohibited. The prohibition on the to provision of services other than audit would also be extended to the parent company of the audit client and at least its material subsidiaries. A cooling off period of 2 years after the end of the audit engagement will be envisaged before being in a position to provide services other than audit.

Some services which are closely connected to statutory audit (including other statutory duties) should, however, be authorised (a "white-list"). This "white-list" would include the following services:

- review of interim financial statements;
- assurance on corporate governance statements;
- assurance on corporate social responsibility matters;
- assurance on or attestation of regulatory reporting provided to regulators of financial institutions beyond the scope of the statutory audit and designed to assist regulators in fulfilling their role, such as on capital requirements or specific solvency ratios determining how likely a company will be to continue meeting its debt obligations;
- any other statutory duty related to audit work imposed by EU legislation.

Option 3: Pure audit firms. Audit firms providing statutory audit services and related financial audit services would only provide audit services and be unconnected to firms providing non-audit services. The obligation would primarily consist in requiring that audit firms (but not statutory auditors practicing as natural persons: sole practitioners) providing statutory audit services must only provide audit services (i.e. they should only have audit clients).

For this obligation to be effective, it should be accompanied by some ancillary measures in order to make sure that the obligation is not circumvented. In particular:

- The audit firm should not be part of a network/group which provides "non-audit services" to avoid circumventing this restriction by simply splitting the responsibility for the different services into two different legal entities within a network;
- If the capital of the audit firm is open to non-partners, no more than 5% of the voting rights and/or the capital is held individually by any firm providing non-audit services and firms providing non-audit services taken as a whole do not account for more than 10% of the voting rights and/or of the capital;
- The audit firm should not directly or indirectly invest in firms providing non-audit services.

This option would be adjusted (see the proportionality analysis in [Annex 19](#)) to the size and dimension of the activities of the audit firms. Certain audit firms are essentially providing audit services to small PIEs and non-PIEs and are hardly present in the market for audits of large PIEs. Requiring their conversion into pure audit firms may lead to the creation of a barrier to growth and/or it may lead to their abandoning of the PIE market. Therefore, this option 3 aims at pure audit firms for those firms obtaining more than 50% of their fees from large PIEs. Large PIEs are to be understood as those with a capitalisation (or a balance sheet, if not listed) above €1 billion.

On pure audit firms and non-audit services, see also [Annex 10](#).

Objective 2.2 Reduce and mitigate the risk of any conflict of interest due to the existing system of "auditee selects and pays the auditor"

Baseline scenario: No change. If no measure is enforced in this area the potential risk of conflict of interest will not be mitigated since no real independent and technically competent monitoring will be put in place. Currently, the audit committee presents a recommendation to the administrative or supervisory body on the appointment of a statutory auditor or audit firm. The Statutory Audit Directive requires that the "*proposal of the administrative or supervisory body for the appointment of a statutory auditor or audit firm of a PIE shall be based on a recommendation made by the audit committee*", but it is unclear whether managers are obliged to follow this recommendation. Therefore, the selection process and decision on the appointment of the statutory auditor will continue to be done *de facto* by management with a formal validation by the Annual General Meeting of shareholders. Moreover, due to its limited technical resources the Audit Committee will not be in a position to effectively monitor the independence and the work of the auditors once appointed.

Option 1: Stricter rules on the procedure for the appointment of auditors with an increased role for a strengthened Audit Committee. Under this option, stricter requirements would apply to the structure and the technical competence of the members of the Audit Committee. Currently, only at least one member has to have an audit qualification and be independent. Strengthening the requirements for the selection of audit committee members would mean that at least one member has to have an audit qualification and at least two members have to have competence in accounting and/or auditing. In addition, the committee members as a whole should have experience in the sector of operation of the company. In terms of independence, the majority of the members should be independent (including the chairman). The concept of independence should be understood in the "corporate governance" context.

The role of the Audit Committee in the tendering and selection of the statutory auditor will be strengthened. The Audit Committee should be responsible for the monitoring and validation of the result of the selection procedure and the appointment of the statutory auditor. The recommendation of the Audit Committee should be transmitted to the general meeting of shareholders and, if management does not support it, it should explain why. The recommendation of the Audit Committee should contain at least two possible auditors, for the consideration of the general meeting.

This option takes account of the size of PIEs (see the assessment in Annexes 16 and 19). As is the case today in the Statutory Audit Directive, PIEs which are SMEs should not be obliged to have an audit committee provided that the board undertakes this function under a different chairmanship. This option should also be extended to small caps, understood as companies with reduced capitalisation (less than €100 Million). Also, the flexibility offered to companies with a dual board system to entrust the supervisory board with the audit committee function is maintained in this option.

Option 2: Appointment of auditor by a third party. A third party would be responsible for the appointment of the auditor. Such third party could be the supervisor of the PIE in question. For financial institutions, this option represents an evolution from the current situation. Currently, some supervisors have a veto right against auditors of important financial institutions (e.g. banks) since the choice and performance of the statutory auditors could have a big influence on preserving market stability.

Veto rights exist in at least the following countries: AT (banking supervisor), BE, BU, CZ, DE, FR, IE, LT, LV, MT, PT, RO and SK. A pre-approved list of bank auditors exists in BE.

In EE, the authority can appeal to the courts if unsatisfied with the auditor appointed. Additionally, in AT the Austrian Financial Market Authority may raise an objection to the appointment of a bank auditor if it has a substantiated reason to suspect that exclusion or another reservation is warranted. Where the appointment is subject to a reporting requirement the objection must be raised within one month. The civil courts are competent in this matter and must rule on the objection with due consideration of the reasons for exclusion. Until a legally effective ruling by the court has been handed down, the bank auditor may neither perform audit activities nor be provided with information subject to banking secrecy requirements by the credit institution.

There is not enough public evidence on the formal use of these rights in most of these countries. It appears that authorities use soft powers in this regard.

Objective 2.3 Reduce and mitigate the risk of any conflict of interest due to a "familiarity threat"

Baseline scenario: No change. No restriction on the duration of the audit engagement, only a requirement for the rotation of the key audit partner after 7 years. No specific requirements at EU level except on ethics and a prohibition of contingent audit fees. Moreover, due to its limited technical resources the Audit Committee will not be in a position to effectively monitor the independence and the work of the auditors once appointed.

Option 1: Limiting the duration of the audit engagement and requiring rotation of an audit firm. The statutory auditor/audit firm would not be allowed to audit the same PIE after 9 years of consecutive engagement (currently, the rotation of the audit partner is set at 7 years) and a 4 year

cooling off period would be established (currently, the cooling off period for the audit partner is set at 2 years).

On mandatory rotation of audit firms, see also option 2 under objective 3.1. (Policy options to facilitate switching of an audit firm) and Annex 11.

Option 2. Strengthening the role of the Audit Committee in overseeing the work of the statutory auditors. Under this option, stricter requirements would apply to the structure and the technical competence of the members of the Audit Committee. Currently, only at least one member has to have an audit qualification and be independent. Strengthening the requirements for the selection of audit committee members would mean that at least one member has to have an audit qualification and at least two members have to have competence in accounting and/or auditing. In addition, the committee members as a whole should have experience in the sector of operation of the company. In terms of independence, the majority of the members should be independent (including the chairman). The concept of independence should be understood in the "corporate governance" context.

The role of the Audit Committee will be also strengthened in the monitoring of the independence and work of the statutory auditor and audit firm.

The Audit Committee should furthermore monitor all major outcomes of the statutory audit in addition to focussing specifically on internal controls around the financial reporting process. The Audit Committee also has the responsibility to inform the administrative/ supervisory body of all major outcomes of the statutory audit.

The Audit Committee will also take responsibility among others to ensure together with the statutory auditor that the amount of fees paid to the statutory auditor represent less than 20% annually (or less than 15% for two consecutive years) of total fees received by the audit firm. In case of a breach of these thresholds, the Audit Committee should decide if the audit engagement should be subject to a quality control review by another statutory auditor prior to the issuance of the audit report.

See also option 3 regarding objective 1.2 above and option 1 regarding objective 2.2 on the Audit Committee.

Option 3. Establishing additional requirements on the internal organisation and governance of audit firms. Under this option a statutory auditor or an audit firm would be required to:

- establish appropriate and effective organisational (including governance of firms) and administrative arrangements, also with regard to outsourced services, to prevent, identify, eliminate or manage and disclose any threats to independence;
- establish a policy to preclude his, her or its involvement and that of his, her or its employees in any criminal offence or breach of the law that would be detrimental to public confidence in the statutory audit, statutory auditor, audit firms or financial markets;
- establish appropriate and effective organisational and administrative arrangements for dealing with and recording incidents which have or may have serious consequences for the integrity of his, her or its statutory audit activities;

- respect the highest principles of professional ethics and respect the national measures enacted pursuant to Article 21(1) of the Statutory Audit Directive.

(3) OBJECTIVE 3: POLICY OPTIONS TO IMPROVE MARKET CONDITIONS FOR AUDITS OF PIEs WITH A VIEW TO INCREASING AUDIT QUALITY

Objective 3.1: Sub-policy options to facilitate switching of an audit firm

Baseline scenario. Companies do not want to spend management time to organise tenders and are ready to pay a premium to Big Four auditors as audit costs are very low (<0,15% of total turnover, see [Annex 20](#)) for most of PIEs. Contracts with auditors tend to be renewed, there are few cases of switching and rare cases in which tendering of audit services takes place. There are some exceptions, such as in France, where there is more of a tradition to tender audit services in the context of joint audit, Italy where there is mandatory rotation of audit firms and Poland as regards insurance companies, where mandatory rotation is also applied.

Option 1. Regular tendering. Audited entities would invite a minimum number of auditors/firms to participate in a tendering procedure, including at least one non-Big Four firm. The tendering process should be organised by the Audit Committee. The audited entity should be free to choose the method to contact potential bidders and the applicable selection procedure. Predefined evaluation criteria should be set and bidders judged against such criteria.

Option 2. Mandatory rotation of an audit firm. The statutory auditor/audit firm would not be allowed to audit the same PIE after 9 years of consecutive engagement (currently, the rotation of the audit partner is set at 7 years) and a 4-year cooling off period would be established (currently, the cooling off period for the audit partner is set at 2 years). This option does not necessarily imply that a tendering procedure takes place.

On mandatory rotation, see option 1 of objective 2.3 and also [Annex 11](#).

Option 3. Mandatory rotation of an audit firm via tendering. This option combines options 1 and 2.

Objective 3.2: Sub-policy options to facilitate the objective choice of an audit provider

Baseline scenario. Competent authorities do not disclose the individual reports on quality assurance reviews of statutory auditors or audit firms. Authorities only publish annually the overall results of the quality assurance reviews undertaken.

Audit firms and statutory auditors auditing PIEs are required to publish an annual transparency report which should contain the following information:

- a description of the legal structure and ownership of the audit firm;
- where the statutory auditor or audit firm belongs to a network, a description of the network and the legal and structural arrangements in the network;
- a description of the governance structure of the audit firm;
- a description of the internal quality control system of the audit firm and a statement by the administrative or management body on the effectiveness of its functioning;

- an indication of when the last quality assurance review took place;
- a list of public-interest entities for which the statutory auditor or audit firm has carried out statutory audits during the preceding financial year;
- a statement concerning the statutory auditor's or audit firm's independence practices which also confirms that an internal review of independence compliance has been conducted;
- a statement on the policy followed by the statutory auditor or audit firm concerning the continuing education of statutory auditors referred to in Article 13 of Directive 2006/43/EC;
- financial information showing the importance of the audit firm, such as total turnover divided into fees from the statutory audit of annual and consolidated accounts, and fees charged for other assurance services, tax advisory services and other non-audit services;
- information concerning the basis for the partners' remuneration in audit firms.

However, audit firms are not required by EU law to publish their financial statements²⁸⁶.

Due to lack of information and criteria to assess and compare the quality of audits, the reputation of Big Four audit firms remains the most important proxy of audit quality.

Option 1. Prohibit contractual clauses limiting the choice of audit firm (e.g. clauses between the audited entity and a third party (such as a bank) requiring that the statutory audit is performed by a "Big-Four firm" only. These clauses are often referred to as "big-Four only clauses").

Under this option, it would be made clear that any contractual clause limiting the audit firm choice would be null and void as it would restrict the right of the general meeting of shareholders to select the auditor.

Option 2. Increase transparency on audit quality and on audit firms. This option includes two sets of measures.

(a) Competent authorities will disclose inspection reports on individual statutory auditors or audit firms following quality assurance reviews.

(b) Audit firms auditing PIEs would be required to disclose their financial statements and statutory auditors their income statement. Financial information at the level of the network should also be provided. This financial information would be made available on their website, alongside the transparency report, which is disclosed pursuant to an existing obligation. In addition, audit firms and statutory auditors auditing PIEs would provide more information in the existing transparency report regarding their large clients, their policy on rotation of staff and their corporate governance policy. Audit firms and statutory auditors will additionally report information on fees to supervisors (but not to the public).

²⁸⁶ Depending on the legal form of the audit firm, it may be required under national law to publish financial statements.

Option 3. Establish an audit quality certification. A pan-European system that would certify that an auditor or firm meets some quality requirements enabling them to carry out high quality statutory audits of PIEs. This certification would be delivered by ESMA (see policy options regarding objective 5). The certification would be voluntary.

This option would require that secondary legislation is developed: ESMA would develop technical standards for endorsement by the Commission:

Those technical standards would need to comply with the following principles:

- ESMA would deliver the European quality certificate;
- The certificate would be valid across the EU;
- EU auditors and audit firms meeting the relevant requirements would be entitled to apply for the certificate;
- The requirements for obtaining the European quality certificate would be based on audit quality and the experience of the national quality assurance reviews;
- Specific procedural steps for the treatment of the applications would be established, including the participation of national competent authorities in the examination of applications;
- ESMA could be entitled to charge fees for delivering the European quality certificate, as long as they are proportionate to the cost incurred;
- There should be the possibility to re-examine the granting of the certificate (and where appropriate withdraw it) since audit firms would be expected to respect the conditions at any time.

Option 4. Combination of options 1 to 3.

Objective 3.3: Sub-policy options to increase the choice of audit providers for PIEs

Baseline scenario. PIEs would continue to face limited choice of audit firms capable of performing high quality statutory audits, in particular in the segment of large and systemically important PIEs.

Option 1: this option is divided in 3 sub-options.

Sub-option 1.1. Pure audit firms. PIE audits would be performed by the firms who will be allowed to provide only audit services (see further information in the description of option 3 under objective 2.1; see also [Annex 10](#)). Audit firms, which reach the threshold of having 1/3 of their total audit revenues from large PIEs would have to restructure their business and become pure audit firms.

Sub-option 1.2. Mandatory Joint audits (see [Annex 12](#) for further detail on joint audit, including the French experience with the mandatory joint audit rule). Obligation for large PIEs to have more than one audit firm, at least one of which is not among the largest four audit firms (see [Annex 19](#) for the proportionality assessment).

Considering option 3 of objective 3.1, there would be a tendering process for the selection of joint auditors where the scope and responsibility of each auditor is clearly defined.

The 4 eyes principle would be applied in the strategic preparation of the joint audit as well as in the analysis of the findings. Both audit firms would have joint responsibility for the audit.

Similarly to the French system, where there is a specific professional standard that takes account of the specificities of joint audit, this option would require that the European supervisory authorities develop technical standards on the detailed implementation of the joint audit rule, with a view to facilitating its smooth application.

In terms of proportionality, this sub-option would only apply to large PIEs.

Sub-option 1.3. Mandatory joint audit applied only to large PIEs in the financial sector

Sub-option 1.3. is expected to have all the described characteristics presented above with the main difference being that it will have a more limited scope i.e. large financial institutions (FIs) only. This option could be considered as being more proportionate to the problem as it will be applied to the most systemically important entities, representing a higher risk for the whole. The possibility for exemptions will be allowed for certain FIs operating under a special national legal regime with respect to audit (e. g. cooperatives in Austria and Germany). The enforcement of those exceptions will have to be coordinated with ESMA, the body in charge of developing the standards for enforcement of joint audit (see also description of policy option 2 under objective 5.2. as well as Annex 8 on ESMA). It should also be mentioned that joint audit is currently used not only for French FIs but also on a voluntary basis in some FIs in Sweden and Austria.

Sub-options 1.4. Mandatory joint audit to all large PIEs by pure audit firms; and

1.5. Mandatory joint audit only to large PIEs in the financial sector by pure audit firms

The respective sub-options 1.1/ 1.2, 1.1/ 1.3 and 1.1/ 1.6 (sub-options 1.4 and 1.5 and 1.7)) maintains the positive impacts of both sub-options in each case. In addition, joint audit would help smaller audit firms to compete against large pure audit firms focusing on audit services only. In terms of proportionality, however, joint audit and pure audit firms would need to be limited to large PIEs only in the case of sub-option 1.4 and to large PIEs in the financial sector in the case of sub-option 1.5 (see Annex 19).

1.6. Voluntary joint audit for all PIEs: creates incentives for audit providers and audited entities alike to use joint audit on a voluntary basis.

Sub-option 1.6 considers the introduction of joint audit as a voluntary measure by only creating incentives for audited entities to use it as a way to increase audit quality and auditors' independence. This sub-option takes into account the existing uncertainty among market operators and regulators alike about the real cost of this measure compared with its potential value-added (one of the reasons for which joint audits have been abolished in Denmark). The lack of sufficient and comprehensive data on the cost side of the joint audit does not provide sufficiently strong arguments justifying its mandatory introduction, since it could result in an excessive cost burden for certain PIEs. Therefore, also considering that joint audit is used by PIEs in the financial sector on a voluntary basis in certain countries like Austria and Sweden, it could be considered more economically prudent and proportionate to test the viability of this measure by only creating incentives for its use on a voluntary basis, while leaving to the discretion to PIEs to test it and decide about its use on an individual basis.

Option 2. Lift restriction on ownership of audit firms. This option would imply allowing any investor to buy shares and invest in audit firms, without limitation.

This option implies requiring that holders of voting rights in an audit firm shall be independent of the audited entity and not be involved in the decision-taking of the audited entity.

However, this option does not imply removing restrictions on the management of audit firms. As a result, statutory auditors would continue to direct audit firms through the control of the boards.

Option 3. Establish a market share ceiling for large audit service providers. No audit firm would be allowed to have more than 20% of the market share regarding the statutory audit of (large) PIEs.

(4) OBJECTIVE 4: POLICY OPTIONS TO AVOID UNNECESSARY ADDITIONAL COMPLIANCE COSTS FOR AUDITED SMES AS WELL AS FOR AUDIT PROVIDERS IN A CROSS-BORDER CONTEXT

Objective 4.1: Sub-policy options to facilitate the cross-border recognition of audit providers' competence

Baseline scenario. Auditors and audit firms should be approved in all Member States in which they want to carry out statutory audit. For an audit firm such approval may entail a bureaucratic process; the conditions for approval should be the same in the different Member States, with the exception that the auditors carrying out the statutory audit on behalf of the audit firm should be approved in the Member State concerned. For statutory auditors, the approval procedure also requires passing an aptitude test. This test is limited by the conditions of Directive 2006/43/EC: the aptitude test must be conducted in one of the languages permitted by the language rules applicable in the Member State concerned and must cover only the statutory auditor's adequate knowledge of the laws and regulations of that Member State in so far as relevant to statutory audits²⁸⁷. While there is certain convergence in the educational qualifications of auditors²⁸⁸ and the test of theoretical knowledge in the Directive includes many common themes with no national connection (e.g. international accounting standards, risk management and internal control, financial analysis etc)²⁸⁹, the scope of statutory audit still requires from the statutory auditor the knowledge of and familiarity with some national requirements (e.g. company law, tax law, civil and commercial law etc.). The test may differ from Member State to Member State and there is no requirement in Directive 2006/43/EC to make it predictable.

Option 1: Mutual recognition of audit firms. Under this option, an audit firm approved in one Member State would automatically be approved to carry out statutory audits in all Member States. However, the condition that the key audit partner leading the audit is approved as an auditor in the concerned Member State is maintained. Under this option, the organisational requirements of the firm would not be checked by all Member States: indeed, the statutory auditors who direct a firm and/or set its internal policies and procedures would not necessarily be statutory auditors approved in the Member States in which the firm operates. This option would result in changes to the supervisory environment since a supervisor could be led to inspect the statutory audit of an entity located in its territory but carried out by a firm registered in a another

²⁸⁷ Cf. Article 14.

²⁸⁸ See for instance the Common Content Project, www.commoncontent.com

²⁸⁹ Cf. Article 8.

Member State. A simple registration procedure, similar to the one for third country audit firms, could be necessary to facilitate supervisory tasks.

Option 2: Mutual recognition of statutory auditors. Under this option, a statutory auditor approved in one Member State would automatically be approved in all Member States. This option would no longer require a statutory auditor to pass an aptitude test (or a different procedure) to be approved in a different Member State (although registration may be required). Similar considerations as for option 1 would apply regarding supervision.

This option has two different dimensions: the mutual recognition of auditors in the context of a free (cross-border) provision of audit services and the mutual recognition of auditors in the case of establishment in a host Member State.

Option 3: Introduction of an adaptation period scheme and increased convergence, transparency and predictability in the aptitude test. This option would allow statutory auditors to choose between two methods to obtain his/her approval in another Member State, which is the general principle governing the rules on professional qualifications at EU level²⁹⁰:

- (a) an adaptation period scheme under the supervision of a local auditor. Under the adaptation period, statutory auditors approved in one Member State would be allowed to work in another Member State after a minimum probation period has elapsed without having to pass an aptitude test. Such minimum period could be three years, as for lawyers²⁹¹. During the adaptation period, the applicant auditor would register with the competent authority in the host Member State, comply with the applicable standards (including ethical ones) in the host Member States and be supervised by a local auditor.
- (b) an (improved) aptitude test. Member States would be required to be more transparent and predictable with the requirements of the test, as well as to converge with other Member States both regarding the requirements of the aptitude test and the national educational standards.

Objective 4.2: Sub-policy options to streamline and harmonise audit standards on audit practice, independence and internal control of audit firms across the EU

Baseline scenario: Under the existing Statutory Audit Directive, Member States continue to be free to require an audit in accordance with the national auditing standards but may additionally comply with the clarified ISAs in the conduct of an audit²⁹². At present, most EU jurisdictions apply national auditing standards which are largely based on the current ISAs, but often with amendments to comply with national legislation and quality aspects of the audits²⁹³. As a result, there are, to a large extent, divergences in auditing standards between jurisdictions which, according to preparers represent additional audit costs which could be passed on to companies.

²⁹⁰ See Directive 2005/36/EC, Article 14.

²⁹¹ See Directive 98/5/EC.

²⁹² In principle, the adoption of the International Standards on Auditing (hereafter "ISAs") of the International Auditing and Assurance Standards Board (IAASB, www.ifac.org/IAASB/) for statutory audits required by Union law is possible on the basis of Article 26 of the Statutory Audit Directive. Article 26 empowers the European Commission to make such adoption under certain conditions. However, the Commission has not taken any steps towards the adoption of the ISAs.

²⁹³ Currently, the following Member States apply ISAs: BE, BG, CY, CZ, EE, EL, HU, IE, LV, KT, LU, MT; NL, RO, SE, SI, SK and UK. Several other Member States apply national standards which follow the most important principles of ISAs.

In addition, maintaining distinct sets of auditing standards at Member State level could prove burdensome to regulators, standard setters and practitioners, not only at jurisdiction level but also in cross border activities.

Option 1: Introduction of clarified ISAs²⁹⁴ in the EU through their endorsement by Member States, who would be allowed to impose additional requirements (add-ons).

The International Standards on Auditing (ISAs) are professional standards for the performance of financial audit of historical financial information. These standards are issued by the International Federation of Accountants (IFAC) through its International Auditing and Assurance Standards Board (IAASB). The ISAs cover, *inter alia*, (i) objective and general principles governing an audit of financial statements (ISA 200); (ii) terms of audit engagements (ISA 210); (iii) quality Control for Audits of Historical Financial Information (ISA 220); (iv) audit evidence (ISA 500); (v) going concern (ISA 570); (vi) forming an opinion and reporting on financial statements (ISA 570) and other areas of the financial audit.

ISAs are written in the context of an audit of financial statements by an independent auditor. They are to be adapted as necessary in the circumstances when applied to audits of other historical financial information. In March 2009, the IAASB announced the completion of the so-called "*Clarity project*", whose purpose was to review in a comprehensive manner all the ISAs in order to improve their clarity.²⁹⁵ Following completion of the programme, auditors worldwide have access to 36 updated and clarified ISAs. These standards are designed to enhance the understanding and implementation of the ISAs, as well as to facilitate translation. The clarified standards are effective for audits of financial statements for periods beginning on or after December 15, 2009. The final set of clarified standards comprises 36 ISAs and ISQC, including:

- One new standard, addressing communication of deficiencies in internal control;
- 16 standards containing new and revised requirements (these have been referred to as "revised and redrafted ISAs"); and
- 20 standards that have been redrafted to apply the new conventions and reflect matters of general clarity only (these have been referred to as "redrafted ISAs and redrafted ISQC").

Option 2: The introduction of clarified ISAs in the EU through their endorsement by Member States, with the possibility for Member States to adapt and modify (carve-out) the international auditing standards to the specificities and the requirements of individual jurisdictions.

Objective 4.3: Sub-policy options to ensure that statutory audit is adapted to SMEs needs

Baseline scenario. In the absence of legislative measures, it could be possible that some Member States would voluntarily follow the example of France in adapting the audit standards to the size and dimension of activity of SMEs or provide for a "limited review" instead of statutory audit

²⁹⁴ See FEE (September 2011).

²⁹⁵ In addition to the ISAs, the "Clarity project" deals with the review of the International Standards on Quality Control (ISQC).

for small companies, which is mandatory in Estonia and voluntary in other Member States. It could also be possible that individual auditors or firms would take the initiative to apply the auditing standards in a proportionate manner to the audit of small companies²⁹⁶. However, this is unlikely to have a substantial impact across the EU for SMEs.

Option 1: Adapt audit standards to the size and complexity of the business of the audited entity. This option would consist in requiring Member States to ensure that the applicable audit standards are applied in a proportionate and simplified manner to SMEs. Audit standards, including international auditing standards, are scalable to size²⁹⁷. In order to maintain the unicity of auditing standards (see the policy options regarding the objective 4.2), this option would not require the enactment of other standards that would derogate from the ISAs. It would rather consist in: (a) ensuring that the audit oversight bodies accept such proportionate and simplified audits as a valid application of the auditing standards and (b) requiring national professional bodies to provide auditors with guidance on how the auditing standards should be applied in a proportionate and simplified manner.

Option 2: Introduce limited reviews for SMEs instead of statutory audit. This option would consist in requiring Member States to introduce a different type of assurance service providing a lower level of assurance than statutory audit for small companies (e.g. “limited review”), as an alternative option to statutory audit, whether simplified audit or not.

Option 3: Combination of options 1 and 2.

(5) OBJECTIVE 5: POLICY OPTIONS TO IMPROVE THE EFFECTIVENESS, INDEPENDENCE AND EU-WIDE CONSISTENCY OF THE REGULATION AND SUPERVISION OF AUDITORS

Objective 5.1: Sub-policy options to ensure the independence and effectiveness of supervision of national statutory auditors and audit firms.

Baseline Scenario. The Statutory Audit Directive, complemented by the *Commission Recommendation on external quality assurance for statutory auditors and audit firms conducting audits of public interest entities* (see [Annex 2](#)), only establishes a principles-based legislative framework. Member States have discretion concerning the appointment of national authorities for the different tasks foreseen in the Directive. It is specifically allowed to appoint a private professional body as competent authority for the approval and registration of auditors and audit firms.

This framework has failed to ensure the robustness and independence of all national audit supervisors. The external quality assurance and supervisory practices are still very divergent between Member States, which does not ensure a level playing field for audit firms. In terms of sanctions, the activity of Member States is relatively limited.

On the whole, there is little public information regarding sanctions imposed by European Audit Oversight Authorities for auditors. Generally speaking, following their inspections, Oversight Authorities make recommendations to audit firms on how to improve their audit quality and

²⁹⁶ See for instance, the initiative of a Canadian auditor in Cowperthwaite (2011).

²⁹⁷ Therefore, it is technically possible for a statutory auditor/audit firm to issue a valid audit opinion ("an audit is an audit") while limiting the audit work to the essential steps that are meaningful to the dimension and complexity of the business of SMEs.

follow-up these recommendations. However, only a few Authorities report on sanctions coming from those recommendations:

- In the Netherlands, the inspection report for 2010 states that the AFM intends to take formal enforcement measures against one or more Big 4 firms. Formal enforcement measures may include an instruction, an order for incremental penalty payments or an administrative penalty. However, it is also added that imposing a formal enforcement measure involves a certain amount of time;
- In France, the inspection reports for 2009 and 2010 give details of the recommendations made to audit firms following inspections undertaken during those years. However, no information is provided regarding sanctions imposed on audit firms (just the "follow-up" of those recommendations);
- In Italy, the situation is similar to France. Consob has formulated specific recommendations on actions to be taken to remedy shortcomings discovered during the reviews. However, there is no information on any sanctions which may have been imposed as a consequence of those recommendations (just the "follow-up" of the recommendations)
- In Spain, there have been no sanctions coming from the quality assurance system/inspections (mainly due to the late transposition of the Directive). However, there have been sanctions coming from the investigation system; 42 sanctions in 2010 and 40 sanctions in 2011 were imposed to auditors (which represents around 15% of the total number of investigations initiated);
- In Germany, the disciplinary proceedings are reflected in the following table:

	2010	2009	2008	2007
Reprimands	115	61	58	46
- with fines	75	32	19	14
Judgment of court	-	1	2	5
Other sanctions by public prosecutor's office	19	22	21	17
Instructions	105	165	145	160
Dismissals	211	218	150	229
	450	467	376	457

- In the UK, the situation is similar to that in France and Italy. The annual reports for 2008/2009 and 2009/2010 detail the findings arising from the inspections and the need for improvements in the audits but do not mention any sanctions imposed following those findings. Professional bodies do impose sanctions, however.

It is unlikely that this situation will change in the absence of amendments to legislation.

Option 1: establishing an EU oversight authority. A newly created EU oversight authority would be responsible for the supervisory tasks foreseen in EU legislation on statutory audit.

Option 2: strengthening national audit supervisory practices. This option would imply building upon the existent national auditor supervisory structures, but establishing clear and robust requirements at the pan-European level on audit supervision, rather than relying on high level principles established currently in the Statutory Audit Directive. The requirements would be established in the field of independence (from the accounting/auditing profession), mandate and

powers of national audit supervisors. These requirements would be adjusted depending on the part of the market addressed: in the case of the audit of PIEs, the requirements would be more detailed in EU legislation.

For the supervision of the audit of non-PIEs, this option would imply reinforcing the independence requirements of the national competent authorities. It would also imply establishing a single authority holding the ultimate responsibility for the supervisory duties, even if the delegation of certain tasks could be admissible.

In the case of national authorities supervising statutory audits of PIEs, this option would imply that a national competent authority takes responsibility for the supervisory duties. This authority would be selected from three possible options: the securities markets supervisor²⁹⁸; the national authority that controls compliance with the financial reporting framework in accordance with the derogation foreseen in the second paragraph of Article 24(1) of the Transparency Directive²⁹⁹; or a national authority that is specifically entrusted to carry out supervision on audit³⁰⁰.

The requirements for national supervisors regarding supervision of statutory audits of PIEs would include:

- cooperating with other relevant authorities at national level, including supervisors of PIEs or financial intelligence units;
- undertaking quality assurance reviews on the audits carried out;
- investigating with a view to detecting, correcting and preventing inadequate execution of the statutory audit of PIEs;
- monitoring the developments in the market for the provision of statutory audit services to PIEs, in particular (but not exclusively) in relation to market concentration levels, including at the level of specific sectors; and assessing the need for structural measures to mitigate any risk arising from high concentration, such as: establishing caps on market shares, requiring the deconsolidation of audit firms or carving out part of the sectoral expertise of large audit firms;
- regularly monitoring the possible threats to the continuity of operations of large audit firms, including the risks arising from high concentration, as they could disturb the market and have effects on financial stability; and requiring large audit firms to establish contingency plans to address such threats³⁰¹;
- being transparent as regards their activity, including publication of individual quality assurance reviews reports;
- cooperating with other national authorities (see objective 5.2).

This option would imply that the authorities supervising the statutory audit of PIEs be appropriately empowered to undertake their duties: access documents, demand information,

²⁹⁸ This is the case in Italy (Consob) or the Netherlands (AFM).

²⁹⁹ This is the case in the UK (FRC).

³⁰⁰ Such as in France (H3C), Germany (Abschlussprüferaufsichtskommission) or Spain (ICAC)

³⁰¹ See European Parliament (2011), §49 and seq.

carry-out inspections etc. They should also be able to take specific supervisory measures, such as temporarily prohibiting the statutory auditor, audit firm or key audit partner from carrying out statutory audits of PIEs, declaring that the audit report does not meet the legal requirements, requiring the statutory auditors/audit firms to modify their transparency reports, require the statutory auditor, audit firm or PIE to bring an infringement to an end, issuing public notices or referring matters for criminal prosecution. See also [Annex 22](#) on sanctions.

Objective 5.2: Sub-policy options to set-up an effective EU-wide supervisory cooperation mechanism that would also ensure an efficient supervision of supranational audit firm structures

	Baseline scenario	Option 1	Option 2	Option 3
	EGAOB	Level 3 Lamfalussy-type committee	Integration of cooperation within the European Supervisory Authorities (ESMA, EBA, EIOPA)	New European Authority on Audit Supervision
Legal entity	No	Yes, under national law	Yes, created by EU legislation	Similar to option 2
Created by	Commission decision	Commission decision and a parallel private law agreement between members	European Parliament and Council Regulations	Similar to option 2
Administrative structure	No independent secretariat and no specific premises. The Commission provides both	Independent secretariat would need to be created Specific premises needed	Integration within the secretariat and premises of the ESAs and their Joint Committee	New administrative organisation to be created, including chair, executive director and secretariat
Funding	EU budget (meeting room, Commission secretariat and travel expenses of a national representative per Member State)	Members contributions EU budget contribution possible under certain circumstances	Partially financed by EU budget, partially by members. Some fees from some market participants are possible	Similar to option 2
Commission's role	Chair	Observer	Non-voting member	Similar to option 2
Role in regulation and standard setting	Advisory role to the Commission	Advisory role to the Commission Prepares guidance	Advisory role to the Commission Prepares guidance Prepares draft technical standards for Commission endorsement	Similar to option 2
Role in supervision	Exchange of good practices and information	Exchange of good practices and information Mapping and peer reviews	Exchange of good practices and information Mapping and peer reviews Coordination Colleges of supervisors	Similar to option 2

Baseline scenario: The continuation with the *status quo* on the EU-wide cooperation poses the following regulatory issues:

- misalignment of incentives and asymmetric information. The Commission services would continue to run the structure though it has no incentives to organise the supervisory cooperation and exchange of best practice since these tasks do not normally fall under the Commission's mandate. The agenda is developed by the Commission services, which does guarantee that the issues put forward for discussion are those which are a priority for audit regulators. With the Commission leading the EGAOB, there is no possibility for European audit regulators to discuss confidential matters, such as the findings of audit inspections or organisation of inspections of pan-European audit firm structures.
- The EGAOB structure is informal. The EGAOB is legally speaking an "expert group" advising the Commission, under the control of the latter. As such, the EGAOB has no mandate or powers to take any formal decisions, such as in the field of EU-wide oversight or inspections of pan-European audit firm networks.
- The absence of a performing structure does not result in supervisory convergence. There are no common minimum criteria regarding inspections, no common practices regarding the adaptation of inspections/supervision to the different size/type of auditors, no convergence on the access to the profession/apptitude tests etc.

Option 1. Level 3 Lamfalussy Committee type structure

This option would require the establishment of an independent advisory Committee by the Commission. This option would require that Member States agree on a seat for the level 3 Committee, the establishment of a secretariat and related funding issues.

This option would give an independent legal status to the EGAOB. The level 3 Committee would be empowered to decide on its own work and would be independent from the Commission in its decision taking, with the Commission being only an observer at its meetings.

The scope of work of this level 3 Committee would cover convergence in the application of supervisory practices at Member State level, whether regarding audit of PIEs or of other entities. However, it would not have the same legal powers enjoyed by the European Supervisory Authorities (ESAs) in the area of convergence in supervisory practices. It would provide a platform to coordinate the EU-wide supervision/inspections of pan-European audit firm networks but with no possibility of direct involvement in the supervision or inspections of supranational audit firm structures.

In terms of costs, it is expected that the annual budget of a level 3 Committee dealing with auditing issues could be around €3 – €4M. In 2010, the smallest budget for a level 3 Committee was €3.7M for CEIOPS.

Option 2. EU-wide cooperation on auditor oversight within ESMA (See also Figure A18.7 in Annex 18)

This option would consist in entrusting ESMA to organise the EU-wide cooperation on audit oversight. ESMA would cooperate with EIOPA and EBA within the Joint Committee established by the 3 European Supervisory Authorities (ESAs).

A requirement for ESMA to establish a specific internal committee devoted to audit policy would be imposed (currently, there is a sub-committee within ESMA dealing with audit policy).

This option would also allow for the application of the legal powers of the ESAs: the possibility to issue guidelines or to prepare technical standards for endorsement by the Commission, where specifically so empowered.

The legal framework governing ESMA allows for accommodating different national authorities with different competences within its structure, while respecting the repartition of competences at national level. Therefore, no legal change would be needed regarding the decision-making chain within ESMA.

Option 3. New European Authority of Audit Supervisors

European cooperation between audit supervisors would adopt the same approach as in other areas of the financial sector: i.e. creation of a new European Supervisory Authority specifically devoted to the audit market. If this option is pursued, a Regulation creating the new Authority, similar to the ones creating ESMA, EIOPA and EBA, would be needed.

Advantages of Option 2 compared to options 1 and 3.

Out of the three Authorities, *a priori*, the European Securities Markets Authority (ESMA) would be the most appropriate body to undertake enhanced EU-wide audit cooperation and supervision matters:

- Some national audit regulators (LU, NL, IT) already function within the structure of national securities regulators.
- ESMA members are also responsible for supervision of compliance with the Transparency Directive, which applies to all listed companies (the bulk of the "public interest entities"). This includes compliance with the financial reporting obligations.
- ESMA has a flexible structure: while Member States should appoint a "main" member (the main securities regulator in each market), the rules allow for this member to be accompanied in board meetings by other responsible authorities if the subject matter so requires. This allows, for instance, that other authorities are involved in specific issues: e.g. for the UK, FRC regarding accounting or The Takeover Panel regarding takeover rules.
- ESMA already has an active group dealing with auditing issues within the Corporate Reporting Standing Committee. The ESMA secretariat would, with some marginal increase, cope with additional work.
- While ESMA could take a leading role, this does not prevent EIOPA and EBA from also being involved in auditing matters. The Joint Committee (grouping the 3 authorities) formalises cooperation between the three authorities and it is already expected to work on auditing issues (cf. Article 54 of the ESMA Regulation).
- This option is less costly to implement than creating a new European Authority of Audit Supervisors, but ESMA would contribute to the convergence of supervisory practices, coordination of the supervision of the supranational audit firms structures. In terms of the costs, they are expected to be similar to the costs of running the current EGAOB structure (which mainly comprise the costs of meetings).

Compared to option 1, the ESMA structure could address these issues of the current EGAOB structure:

- it could provide a platform to coordinate the EU-wide supervision/inspections of pan-European audit firm networks, in particular as regards PIEs;
- reducing differences in the application of supervisory practices at MS level, in particular as regards PIEs;
- the structure provides legal recognition to the cooperation and integrates into the recently created structure for the supervision of the EU financial sector;
- this option would allow the ESAs to develop "technical standards", helping convergence in auditor regulation and supervision.

The main limitation of ESMA (or generally the European Supervisory Authorities) option is that any cooperation at ESMA (or ESAs) level would be mainly limited to public interest entities (listed companies and financial institutions). This would imply that cooperation on supervision of non-PIEs would more than likely be carried out on a bilateral basis. At the same time, the cross-border dimension of non-PIEs (and therefore the need for coordination on the supervision of audits) is limited.

A new European Authority of Audit Supervisors (option 3) would provide an additional benefit of being coherent in terms of mandate and powers with other European Supervisory Authorities and of making sure that the cooperation on the oversight of the audits of non-listed companies is fully taken into account.

The new European Authority of Audit Supervisors would be much more costly and time consuming to implement compared to all the other options considered in this analysis. The 2011 budget for the current European Supervisory Authorities ranges from €12.7M to €16.9M.

Additionally, the scope of such an Authority would be relatively limited, compared to EBA, EIOPA and ESMA.

ANNEX 9. SUMMARY OF VIEWS OF STAKEHOLDERS ON PREFERRED POLICY OPTIONS

This Annex presents a summary table with the views of stakeholders on preferred policy options. When appropriate, it illustrates the alternative solutions proposed.

Table A9.1

Policy option	Stakeholders	
	In favour	Against/Other views
Clarify and specify the scope of statutory audit to reduce the expectation gap	Broad support by the majority of stakeholders (professional bodies and associations linked to the profession; investors; public authorities and others). The European Parliament supports clarification of the role of auditors in order to address the expectation gap.	Many representatives of the profession maintain that the expectation gap is unlikely to be closed. Some representatives of the profession suggested that the audit report should provide more forward-looking information and some more disclosures on risk, judgements and estimates, whereas public authorities strongly disagree on this point.
Improve and expand the content the audit report disclosed to the public and require the preparation of a longer and more detailed report for the audited entity	Broad support by the majority of stakeholders (professional bodies and associations linked to the profession; investors; public authorities and others). The European Parliament is in favour of providing more information in the audit report and that auditors should focus more on substance than on form.	<i>N.A.</i>
Increase the communication between the auditor and the audit committee	Broad support by the majority of stakeholders (professional bodies and associations linked to the profession; investors; public authorities and others)	<i>N.A.</i>
Requiring the establishment of regular dialogue between auditors and supervisors of PIEs which are financial institutions	Broad support by the majority of stakeholders (professional bodies and associations linked to the profession; investors; public authorities and others) The European Parliament is in favour of enhanced, two-way communication between auditors and financial supervisors of financial institutions, especially in relation to specific areas of concern.	<i>N.A.</i>
Strengthening the role of the audit committee regarding the appointment of auditors	Broad support by the majority of stakeholders (professional bodies and associations linked to the profession; investors; public authorities and others) Strong support by the European Parliament.	Some stakeholders are in favour of establishing a procedure for the appointment of the auditor by a third party in the case of certain public interest entities or that a regulatory authority has the "right of veto" (public authorities, some professional bodies and investors).

Mandatory rotation	Some public authorities suggested that the audit firm should rotate at the same time as the audit partner. In addition, there is some support from academics.	There is a general rejection of mandatory firm rotation by the profession. Large audit firms and other professional bodies and associations linked to the profession claim that rotation would harm audit quality and increase costs. The European Parliament considers that internal rotation of key audit partners suffices to address the issue of auditors' independence.
Mandatory regular tendering	There is strong support among professional bodies and associations linked to the profession for tendering on a regular basis (e.g. every 3 or 5 years mentioned) or even mandatory tendering. Mid-tier Firms and SMPs are also in favour of mandatory tendering. Many investors, as well as some public authorities, support mandatory re-tendering after a specific period of time. The European Parliament is in favour of an open tendering process for statutory appointments of auditors every eight years, on a renewable basis.	Some audited entities insist that the company should decide in certain circumstances to keep the same auditor if the benefits of continuity are demonstrable.
Pure audit firms/prohibition of the provision of non-audit services	Some of the representatives of the profession could consider restricting non-audit services to audit clients. Mid-tier Firms and SMPs approve the prohibition of non-audit services only with regard to PIEs. Investors support the prohibition of non-audit services that have no natural connection with the audit. Public authorities consider that the prohibition of non-audit services should be done on a case by case basis. There is broad support by academics for the introduction of such a prohibition. The European Parliament is in favour of the drawing-up of a list of conditions under which such services would be deemed incompatible with audit services (blacklisting).	The vast majority of the profession are against the prohibition of the provision of NAS by audit firms as they consider that this would weaken the range of skills they can offer.
Joint audit	Mid-tier firms and SMPs strongly support joint audit where at least one non-systemic firm is included. Public authorities generally support the introduction of joint audits provided that there are clear rules as to how it will work in practice. Preparers are not opposed to joint audit if it is well-balanced.	The Big Four are quite negative towards joint audit as they believe that it will impair audit quality and will cause coordination problems. Some public authorities expressed concerns regarding the introduction of joint audits as they might pose coordination problems.

The European Parliament recognises that the implementation of joint audits could have positive effects on the diversification of the audit market.

Prohibition of contractual clauses limiting the choice of an audit firm	There is a strong support amongst the majority of stakeholders (profession; investors; Big Four; Mid tier firms and SMPs).	<i>N.A.</i>
Mutual recognition of audit firms and introduction of an adaptation period scheme and increased convergence, transparency and predictability in the aptitude test for statutory auditors	There is broad support among stakeholders (profession, investors) on the idea of a passport, though they do not focus on the details. The European Parliament is in favour of enhanced harmonisation with a view to creating a European passport for auditors.	Many public authorities were reluctant to accept the introduction of an European passport as this would harm quality and would be difficult to supervise.
Introduction of clarified ISAs	Very broad support amongst the majority of stakeholders albeit not always for a binding approach (professional bodies and associations linked to the profession; investors; public authorities and others). The European Parliament is in favour of the adoption of clarified ISAs, through a regulation.	Some SMPs requested sensitivity to the administrative burden. Companies expressed less enthusiasm about the adoption of ISAs. The main reasons were that ISAs do not take account of the diversity of the audit model in Europe and that there is an important cost dimension associated with the adoption of ISAs.
Adapt audit standards to the size of the audited entity: proportionate audits for SMEs	General support amongst stakeholders, especially by SMEs and SMPs	<i>N.A.</i>
Strengthening national audit supervisory authorities and giving ESMA responsibility for EU-wide cooperation on audit oversight	The vast majority of stakeholders favoured the strengthening of the national audit supervisory authorities. The European Parliament is in favour of integrating the European Group of Auditors' Oversight Bodies into the European System of Financial Supervision, possibly through the ESMA	The Big Four do not support integrating audit oversight bodies in the new European Supervisory Authorities.

ANNEX 10. THE PROVISION OF NON-AUDIT SERVICES TO THE AUDIT CLIENT AND THE QUESTION OF PURE AUDIT FIRMS

Information is a key pillar for financial markets. Audits give investors assurance on the integrity of the financial information they receive. Auditor independence is therefore a key element in the statutory corporate reporting process.

Providing non-audit services (NAS) while auditing a company presents a potential source of conflict of interest arising from or within the audit firm: i.e. the audit firm has an interest to secure additional revenue from the provision of other (non-audit) services. In instances where the revenues from NAS become substantial from a statutory audit client, the independence of the auditor is even more at risk. If the provision of statutory audit effectively becomes a gateway to the provision of NAS to the same client, "professional scepticism" – i.e. the ability of the auditor to question the assumptions made by the audited entity – would naturally be compromised³⁰².

This annex presents (1) the experience in the EU and the US in dealing with this conflict of interest. It also describes the main advantages and disadvantages of two possible policy options to address this conflict of interest: (2) a ban the provision of certain NAS to the audit client and (3) a ban the provision of any NAS to the audit client and (4) the creation of "pure" audit firms.

(1) The experience in the EU and the US in dealing with the conflict of interest created by the provision of NAS.

There is currently no EU-wide ban preventing auditors from offering NAS to audit clients. According to Article 22 of the Statutory Audit Directive, audit should not be provided in cases where "*an objective, reasonable and informed third party would conclude that the statutory auditor's or audit firm's independence is compromised*". However, Article 22 stipulates only the principles and, given the Member States' discretion, it has so far been implemented in a very divergent manner across the EU.

In France and Belgium, national legislation provides a strict framework regarding the provision of NAS. In the other Member States, auditors and audit committees have a large margin of manoeuvre in appreciating whether the provision of NAS results in a conflict of interest.

The practice in Belgium

Following the EC recommendation of 16/05/2002 on Statutory Auditors' Independence in the EU: a set of fundamental principles, a 2003 Belgian law introduced a list of services which are not compatible with the provision of statutory audit services. The list covers the following type of services:

- taking part in the decision making of the audited entity;

³⁰²

The International Standards on Auditing (ISAs) define professional scepticism as "*an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence*". The application of an appropriate degree of professional scepticism "*is a crucial skill for auditors*". See FRC (March 2011), p.1. See also FRC (August 2010) generally.

- assisting or taking part in the bookkeeping or in the preparation of the annual accounts or the consolidated accounts of the audited entity;
- conceptualising, developing, and/or installing information systems to manage financial information within the audited entity;
- carrying out evaluations of important elements reflected in the annual and consolidated accounts;
- taking part in the internal audit function;
- representing the audited entity in the settlement of disputes (including with the Tax Office);
- intervening in the recruitment of staff for the audited entity.

It should be noted that the definition of audit firm (or statutory auditor) is enlarged to cover, apart from the audit firm performing the audit, any other legal entity or physical person linked to the statutory auditor. However, the notion of audit network is not introduced by this definition.

As far as the volume of NAS (not banned by the law) is concerned, the so called "one to one" rule is applied (revenues from NAS should not be greater than revenues from statutory audit services). This rule aims at limiting the NAS but only for a special group of entities (listed companies and companies publishing consolidated accounts). At the same time, an option to derogate from the above mentioned rule for these companies is envisaged. Such a derogation can be approved in 3 cases, namely by the audit committee, the Controlling Committee under Belgian Law, or in case no audit committee exists a derogation can be approved by a college of independent auditors (if such body has been introduced in the audited entity).

The practice in France

The definition and enforcement of independence rules in the area of audit in France are developed in the Code of ethics of the audit profession. As far as the provision of NAS is concerned, it is forbidden for the statutory auditor (or any entity/ person part of its national/ international network, controlled by him or controlling him) to provide any service not directly related to the core statutory audit service. In the case of the provision of services directly by the statutory auditor or other auditor (part of its network or having common commercial interests with him/her), the statutory auditor must ensure that they are compatible with its statutory audit functions. In case of doubt, he/she may also consult the High Audit Commission for an opinion.

The compatibility of any services with the provision of statutory audit is assessed against a list of activities, some of which are considered directly incompatible with statutory audit services, while others are presumed to affect the independence of the statutory auditor.

Services which are incompatible with statutory audit service:

- preparation of any financial or accounting information to be included in the consolidated accounts subject to the statutory audit;
- development or enforcement of any procedural element of the internal control or the risk management, related to the preparation or control of financial or accounting information to be included in the consolidated accounts subject to the statutory audit;

- Carrying out of any activity directly or on behalf of the management of the audited entity.

Services presumed to affect the independence of the statutory audit:

- bookkeeping and any other activity related to the preparation of the accounts;
- recruitment of staff exercising sensitive functions;
- participation in the process of developing and installing financial information systems;
- legal advice to the management of the audited entity;
- advice related to financial management;
- advice on tax issues;
- acting on behalf of the management in financial operations, representing them before any jurisdiction or providing expert advice to the management/ entity in the defense of their interests in legal disputes;
- monitoring of subcontracting related to the above mentioned type of activities.

The United States of America's example:

In the United States of America, under the Sarbanes-Oxley Act of 2002, the audit committee is responsible for the appointment, compensation and oversight of the work of the independent auditor. As part of this responsibility, the committee is required to pre-approve any audit and NASs performed by the independent auditor in order to ensure that they do not impair the auditor's independence from the company. To implement these provisions of the Act, the Securities and Exchange Commission (SEC) issued rules specifying the types of services that an auditor may not provide to its audit client, and outlining the audit committee's administration of the engagement of the independent auditor. The rules list services that, regardless of the size of the fees they generate, place the auditor in a position inconsistent with the necessary objectivity. It is considered that bookkeeping services, for example, place the auditor in the position of later having to audit his or her own work and identify the auditor too closely with the enterprise under audit. Similarly, an auditor who helped to negotiate the terms of employment for an audit client's chief financial officer is less likely to bring quickly to the audit committee questions about the new chief financial officer's performance. However, it is considered that an audit firm can provide tax services such as tax compliance, tax planning and tax advice to its audit clients, as long as such services are pre-approved by the audit committee, without impairing the audit firm's independence.

The SEC's rules establish two different approaches to pre-approving services, which the SEC considers to be equally valid. Proposed NASs may be pre-approved by the audit committee without consideration of specific case-by-case services ("general pre-approval"), or pre-approved by the audit committee on a specific case-by-case basis ("specific pre-approval").

Under the US rules, while there are certain audit services for which there is a presumption of conflict of interest and which, therefore, cannot be provided by the auditor to the audited entity, for a number of others it is up to the company to decide, on a case by case basis, whether a

conflict of interest exists, and thus whether or not the auditor concerned could be appointed to perform the audits of the company.

(2) A ban on the provision of CERTAIN non-audit services to the audited entity (blacklisting)³⁰³:

This is the option supported by the European Parliament³⁰⁴. Some stakeholders (authorities, investors) could also accept it.

This solution implies that audit firms providing statutory audit and financial audit services would not provide certain NAS to an audited entity. This would amount to a blacklist of NAS. The prohibition would be extended to the parent company of the audited entity and its material subsidiaries.

The blacklist of certain NAS would include the following services:

- preparing accounting records and financial statements;
- bookkeeping services;
- designing and implementing financial information technology systems;
- valuation services (including appraisal or valuation services, fairness opinions or contribution-in-kind reports);
- actuarial services;
- participation in the audit client's internal audit and the general provision of services related to the internal audit function;
- design and implementation of internal control or risk management procedures related to the preparation and/or control of financial information included in the financial statements;
- acting for the audit client in the resolution of litigation;
- legal services and expert services unrelated to the audit;
- tax advice/consultancy services;
- recruiting senior management and human resources generally;
- broker or dealer, investment advisor, or investment banking services;
- risk advice;
- due diligence services to the vendor or the buy side on potential mergers and acquisitions;
- providing assurance on the audited entity to other parties at a financial or corporate transaction;
- providing comfort letters for investors in the context of the issuance of an undertaking's securities;
- general management consultancy services; and
- any partial or total outsourcing of the above tasks.

It would also require adding a general catch-all clause for non-audit services modelled on the existing Article 22(2).

In addition, concerning the provision of other services which are not part of the audit mandate and are not included in the blacklist, the general rules on the assessment of possible threats to

³⁰³ The blacklist could include services such as preparing accounting records and financial statements, bookkeeping services, designing and implementing financial information technology systems, etc. See [Annex 8](#).

³⁰⁴ European Parliament (2011), §29 and seq. The European Parliament also suggests that the role of the audit committee in deciding whether the provision of NAS is possible should be reinforced.

independence would apply. Therefore, to provide these other services, the audit firm would need to request the approval of the audit committee³⁰⁵.

Advantages:

- The issue of conflict of interest which is generally associated with the auditor providing both audit services and NAS to the audit client would not be as patent as it is today. Allowing the auditor to provide only a limited number of NAS would mean that his/her independence would no longer be potentially questioned in all circumstances.
- Blacklisting would have a positive effect on streamlining and harmonising policies among Member States³⁰⁶, creating a level playing field for all audit providers in the EU. It would be easier for investors and regulators to identify the cases in which auditor independence might raise an issue.
- It would also eliminate the legal uncertainties and potential conflicts of interest³⁰⁷ due to discrepancies in the blacklisting among Member States on the one hand and global geographical coverage of big audit firms on the other hand.
- This option could be supplemented with a cap on the other service (those which are not within the audit mandate and are not in the blacklist) fees compared to the total audit fees for a given client³⁰⁸.

The credibility of the audited financial statements of companies would increase accordingly (although not necessarily to the same extent as in the case of pure audit firms).

Disadvantages:

- In the case of a ban on the provision of certain NAS to the audit client, the issue of conflict of interest is not entirely solved, at least in appearance. Since the revenue of the audit firm from NAS is generally higher to that from audit services, it is difficult to envisage, at least in appearance, that the engagement partner is ready to admit that his/her objectivity might be impaired when providing NAS to the audited client. But it is not only the amount of NAS fees that creates the problem.

³⁰⁵ The current system in the Statutory Audit Directive relies on the role of the audit committee to take decisions regarding the provision of NAS by the statutory auditor or audit firm. It must review and monitor the independence of the statutory auditor or audit firm, and in particular the provision of additional services to the audited entity. For this, the statutory auditor or audit firm is required to (a) confirm annually in writing to the audit committee their independence from the audited public-interest entity; (b) disclose annually to the audit committee any additional services provided to the audited entity; and (c) discuss with the audit committee the threats to their independence and the safeguards applied to mitigate those threats.

³⁰⁶ Belgian and French lists are not identical, for instance.

³⁰⁷ For instance, an audit firm providing the same NAS to several entities within the same group in different MSs may be in situation of conflict of interest in one and in not in the other MS due to the differences in the way NASs are treated. In such a case, in order to provide the audit service to the parent undertaking of the group, the audit firm may apply the more lenient rules on independence of the country of the parent undertaking in the assessment of potential conflict of interests at the level of a given subsidiary, even if the legislation in the country of the subsidiary is stricter.

³⁰⁸ An option that would be based only on a cap on NAS fees (without blacklisting certain services) would not be practicable because of the risk of self-review.

- A conflict of interest arises not necessarily from the proportion of NAS fees compared to the audit fees, but from the fact that by performing two kinds of services, the audit firm is serving two kinds of clients: the management in the case of NAS and the audit committee in the case of the audit. The performance by the company's auditor of NAS at the direction and under the control of management is inherently corrosive and fundamentally incompatible with the duty of independence owed by the auditor to the investors. Therefore, the freedom necessary to perform the auditor's duties is curtailed and could even be eliminated where the auditor is also the provider of NAS.
- This option also does not address the perception problem concerning the role played by the audit partner. As the primary link between the audit firm and the client company, the audit partner has significant influence on the company's perceptions of the audit firm's reliability and the value of its services. Therefore, the company's trust in the audit firm's ability to provide NASs often comes from the confidence in the audit partner's competence. Such a close relationship between the audit partner and the company may impair both the real and perceived independence of the auditor because the audit firm is not likely to criticise the work done by its consultancy department.
- Despite the existence of a list of banned services, the audit firm has incentives to "rename" a NAS so as to avoid being captured by the blacklist. In addition, any service which is not on the blacklist is not *a priori* prohibited, but should be assessed. This obliges the audit committee to be vigilant on the issue, therefore relying on its capacity to take decisions on a case-by-case basis as to whether there are threats to independence arising from the provision of NAS. The system therefore over-relies on the judgement of audit committee members.

(3) A ban the provision of ANY non-audit services to the audited entity

Another way to reinforce the auditor independence is to ban the provision of any NAS by the statutory auditor or audit firm to the audited entity (PIE): statutory auditors or audit firms providing statutory audit to a PIE would not provide any non-audit service to this audited entity. However, the provision of non-audit services to entities which are not audited by the statutory audit or audit firm would not be prohibited.

The prohibition on the provision of services other than audit would also be extended to the parent company of the audit client and at least its material subsidiaries. A cooling off period of 2 years after the end of the audit engagement will be envisaged before being in a position to provide services other than audit.

Some services which are closely connected to statutory audit (including other statutory duties) should, however, be authorised (a "white list"). They would not be considered "non-audit" services.

Services closely connected to statutory audit which could be authorised:

- review of interim financial statements;
- assurance on corporate governance statements;
- assurance on corporate social responsibility matters;
- assurance on or attestation of regulatory reporting provided to regulators of financial institutions beyond the scope of the statutory audit and designed to assist regulators in fulfilling their role, such as on capital requirements or specific solvency ratios determining how likely a company will be to continue meeting its debt obligations;

– any other statutory duty related to audit work imposed by EU legislation.

Similar rules apply to credit rating agencies: credit rating agencies in the EU are not allowed to provide "*consultancy or advisory services*" to the rated entity or a related third party regarding the corporate or legal structure, assets, liabilities or activities of that rated entity or related third party³⁰⁹.

This option is supported by investors and accepted by some representatives of the profession, provided it applies to PIEs only³¹⁰.

Advantages:

- The positive effects would be similar to those for the previous option.
- In addition, independence of the auditor/audit firm/key audit partner would be reinforced, since no NAS could be provided to the audited entity, thus eliminating the conflict of interest that could arise from the provision of NAS. Therefore, the disadvantages of the first option (see above) would disappear.
- The incentives for audit firms/statutory auditors to by-pass the blacklist by providing remaining/other services would be reduced. Only a few additional audit-related services would be permissible and the list is less open to interpretation.
- Also, the over-reliance on the audit committee is reduced to the minimum.
- At the same time, this option should facilitate the growth of mid-size audit firms focusing on audit services and of consultancy firms focusing on NAS.

Disadvantages:

- A drawback, however, is that if the audit firm provides NAS to a particular client, it would no longer be able to provide audit services to that client, which could *de facto* reduce the number of audit firms eligible to audit large PIEs in the short term³¹¹.

(4) The option of 'pure' audit firms

Another way to reinforce auditor independence is to ban the provision of NAS by the audit firm³¹² to any client. In other words, audit firms would only provide statutory audit (and related

³⁰⁹ See Regulation (EC) No 1060/2009.

³¹⁰ On the contrary, audit firms fear the weakening of the range of skills they can offer and anticipate difficulties in attracting talented staff. This argument is somehow counterintuitive: if talented staff are recruited to provide NAS rather than audit services, this would have no direct effect in raising audit quality.

³¹¹ For instance, information provided by Assonime, the association of Italian listed companies, suggests that large Italian PIEs, when implementing the rotation of audit firm rule, find themselves faced with a very limited choice. Sometimes, only one audit firm (a Big-Four audit firm) is available to provide the statutory audit service (the outgoing audit firm being prevented from providing the service during the cooling-off period; the two other large audit firms being prevented from providing the service because of independence rules either in Italy or with regard to subsidiaries in other countries, and smaller audit firms are not always able to cope with the geographical coverage of the group of the PIE). This implies a shift of bargaining power to the detriment of the PIE. It also effectively results in rotation between two Big-Four audit firms.

³¹² This ban would be difficult to enforce regarding a statutory auditor as natural person. However, statutory audit services to PIEs are normally provided by audit firms.

services, see above) and only have audit clients. This would result in the creation of 'pure' audit firms.

For this obligation to be effective, it should be accompanied by some ancillary measures in order to make sure that the obligation is not circumvented. In particular:

- The audit firm should not be part of a network/group which provides "non-audit services" to avoid circumventing this restriction by simply splitting the responsibility for the different services into two different legal entities within a network;
- If the capital of the audit firm is open to non-partners, no more than 5% of the voting rights and/or the capital is held individually by any firm providing non-audit services and firms providing non-audit services taken as a whole do not account for more than 10% of the voting rights and/or of the capital;
- The audit firm should not directly or indirectly invest in firms providing non-audit services.

The advantages of 'pure' audit firms

- If 'pure' audit firms were created, this will radically solve the issue of both real and perceived conflict of interest arising from the provision by the audit firms of audit and NAS to the same client because the auditors would no longer be connected to the persons providing NASs. Indeed, public perception is important and investor confidence in the effectiveness of audit can be undermined if there is a perception that auditors lack independence and objectivity by providing NASs. If 'pure' audit firms existed, situations where the shareholders/the public consider that it is possible that an audit partner/firm when faced with an important client is likely to sacrifice his/her independence to secure a longer auditor-client relationship would be avoided. Consequently, the confidence of investors in the audit reports issued by the auditor would increase;
- The credibility of the audited financial statements of companies would increase as the auditor's independence would no longer be questioned, whereas currently due to the provision of dual sets of services to the same audit client there might be a perception that the professional judgement of the auditor is negatively influenced by his/her proximity to the audit client;
- This option would create incentives, on both the demand and the supply sides, to focus on audit quality: PIEs would have to select an auditor purely on the basis of their audit capabilities and audit firms would have to focus on audit services, which would significantly reinforce audit quality and the perception of the independence of the auditor;
- At the same time, a separation of the audit services from the NAS would not necessarily lead to a situation where the revenues of the audit partners would decrease, since profit margins would remain the same due to the respective adaptation of cost structure/business model of the "pure audit firms"..
- Despite the fact that audit companies will still be paid by the audited clients, the audit partners would become less vulnerable to economic pressure from these audit clients, since the potential loss of the parallel provision of NAS will no longer be at stake. At

the same time, if this option will be combined with mandatory rotation, the economic pressure not to lose the audit client would also be mitigated due to the inevitable switch;

- The audit report would better play its role as a key element of information for investors on the financial statements of a company and, thus, the investors would not be inclined to seek other sources of information to confirm the conclusions of the audit report;
- There would be a level playing field for the provision of NAS allowing other providers to compete for NAS previously provided by audit firms to their 'captive' audit clients;
- Some market entry barriers could be eliminated as new or smaller audit firms might be ready to invest knowing that in the context of 'pure' audit firms they would have a better change to enter the market segments of large listed companies and financial institutions currently largely dominated by Big Four audit firms;
- The choice of audit firms for the financial institutions and large listed companies which currently receive NASs from some audit firms would be enlarged: once converted into 'pure audit' firms there would no longer be any impediment to providing audit services to any entity (currently, an audit firm providing certain NAS to a client is *de iure* not eligible to provide audit services to that client because of the conflict of interest).

The disadvantages of 'pure' audit firms:

- Audit firms would need to segregate their audit and non-audit services into two separate entities. This entails legal transaction costs.
- The multi-disciplinary networks of the Big Four audit firms would also have to separate the audit services from NAS, which also entails costs and possibly resistance by third country members of those networks.
- Audit firms consider that this option might deprive them of the knowledge and understanding of their clients' businesses which they deem necessary to the provision of good quality audit services. While there may be synergies, providing NAS to an audited entity is not a condition necessary to provide audit services or be able to do so³¹³.
- The audited entities would have to rely on other service providers for the NAS, who may or not have appropriate skills and experience. Finding alternative NAS providers could entail initial extra costs for the companies. However, the audited entity may decide to keep the new entity segregated from the audit firm (and independent from it) as a provider of NAS, in which case this concern disappears. In any event, if the audited entity decides to look for another provider, the cost would be part of a business as usual situation.
- Any new NAS providers would require time to get to know the audited client. Similarly, the audited client would need to invest time and resources in order to facilitate the NAS provider's familiarisation with the client's business. This concern, however, is part of a business as usual situation.

³¹³ See Articles 6 and seq. of the Statutory Audit Directive.

- The conversion into 'pure audit' firms may act as a barrier to growth for mid-tier and small audit firms. Certain audit firms are essentially providing audit services to small PIEs and non-PIEs and are hardly present in the market for audits of large PIEs. Requiring their conversion into pure audit firms may lead to the creation of a barrier to growth and/or it may lead to their abandoning of the PIE market. This may impact on complementary initiatives such as joint audits with at least one non-Big Four audit firm. However, this concern may be addressed if this option is adjusted (see the proportionality analysis in [Annex 19](#)) to the size and dimension of activities of the audit firms (see [Annex 16](#)).

ANNEX 11. MANDATORY ROTATION OF AUDIT FIRMS

The introduction of mandatory audit firm rotation is one of the proposed options to mitigate the risk of any potential conflict of interest due to a "familiarity threat" (objective 2.3). Together with other options, it could also aim at contributing to the switching of an audit firm to improve market conditions (objective 3.1). This option, however, is controversial and has attracted the opposition of many stakeholders, in particular from the profession. The European Parliament has also expressed opposition. Opponents of mandatory firm rotation claim that the Statutory Audit Directive rules on partner rotation (as opposed to audit firm rotation) are enough to deal with the independence concerns. They also argue that the Italian experience has not been positive and the Italian market is as concentrated as others. Italy is currently the only Member State where the mandatory rotation of audit firms is enforced. In addition, they often refer to the increased costs, the loss of knowledge and therefore the negative impact on audit quality, the difficulty in maintaining industry specialisation and the potential lack of choice.

This annex presents (1) the experience of Italy with mandatory rotation of audit firms; (2) the main arguments in favor of mandatory rotation of audit firms; (3) the main arguments against mandatory rotation of audit firms and some counter-arguments; and (4) other experiences with mandatory rotation.

(1) The experience of Italy and others with mandatory rotation

Currently, Italy is the only Member State that requires mandatory audit firm rotation. It was introduced in 1974 to guarantee independence. The Italian model is as follows:

- **Duration of the audit engagement (9 years).** Public-interest entities are obliged to change audit firm every nine years. The initial duration of a single audit appointment was three years and the same audit firm could be re-appointed twice. However, in order to reinforce independence, the system was modified in 1998. Currently, the audit firm is appointed for 9 years. The Italian authorities consider that this long-term appointment guarantees the well-functioning of the rotation system. In addition, the duration of the engagement allows the audit firm enough time to recover the higher investment (e.g. to understand the audited entity etc) in the first years of the audit engagement.
- **Cooling-off period (3 years).** Until 1998, audit firms that finalised their activities after a nine year appointment, could not be re-appointed for five years; since 1998, this time limit has been reduced to three years.
- **Rotation of audit partner (7 years).** The rotation of audit firm rule applies in combination with the Statutory Audit Directive rule on audit partner rotation. Therefore, the audit firm would need to change the key audit partner within the 9-year audit engagement.

Concerning the question of **independence**, according to a Bocconi study conducted to investigate the impact of the mandatory rotation rule in Italy³¹⁴, 69 % of managers of listed companies approve of rotation. 14 % consider it negatively. They take a positive view mainly because they believe that over the years auditors tend to concentrate on routine activities and pay

³¹⁴ Bocconi (2002).

less attention to making suggestions/improvements. The people contacted in the survey generally agreed that the current existing mandatory rotation in Italy constitutes a mechanism to guarantee auditor independence. This has also been recognised by Assonime, the association of Italian listed companies³¹⁵.

Concerning the question of **market structure**, the Bocconi study³¹⁶ came to the conclusion that: mandatory audit firm rotation did not have much impact on the level of competition in the mandatory audit segment; and it has not given small to medium sized audit firms the opportunity to compete against large audit firms for contracts with the large public-interest entities.

These findings suggest that mandatory rotation of audit firms, taken in isolation, would have a limited effect on the structure of the market. However, mandatory rotation may have a positive effect in enlarging the choice of auditor for the audited entities when combined with other measures, such as a mandatory tendering rule requiring the audited entity to also invite small and medium-sized audit firms to submit bids or the joint audit rule. None of these rules are applied in Italy. Indeed, if a joint audit rule would require that at least one of the audit firms in the consortium is not among the largest firms, it would automatically introduce new players to compete in that segment of the market. Therefore, the rotation of audit firm rule may contribute to enlarging the choice of auditor and to provide an opportunity to (especially) medium-sized entities to enter into that segment of the market and compete with the largest ones.

Another argument, raised in the Bocconi study³¹⁷, refers to the point that mandatory audit firm rotation has a considerable impact upon the overall costs of audit services. More man-hours were necessary for the incoming auditor/audit firm in order to get to know the entity's business.

However, other measures may help to reduce this costs. Firstly, a true handover file could be made available by the outgoing auditor/audit firm. Secondly, if joint audits were required, it would mitigate that risk as both auditors would not need to rotate at the same time. This would smooth the transition of the audit engagement from one firm to the other and also ensure that the specialised knowledge of the entity is not lost. Therefore, the amount of working hours needed to introduce the incoming audit firm to the special features of the audited entity could be reduced (see also the arguments advanced in section 6.3 of this paper).

(2) Positive impacts of mandatory rotation

Mandatory audit firm rotation presents advantages both in terms of meeting potential conflicts of interest and stimulating competition. The following issues should be considered:

- In a long term audit relationship, the auditor will tend to identify too closely with the management. The proper professional scepticism will be diluted and auditors will be more likely to smooth over areas of difficulty in order to preserve the relationship. Auditors may become stale and view the audit as a simple repetition of earlier engagements³¹⁸. This staleness fosters a tendency to anticipate results rather than

³¹⁵ "Il nostro sistema...garantisce alti livelli di indipendenza". Assonime (February 2011), p. 9

³¹⁶ Bocconi (2002).

³¹⁷ Bocconi (2002).

³¹⁸ A long term engagement leads to audit work becoming excessively routine, which would ultimately affect the competence. A long period working with the same client can lead the auditor to put too much trust in the previous years' work and, consequently, may lead the auditor to treat the work as a repetition of the reviews performed in prior years.

keeping alert to subtle but important circumstances. The great preponderance of high profile financial reporting failures occurred in circumstances where the audit firm had been engaged for many years³¹⁹.

- As explained above, managers of Italian listed companies broadly approve of mandatory rotation of the audit firm³²⁰ and consider that this mechanism guarantees auditor independence.
- A similar effect is alleged in "self-revision" cases, those in which the auditor must report negatively on his previous work. In these contexts, by bringing a "fresh view" and forcing an in-depth review, rotation of the audit firm might attenuate these problems³²¹.
- In addition, in long term engagements it is more likely to increase materiality thresholds. A study performed by Bates et al.³²² demonstrated that in the absence of rotation of the audit firm, the materiality threshold was set at an average of \$ 365,000. When there was rotation of audit firms, the threshold was only set at an average of \$ 201,000.
- Dopuch, King and Schwartz (2001) observed that the highest frequencies of favourable auditors' reports, as a measure of the actual behaviour of the auditor, occurred in regimes without mandatory audit firm rotation.
- The fear that reputation will be affected, when discovery of an unreported breach is made public, will also enhance audit quality. According to Hoyle³²³, mandatory rotation will make it possible for audit firms to control each other's work. The knowledge that another audit firm will scrutinise the auditor's work within a short period of time will encourage the auditor to do its best. Mandatory rotation will also minimise the risk that errors in the audit procedure continue due to the fact that the auditor looks upon the audit engagement as a reiteration of last year's audit.
- As shown in [section 2.3](#) high concentration is observed in national markets for audits of listed companies and financial institutions. This leads to limited choice and high prices. The introduction of mandatory audit firm rotation ensures that mandates regularly become available in the market. This opens the opportunity to acquire new engagements and therefore stimulates competition.
- Mandatory rotation of audit firms addresses the shortcomings of the "partner rotation." According to Article 42 (2) of Directive 2006/43/EC, the key audit partner(s) responsible for carrying out the statutory audit of a PIE on behalf of the audit firm needs to rotate from the audit engagement within a maximum period of seven years. The European Parliament seems satisfied with the *statu quo* on this point: while it regards external rotation as a means of strengthening the independence of auditors, it reiterates

³¹⁹ Arel et al. (2005).

³²⁰ The main reason why they take a positive view is that they believe that over the years auditors tend to concentrate on routine activities and pay less attention to making suggestions/improvements. See Bocconi (2002).

³²¹ Arruñada & Paz-Ares (1997).

³²² Bates et al. (1982). See also FEE (2004), p. 9.

³²³ Hoyle (1978).

its view that "*the existing partner rotation arrangements provide the independence necessary for audits to be effective.*"³²⁴ However, the key partner rotation seems to be insufficient to solve the existing problems. On the one hand, the threat of familiarity is not resolved. The "partner rotation scenario" with no rotation of audit firm risks perpetuating the syndrome of decades-long audit engagements, where the partner of a firm's long standing (sometimes over a hundred years) audit client naturally remains under pressure not to lose the client³²⁵. Moreover, in case of partner rotation only, a new partner will likely feel obliged to live with decisions and agreements made by the previous partner; he/she may have little flexibility to reopen them. The partner of a new firm does not have that problem³²⁶. On the other hand, opportunities to enter the upper segment of the market are not provided.

Taking the above mentioned into consideration, the introduction of mandatory rotation of audit firms improves audit quality in terms of the avoidance of over-familiarity with the client and its management and the opportunity for a fresh approach to the audit. Moreover, it provides a better perception of auditor independence³²⁷. Additionally, it stimulates competition so that potential new players have access to certain segments of the market. Furthermore, the stimulation of competition could lead to a decrease in audit costs because when looking for a new auditor, the audited firm is also able to look at different price offers and can include that in their decision.

The audit as such gains in terms of reliability and trust taking into consideration that statutory auditors and audit firms fulfil a societal role.

(2) Downsides of mandatory rotation

Those who speak out against mandatory audit firm rotation often refer to the increase of costs, the loss of knowledge and therefore the negative impact on audit quality, the difficulty maintaining industry specialisation and the potential lack of choice. To address these suggested disadvantages the following issues should be taken into consideration:

- It is obvious that the new auditor has to become familiar with the company's business, its financial and non-financial procedures, systems and recent history and therefore more time might be needed. Moreover, there are costs in terms of management time particularly in terms of working with the new auditor to familiarise him/her with the company. However, other issues should be also considered. The turnover of executive management is an important factor. As a consequence, the auditor-management relationship is renewed continually even without mandatory rotation. To address those situations, audit firms developed internal procedures to smooth the transition on such occasions and to reduce cost in case of a management change. These rules could also apply in case of audit firm rotation. Moreover, audit firms developed even more detailed and specified rules for new engagements in order to reduce costs.

³²⁴ See European Parliament (2011), §26. On the contrary, the US has recently launched a reflection on "*whether mandatory audit firm rotation would help address the inherent conflict created because the auditor is paid by the client.*" See Doty (2011a), section III.B. See also the consultation document published by the audit oversight body, US PCAOB (August 2011).

³²⁵ See above [Section 2.3.2.](#)

³²⁶ See Doty (2011b), section II.

³²⁷ A study conducted by Gates et al. (2007) concluded that rotating the audit firm will better advance the goal to enhance auditor independence and audit quality and to restore investor confidence in the markets.

- As it is more likely that additional costs would appear during the first or second year than at a later point of time, the frequency of mandatory firm rotation should be not too high. Rotation every three years would be too cost-intensive. Therefore, the rotation period should not be too short and should include the possibility to renew the contract once. As a consequence, potential additional costs are spread over a certain number of years. Taking this into consideration, the initial time period of engagement should not be on a short term basis, e.g. for less than five years. A possibility to renew the contract should be given once. However, to avoid conflicts of interest, nine years should not be exceeded.
- Currently, in some Member States, the audit contracts are only signed for one year. This implies uncertainty for the auditor regarding his own planning for subsequent years. By introducing mandatory rotation, the contracts would be signed for a longer period and therefore give the auditor a better possibility to plan his future work. All the above mentioned aspects outweigh potential additional costs.
- Often, it is feared that mandatory firm rotation leads to a loss of knowledge and therefore audit quality would be undermined. As mentioned above, at the beginning of an audit engagement the auditor needs to familiarise himself/herself with the special procedures, systems and the recent history of the entity - a knowledge what the previous auditor had already gained. In this process knowledge could be lost. This threat could be minimised by ensuring that the incoming auditor has access to the important information on the entity he needs by providing a handover file. Additionally, in combination with another option such as joint audit, the loss of knowledge could be minimised. Both incumbent statutory auditors and audit firms do not necessarily need to rotate at the same time. Therefore, one auditor would stay in place while a new one comes in ensuring that the knowledge of the entity is preserved.
- Another negative impact that is feared is the potential difficulty of auditors to develop and maintain the industry knowledge to operate in specialised sectors. However, specialised knowledge can also be obtained by working together with external specialists. An increase in costs should not be feared because the specialist would be appointed for a certain period of time. He or she would only be paid for the actual work and not throughout the whole year.
- Finally, the introduction of mandatory firm rotation is opposed because of the fear that it would lead to a lack of choice when appointing a new auditor. First of all, by introducing transitional periods for introducing mandatory firm rotation, only a certain number of auditors rotate at the same time. Moreover, audit firms or statutory auditors that have not been previously engaged in certain segments of the market could participate in the selection procedure in order to obtain such engagements.

(4) Other issues: Spain and the rotation obligation; the International Monetary Fund, Brasil and the US

Other aspects that have not been considered so far are the following:

- Those opposing mandatory firm rotation often mention Spain as an example where mandatory firm rotation was introduced and abolished. However, a study³²⁸ clearly demonstrates that at no stage was mandatory rotation of audit firms ever enforced on Spain. Therefore, it is difficult to use this as an example that mandatory rotation does not fulfil its expectations.
- Looking at practical examples, the International Monetary Fund requires the mandatory rotation of the Fund's external audit firm every 10 years³²⁹. The contracts to conduct the annual external audit of the financial statements of the Fund are subject to bids every five years.
- In Brazil, currently auditors of listed companies must rotate after 5 years, with a cooling-off period of 3 years. Recent academic studies present evidence favourable to rotation. For instance, Assunção and Carrasco³³⁰, using data from 1999 to 2006, point that rotation of audit firm has a positive and statistically significant impact on the audit process of listed companies. It is argued that rotation of audit firms increases the effectiveness of governance mechanisms in those companies. Braunbeck suggests that audit quality is lower when agency conflicts between controlling and non-controlling shareholders are higher and when auditors' tenure is higher³³¹. It is often raised in Brazil that rotation of audit firms every five years entails a high cost. The Brazilian stock exchange supervisor (*Comissão de Valores Mobiliários*, CVM), however, interprets that this argument is more related to the time-limit (5 years) rather than rotation itself³³². As a result, the CVM has recently proposed to modify the rotation rule: the rotation of audit firms would be maintained as an obligation, but it would only be required every 10 years (provided that the audited entity has an audit committee)³³³.
- The US has recently launched a reflection on "*whether mandatory audit firm rotation would help address the inherent conflict created because the auditor is paid by the client*."³³⁴ This led to the publication of a consultation paper on 16 August 2011 on this issue by the US audit oversight body³³⁵. This consultation paper links the question of rotation of audit firm to the question of independence, which is seen as "*critical to the viability of auditing as a profession*"³³⁶. The paper presents the historical context of the mandatory firm rotation option in the US, showing arguments put forward in favour and

³²⁸ Gómez-Aguilar et al. (2006).

³²⁹ International Monetary Fund (2004).

³³⁰ "Os números indicam que o rodízio tem impacto positivo e estatisticamente significativo sobre o processo de auditoria para as empresas listadas. Como auditoria é um insumo para um série de mecanismos de governança, os resultados sugerem que o rodízio aumenta a efetividade desses mecanismos". Assunção & Carrasco, p. 5.

³³¹ Braunbeck (2010).

³³² "O grande argumento contrário à realização do rodízio que vem sendo trazido à CVM desde a emissão da Instrução CVM nº 308, de 1999 está relacionado ao custo que o rodízio a cada 5 anos impõe às firmas de auditoria e às companhias auditadas – incluindo os custos de aprendizado da realidade operacional do novo cliente. Tal argumento, no entanto, é mais relacionado ao prazo entre as rotações do que ao rodízio propriamente dito. Mantido o rodízio obrigatório com prazos mais dilatados, tais custos seriam diluídos ao longo do tempo, o que mitigaria, em grande parte, a força do argumento." CVM (2011). See also Assunção & Carrasco, p. 34 and seq. regarding arguments raised on costs of rotation of audit firms.

³³³ See CVM (2011). The deadline for comments on the possible modification of the rules was 15 August.

³³⁴ See Doty (2011a), section III.B.

³³⁵ US PCAOB (August 2011).

³³⁶ US PCAOB (August 2011), p. 4.

against this measure³³⁷. It also refers to the limitations of existing academic studies, which observe the consequences of "voluntary" audit firm rotation, which "may be associated with auditor-issuer disagreements, other financial reporting issues or economic issues". As a result, those studies may not be fully reliable in showing whether the effects of short audit tenure are riskier or not³³⁸. The consultation paper presents a number of questions for discussion. It is noteworthy that, regarding the possible maximum duration of an audit contract, reference is made to 10 years as "*a substantial period of time*".³³⁹

³³⁷ *Ibid.* p. 10 and seq.

³³⁸ *Ibid.* p. 16 and seq.

³³⁹ *Ibid.* p. 19. On this issue, the PCAOB refers to a report prepared in 2003 by another body. See US Conference Board (2003), p. 39.

ANNEX 12. JOINT AUDIT OF FINANCIAL STATEMENTS OF PIEs

One of the possible ways to increase the choice of audit providers for public-interest entities (PIEs) and to further improve audit quality would be the introduction of the obligation for PIEs to have more than one audit firm to perform the statutory audit or in other words – introduction of a "joint audit" requirement. This would entail a tendering process for the selection of joint auditors where the scope and responsibility of each auditor is clearly defined. Such a measure would increase the choice of audit providers for PIEs (objective 3.3).

According to different studies, France and Denmark, which are two countries that currently or previously require mandatory joint audit (Denmark abolished joint audit requirements in 2005), have the least concentrated audit markets in Europe³⁴⁰. Thus, it has been advanced that joint audit would safeguard auditor independence and would stimulate market competition. Moreover, the Institute of Chartered Accountants in England and Wales (ICAEW), which is one of the UK's most prominent accounting institutes, said that the introduction of mandatory joint audits should be one option explored in a bid to promote competition in the top-heavy audit market.

This option, however, is controversial and has attracted the opposition of many stakeholders, in particular from the Big Four audit firms and some public authorities. Mid-tier audit firms have more positive views on joint audit. The European Parliament recognises that the implementation of joint audits could have positive effects on the diversification of the audit market.

This annex presents the experience in two Member States – (1) France and (2) Denmark; (3) describes the possible joint audit rule at EU level; (4) presents the benefits of joint audit and (5) describes the main arguments against joint audit as well as some counter-arguments.

(1) Joint audit in practice – the French example:

Under French law, the audited entity must appoint at least two statutory auditors or audit firms to carry out a joint examination of the procedures and methods used to draw up the accounts, in accordance with the instructions laid down in a standard of professional practice.³⁴¹ This standard will also determine the principles that govern the distribution of tasks to be carried out by each auditor in order to complete the assignment.

Three goals were pursued by the French legislator when imposing such a requirement on certain companies:

- Reinforcement of the level of transparency and financial security;
- Improvement of the independence of auditors and as a consequence enhancement of audit quality;
- Limitation of the hyper-concentration in the upper end of the audit market³⁴².

The joint audit requirement applies to all entities, which are obliged to publish consolidated accounts – i.e. those entities that exercise exclusive or joint control or significant influence over

³⁴⁰ See London Economics (2006), p.19.

³⁴¹ See French Commercial Code, Article L.823-2.

³⁴² See Fremeaux et Noël (2009).

one or more other companies. There are two groups of entities that are exempted from the general obligation – (i) exemption within a larger group (i.e. if the consolidated financial statements are published by another entity at a higher level in the group); (ii) exemption due to the size of the entity (i.e. the total assets of the entity do not exceed €15 million; the turnover generated by the entity does not exceed €30 million and the entity has less than 250 employees). As a matter of fact, listed companies in France generally publish consolidated accounts, certainly the larger ones.

The auditors are appointed at the shareholders' meeting and they are not obliged to present their bids together or to act in consortia. The only requirement is that the two appointed auditors are members of different firms or networks. Under the French model, there is no restriction on the size of the audit firm to be appointed, thus there are three possible scenarios: (i) appointment of a Big Four and a non Big Four firm; (ii) appointment of two Big Four firms and (iii) appointment of two non Big Four firms. The following table presents the actual combinations for 2004 to 2009 for the top 120 listed companies in France.

	2009		2008		2007		2006		2005		2004	
Category	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%
LL	58	48.3	58	48.3	59	49.2	57	47.5	56	46.7	50	41.7
LM	32	26.7	33	27.5	32	26.7	33	27.5	32	26.7	28	23.3
LS	28	23.3	27	22.5	27	22.5	26	21.7	28	23.3	35	29.2
MM	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0	0	0.0
MS	2	1.7	2	1.7	2	1.7	2	1.7	2	1.7	4	3.3
SS	0	0.0	0	0.0	0	0.0	2	1.7	2	1.7	3	2.5
Total	120	100.0	120	100.0	120	100.0	120	100.0	120	100.0	120	100.0

Source: our database.

Figure A12.1 Source: Billard et al. (2001), p.14 (Table 5: Market share and concentration of audit missions according to size (2004 to 2009)).

LL (combination of two big Four firms); LM (combination of a big Four firm and a medium-size audit firm, such as Mazars or Grant Thornton); LS (combination of a big Four firm and a smaller firm); MM (combination of two medium-sized firms); MS (combination of a medium-sized and a small firm); SS (combination of two small audit firms).

The main underlying principle is that the appointed auditors will together carry out a joint examination of the accounts, in accordance with endorsed professional standards. All rules that are applicable in principle for statutory auditors are also applicable to the joint auditors, with one further requirement – a specific additional professional standard is applicable to them which deals with the organisation of the joint audit, defines the modalities of the allocation of the joint audit work and requires consultation between the auditors at each step of the conduct of the work. The three guiding principles, contained in this additional standard, of joint audits are:

- Balanced distribution of the working programme between the two co-auditors and reciprocal review of the audited documents;
- Functional and effective independence not only between the auditors and the audited company, but also between the two co-auditors, which implies that each of them conducts a significant part of the audit;

- Real participation of each co-auditor in the review stage³⁴³.

Thus, according to this additional standard, each joint auditor must be able to express his/her opinion on the financial statements of the audited entity and must communicate jointly with the company. Thus, at the end of the review, both auditors will deliver a single audit report, which will be signed by both auditors, not allowing the possibility of having two partial or divergent opinions. As a result, both auditors are jointly and severally responsible for the audit opinion provided. This requirement requires a strong consensus to be reached between the joint auditors in the conduct of their work.

Regarding the work allocation, the French system requires a very balanced approach, taking into account quantitative (e.g. hours worked) and qualitative (e.g. experience and qualifications of the audit team members) criteria. Each auditor must be able to obtain a general understanding of the audited entity, to assess the risk of material misstatement at financial statement level and to have an understanding of the analytical procedures in the conduct of the work. Both auditors must jointly decide the overall common strategy and approve the audit plan. The audit procedures are divided among the two auditors and each one of them will cross review the work performed by the other. In practice, the allocation of the work could be done on business, product or geographical location criteria, or the basis of the applicable audit cycles and/or corporate functions of the audited entity.

In relation to the split of audit fees, the main objective is to achieve an overall balance under which each auditor would normally receive between 40% and 60% of the total fees at the level of the consolidating entity. Splits of less than 30% for one of the auditors with more than 70% for the second auditor might be permissible, but are very closely monitored by the AMF, the French Securities Markets Authority, with a view to progressively readjusting them. Studies have shown that uneven audit work allocation between the two co-auditors might seriously harm audit quality and lead to increased audit costs³⁴⁴. The following table (figure A12.2) presents data on the distribution of fees in the French market in recent years. Regarding the difference in the fees paid to each of the two co-auditors, it may be linked to the reputation of each of the audit firms and might not be the direct result of the allocation of the audit work.

Category	2009		2008		2007		2006		2005		2004	
	F	P	F	P	F	P	F	P	F	P	F	P
L/L	12,169.3	50.0	12,466.7	50.0	11,263.1	50.0	12,005.9	50.0	10,586.4	50.0	10,770.8	50.0
L/LM	5,539.5	67.0	5,619.8	67.8	5,864.3	68.9	5,851.7	70.4	5,350.4	72.2	4,826.9	72.4
L/S	1,604.3	84.4	1,558.4	85.5	1,525.2	85.4	1,215.4	74.0	2,072.1	84.6	2,514.7	74.8
M/LM	2,734.3	33.0	2,674.6	32.2	2,652.5	31.1	2,462.5	29.6	2,060.6	27.8	1,843.9	27.6
M/S	1,095.0	66.2	1,161.0	69.9	1,529.0	80.3	433.2	65.7	383.0	67.3	148.8	62.3
S/L	297.0	15.6	263.3	14.5	261.3	14.6	426.6	26.0	376.4	15.4	847.7	25.2
S/M	559.0	33.8	500.5	30.1	374.0	19.7	225.7	34.3	186.4	32.7	90.2	37.7
S/SS	0.0	0.0	0.0	0.0	0.0	0.0	301.2	0.0	269.4	0.0	804.7	0.0

Source: our calculations. F is the average amount of fees in thousands of euros by type of firm. P is the average share of the combination's fees.

Figure A12.2 Source: Billard et al. (2001), p.16 (Table 6: Market shares and distribution of audit fees by size combination (2004 - 2009).

³⁴³ See Fremaux et Noël (2009).

³⁴⁴ See Audousset-Coulier (2006).

It should be noted that the fees reflected in the table correspond to the audit of consolidated accounts, therefore reflecting the work carried out by the respective networks of the joint auditors. If only the data at the level of the parent company is taken into account, unbalances between the joint auditors are normally reduced. Figure A12.3 shows data from selected French companies:

Company	Distribution for consolidated accounts		Distribution at the level of the parent company	
	Auditor 1	Auditor 2	Auditor 1	Auditor 2
Michelin (2009)	91% PwC	9% Corévisé	50%	50%
Axa (2009)	83% PwC	17% Mazars	86%	14%
Peugeot (2009)	75% PwC	25% Mazars	71%	29%
Suez Envir. (2009)	73% E & Y	27% Mazars	55%	40%
Danone (2009)	66% PwC	34% Mazars	57%	43%
Axa (2010)	81% PwC	19% Mazars	82%	18%
Peugeot (2010)	77% PwC	23% Mazars	67%	33%
Suez Envir. (2010)	71% E & Y	29% Mazars	52%	48%
Danone (2010)	69% PwC	31% E & Y	58%	42%

Figure A12.3 Source: data from AMF (2010), p.6 and AMF (2011), P.7.

Joint audits present numerous advantages both in terms of improving audit quality and increasing competition in the market. The main benefits, as well as the principal criticisms of the introduction of joint audit requirement are outlined in turn below.

(2) Joint audit in practice – the Danish example:

Joint audit was introduced in Denmark at a time where the audit firms lacked the capacity to carry out audits of very large, complex and global companies. This was intended to ensure the sufficiency of audit resources for such companies. The concept of joint audit was abolished in 2005, as it was considered that the administration and financial burden placed on entities did not necessarily result in any tangible benefits for the business from an audit quality perspective. The original concerns with audits of large multinational companies are now addressed through independence requirements, review partner requirements, key audit partner rotation and effective internal and external quality control³⁴⁵.

(3) The obligation for PIEs to have more than one audit firm at least one of which is not among the largest audit firms

The Green paper brought forward the idea of a mandatory formation of an audit firm consortium with the inclusion of at least one smaller, non systemic audit firm. This form of joint audit would contribute to higher audit quality through complementary and combined expertise, applying the "four eyes principle" in the strategic preparation of the joint audit as well as in the analysis of the

³⁴⁵ See FEE, Briefing paper, *Appointment of the Auditor*, June 2011.

findings. Both audit firms will have joint responsibility for the audit by signing the final audit report.

The obligation for **PIEs to have more than one audit firm** at least one of which is not among the largest audit firms,³⁴⁶ will provide opportunities for the smaller firms to get exposure, demonstrate their capability and build reputation over time so that they become real competitors to the current Big Four audit firms both in size and in expertise, therefore having positive effects on market structure. Also, there is a real concern that appointing two Big Four audit firms to perform joint audit may result in a less extensive review by each of the auditors of the work of the other, as they may rely too much on the reputation of the other. In other words, one Big Four firm would somehow subconsciously validate any work performed by another Big Four firm, as they link it to quality and high performance. For this reason, it may seem more appropriate to appoint one Big Four and one mid-tier firm as this would result in more confrontation and exchange of views that would ultimately improve audit quality³⁴⁷.

The House of Lords has also explored joint audits in its report as a "*way to enhance competition*".³⁴⁸ Even if the Economic Affairs Committee of the upper chamber was not entirely convinced that this would deliver better financial statements, if it was to be introduced as a means to reduce market concentration in the UK, "*it should be on the basis that at least one joint auditor was a non-Big Four*".

Following that line of reasoning, the long-term benefits in terms of more choice, audit quality and other benefits resulting from more competition in the market are expected to outweigh the increased costs of joint audits.

(4) Benefits of joint audits:

- *Enhance audit quality* – The "four eyes" approach to audit issues would enhance audit quality and reduce the risks of errors. Moreover, audit firms would be able to benefit from their mutual technical expertise and comprehensive geographical coverage, particularly in the case of complex business areas, such as banking, insurance and others. In addition, communication between joint auditors would in some cases lead to a real debate on technical issues and offer additional room for discussion and improvement;
- *Reinforce professional scepticism* – In the conduct of the joint audit, each of the auditors would cross-review the work of the other. As a consequence, knowing that his/her work will be the subject of review by his/her peer, the auditor will have an additional challenge which should normally reinforce professional scepticism. This will have a considerable value added in the case of PIEs in the financial sector given the systemic importance of even a 'small bank' (e.g. *Northern Bank had PwC as its sole auditor and IKB had KPMG*);
- *Overall impact of joint audit on the financial sector*–: It will create more expertise at the top level of the market. In some MS, statutory audits in the banking sector are currently conducted by Big Three or Big One (Spain, UK, Germany), which results in a lack of

³⁴⁶ Joint audits combining an audit firm with a substantial market share in the top listed company market segment in a Member State with an audit firm that has a small or no market share in that same segment.

³⁴⁷ See Fremaux et Noël (2009).

³⁴⁸ See House of Lords (March 2011).

sufficient expertise even at the top level of the market. Therefore, applying the joint audit in this area could build up respective expertise and bring additional audit providers in this segment within the medium term (by also creating incentives for next-tier firms to invest and to grow). It could be also expected that some of the specialist sector teams (e.g. the banking audit team) may leave the Big Four and form specialist new firms that could then be appointed as a second auditor. The French experience of joint audit in the financial sector shows a demonstrated added value for major banks. BNP Paribas today has three auditors, which shows real added value and demonstrates that there are no major operational problems linked to joint audit. The empirical evidence shows that voluntary joint audit is used also in some MSs by some listed companies and financial institutions, which is a clear indicator of its value added to audit quality. In Sweden, including a number listed on the main stock exchange index (OMX Stockholm 30) (e.g. Svenska Handelsbanken). Voluntary joint audit is also used by a number of banks in Austria (e.g. Raiffeisenlandesbank Niederösterreich-Wien, Raiffeisenlandesbank Oberösterreich, Raiffeisenlandesbank Steiermark).

- *Reduce overall concentration in the market* – Joint audits, in the form of a mandatory creation of an audit firm consortium with the inclusion of at least one smaller, non systemic audit firm, would allow non Big Four firms to penetrate the audit market for listed companies, as today this top end of the market is highly dominated by the Big Four. The French market is less concentrated than other European markets³⁴⁹. According to a study carried out by the AMF, the French securities regulator, and to estimations provided to the Commission by different stakeholders, around 50% of the audit engagements for the companies listed on the CAC 40, the French stock market, are performed by a Big Four firm, working jointly with a non Big Four audit firm; 33% are performed by two Big Four companies and 16% by two non Big Four companies. This permits one mid-tier firm to be involved in 12 audit engagements of the 40 companies listed in the CAC 40. The French experience thus shows that joint audits (despite the fact that the French model does not intend, and therefore it is not designed, to address market concentration) could contribute to facilitating the growth of audit firms other than the Big Four audit firms;
- *Ensure continuity of audit work* – Joint audit secures the minimal loss of information on the entity in the event of resignation or replacement of one of the auditors, especially in the scenario where joint audit is combined with mandatory rotation of the statutory auditor after a certain period of time has elapsed. As there is no legal requirement for the dates of appointment of both audit firms to coincide, the disruption would be minimised, as only one of the audit firms would be changed, allowing a certain degree of continuity of the audit work to be ensured. Thus, it has been suggested that the audited company could stagger the appointments whereby changing one of the two auditors without putting the whole audit at risk. Taking this into consideration, joint audits are well suited to banks because of their systemic risks and complexity of their financial statements;
- *Reinforce the auditor's position vis-à-vis the audited entity* – Joint audits allow the statutory auditor or audit firm to move away from the close client relationship to a more balanced situation where the audited entity will be exposed to two suppliers instead of

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See Francis, Richard and Vanstraelen (2006).

one³⁵⁰. This would further address the "familiarity threat", as under a joint audit scenario, it seems less likely that any auditor develops a too-trusting 'cosy' relationship with the client. In addition, in the case of disagreement between one of the auditors and the audited entity, the auditor will have more incentive to stand its ground.

³⁵⁰ See Haapamäki, Järvinen, Niemi and Zerni (2011).

(5) Downsides of joint audits:

- *Extra costs* - It has rightly been suggested that joint audit entails further costs for the audited entity. However, based on the available data, it is difficult to determine exactly this additional cost. According to estimations received from different stakeholders, the joint audit approach would involve about 10% (according to data from France) in additional costs compared to a single auditor scenario. However, the cost mentioned by several stakeholders, including Danish representatives, which have had experience with joint audit in the past, is significantly higher, although, no estimates are provided³⁵¹;
- *Additional complexity and workload* – Joint audits may bring additional complexity as the audited entity must choose and must communicate with two auditors instead of one and in some instances the audited entity may have to act as a referee in case of a disagreement between the auditors³⁵². In addition, it has been suggested that joint audits could lead to an increase in the workload resulting from the duplication of audit work;
- *Risk of loss of information* – It has been argued that under a joint audit scenario, some issues may fail to be considered by any of the auditors, following the division of the work. For instance, in its reply to the Green paper, the Canadian Public Accountability Board insisted on the fact that under certain circumstances, joint audit might lead to a reduction in audit quality as some issues might fail to get addressed as they fall between the two firms;
- *Limited review* – Some stakeholders fear that there is a risk that, in the conduct of the joint audit, the work performed by one of the auditors will be subject only to a limited and superficial review by other joint auditor and would not bring any added value.
- *Unbalanced relationship between the two auditors* – In the scenario where one Big Four audit firm is appointed to perform the statutory audit, together with a non Big Four firm, the latter can easily become dependent on the first one, as it does not possess a high level of technical expertise³⁵³. Thus, the second auditor might act simply as a "sub-auditor" of the first one and follow the instructions he is given³⁵⁴.

³⁵¹ Estimation provided to Commission services by stakeholders.

³⁵² See Francis, Richard and Vanstraelen (2006).

³⁵³ See Benecib (2002).

³⁵⁴ See Fremaux et Noël (2009).

ANNEX 13. DEFINITION OF PUBLIC-INTEREST ENTITY

(1) The existing definition of PIE

Currently, the Statutory Audit Directive establishes stricter requirements for the statutory audit of the annual or consolidated accounts of public-interest entities (PIEs) because they "*have a higher visibility and are economically more important*"³⁵⁵.

The Statutory Audit Directive defines PIEs³⁵⁶ as:

- entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State³⁵⁷;
- credit institutions; and
- insurance undertakings.

It is noted that Member States have some flexibility when implementing this definition. On the one hand, they may also designate other entities as PIEs, for instance entities that are of significant public relevance because of the nature of their business, their size or the number of their employees³⁵⁸. On the other hand, Member States may exempt PIEs which have not issued transferable securities admitted to trading on a regulated market and their statutory auditor(s) or audit firm(s) from one or more of the specific requirements applying to the statutory audit of PIEs³⁵⁹.

(2) The growing importance of financial institutions other than credit institutions and insurance companies

Financial institutions other than credit institutions and insurance companies have a growing importance for the financial system.

Assets managed by investment funds are increasing (see [figure A13.1](#) as regards UCITS). Total net assets of the European Investment Fund Industry were above €8 trillion at the end of December 2010³⁶⁰, of which roughly 75% corresponded to UCITS funds and 25% to non-UCITS funds. Only some investment funds (those that issue securities admitted to trading on regulated

³⁵⁵ Cf. recital 23 of the Statutory Audit Directive. In the explanatory memorandum accompanying the Commission proposal, the Commission explained that recent scandals showed the importance of further strengthening requirements concerning the audits of public interest entities. See European Commission (2004).

³⁵⁶ Article 2, point 13, of the Statutory Audit Directive. The Commission proposal of 2004 contained a slightly different definition, based on open-ended criteria to define the public relevance of the audited entities. Those criteria were: the nature of the business, size or number of employees. The draft article made clear that this definition was intended to capture listed companies, banks, insurance undertakings and "*other financial institutions*". See European Commission (2004), point (11) of draft Article 2.

³⁵⁷ Third country issuers of securities admitted to trading on regulated markets are thus not covered by the definition of PIE.

³⁵⁸ Article 2, point 13 *in fine* of the Statutory Audit Directive.

³⁵⁹ Article 39 of the Statutory Audit Directive.

³⁶⁰ See Efama (2010), table 6. Data includes UCITS and non-UCITS funds. Data includes funds from Norway, Switzerland and Turkey.

markets) are captured by the definition of public interest entity. But alternative investment funds are not.

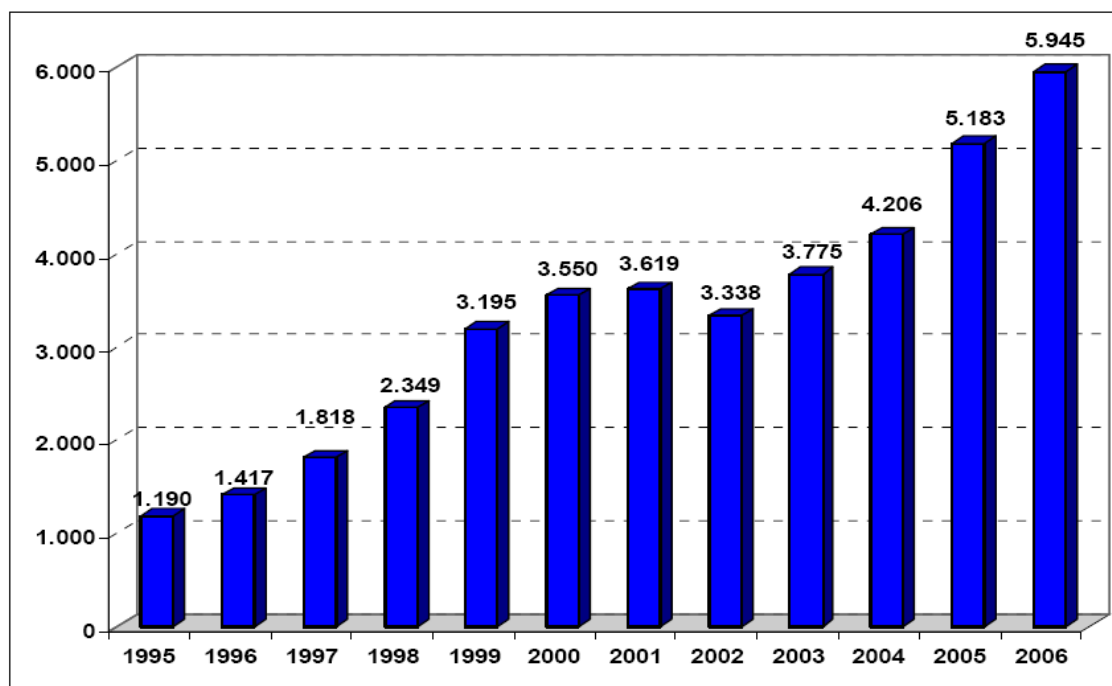


Figure A13.1 – UCITS assets under management (€bn). Source: Efama factbook 2007.

When comparing the total assets held by credit institutions, insurance undertakings, pension funds and investment funds (excluding money market funds) in the EU, the non-banking institutions represent around 25% of total assets³⁶¹. Investment funds have a similar weight as insurance undertakings.

Institutions	2009		2008	
	Total assets	% of total	Total Assets	% of total
Credit institutions	42143710	74	42217558	76
Insurance undertakings	6381947	11	6066224	11
Investment funds	6291915	11	5125478	9
Pension funds	2363128	4	2073043	4
Total	57180700		55482303	

Figure A13.2 – Distribution of assets for credit institutions, insurance undertakings, pension funds and investment funds. Source: data from ECB (2010).

The recent financial crisis has also shown the risks involved in the non-banking financial system for financial stability³⁶² and for market integrity.

The financial crisis has evidenced that "*systemically important pockets developed in the financial system without any regulatory oversight*"³⁶³. The importance of the so-called shadow financial

³⁶¹ ECB (2010).

³⁶² See Generally European Commission (April 2011c).

³⁶³ González-Páramo (2011).

system is growing³⁶⁴ and the Financial Stability Board is looking at policy options to deal with systemic risks arising in the sector³⁶⁵.

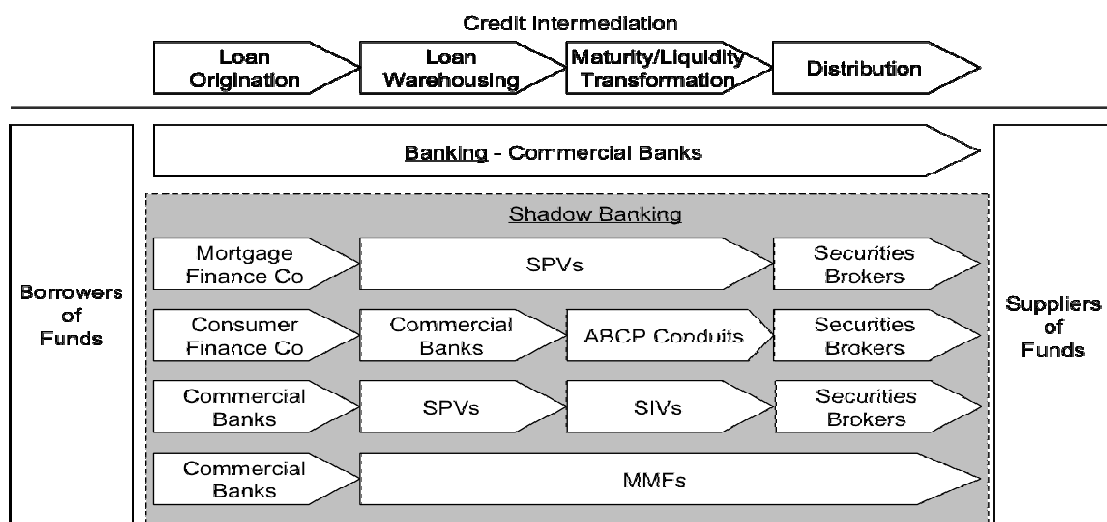


Figure A13.3 – The shadow banking sector (MMFs means money market funds; SPVs means special purpose vehicles; SIVs means special investment vehicles; ABCP means asset-backed commercial paper). Source: FSB.

For this reason, it is believed that *"the regulatory reform should not only focus on regulated banks. It should instead be based on a comprehensive system that extends in a proportional way to all actors, intermediaries, markets and activities that embed potential systemic risk. In this area the identification of data gaps and putting in place an effective monitoring framework as well as reinforcing the accounting rules on consolidation internationally are key"*³⁶⁶. Moreover, the shadow financial system also conducts an enormous amount of trading activity in the over-the-counter (OTC) derivatives market, which grew exponentially in the decade prior to the 2008 financial crisis³⁶⁷.

However, investment firms (securities brokers), alternative investment funds, central securities depositories or clearing houses are not included in the concept of public-interest entity for the purposes of auditing their financial statements.

³⁶⁴ For instance, by June 2008, the U.S. shadow banking system (e.g. non-depository banks and other financial entities such as investment banks, hedge funds, money market funds and insurers) was approximately the same size as the U.S. traditional depository banking system. In a June 2008 speech, U.S. Treasury Secretary Timothy Geithner, then President and CEO of the NY Federal Reserve Bank, described the growing importance of the shadow banking system: *"The structure of the financial system changed fundamentally during the boom. This non-bank financial system grew to be very large, particularly in money and funding markets. In early 2007, asset-backed commercial paper conduits, in structured investment vehicles, in auction-rate preferred securities, tender option bonds and variable rate demand notes, had a combined asset size of roughly \$2.2 trillion. Assets financed overnight in triparty repo grew to \$2.5 trillion. Assets held in hedge funds grew to roughly \$1.8 trillion. The combined balance sheets of the then five major investment banks totaled \$4 trillion. In comparison, the total assets of the top five bank holding companies in the United States at that point were just over \$6 trillion, and total assets of the entire banking system were about \$10 trillion."* See Geithner (2008).

The size of the shadow financial system in the EU, compared to the banking system, is estimated to be lower than in the US.

³⁶⁵ FSB (2011).

³⁶⁶ González-Páramo (2011).

³⁶⁷ See European Commission (September 2010), p. 11 and seq.

In this context, transparency about financial information (including the auditing of disclosed information) is of paramount importance: *"private financial markets cannot function properly unless there is enough information and reporting both to market participants and to relevant regulators and supervisors. The financial crisis evidenced the increasing opaqueness of the financial sector and the resulting counterparty risk externality"*³⁶⁸.

Concerning market integrity, the recent Madoff fraud case, which constitutes the biggest financial fraud ever, originated from the investment fund sector (i.e. a non-banking financial institution). The diligence and capacity of the audit firm auditing Madoff's accounts has indeed been questioned.

Additionally, EU legislation has recently created new categories of financial institutions such as the payment institutions³⁶⁹ and the electronic-money institutions³⁷⁰. They are allowed to provide specific financial services, under certain circumstances, in competition with traditional credit institutions. They are also subject to prudential requirements and specific supervision. However, they are not included in the category of public-interest entities for the purpose of having their accounts audited.

(3) A new definition of PIE appears necessary

In this context, it appears that the existing definition of public-interest entities no longer covers all financial institutions that are relevant from the perspective of financial stability or investor protection (e.g. protection against fraud).

Hence, it is appropriate that the definition of public-interest entities is expanded to also encompass the following institutions:

- Investment firms;
- UCITS;
- Alternative investment funds;
- Payment institutions;
- Electronic-money institutions;
- Central securities depositories and institutions clearing securities transactions³⁷¹.

(4) Implications of the new definition

For the PIE itself, the main consequences would be to have an audit committee; increase the dialogue between the auditor and the audit committee; receive expanded audit reports as well as internal audit reports from their auditor(s); apply the specific rules on the appointment of the auditor(s) which would imply limiting the duration of the audit engagement (rotation rule) and

³⁶⁸ *Ibid.* On the importance of transparency on financial reporting for the good functioning of financial markets and financial stability, see also Maaijoor (2001).

³⁶⁹ Currently, there are about 200 payment institutions in the EU.

³⁷⁰ The e-money Directive was due to be transposed by April 2011. E-money institutions are required to have a minimum initial capital of at least €350,000.

³⁷¹ This is already the case in Italy, for instance.

inviting tenders when seeking to engage a new auditor (tendering rule); and, in certain circumstances, engage more than one auditor (joint audit rule).

However, as explained in [Annex 19](#), these rules would apply in a proportionate manner. Not all public-interest entities would be subject to these obligations. The application of some of them (joint audit rule, tendering rule or existence on an audit committee) would depend on their size (see also [Annex 16](#) on this). Moreover, for some of the institutions, because of their nature (i.e. UCITS and alternative investment funds), it would not be appropriate that they are required to have an audit committee in all circumstances (e.g. when these funds function merely for the purposes of pooling assets).

The implications of the new definition of PIE for the statutory auditors or audit firms are limited. In practice, it is estimated that most of the statutory auditors or audit firms auditing financial institutions other than credit institutions and insurance undertakings are already auditing PIEs. Therefore, they are already subject to the stricter requirements for the auditors of PIEs.

ANNEX 14. CHOICE OF LEGAL INSTRUMENT: DETAILED EXAMINATION

A non-binding legislative instrument would not be appropriate to implement the policy options described. As explained in [Section 3.2](#) there is a need for a more harmonised legal framework within which statutory audit is conducted across the Union, in particular as regards the audit of PIEs. The current legal framework (a principles-based directive) which allows for a large margin of self-regulation by the profession has proved to be inadequate to address all the problems described. The objectives presented in [Section 4](#) can only be achieved with a legally binding instrument, whether a regulation or a more detailed directive. Therefore only these options will be examined in detail in this [Annex](#). The examination will consider the following criteria:

- (i) effectiveness: the extent to which the measure fulfils the objectives in Section 4;
- (ii) certainty: highest possible confidence of the relevant stakeholders as to the content of the rules to be respected and that the rules followed in practice are closely aligned with the objectives of the framework; and
- (iii) common framework: the same requirements applying in all Member States.

(1) Regulation.

Under this hypothesis, rules applicable to statutory audit would be included in a directly applicable Regulation. This solution presents several advantages. While a Directive requires national implementing provisions to be adopted, leaving scope for interpretation, the direct applicability of a Regulation would offer greater legal certainty for those subject to the legislation across the EU. Also, the legislation becomes applicable on the same date across the EU, thus avoiding problems associated with late transposition of legislation by Member States. Furthermore, a Regulation would offer the highest degree of harmonisation: statutory audits would be applied under substantially identical rules in all EU Member States. Once in force, it would override incompatible provisions in domestic legislation. In terms of administrative costs, it avoids the resource-intensive and time-consuming transposition of directives by national legislators as well as the monitoring of timely and correct transposition by the Commission.

A regulation could effectively deal with some of the policy options described above, in particular those regarding the performance of the statutory audit of PIEs. These policy options are sufficiently detailed so that the transposition into national law would amount to a mere copy-and-paste exercise: e.g. rules on duration of audit engagement. The Regulation solution is considered the best regulatory choice for these policy options: the same regulatory framework based on the same principles, thereby ending the current fragmentation of the regulatory response.

The adoption of a regulation would not prevent Member States from adopting additional supplementing legislation, as long as such legislation would not contradict the regulation. It should be noted that the policy options regarding supervision (see [section 6.5](#)) would, in any case, require Member States to adopt implementing legislation.

However, the regulation solution seems to be legally impossible for some of the policy options presented. Indeed, rules regarding the establishment of companies, such as those in connection

with the approval and registration of auditors and firms, would need to be adopted as a directive given the requirement in Article 50(1) TFUE (ex article 44 TEC)³⁷². This implies that, should a regulation be adopted for the rules concerning the audit of PIEs, a directive would need to co-exist at least to regulate the rules regarding approval and registration of firms.

(2) Directive (or modification of Directive 2006/43/EC).

Under this hypothesis, a new directive would be proposed or Directive 2006/43/EC amended. A Directive has the advantage of being a legally binding instrument which at the same time leaves Member States the flexibility to adapt some measures to their legal and economic environment. The main disadvantage is that national transposition may lead, and often does, to different interpretations and variations in national rules. Another recurrent problem is the delayed or incomplete transposition. Therefore, in terms of certainty and common framework criteria, it presents fewer advantages than a regulation, certainly as regards those policy options calling for detailed rules such as those in connection with the audit of PIEs.

In terms of effectiveness, as advanced above, a directive would be the only legal solution for the policy options regarding the approval and registration of auditors and audit firms. Also, it appears to be a suitable solution for the policy options regarding the audit of SMEs, considering the content (i.e. a mandate to Member States to act) and level of detail of the policy option. Concerning the policy options on the adoption of audit standards, the choice of the legal instrument would be neutral, given that the content of the obligation would be determined by the texts to which they would make reference. This obligation would become ancillary to other policy options.

In terms of coherence, should a regulation be adopted in connection with the audit of PIEs and a directive remain for the approval and registration of auditors and audit firms, the existing principles in the Directive regarding professional ethics, professional secrecy, independence and reporting as well as the associated supervision rules could remain applicable for the audit of non-PIEs. Transferring these rules to a regulation would add little value at this stage, given the margin of discretion enjoyed by Member States.

(3) Completing the regulation or directive with additional legislation.

Whether a European Parliament and Council regulation or directive is proposed as the preferred solution, it would need to be completed at a later stage with additional secondary legislation in some cases. There are instances in which the policy options regarding the audit of PIEs require detailed technical rules that would need to be drafted with the cooperation of the national competent authorities. Having recourse to the "technical standards" that could be developed by ESMA or the other ESAs appears the logical solution³⁷³. In the case of the areas covered by the directive, it would also be necessary to complete it in the future, but technical standards developed by ESMA would not be the solution in this case, but rather delegated acts³⁷⁴ or implementing acts³⁷⁵ prepared by the Commission under the normal Treaty conditions.

³⁷² "In order to attain freedom of establishment as regards a particular activity, the European Parliament and the Council, acting in accordance with the ordinary legislative procedure and after consulting the Economic and Social Committee, shall act by means of directives". Emphasis added.

³⁷³ See articles 10 (regulatory technical standards) and 15 (implementing technical standards) of ESMA Regulation.

³⁷⁴ Article 290 TFUE:

Figure A14.1

Objectives	effectiveness	certainty	common framework
Policy option			
<i>Policy options relating to the audit of PIEs, including supervision</i>			
Regulation	++	++	++
Directive	+	+	+
<i>Policy options relating to the audit of SMEs</i>			
Regulation	≈	+	+
Directive	++	+	+
<i>Policy options relating to the approval and registration of statutory auditors and audit firms</i>			
Regulation	--	--	--
Directive	+	+	+
<i>Policy options relating to the adoption of auditing standards</i>			
Regulation	+	+	+
Directive	+	+	+
<i>Policy options relating to the supervision of the audit of non-PIEs</i>			
Regulation	≈	≈	≈
Directive	+	+	+

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; -- strongly negative; - negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

On this basis, the Commission services conclude that:

- (i) a regulation is a suitable and proportionate solution for the policy options that are connected with the audit of PIEs, including the supervision of compliance with the obligations as long as the rules on supervision are ancillary to the main substantive rules;
- (ii) a modification of the existing directive is a suitable and proportionate solution for the policy options that are connected with the approval and registration of statutory auditors and audit firms and those connected with the audit of SMEs;

"1. A legislative act may delegate to the Commission the power to adopt non-legislative acts of general application to supplement or amend certain non-essential elements of the legislative act. The objectives, content, scope and duration of the delegation of power shall be explicitly defined in the legislative acts. The essential elements of an area shall be reserved for the legislative act and accordingly shall not be the subject of a delegation of power.

2. Legislative acts shall explicitly lay down the conditions to which the delegation is subject; these conditions may be as follows:

(a) the European Parliament or the Council may decide to revoke the delegation;

(b) the delegated act may enter into force only if no objection has been expressed by the European Parliament or the Council within a period set by the legislative act.

For the purposes of (a) and (b), the European Parliament shall act by a majority of its component members, and the Council by a qualified majority.

3. The adjective 'delegated' shall be inserted in the title of delegated acts."

Article 291 TFUE:

"1. Member States shall adopt all measures of national law necessary to implement legally binding Union acts.

2. Where uniform conditions for implementing legally binding Union acts are needed, those acts shall confer implementing powers on the Commission, or, in duly justified specific cases and in the cases provided for in Articles 24 and 26 of the Treaty on European Union, on the Council.

3. For the purposes of paragraph 2, the European Parliament and the Council, acting by means of regulations in accordance with the ordinary legislative procedure, shall lay down in advance the rules and general principles concerning mechanisms for control by Member States of the Commission's exercise of implementing powers.

4. The word 'implementing' shall be inserted in the title of implementing acts."

- (iii) both instruments are equally effective, certain and provide a similar harmonisation level concerning the adoption of international auditing standards; and
- (iv) both a directive or a regulation would need to be completed with additional secondary legislation, in one case delegated acts, in the other technical standards developed by ESMA.

ANNEX 15. IMPACT ON STAKEHOLDERS: ANALYSIS

This Annex presents a summary analysis of the main impacts of the preferred policy options on different stakeholders. This analysis integrates the results of the assessment of the costs and benefits of the preferred policy options done under [Annex 20](#), while presenting their impact from the point of view of key stakeholders.

The following stakeholders are considered separately:

- users of audited accounts: e.g. investors, analysts etc. It should also be noted that employees are users of audited accounts and they are generally interested in the ability of the audited entity to continue as a going concern;
- audited entities: PIEs and SMEs. Concerning SMEs, it should be noted that when the options considered are addressed at PIEs only, SMEs are not affected unless they are also PIEs themselves. Having said this, one should consider that within PIEs, size also matters. Smaller PIEs, although bigger than SMEs, may still be quite small compared to larger PIEs and, in some cases, any cost implication of the proposed measures will be proportionally more important for them than for larger PIEs; and
- providers of statutory audit services: the impact on providers of statutory audit services is considered separately for Big Four firms, mid-size audit firms and smaller firms/auditors (referred to as small and medium-size practitioners, or SMPs).

The impact of those measures on governments, employment and financial stability are jointly considered for each of the five general objectives.

Concerning the impact on third countries, see [Annex 17](#).

(1) Comparison of preferred options - Objective 1: Clarify and define the role of the statutory auditors generally as well as with specific regard to PIEs

Stakeholder / Policy option	Investors, analysts, employee organisations and other users of audit reports	PIEs	SMEs [only medium-sized enterprises are required to have their accounts audited, unless they are PIEs]	Big Four audit firms	Mid-size audit firms	SMPs
Baseline scenario	0	0	0	0	0	0
Clarify and specify the scope of statutory audit to reduce the expectation gap	+	+	+	+	+	+
	Better understanding of scope of audit and therefore better valuing the accounts of the audited entity	Certainty on the accounts of PIEs and therefore on its credibility will be reinforced	Certainty on the accounts of PIEs and therefore on its credibility will be reinforced	Positive impact as the role of the auditor will be clarified.	Positive impact as the role of the auditor will be clarified.	Positive impact as the role of the auditor will be clarified.
Improve and expand the content the audit report disclosed to the public	+	+	n.a.	+	+	+
	Investors will obtain more and better information from auditors on the accounts of the PIE, which should facilitate the evaluation of the accounts	Better judgement of accounts by investors should result in more confidence in the PIEs accounts and therefore better value of their securities. The additional disclosure requirements will have a certain cost (estimated at 8 working hours/ report).	This measure would only affect SMEs which are also PIEs.	Audit firm will be in a position to better explain the quality of the work undertaken and this should improve the reputation of the audit firm	Audit firm will be in a position to better explain the quality of the work undertaken and this should improve the reputation of the audit firm	If SMPs audit accounts of PIEs, same positive effect as for mid-size audit firm
Require the preparation of a longer and more detailed report for the audited entity	+	++	n.a.	++	++	++
	Investors will indirectly benefit from this measure as a result of the expected increase in audit quality.	The audited company will receive more and better information from the auditor as regards the outcome of the statutory audit. The preparation of the additional report will result in a cost increase (estimated at 80 working hours/report for large PIEs)	This measure would only affect SMEs which are also PIEs.s	The audit firm will be in a position to better explain to the audited entity the outcome of the statutory audit. It is expected that the cost increase will be transferred to audited entity.	The audit firm will be in a position to better explain to the audited entity the outcome of the statutory audit. It is expected that the cost increase will be transferred to audited entity.	If SMPs audit accounts of PIEs, same positive effect as for mid-size audit firm
Increase the communication between the auditor and the audit committee	+	++	n.a.	++	++	++
	Investors will indirectly benefit from this measure as a result of the expected increase in audit quality.	Audit committee is better able to exercise its role on the monitoring of the audit. Possible cost implications (greater involvement of the audit committee members), which are estimated at about	This measure would only affect SMEs which are also PIEs. In any case, SMEs that are PIEs are not obliged to have an audit committee and another body can fulfil this function, so the cost	Reinforced communication with the audit committee can only result in improved quality of the statutory audit carried out by the audit firm. Hence, positive reputational effects too. As shown by he	Reinforced communication with the audit committee can only result in improved quality of the statutory audit carried out by the audit firm. Hence, positive reputational effects too.	If SMPs audit accounts of PIEs, same positive effect as for mid-size audit firm

Stakeholder Policy option	Investors, analysts, employee organisations and other users of audit reports	PIEs	SMEs [only medium-sized enterprises are required to have their accounts audited, unless they are PIEs]	Big Four audit firms	Mid-size audit firms	SMPs
		53.600 euro on a yearly basis (based on 20 expert days and cost of 3 annual meetings).	implications are lower.	cost estimate in Annex 20, the potential cost increase for Big 4 participation should be marginal and is expected to be transferred to the audited PIE..	Cost increase should be marginal only.	
Requiring the establishment of regular dialogue between auditors and supervisors of PIEs which are financial institutions	+ Investors will indirectly benefit from this measure as a result of the expected increase in audit quality.	+ PIEs will indirectly benefit from this measure as a result of the expected increase in audit quality. It could be expected that cost will be invoiced to the PIE.	n.a. This measure would only affect SMEs which are also PIEs.s	++ Reinforced communication with the audit committee can only result in improved quality of the statutory audit carried out by the audit firm. Hence, positive reputational effects too. Yearly cost increase estimated at about 11,000 euro (cost for 2 annual meetings). Cost likely to be transferred to the audited PIE.	++ Reinforced communication with the audit committee can only result in improved quality of the statutory audit carried out by the audit firm. Hence, positive reputational effects too. Yearly cost increase estimated at about 11000 euro (cost for 2 annual meetings). Cost likely to be transferred to the audited PIE.	++ If SMPs audit accounts of PIEs, same effect as for mid-size audit firm

Stakeholder Policy option	Government	Financial stability	Employment
Joint impact of all measures under objective 1	++ The combined effect of the measures under objective 1 should facilitate the exercise of supervisory tasks over statutory auditors and audit firms as well as over PIEs. This should result in improved supervision, which in turn should help prevent market	+ The expected increase in audit quality as well as the improvement in the quality of supervision should have positive effects on the financial markets and their stability.	~ Regarding the level of employment, the effect of these measures should be neutral. The greater involvement of key audit partners in reinforced dialogue with audit committees and supervisors could result in opportunities for other

Stakeholder Policy option	Government	Financial stability	Employment
	problems.		auditors to also become key audit partners, therefore enlarging the pyramidal structure within the firm. This could lead to marginal job increase at lower levels.

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; -- strongly negative; - negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

(2) Comparison between options - Objective 2: Eliminate the inherent conflict of interest in the provision of statutory audit to PIEs

Stakeholder Policy option	Investors, employee organisations and other users of audit reports	PIEs	SMEs [only medium-sized enterprises are required to have their accounts audited, unless they are PIEs]	Big Four audit firms	Mid-size audit firms	SMPs
Baseline scenario	0	0	0	0	0	0
Strengthening the role of the audit committee regarding the appointment of auditors	+ Investors will indirectly benefit from this measure as a result of the expected increase in audit quality.	++ Audit committee will be better able to exercise its role on the monitoring of the audit. Possible cost implications (greater involvement of the audit committee members).	n.a. This measure would only affect SMEs which are also PIEs. In any case, SMEs that are PIEs are not obliged to have an audit committee and another body can fulfil this function, so the cost implications are lower.	+ Stronger audit committees can only result in improved quality of the statutory audit carried out by the audit firm. Hence, positive reputational effects too.	+ Stronger audit committees can only result in improved quality of the statutory audit carried out by the audit firm. Hence, positive reputational effects too.	+ If SMPs audit accounts of PIEs, same positive effect as for mid-size audit firm
Mandatory rotation of an audit firm via regular tendering	+ Investors will indirectly benefit of this measure as a result from the expected increase in audit quality and reduction in audit costs.	+ Tendering costs will have to be covered by the PIE (most likely tendering costs on the audit firms side will be also transferred to the PIE). As estimated in Annex 20 a rough annual cost for a PIE with a turnover of 2 bn euro would be about 330.000 euro. The likely cost increase resulting from the need to support the new auditor at initial stages, which may be partially compensated if hand-over file is prepared by the previous auditor. Feedback from PIEs also shows that a first re-tendering may result in audit cost decrease by 15-20% due to increased competition.	+ This measure would only affect SMEs which are also PIEs. For small PIEs, cost implications may be higher than for larger ones, but at the same time the complexity of accounts should normally be lower.	- / ≈ Rotation will result in the need for these firms to search for new customers, with potentially lower fees. There is a potential loss of market share in the top end of the market. At the same time, rotation should result in increased quality audits. Hence, positive reputational effects too. It is expected that there will be certain costs for the preparation of a tender, which is considered to be between 100.000 and 1M euro (in exceptional cases of very large PIEs up to 5M euro). However, these costs represent between 0.6-1% of audit fees on an annual basis. It could also be expected that those cost will be transferred to audited entity later on. The real cost for audit firms will be the tenders which will not result	+ Rotation will result in the need for these firms to search for new customers, with potentially lower fees. But at the same time, rotation will potentially lead to possible new market opportunities for these firms in the top end of the market. The tendering will have certain costs as presented in the case of Big Four audit firms.	- / ≈ SMPs will lose their audit engagements with PIEs with no guarantee that they will be able to take up new ones without important investments.

Stakeholder / Policy option	Investors, employee organisations and other users of audit reports	PIEs	SMEs [only medium-sized enterprises are required to have their accounts audited, unless they are PIEs]	Big Four audit firms	Mid-size audit firms	SMPs
	in a signed contract.					
Pure audit firms	++ Investors will indirectly benefit from this measure as a result of the expected increase in audit quality that would result from such increased independence.	+ This measure should result in increased audit quality, which in turn should lead to better judgement of accounts by investors and in turn more confidence in the PIEs accounts and therefore better value of their securities. Possible increase in audit fees, as no longer possible for firms to charge for other non-audit services, although these costs may be offset due to the tendering process and/or due to the entry of new audit providers into the upper segment of the market.	+ This measure would only affect SMEs which are also PIEs. Same effects as for other PIEs.	-- Negative financial impact in the short term resulting from the need to adapt the firm structure and segregate audit from other activities, which are today more profitable and a larger source of revenues. This negative financial impact would be mitigated by adapting the cost structure to the new scope of authorised activities. At the same time, this measure offers the possibility to focus on the real audit service, thus increasing the quality of the service.	- Similar impact as for Big Four, although the scale and dimension is smaller. Mid-size firms tend to provide less non-audit services than Big Four ones. At the same time, this measure offers the possibility to focus on the real audit service, thus increasing the quality of the service.	-- SMPs will most likely prefer not to audit PIEs and continue to be able to provide non-audit services to audited companies. Therefore, this measure is likely to exclude SMPs from the audit of PIEs, where they are less present anyway.
Additional requirements for the internal organisation and governance of audit firms	+ Investors will indirectly benefit from this measure as a result of the expected increase in audit quality.	+ PIEs will indirectly benefit from this measure as a result of the expected increase in audit quality	+ This measure would only affect SMEs which are also PIEs. Same effects as for large PIEs	+ Virtually no cost effect on these firms, due to the partial existence of such policies and procedures. Positive effects in terms of audit quality.	+ Virtually no cost effect on these firms, due to the partial existence of such policies and procedures. Positive effects in terms of audit quality.	-/~ Costs arising from these requirements likely to be important for SMPs willing to audit PIEs, although there is the possibility to adapt requirements to size.

Stakeholder / Policy option	Government	Financial stability	Employment
Joint impact of all measures under objective 2	++ The combined effect of the measures under objective 2 should lead to a market which is	+ The expected increase in audit quality as well as the improvement in the	≈ Regarding the level of employment, the effect of these measures should be neutral. There could be some positive employment implications in

Stakeholder	Government	Financial stability	Employment
Policy option	more focused on the audit service and audit quality. This should facilitate the exercise of supervisory tasks over statutory auditors and audit firms as well as over PIEs. This should result in improved supervision, which in turn should help prevent market problems.	quality of supervision should have positive effects on the financial markets and their stability.	PIEs (need to organise tenders, monitor more closely the incoming auditor, support to a more active audit committee etc.). Regarding firms, it is alleged that prohibiting audit firms from providing non-audit services will result in high quality employees leaving these firms to join consultancy firms. However, this will not necessarily result in fewer employees in audit firms, although an overall diminution of revenues for the average junior auditor or staff support may be expected.

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; -- strongly negative; - negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

(3) Comparison between options - Objective 3: Improve market conditions for audits of PIEs so that audit firms compete more on audit quality and price while eliminating the existence of or emergence of the 'too big to fail' phenomena

Stakeholder Policy option ³⁷⁶	Investors, employee organisations and other users of audit reports	PIEs	SMEs	Big Four audit firms	Mid-size audit firms	SMPs
Baseline scenario	0	0	0	0	0	0
Mandatory rotation with regular tendering	+	+	+/~	-	+	+/~
	Will have a positive impact resulting from more competition in audit markets: higher audit quality, lower price	Initial costs of mandatory rotation and tendering will be offset by lower prices and higher quality of audits resulting from more competition (on the cost estimates see same point above as well as respective section in Annex 20)	There will be a positive impact on those SMEs that will be considered as PIEs	Profits margins and the revenues paid out to partners within Big Four firms will go down closer to the margins of non-Big Four audit firms	Non-Big Four audit firms will profit from the possibility to compete for new contracts in the market for listed companies and other PIEs	SMPs may benefit from more competition between large audit firms for the market of audits of PIEs, e.g. by becoming more attractive employers in the labour market
Pure audit firms	+	+	+	-	-	-
	Investors will indirectly benefit from this measure as a result of the expected increase in audit quality that would result from more choice and independence in the audit market	This measure should result in increased audit quality and lower cost due to more choice and thus more bargaining power for the companies, especially the largest ones, since they are the most affected by limited choice in the market, such as the financial institutions.	This measure would only affect SMEs which are also PIEs. Same effects as for other PIEs.	Negative financial impact in the short term resulting from the need to adapt the firm structure and segregate audit from other activities. This measure is likely to make audit firms focus on the real audit service, thus increasing the quality of the service.	Similar impact as for Big Four, although the scale and dimension is smaller. Mid-size firms tend to provide less non-audit services than Big Four ones. This measure is likely to make audit firms focus on the real audit service, thus increasing the quality of the service.	This measure is likely to exclude SMPs from the audit of PIEs, where they are less present anyway. SMPs will most likely prefer not to audit PIEs and continue to be able to provide non-audit services to audited companies.
Joint audits on a voluntary basis	+/-	+/-	+/-	-	+	+/~
	Could have positive impact in long-run due to increased competition and less concentration in the audit markets. In short run, there will be additional costs for joint audits that would finally have to be	In long-run, the market will provide companies with a sufficient choice of audit firms. In short run, there will be additional costs for joint audits, but also the beneficial effects on the quality of audits. Although,	To the extent that SMEs are considered as PIEs, in the long-run, there will be a positive impact since the market will provide companies with a sufficient choice of audit firms. In short run, there will be	Big Four audit firms will become smaller and in the long-run less likely to stay "too big to fail" by being required to share the audit work with smaller audit firms on the audits of PIEs.	Non-Big Four audit firms will profit from building expertise on audits of PIEs which in the long-run will make them similar to Big Four audit firms in terms of size and expertise.	SMPs may benefit from more competition between large audit firms for the market of audits of PIEs, e.g. by becoming more attractive employers in the labour market

³⁷⁶

On the impacts of the pure audit firm option, see the table regarding objective 2 in [Annex 10](#).

Stakeholder Policy option ³⁷⁶	Investors, employee organisations and other users of audit reports	PIEs	SMEs	Big Four audit firms	Mid-size audit firms	SMPs
	transferred to companies and finally investors, but there will be also the beneficial effects on the quality of audits	no clear cost estimate can be established, it is considered that there will be an increase in audit cost of between 5 and 10% (based on data from France).	additional costs for joint audits that will be likely transferred to companies, but also the beneficial effects on the quality of audits			
More transparency on audit quality, on audit firms' financial statements and a pan European audit quality certificate	+ More objective information on the quality of audits and audit firms in the market	+ More objective information on the quality of audits and audit firms in the market	+/ There will be a positive impact to those SMEs that will be considered as PIEs	- Big Four firms' reputation versus non-Big Four firms is likely to decrease and will be less likely to act as a competitive advantage over non-Big Four firms There is a cost increase resulting from the publication of information. The cost of applying for the pan-European certificate is not estimated at this stage.	+ Big Four firms' reputation versus non-Big Four firms is likely to decrease and will be less likely to act as a competitive advantage over non-Big Four firms. On costs, same costs issues as for Big Four audit firms.	+ Big Four firms' reputation versus non-Big Four firms is likely to decrease and will be less likely to act as a competitive advantage over non-Big Four firms. On costs, same costs issues as for Big Four audit firms.
Lift restrictions on ownership of audit firms	+ Allowing non-auditors to own audit firms will increase competition in the audit markets	+ Allowing non-auditors to own audit firms will increase competition in the audit markets	+ Allowing non-auditors to own audit firms will increase competition in the audit markets	- Allowing non-auditors to own audit firms will increase competition in the audit markets	- Allowing non-auditors to own audit firms will increase competition in the audit markets	- Allowing non-auditors to own audit firms will increase competition in the audit markets
Prohibition of contractual clauses limiting the choice of an audit firm	+ Disappearance of contracts favouring Big-Four audit firms will have a positive impact on other audit service providers	+ Disappearance of contracts favouring Big-Four audit firms will have a positive impact on other audit service providers	+ Disappearance of contracts favouring Big-Four audit firms will have a positive impact on other audit service providers	- Since Big-Four audit firms, to our knowledge, were the only ones benefiting from these contractual clauses they would be the only stakeholder group worse-off	+ Disappearance of contracts favouring Big-Four audit firms will have a positive impact on other audit service providers	+ Disappearance of contracts favouring Big-Four audit firms will have a positive impact on other audit service providers
Joint impact of all measures under objective 3	+ Overall, investors and other users of audited financial information will be better-off from more competition and choice in the audit market.	+ Overall, PIEs will be the winners with more competition and choice in the audit market. The benefits brought about by more competition will offset the slight increase of costs in organising regular	+ Overall, SMEs will benefit from more competition in the provision of audit services	- Overall, the Big Four audit firms will be the only stakeholder group which will suffer from the measures to open up the market for audits of large companies to competition. Competitive pressure will raise the audit	+ Overall, other international non-Big Four networks will be better off due to opening up of the market for audits of PIEs, despite the competitive pressure they might be facing due to removal of ownership	+ Overall, SMPs will be positively, though not likely significantly, impacted by the measures taken to promote competition in the market for audits of PIEs

Stakeholder Policy option ³⁷⁶	Investors, employee organisations and other users of audit reports	PIEs	SMEs	Big Four audit firms	Mid-size audit firms	SMPs
		tenders and changing an audit firm		quality and lower the costs of services	restrictions	

Stakeholder Policy option	Government	Financial stability	Employment
Joint impact of all measures under objective 3	+ Facilitating the development of a competitive market for audits of PIEs as well as the removal of barriers to entry into this market will ensure that there will be no place in the market for a "too big to fail" audit firm. Thus, the need to bail out an audit firm in the case of its demise will become a highly unlikely scenario	+ The higher quality of PIE audit, resulting from more competition (without taking into account other measures discussed in this Impact Assessment under other objectives) will contribute to the stability of financial markets	≈/+ Regarding the level of employment in the provision of statutory audit services to PIEs, there is no likely change, since the measures proposed will not affect a number of audits to be performed. However, more efficient audit markets might generate savings for the economy as a whole and indirectly have a slightly positive impact on the employment level in the whole economy

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; -- strongly negative; - negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

(4) Comparison between options - Objective 4: Avoid unnecessary additional compliance costs for audited SMEs as well as for audit providers in a cross-border context

Stakeholder / Policy option	Investors, employee organisations and other users of audit reports	PIEs	SMEs [only medium-sized enterprises are required to have their accounts audited, unless they are PIEs]	Big Four audit firms	Mid-size audit firms	SMPs
Base line scenario	0	0	0	0	0	0
Mutual recognition of audit firms	≈ No particular impact for users of audit reports	+	+	++	++	++ Small firms could be able to provide services in a cross-border context.
Introduction of an adaptation period scheme and increased convergence, transparency and predictability in the aptitude test for statutory auditors	≈ No particular impact for users of audit reports	≈ PIEs in general use audit firms and not individual auditors, so the impact is likely to be neutral	+	++	++	++ Easier for statutory auditors to be approved in another Member State and therefore be able to provide statutory audit services in that Member State. Of particular interest for SMPs working in cross-border environments.
Introduction of clarified ISAs	+	+	≈	++	++	+
	Investors will indirectly benefit from this measure as a result of the greater uniformity of audits across the EU and the expected increase in audit quality.	Clarified ISAs should lead to more structured audit work and ultimately increase financial reporting quality. This should benefit the audited entity.	Clarified ISAs should lead to more structured audit work and ultimately increase financial reporting quality. But they may be costly for SMEs unless adapted to their size.	Clarified ISAs across the EU facilitates the structuring of the audit work by firms, in particular those of larger size providing audit services to PIEs. Improvement in quality of transnational audits	Clarified ISAs across the EU facilitates the structuring of the audit work by firms, in particular those of larger size providing audit services to PIEs. Improvement in transnational audit client access to capital and business opportunities.	If SMPs audit accounts of PIEs, same positive effect as for mid-size audit firm. The impact of clarified ISAs is less positive as regards the audit of SMEs. Improvement in transnational audit client access to capital and business opportunities
Adapt audit standards to the size of the audited entity: proportionate audits for SMEs	+	n.a.	++	≈	+	+
	Investors will indirectly benefit from this measure as a result from the expected increase in audit quality.	[this measure would not apply to SMEs which are also PIEs]	Adapted audit standards to the size of SMEs should result in cost savings and no diminution of audit quality.	Big four firms are less present in the market for the audit of SMEs. The impact of this measure should be of	Possibility to provide better value for money to audit clients. In the short term, it could entail a diminution of	Possibility to provide better value for money to audit clients. In the short term, it could entail a diminution of

Stakeholder Policy option	Investors, employee organisations and other users of audit reports	PIEs SMEs [only medium-sized enterprises are required to have their accounts audited, unless they are PIEs]	Big Four audit firms	Mid-size audit firms	SMPs
			marginal importance for them.	audit fees, but it could be compensated by small enterprises continuing to having their accounts audited under a proportionate and simplified audit for SMEs.	audit fees, but it could be compensated by small enterprises continuing to having their accounts audited under a proportionate and simplified audit for SMEs.

Stakeholder Policy option	Government	Financial stability	Employment
Joint impact of all measures under objective 4	≈ The combined effect of the measures under objective 4 should have a relatively neutral effect regarding the exercise of supervisory tasks over statutory auditors and audit firms.	≈ No particular impact on financial stability is identified.	- / ≈ It is possible that these measures may lead to a diminution of employment in audit firms in the short term. A proportionate and simplified audit for SMEs should entail fewer resources invested by firms, which could result in lower levels of employment. Also, facilitating the recognition of auditors from other Member States should lead to better allocation of resources within firms and therefore an overall diminution of employment. At the same time, more efficient audit markets might generate savings for SMEs and the economy as a whole and indirectly have positive impact on the employment level in the whole economy.

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; -- strongly negative; - negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

(5) Comparison between options under - 5: Improve the effectiveness, independence and consistency across the EU of the regulation and supervision of auditors of PIEs

Stakeholder Policy option	Investors, employee organisations and other users of audit reports	PIEs	SMEs	Big Four audit firms	Mid-size audit firms	SMPs
Strengthening national audit supervisory authorities and giving ESMA responsibility for EU-wide cooperation on audit oversight	+	+	+/~	+/~	+/~	~
	Independent and robust supervision will ensure trust in the audited financial statements	Companies will get additional assurance that the audits provided to them were of high quality	To the extent SMEs are PIEs, companies will get additional assurance that the audits provided to them were of high quality.	The consistency of supervisory practices will reduce the regulatory burdens	The consistency of supervisory practices will reduce the regulatory burdens	As long as SMPs does not provide statutory audit services to PIEs, no impact is foreseen

Stakeholder Policy option	Government	Financial stability	Employment
Strengthening the national audit supervisory authorities and giving ESMA responsibility for EU-wide cooperation on audit oversight	-	+	~/+
	There will be additional, but not substantial, oversight costs in establishing and running the national public oversight authorities to the extent these will not be recovered; running cooperation at EU level would also require contributions from the national/EU budgets	Independent and effective national supervisory practices and their coordination at EU level will ensure an efficient functioning of markets for audits of PIEs, will have a positive impact on audit quality and ultimately will be conducive to financial stability	No direct impact is expected; indirectly positive with distortions less likely in the financial markets and their impact on the economy as a whole

Magnitude of impact as compared with the baseline scenario (the baseline is indicated as 0): ++ strongly positive; + positive; – – strongly negative; – negative; ≈ marginal/neutral; ? uncertain; n.a. not applicable

ANNEX 16. IMPACT ON SMES (AND PIEs OF SMALL DIMENSION)

One of the main concerns of the stakeholders who have been consulted is to ensure that any possible new initiative on the role of statutory audit, as well as the current functioning and the configuration of the audit market in the EU, will not increase the costs and administrative burden on SMEs and that any new requirement is proportionate to SMEs.

This annex aims at explaining how the principle "think small first" is applied by the Commission and that the policy options described in Sections 5, 6 and Annex 8, take due care of the possible impact on SMEs, whether as audited entities or audit firms/auditors.

For the purposes of this annex, unless otherwise specified, 'small and medium-sized enterprises' means companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding EUR 43 000 000 and an annual net turnover not exceeding EUR 50 000 000³⁷⁷.

(1) Statutory audit and SMEs

It is often stated that there are about 22 Million SMEs in the EU.

It should be underlined from the start that statutory audit, as required by EU law, does not concern all those SMEs. On the contrary, only a small fraction of those 22 Million SMEs: less than 300,000 SMEs would be concerned. In other terms: less than 2%.

As explained in Annex 2, statutory audit is essentially required for companies with limited liability and certain types of companies because of the nature of their activities (PIEs). Statutory audit of the accounts of European Companies (SE) and European Cooperatives (SCE) is also required, but the number of entities using these legal forms is marginal.

The following table provides an overview of the number of SMEs which prepare accounts and consolidated accounts in accordance with the 4th Company Law Directive, the 7th Company Law Directive and the Transparency Directive (which refers to the IAS Regulation).

Figure A16.1 - Number of companies in the scope of the 4th and 7th Directive and the IAS Regulation					
Directive	Micro	Small	Medium-sized	Large	Total
4 th Directive on Annual Financial Statements*	5,936,774	1,117,214	245,431	45,301	7,344,720
7 th Directive on Consolidated Financial Statements**	86,748	33,657	12,365	14,095	146,865
IAS Regulation	~150****	≤ 1,100****		≥ 6,115****	7,365***

Source: European Commission (October 2011a)

The requirement to have the accounts audited does not apply to all companies (with limited liability) that are subject to the 4th and 7th Company Law Directives.

- Currently these directives require that the accounts of the companies concerned (those with limited liability) should be audited, whatever the size of the company, but Member States are permitted to exempt small companies from this obligation.

³⁷⁷ Cf. Article 2(1)(f) of Directive 2003/71/EC.

- In 2011, however, the Commission proposed that small companies should no longer be required to have their accounts audited³⁷⁸, although Member States may still require it. Small companies are those which do not exceed two of the following criteria: balance sheet total (EUR 5,000,000), net turnover (EUR 10,000,000) and average number of employees (50). Compared to the table above, the estimation is that as a result of the application of these thresholds, around 62,000 medium-sized companies would shift to the small category³⁷⁹.

The savings that arise from this proposal are evaluated in the impact assessment accompanying it³⁸⁰.

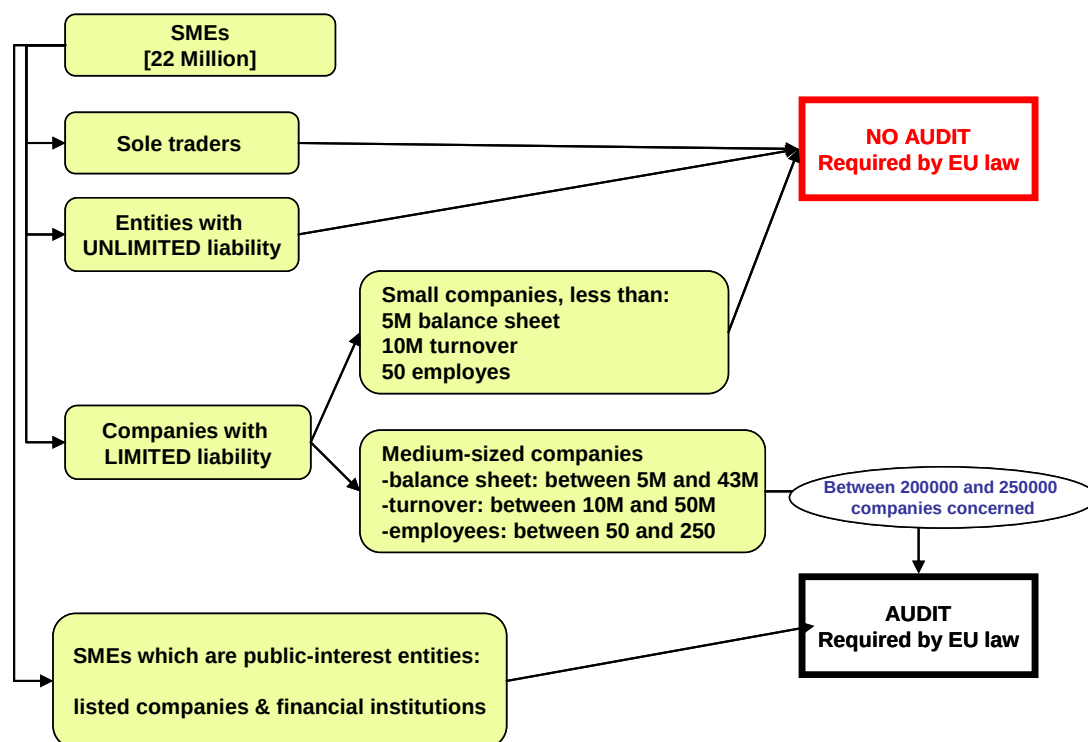


Figure A16.2

To maintain coherence with the 2011 proposal to modify the 4th and 7th Company Law Directives, only SMEs of certain size (as well as SMEs which are PIEs) will be subject to an audit obligation arising from EU law: less than 250,000 companies for the whole EU³⁸¹. Therefore, the policy options described in Sections 5, 6 and Annex 8 should be assessed in the light of this very limited scope.

(2) SMEs as audited entities

Two possibilities need to be distinguished when a SME is an audited entity:

³⁷⁸ See European Commission (October 2011b).

³⁷⁹ See European Commission (October 2011a).

³⁸⁰ *Ibid.*

³⁸¹ Total = (245431+12365+1100+150) – 62000 + (large companies according to the accounting directive which meet the SME criteria). Please note that the definition of "large company" in the accounting directive includes SMEs when the traditional definition of SME is used.

- (2.1) the audited entity is a PIE;
- (2.2) the audited entity is not a PIE.

(2.1) SMEs as PIEs and other PIEs of small dimension (small caps).

The majority of the preferred policy options in this paper address the audit of PIEs. SMEs will not be affected by the new measures regarding the audit of PIEs, unless they are PIEs themselves.

While the possibility that a bank or an insurance company is a SME is low, many listed companies are SMEs or have a small dimension compared to the size of financial markets. Also, payment institutions or e-money institutions may also be of small dimension.

There is an on-going debate about the question of adapting the disclosure obligations of SMEs and issuers of small dimension to their size, so as to reduce the burden associated with such disclosure. The publication of the annual financial report with audited financial statements is among these obligations.

Extract from the impact assessment on the amendment to the Transparency Directive (European Commission (October 2011c), p.10).

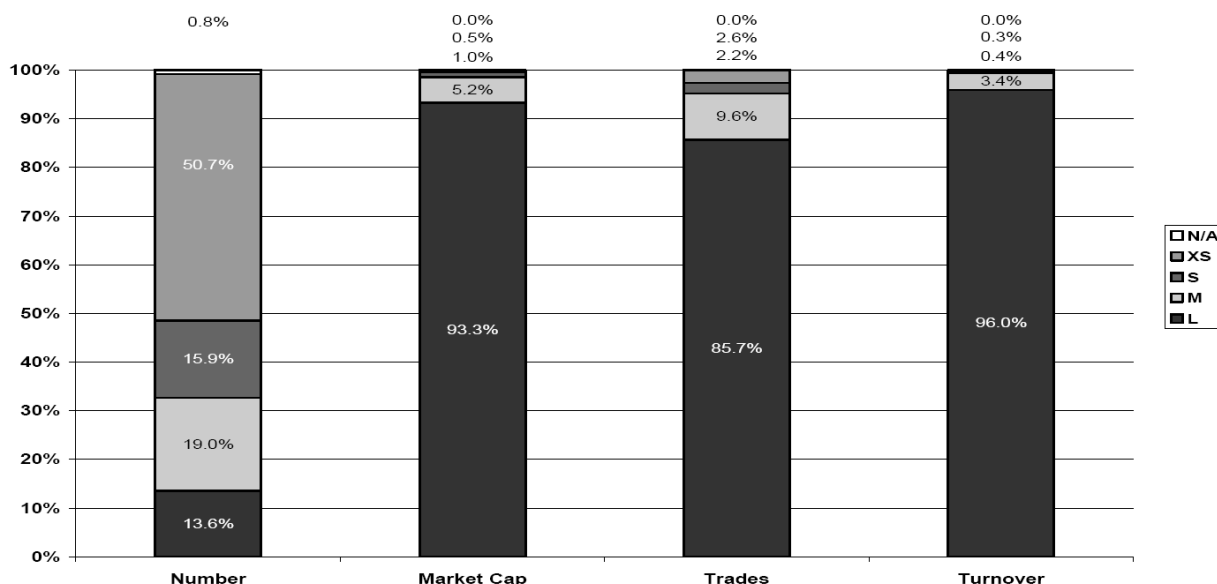
"[...] Small and medium sized issuers often argue that, for them, the costs of compliance with transparency requirements are disproportionate³⁸². They consider this is the case both compared to the relative costs borne by larger companies, and in relation to the benefits they obtain from being listed.

Indeed the smaller issuers do not benefit from an increase in investment volumes. In absolute terms, they make up the majority of listed companies on financial markets, but they represent only a small part of total market capitalisation and of total trading volumes. This is particularly the case on Regulated Markets³⁸³, as illustrated by Figure 2 below.

Figure 2: Relative importance of listed companies on EU regulated markets by size

³⁸² "See for instance replies from EuropeanIssuers, QCA and Middlednext to the consultation on the Modernisation of the Transparency Directive (the question of disproportionate costs was not asked as such in this consultation). This view is also supported by Demarigny (2010). According to Mazars (2009), 34.6 % of mid-cap companies and 38.1% of small listed companies consider that compliance with the Transparency Directive has been onerous for them: see section 2.3.5, p. 71."

³⁸³ "See Glossary Annex 4."



Source: FESE (2009). (Federation of European Securities Exchanges) which establishes four categories of companies: micro caps (XS $\leq$ €50M), small caps (S: between €50M and €150M), mid caps (M: between €150M and €1b) and large cap (L: $\geq$ €1b). The first column presents the relative importance (%) by number of listed companies (equity issuers); the second column by market capitalisation; the third column shows the trades, in numbers, while the fourth column shows the turnover, in volume.

Low trading volumes mean lower market liquidity and more difficulties for small and medium size companies to raise capital on regulated markets, compared to larger companies. However, small and medium size listed companies still bear the full costs associated with the listing³⁸⁴. According to recent research³⁸⁵, the explosion of the private equity market in the last twenty five years suggests that for some firms, especially small firms in R&D intensive sectors, disclosure costs are substantial."

Similar issues arise regarding the question of statutory audit. For SMEs which are PIEs as well as for PIEs of small dimension, specific obligations regarding the conduct of audits may increase the burden on boards and senior management (opportunity cost) in addition to the costs of the service.

Therefore, adapting the requirements on statutory audit to the size and dimension of the business of PIEs appears appropriate and proportionate. From the perspective of stability of financial markets, it must be underlined, as shown by the above figure, that small listed companies (e.g. below €150 Million capitalisation) while constituting the majority in number, account for less than 5% of the capitalisation of EU regulated markets.

Such adaptation was already present in the Statutory Audit Directive regarding the need to have an audit committee: the administrative or supervisory body as a whole of a SME was allowed to perform the functions of the audit committee, provided that this body was not chaired by an executive member when performing those functions.

³⁸⁴ "Many aspects of these costs do not directly result from the requirements of the Transparency Directive but are linked to national additional measures or other legislative texts (e.g. obligation to publish all regulated information in the printed press, accounting rules), which are particularly problematic for smaller companies. However, these costs are outside the scope of this impact assessment."

³⁸⁵ "Zingales (2009) p.18."

When developing the policy options described in Sections 5, 6 and Annex 8, account has been taken of the SME dimension. As a result, the following adaptations are foreseen:

- Audit Committee: As is the case today in the Statutory Audit Directive, PIEs which are SMEs should not be obliged to have an audit committee provided that the board undertakes this function under a different chairmanship. This option should also be extended to small caps, understood as companies with reduced capitalisation (less than €100 Million)³⁸⁶. Also, the flexibility offered to companies with a dual board system to entrust the supervisory board with the audit committee function is maintained in this option;
- Tendering: PIEs which are SMEs should not be obliged to tender for their audit service and may directly negotiate with a possible service provider. At least 0.6 – 1% of the total audit fees will be saved by SMEs (for the assessment of tendering costs, see Annex 20);

(2.2.) SMEs as audited entities which are non-PIEs.

Medium-sized companies

When SMEs which are not PIEs are audited, the preferred policy option under objective 4 requires Member States to make sure that the audit standards are applied to SMEs in a proportionate manner. In practice, this would only apply to "medium-sized companies" which are the only ones subject to audit requirements by EU law. As seen above, small companies would only conduct audits if required by national law or if done voluntarily.

The adaptation of the audit standards to the size of the audited entity should result in better audit services to the SMEs concerned – with no diminution in audit quality – and possibly lower cost.

The proposed measure does not define in detail how this adaptation must be done, this is left to the discretion of Member States. Therefore, given that such an adaptation of standards must be done at national level it is not easy to estimate in advance the savings for the audited entities.

In France, auditing standards have already been adapted for a category of small companies since 2009: the "small enterprise" standard (*norme petite entreprise*).

In **France**, there is a specific standard (*norme petite entreprise, NEP 910*)³⁸⁷ that provides for a simplified and proportionate audit for certain small limited liability companies, those that do not exceed two of the following three criteria: balance sheet total (€1,550,000), net turnover (€3,100,000) and employees (50)³⁸⁸. This French standard is inspired and adapted from the ISAs and, according to the French auditors'

³⁸⁶ Cf. definition of company with reduced market capitalisation, Article 2(1)(t) of Directive 2003/71/EC.

³⁸⁷ See *Arrêté du Ministère de la Justice du 2 mars 2009 portant homologation de la norme d'exercice professionnel relative à la certification des comptes annuels des entités mentionnées à l'article L.823-12-1 du code de commerce, Journal officiel de la République Française du 14 mars 2009*.

The NEP 910 is accessible at:

https://www.cncc.fr/sections/documentation_profes/documentation_de_ref/norme_et_doctrine_pr/table_synthetiques_d/nep_910_certificati/ooo_preview_html

³⁸⁸ However, this specific standard is not applicable to the companies incorporated as "sociétés anonymes". In this case, the normal standards should be applied.

professional body (Compagnie Nationale des Commissaires aux Comptes, CNCC), it would be compatible with the ISA requirements.

The simplified auditing standards allow for the use of audit procedures which are adjusted to the nature, timing and extent of a simple and small entity with the increased use of professional judgment and audit documentation adjusted to the size and complexity of the audited entity.

The French professional body (CNCC) has developed specific operational guidance (so-called "pack PE") to facilitate the auditor's tasks when auditing SMEs. Additionally, the CNCC provides training to auditors on how to audit an SME and to use the "pack PE", irrespective of whether the NEP 910 standard applies or not (so, also for the audit of larger SMEs than those covered by the NEP 910).

This standard, as well as the CNCC support, is modelled to carry out the statutory audit in about 40 hours, compared to 50 to 120 hours in normal circumstances for a company of such this³⁸⁹. Therefore, the audit cost is reduced.

This recent experience in France shows that it is possible to apply the auditing standards in a proportionate manner to small companies without resulting in a corresponding reduction in the value attached to the audit of SMEs. The positive experience results from the combined effect of a legislative empowerment to carry out proportionate and simplified audit and a substantial effort from the audit profession to provide operational guidance and training to auditors auditing SMEs.

It also shows that the potential savings for a small audited entity having its accounts audited under the "*norme petite entreprise*" could be around 40% (of course, savings would depend on the complexity of the audited entity).

The French example, however, is not easy to extrapolate to the entities subject to the auditing obligation under EU law. French thresholds for the *norme petite entreprise* are much lower compared to the EU ones. The SMEs subject to the auditing obligation are companies meeting the following criteria: balance sheet total (between EUR 5 000 000 and 43 000 000), net turnover (between EUR 10 000 000 and 50 000 000) and average number of employees (between 50 and 250).

As a result, it cannot be claimed that the savings would be comparable to the French case for the small companies. In any event, the French example shows that there is a real possibility to achieve savings for SMEs by adapting the auditing standards to the size of the audited entity.

Small companies

Small companies are not subject to the EU requirement to have their accounts audited.

³⁸⁹

Article R823-12 of the French Code of Commerce sets out the working hours that an auditor is "normally" expected to apply considering the size of the audited company. The size is measured by the addition of: the balance sheet, the net turnover (*produits d'exploitation*) and financial income. For a size between €1,525,000 and €3,050,000, 50 to 80 working hours are considered normal. For a size between €3,050,000 and €7,622,000, 70 to 120 working hours are considered normal.

In Estonia³⁹⁰, certain small companies are however required to have a “limited review”³⁹¹ of their accounts done.

Similar types of alternative/limited assurance service are available for certain types of small companies³⁹² in other EU Member States³⁹³, as a voluntary service.

The ICAEW Assurance Service in the UK³⁹⁴

The ICAEW Assurance Service is in line with the IAASB International Framework for Assurance Engagements³⁹⁵. The technical guidance for the service (AAF03/06)³⁹⁶ adopts limited assurance (in contrast to reasonable assurance) instead of moderate assurance as used in ISRE (International Standard on Review Engagement) 2400³⁹⁷. The key characteristic of AAF 03/06 is its focus on the practitioner’s judgement as to the work effort required to reach a limited assurance conclusion.

Under AAF 03/06, the practitioners are expected to perform additional or alternative procedures where minimum defined procedures (analytical review and management enquiry) do not provide them with the assurance required to reach a limited assurance conclusion. The report issued includes a negative opinion. The reporting criteria are the relevant requirements of the Companies Act 2006 and Generally Accepted Accounting Practice in the UK (‘UK GAAP’).

The ICAEW Assurance Service is provided for by practicing members of the ICAEW. In carrying out an assurance engagement, accountants who are members of the ICAEW are subject to ethical guidance as laid down by the ICAEW’s Code of Ethics. When conducting an assurance engagement, there are additional requirements in Independence for Assurance Engagements within the Code. This applies to all assurance engagements outside the scope of audit and is in compliance with the IFAC Code of Ethics.

In addition, the International Standard on Quality Control (UK and Ireland) (ISQC (UK and Ireland)) 1, Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements is applicable to firms providing audits and reviews of historical financial information, and other assurance and related services engagements.

There is no information on the frequency of its use as the ICAEW Assurance Service is a voluntary service and no filing requirements exist.

³⁹⁰ For companies exceeding two of the three following criteria: turnover (€600,000), balance sheet total (€300,000) and number of employees (10); but not exceeding two of the three following criteria: turnover (€800,000), balance sheet total (€900,000) and number of employees (30).

³⁹¹ A different type of assurance service providing a lower level of assurance than statutory audit.

³⁹² Those small companies are not required to have their accounts audited under EU law, since Member States may waive the obligation arising from the Fourth and the Seventh Company Law Directives.

³⁹³ E.g. France, Ireland (for charities and small pension schemes), Italy (continuous assurance by Collegio Sindacale), Romania and the UK (ICAEW limited assurance service). Other EU Member States considered the introduction of limited reviews. See FEE (2009), p.13.

³⁹⁴ See FEE (2009), p. 46. See also ICAEW (2009).

³⁹⁵ <http://www.ifac.org/IAASB/Pronouncements.php>.

³⁹⁶ ICAEW (2006).

³⁹⁷ See www.ifac.org/IAASB/Pronouncements.php#Standards.

In any case, according to ICAEW, the experience is positive and limited reviews are considered valuable by the market³⁹⁸

Concerning third countries, "limited reviews" for the accounts of SMEs are required³⁹⁹ in Switzerland⁴⁰⁰).

In **Switzerland**⁴⁰¹, since 1 January 2008, all limited liability companies (especially corporations Aktiengesellschaft) and closed corporations (Gesellschaft mit beschränkter Haftung)) are either subject to a statutory full scope audit ("ordentliche Revision") or a limited statutory examination ("eingeschränkte Revision").

Swiss alternative assurance service

The Swiss alternative assurance service is called a limited statutory examination, as it provides a moderate level of assurance that the financial statements are free from material misstatement. This is expressed in a negative way in the assurance report (thus similar to a review). Nonetheless, certain substantive audit procedures are required for certain balance sheet or income statement items in case of a heightened risk in that area. In any case, third party confirmations, inventory observations and internal control testing are not part of the limited statutory examination.

The examination is based on a standard which has been prepared by the Institute of Certified Accountants and Tax Consultants (Treuhand-Kammer). A limited statutory examination consists primarily of inquiries of company personnel and analytical procedures as well as certain substantive tests of company documents as considered necessary in the circumstances. However, the testing of operational processes and the internal control system, as well as inquiries and further testing procedures to detect fraud or other legal violations, are not within the scope of a limited statutory examination.

If, during the performance of a limited statutory examination, certain matters come to the auditor's attention, the auditor has to describe those matters and should quantify the possible effect, unless it is impracticable to do so. Situations of material scope limitations are also possible. This new assurance service does not materially differ from review engagements widely applied worldwide.

The limited statutory examination is strongly related to a review as laid out in ISRE (International Standard on Review Engagement) 2400. The structure of the Swiss standard for the limited statutory examination is thus comparable to ISRE 2400.

The companies concerned by the obligation

The limited statutory examination is a compulsory assurance service for small and mid-sized companies.

³⁹⁸ ICAEW (2009).

³⁹⁹ In the US, limited reviews are common practice, but are not required by law.

⁴⁰⁰ A so-called limited statutory examination ("eingeschränkte Revision") is mandatory for small companies with more than 10 employees but which are not required to have their accounts audited (i.e. are covered by the audit exemption).

⁴⁰¹ See FEE (2009), p. 43.

The types of entities subject to limited statutory examination assurance are entities not meeting two out of the following three criteria in two consecutive years as such entities are subject to statutory audit:

- Balance sheet total over 10 million Swiss Francs (approximately €6,6 million);
- Net sales over 20 million Swiss Francs (approximately €13,3 million);
- Employees over 50 (full-time equivalents on average per year).

The following entities are always subject to a full scope audit:

- Companies with listed equity or debt financing; or
- Companies, contributing at least 20% to the balance sheet total or net sales of another company's group accounts, provided this other company has either listed equity or listed debt financing; or
- Companies, which have to prepare group accounts; or
- Companies, which exceed the thresholds as mentioned above.

Nonetheless, the company might decide to opt-out. Under the opting-out rule the company might decide not to have an audit - assurance engagement, provided that the company does not employ more than ten employees on a full employment basis and provided that all shareholders agree with this opting-out.

On the other hand, a company subject to a limited statutory examination might also decide for to opt-up, i.e. it decides to have a full scope audit on its financial statements.

The professionals providing the service

Under the Auditor Oversight Act (AOA), Swiss practice differentiates between licensed auditors and licensed audit experts. There are higher education and qualification requirements for licensed audit experts.

Licensed auditors and licensed audit experts are both allowed to perform limited statutory examinations, but only licensed audit experts are legally permitted to conduct full scope audit engagements required under Swiss Law.

The limited statutory examination is both mandatory and regulated.

In the case of a limited statutory examination, the independence requirements are less strict than for a full scope audit. Thus, advisory services including bookkeeping services are allowed provided that certain safeguard measures are adhered to and disclosed in the report. In general, licensed auditors performing the limited statutory examination are not subject to firm and file reviews (inspections) undertaken by the Federal Audit Oversight Authority.

Nonetheless, licensed auditors have to adhere to high quality standards and compliance with these standards has to be confirmed regularly in connection with re-licensing

procedures. In cases where sole practitioners perform the limited statutory examination, they are subject to an external quality control reviews (peer review).

All auditors who want to perform audit services regulated by Swiss Law (full scope audits, limited statutory examinations, audits in respect of capital decreases, contributions in kind etc.), have to register with the Swiss audit oversight body.

(3) SMEs as Audit firms/statutory auditors: the small and medium-sized practitioners (SMPs)

Audit firms or statutory auditors may as well qualify as "small and medium-sized enterprises". They are often referred to as "Small and medium-size practitioners (SMPs)".

SMPs and the recognition of their competence in a cross-border context.

The automatic recognition of audit firms within the EU should allow small firms to be able to provide services in a cross-border context.

The facilitation of the establishment of auditors in a different Member State (via an improved aptitude test or an alternative adaptation period) should have positive effects for statutory auditors working in cross-border environments. The same is true for the statutory auditor providing cross-border services: the mutual recognition the qualifications should be positive for SMPs.

SMPs and the audit of PIEs

SMPs are also present in the market for audits of listed companies and other PIEs, in particular regarding the audit of PIEs of smaller dimension. Hence, the policy options addressing specifically the auditors of PIEs will also impact on SMPs. In this case, it has also been considered appropriate and proportionate to adjust the policy options described in Sections 5, 6 and Annex 8, to the size and dimension of the business of SMPs.

As a result, the following adaptations are foreseen:

- Pure audit firms. The imposition of the pure audit requirement with respect to audits of PIEs could make the entrance (or maintenance) of SMPs more difficult into this market. In order to avoid that SMPs who currently perform audits of PIEs would have to join larger audit firms or decide to quit this segment of the audit market, a special derogation for SMPs is foreseen: the pure audit firm requirement would only apply to firms that obtain at least one third of their audit fee revenues from large PIEs (see above for the threshold). This derogation would logically cease to apply should the SMP grow.
- Internal policies and procedures to comply with legal requirements regarding potential conflicts of interest. The policies and procedures shall be proportionate in view of the scale and the complexity of the business of the SMP. Supervision should be adapted accordingly.

Concerning the impact of joint audit, small audit firms willing to audit PIEs may be in a position to be the second partner in a joint audit engagement, although this will very much depend on the complexity of the entity to be audited. Concerning the mandatory rotation rule, SMPs auditing PIEs will be on equal footing compared to larger audit firms. SMPs will have to seek new audit engagements once the mandatory rotation rule becomes applicable. The tendering rule should facilitate this process. In the case of individual auditors, they may benefit from more competition

between large audit firms for the market of audits of PIEs: e.g. by becoming more attractive employers in the labour market.

When seeking new audit mandates, SMPs will particularly benefit from the policy options aiming at facilitating the choice of audit provider:

- The prohibition of contractual clauses limiting the audit firm choice: e.g. clauses between the audited entity and a third party (such as a bank) requiring that the statutory audit is performed by a "Big-Four firm" only. These clauses are often referred to as "big-Four only clauses";
- The increased transparency on audit quality through the disclosure of inspection reports on quality assurance reviews should provide information to the market on the quality of SMPs work. The increased transparency by audit firms themselves (e.g. regarding the transparency report) will have a moderate impact on SMPs, due to their less complex structures and businesses.
- The European audit quality certification should also benefit SMPs willing and able to carry out statutory audits of PIEs as they will be in a position to demonstrate that their work is of a satisfactory standard.

SMPs and the audit of non-PIEs

The use of auditing standards adapted to the audit of SMEs should result in the possibility to provide better value for money to audit clients. In the short term, it could entail a diminution of fees, but it could be compensated if small companies (only medium-sized companies are subject to the obligation to have their accounts audited) are willing to voluntarily have their accounts audited under a proportionate and simplified audit for SMEs.

In any case, it should be noted that for non-PIEs, SMPs will be in a position to continue providing other non-audit services to audit clients.

The impact on SMPs resulting from the modification of the 4th and 7th Company Law Directives (only the audit of accounts of medium-sized companies will be required) is examined in that context.

(4) Summary of specific adjustments to the policy options for SMEs⁴⁰²

Figure A16.3

Policy option	SME as audited entity PIE	SME as audited entity Non-PIE	SME as auditor/audit firm SMPs
Audit Committee	PIEs which are SMEs or companies with reduced market capitalisation (below €100M) are not obliged to have an audit committee, provided that the board undertakes this function under a different chairmanship.	N/A	N/A
Tendering	PIEs which are SMEs would not be obliged to organise tenders for their audit service and may directly negotiate with a possible service provider.	N/A	N/A
Joint Audit		N/A	N/A
Prohibition on the provision of non-audit services / pure audit firms	<i>[N.B. the prohibition for the auditor/audit firm to provide non-audit services to the audit client would apply irrespective of the size of the PIE]</i>	N/A	Obligation to become a pure audit firm would only be applicable to large audit firms.
Internal policies and procedures to comply with legal requirements on threats to independence			Policies and procedures to be proportionate in view of the scale and complexity of business of the audit firm or statutory auditor.
Application of the auditing standards (the adopted clarified ISAs)	Request that the auditing standards are applied in a proportionate manner when auditing medium-sized undertakings. The request for the proportionate application of the auditing standards is also extended to small undertakings, if audit required by national law or the company voluntarily decides to have its accounts audited. Voluntary review of financial statements remains possible.		
Supervision			Quality assurance reviews to be proportionate in view of the scale and complexity of business of the reviewed audit firm or statutory auditor

⁴⁰² This table does not take into account the policy options that are expected to have positive impacts on SMEs as audited entities or on SMPs, but which are not necessarily adjusted to the size of either SMEs or SMPs: e.g. the mutual recognition of audit firms or statutory auditors etc.

ANNEX 17. IMPACT ON THIRD COUNTRIES

The proposed measures are rather neutral regarding their effects on third countries. Firstly, there is no change regarding the scope of application of EU audit rules. Secondly, the possibility for third country nationals to become statutory auditors in the EU is not adversely affected but rather facilitated. Thirdly, there are marginal improvements regarding the audit of consolidated accounts: the policy choices take account of the particularities regarding the audit of consolidated financial statements with a view to facilitating such an audit when either a EU company has subsidiaries in third countries or a third country company has subsidiaries in the EU. Fourthly, the supervisory cooperation with third country authorities is encouraged, but the substantive rules on such cooperation (e.g. transfer of audit working papers) remain largely untouched.

(1) No change regarding the scope of application of the EU audit rules: no impact on third country companies.

EU rules respect, in principle, the “company law” of the audited entity as “*critère de rattachement*” for requiring the audit of accounts and for establishing how such an audit should be conducted. The special rules on the audit of PIEs (Regulation) apply to listed companies incorporated in the EU and to certain financial institutions regulated by EU law and which have obtained a license in the EU. The definition of PIE does not capture third country companies, although it may of course capture EU legal entities with foreign ownership. Therefore, these special rules on the audit of PIEs do not affect, as such, third country companies.

The normal rules on the audit of non-PIE companies (Directive) only apply to companies for which the audit is required by EU law. This concerns primarily companies with limited liability incorporated in the EU. A few third country companies may also be captured because of the requirements of the Directive 2004/109/EC (Transparency Directive): third country companies issuing securities in regulated markets in the EU. However, a special procedure for the audit of these companies is already foreseen (see below).

The audit of third country incorporated companies which list securities on EU exchanges presents some particularities, which are not modified by the policy choices made in this impact assessment. Those companies are, because of the applicable company law, already subject to the audit requirements of the third country of incorporation. There are two possible situations within the EU:

- the securities of the third country company are listed in an EU Regulated Market. The Transparency Directive requires that the audit of the accounts of such a company is carried out in accordance with the Directive 2006/43/EC (Statutory Audit Directive)⁴⁰³.

⁴⁰³

It should be noted in this regard that the Transparency Directive specifies the applicable accounting standards: basically IFRS as adopted in the EU, the IFRS and the GAAPs of US and Japan (during a transitional period, also the GAAPs of Canada, China, India and Korea are accepted). See Commission Decision of 12 December 2008 *on the use by third countries' issuers of securities of certain third country's national accounting standards and International Financial Reporting Standards to prepare their consolidated financial statements*, OJ L 340, p. 112.

Therefore, in some cases, a third country issuer may have to restate their accounts (initially prepared under its national law) in accordance to EU law and a second audit report (on the restated accounts) may be necessary.

The audit carried out in the third country by a third country auditor or firm in conformity with the national law of the audited entity is not automatically recognised in the EU⁴⁰⁴. However, the Statutory Audit Directive provides for the recognition of such audits carried out by a third country auditor or audit firm if two conditions are respected: (i) the third country auditor or firm is registered with an EU Member State (but he/she/it does not need to be approved as statutory auditor or audit firm within the EU)⁴⁰⁵; and (ii) the third country auditor or firm is subject to public oversight, quality assurance reviews and investigations and penalties within the EU⁴⁰⁶.

- the securities of the third country company are listed in a market which is not an EU Regulated Market: i.e. a second tier market which qualifies as MTF such as AIM (in London), Alternext (in Euronext markets) or EuroMTF (in Luxembourg). The EU rules are silent in this case and national law applies. In practice, the listing rules in those markets tend to require that those issuers disclose audited accounts.

In conclusion, the EU audit rules, whether those for PIEs or those for non-PIEs, only apply to EU companies, with a few minor exceptions for which specific proportionate measures are already in place.

(2) The possibility for a third country national to audit an EU PIE or an EU company is not adversely affected but rather facilitated.

The proposed measures do not adversely affect the *statu quo*.

Firstly, there is no nationality restriction to become auditor in the EU⁴⁰⁷. Therefore, a third country national can become statutory auditor in the EU, provided he/she meets the required conditions, and audit EU PIEs.

Secondly, the third country national must prove his/her professional qualification in the same manner as an EU national. Currently there are three options:

- *the normal approval procedure foreseen under Article 3 of the Statutory Audit Directive*, as for any domestic applicant: this implies compliance with the conditions established in Articles 4 and 6 to 10 of this Directive regarding good repute and educational qualifications.
- *if he/she has already been approved as a statutory auditor in accordance with Article 3 in an EU Member State*, the third country national can seek approval in another EU

⁴⁰⁴ Cf. Article 45(4) of the Statutory Audit Directive.

⁴⁰⁵ Cf. Article 45(1) of the Statutory Audit Directive.

⁴⁰⁶ Cf. Article 45(3) of the Statutory Audit Directive. However, a Member State may exempt the third country auditor or firm from its system of quality assurance review if the third country's system of quality assurance is assessed as equivalent. So far, the following countries are considered equivalent for these purposes: Australia, Canada, China, Croatia, Japan, Singapore, South Africa, South Korea, Switzerland and the US. A number of other countries are temporarily accepted as equivalent during a transitional period. See Commission Decision of 19 January 2011 *on the equivalence of certain third country public oversight, quality assurance, investigation and penalty systems for auditors and audit entities and a transitional period for audit activities of certain third country auditors and audit entities in the European Union*, OJ L 15, p.12.

⁴⁰⁷ A requirement imposing that only EU nationals could become auditors would not be possible given the international commitments of EU Member States: i.e. GATS.

Member State through the procedure foreseen in Article 14 (aptitude test) of the Statutory Audit Directive;

- *if he/she has already been approved as statutory auditor in a third country*, EU Member States may (but are not obliged to do so) recognise this professional qualification and approve the third country auditor. Article 44 of the Statutory Audit Directive sets three conditions: (i) the third country auditor must indeed provide proof that he or she complies with requirements equivalent to those laid down in Articles 4 and 6 to 13 of the directive, (ii) the procedure foreseen in Article 14 (aptitude test) of the Statutory Audit Directive shall apply, and (iii) it should be possible for an auditor of that Member State to obtain recognition of his/her qualifications in that third country (reciprocity requirement).

The proposed measures intend to simplify the procedure foreseen in Article 14 of the Statutory Audit Directive for the recognition of statutory auditors of a different Member State: the applicant auditor would have the choice between an aptitude test and an adaptation period. Third country auditors would also benefit from this simplification, since the Article 14 procedure is also applicable to them⁴⁰⁸; it will also be easier for them to obtain the recognition because of the conditions required in Article 44.

Thirdly, in the case of third country audit firms, they need to obtain approval in the EU in accordance with Article 3 as would any EU audit firm. It should be noted that there is no nationality restriction regarding the ownership of the firm by third country investors. Additionally, third country audit firms would also benefit from the lifting of ownership restrictions in audit firms as regards voting rights controlled by persons other than statutory auditors approved in the EU.

(3) The proposed measures take account of the particularities regarding the audit of consolidated financial statements with a view to facilitate such audit when either an EU company has subsidiaries in third countries or a third country company has subsidiaries in the EU.

The audit of consolidated accounts, when either an EU company has subsidiaries in third countries or a third country company has subsidiaries in the EU presents some particular needs. The proposed measures take account of these particularities and the following issues are considered:

- *duties and powers of the EU group auditor of an EU PIE*. The existing rules (cf. Article 27 of the Statutory Audit Directive) will be further clarified regarding: the documentation of the work by the EU group auditor and the need to secure the cooperation of third country auditors auditing subsidiaries of the EU PIE;
- *duties and powers of an EU auditor (e.g. auditing an EU subsidiary of a third country company) towards a third country group auditor of a third country company*. Clarification of the circumstances in which the EU auditor can derogate from the professional secrecy rule and transfer relevant documentation to the group auditor situated in a third country for the purposes of the group audit. It is also clarified that the EU auditor cannot send documents to a third country authority (e.g. for a quality

⁴⁰⁸ Cf. Article 44(2) of the Statutory Audit Directive.

assurance review of the group audit) outside the procedure foreseen under Article 47 of the Statutory Audit Directive;

- *the question of the provision of non-audit services to subsidiaries of EU companies in third countries: third country auditors/firms are affected by the new restrictions.* The new measures will establish stricter requirements for EU statutory auditors and audit firms in the EU:
 - an EU statutory auditor and the members of his/her network (whether in the EU or not) will not be allowed to provide non-audit services to the audited entity or to its subsidiaries within the EU;
 - Certain EU audit firms should become pure audit firms (and therefore will not be in a position to provide non-audit services at all) and should not belong to a network providing non-audit services within the EU.

These new measures do not affect the capacity of a third country auditor/audit firm which is a member of the network of an EU statutory auditor/audit firm to provide non-audit services to his/her/its audit clients and do not require third country audit firms to become pure audit firms.

However, regarding subsidiaries of EU PIEs in third countries, the group auditor in the EU shall assess whether the provision of non-audit services by a member of his/her/its network to the subsidiary of the PIE would compromise his/her or its independence. Some services are considered to affect such independence in all cases (blacklist) while some other are presumed (but this presumption is rebuttable) to affect it. As a result, there is an effect on the ability of the third country auditor/firm which is member of the same network of the group auditor to provide certain non-audit services.

- *the question of the rotation of the auditor regarding the subsidiaries of EU PIEs in third countries.* The new measures are silent regarding rotation of auditors in a subsidiary of a PIE, whether such subsidiary is in the EU or in a third country.

(4) Supervisory cooperation with third country authorities: the new measures are neutral.

Supervisory cooperation with third country authorities and bodies regarding the exchange of information, quality assurance reviews and investigations is encouraged. However, the new measures do not establish additional specific channels for cooperation and do not affect the existing rules on cooperation on the transfer of audit working papers which remain untouched. Therefore, the new measures are neutral.

This annex presents an overview of the cumulation of the preferred policy options.

Figure A18.1. General overview.



Figure A18.2. Policy options on the selection and appointment of auditors.

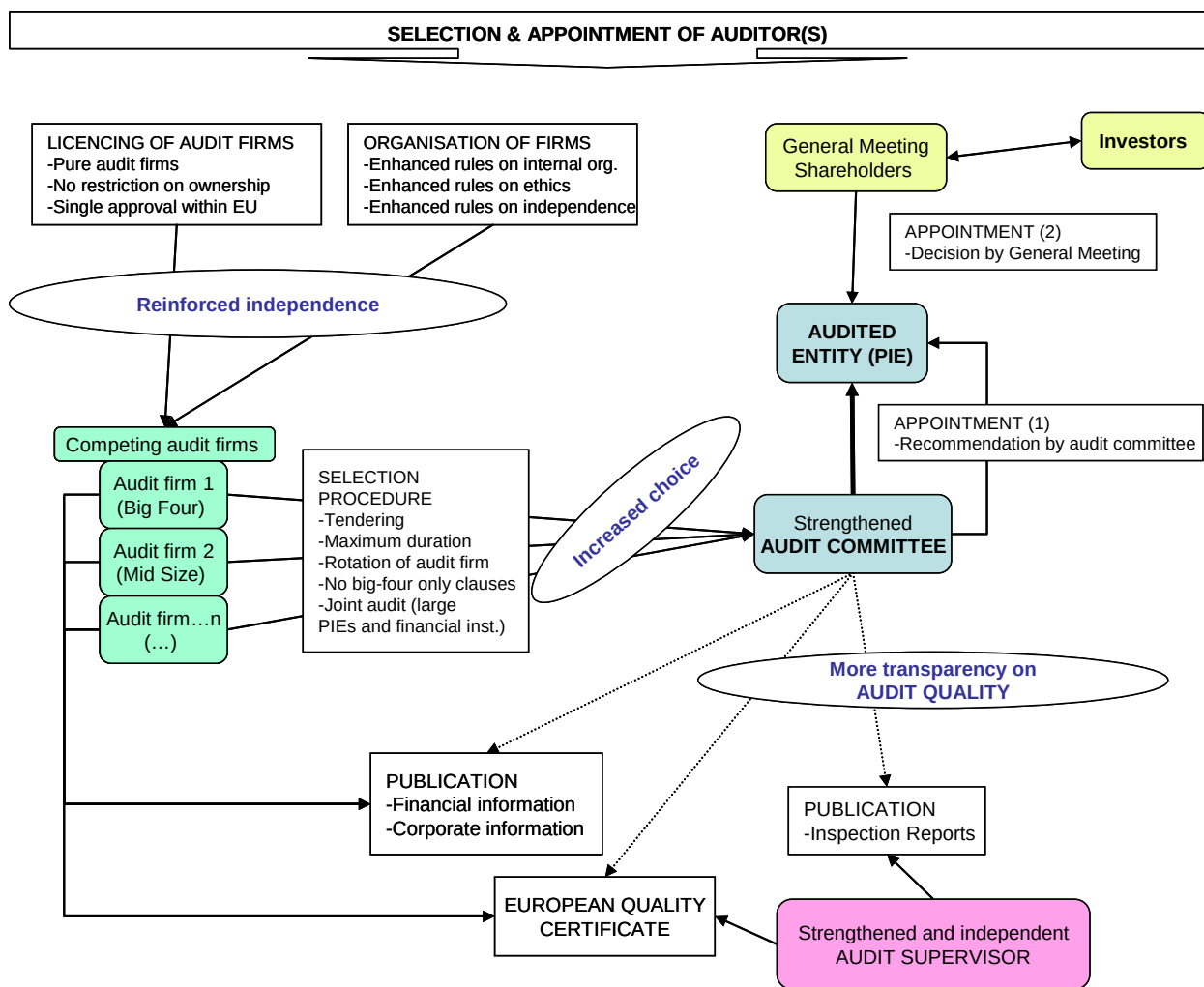


Figure A18.3. Policy options regarding the performance of statutory audit.

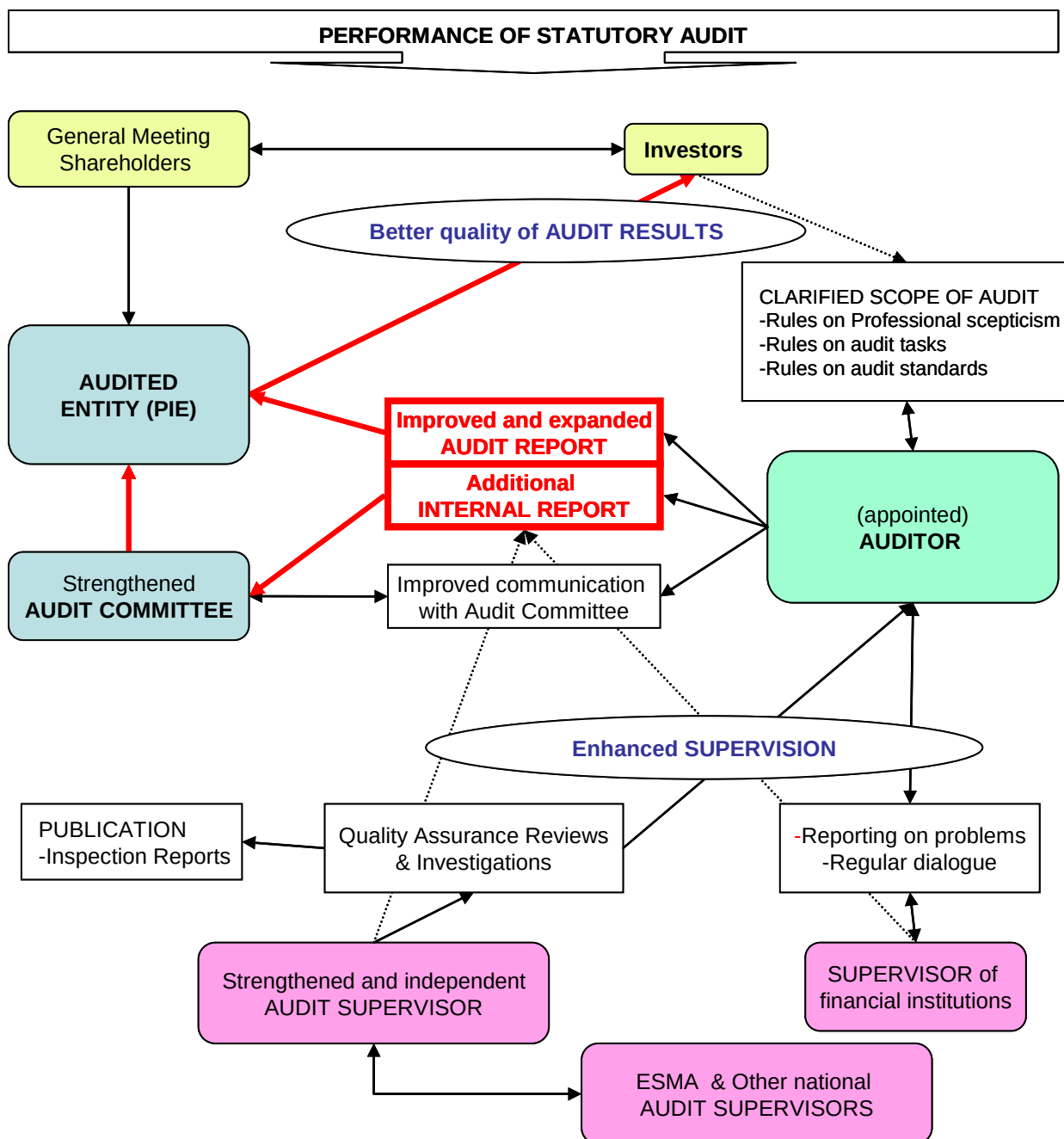


Figure A18.4. Combination of all policy options.

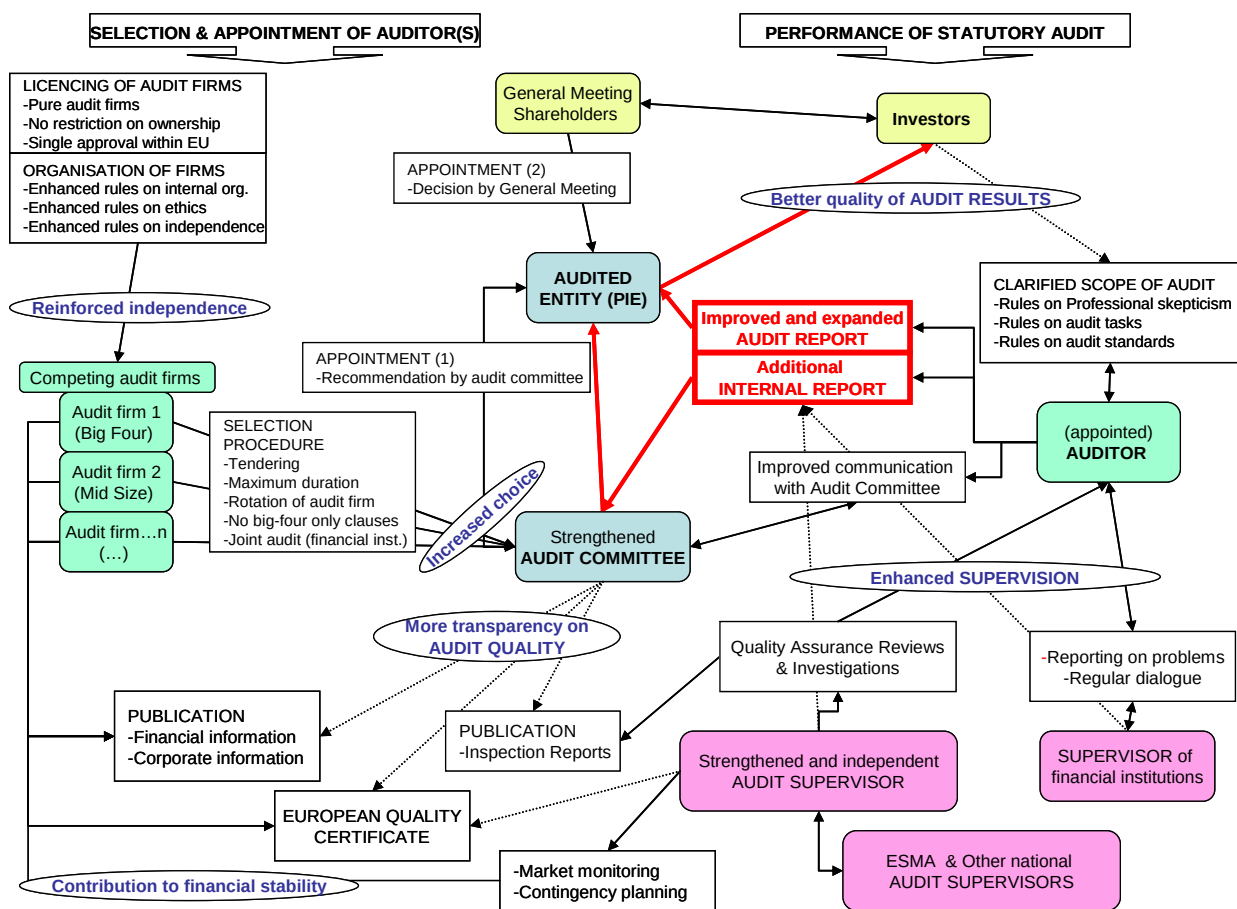


Figure A18.5. Policy options for objective 4.1: facilitate the cross-border recognition of audit providers' competence

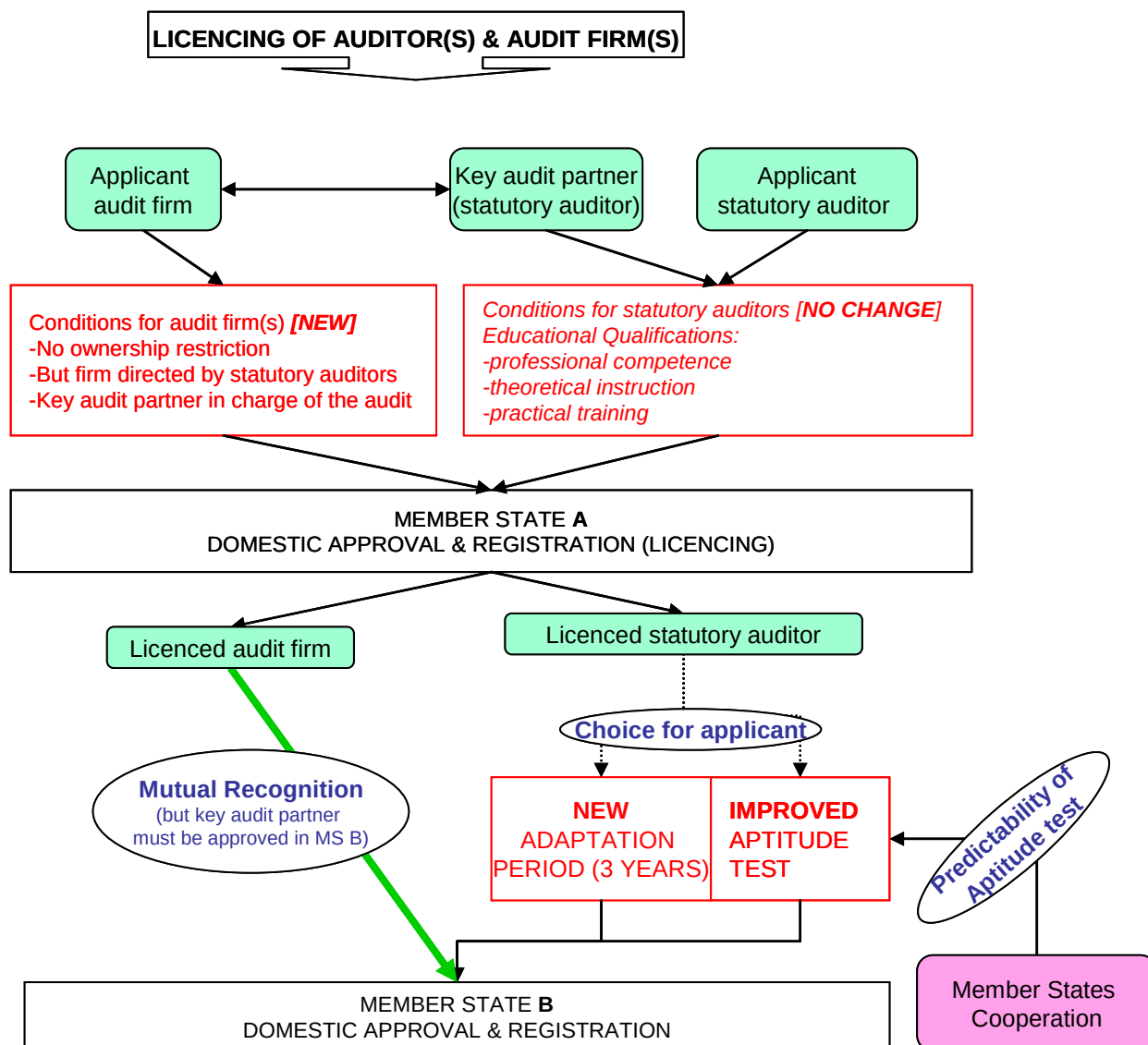


Figure A18.6. Policy options for objectives 4.2 and 4.3: streamline standards on audit practice, independence and internal control of audit firms across the EU and ensure that statutory audit is adapted to SMEs needs.

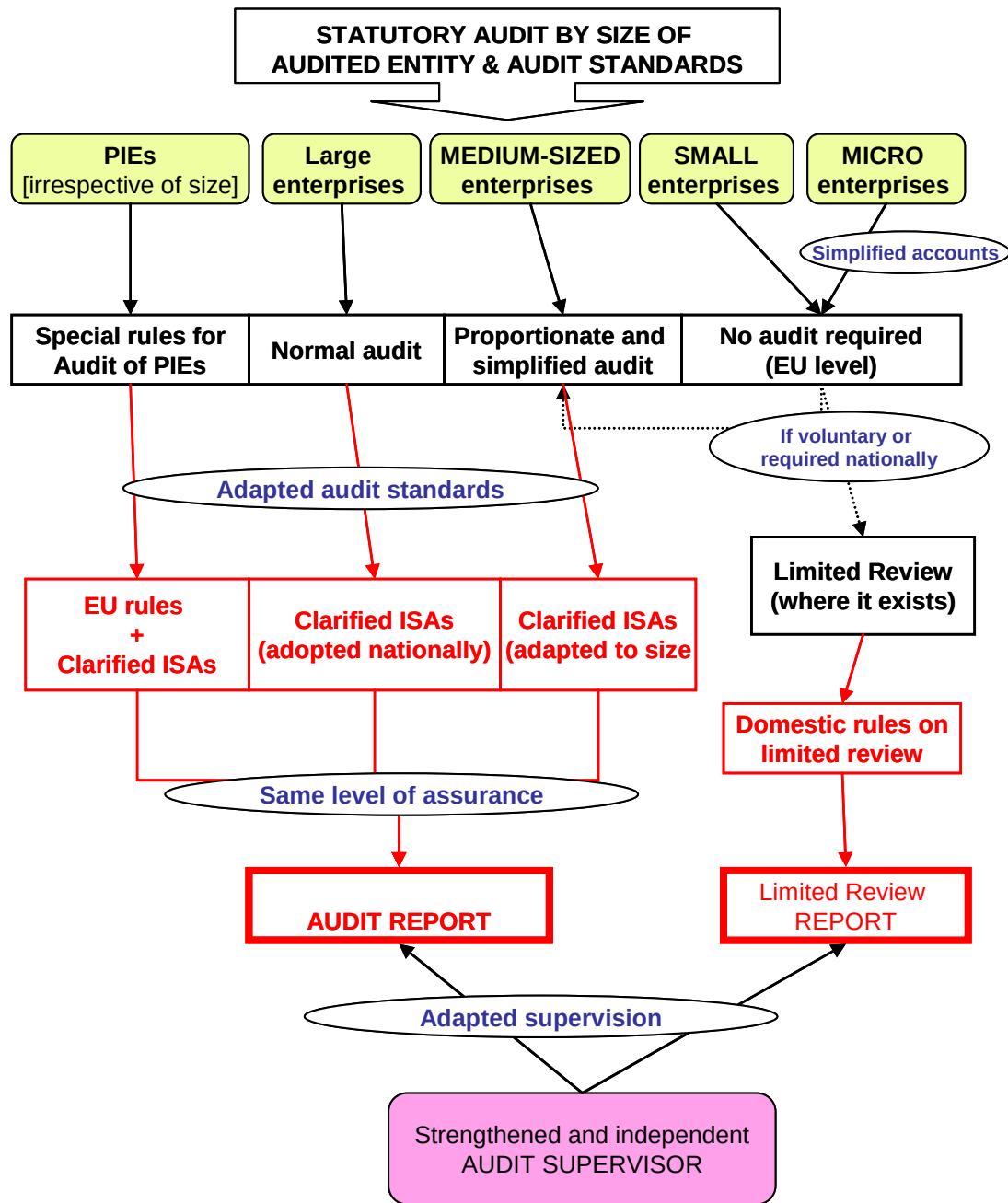
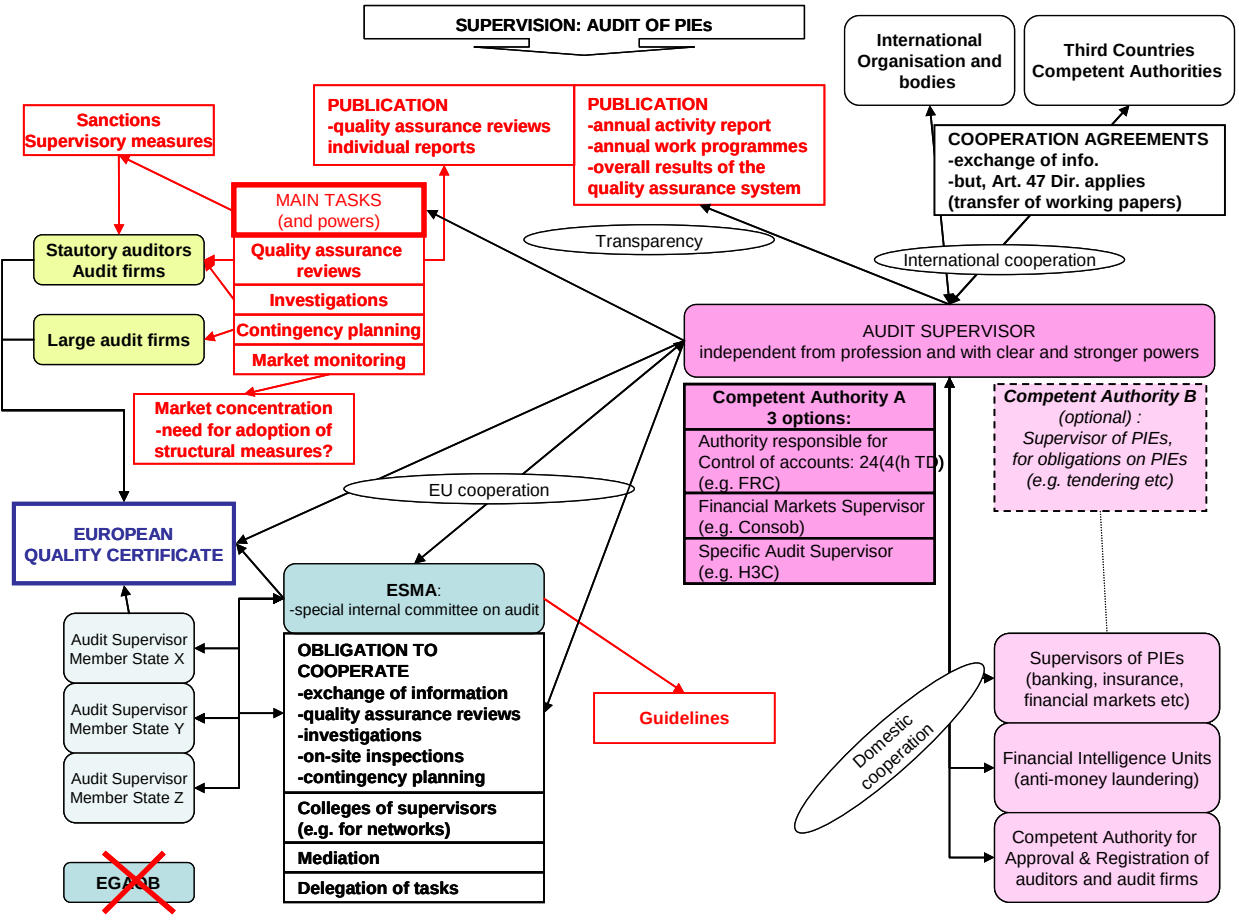


Figure A18.7. Policy options for objective 5: improve the effectiveness, independence and consistency of the regulation and supervision of auditors of PIEs.



ANNEX 19. PROPORTIONALITY ASSESSMENT

This annex presents (1) a summary proportionality assessment of the whole package of policy options, as well as (2) a more detailed assessment regarding the proportionality of a few selected preferred policy options. This assessment concerns the options which are perceived by stakeholders as particularly intrusive⁴⁰⁹, namely: regular tendering, mandatory rotation, pure audit firms/prohibition on the provision of NAS and joint audit.

(1) The proportionality of the package of measures.

This impact assessment proposes different policy options (see [section 6](#)). Some of these policy options, if pursued, would affect the overall baseline scenario, having also an impact on addressing other problems, which are part of the problem tree but not directly targeted by these proposed measures. In turn, it could be argued that if some of the policy options will be successfully implemented the need for other policy measures (affecting especially the statutory audit of PIEs) is not demonstrated. Taking the above into consideration, section (1) of this Annex will explain why the proposed set of policy measures is needed as a package and is considered proportionate despite the changes, which some of the individual measures can bring to the overall baseline scenario. In this regard, the section (1) demonstrates that only as a set of policy measures can the package achieve fully the identified objectives. Therefore, it also demonstrates that each individual policy option is a "*sine qua non*" pre-condition for the full achievement of the overall objective and in this way is proportionate.

The section will focus on the question of the reinforcement of the audit committee and need for structural measures regarding the independence of auditors; the need to request the publication of more detail on the content of the audit report or the impact of the liberalisation of the conditions for accessing the profession (e.g. recognition of audit firms etc); and the need for a quality certificate.

The reinforcement of the audit committee and the need for structural measures regarding independence of auditors

The strengthening of the audit committee could question the need for other policy options regarding objectives 1 (on clarifying the role of the statutory audit) and 2 (on the reinforcement of the independence and professional scepticism of auditors and audit firms). It could be argued, for instance, that such a reinforced audit committee could, on its own, ensure that (see [figure A19.1](#)):

- the auditor/audit firm provides more information on the statutory audit to users (thus eliminating the need for the preparation of an extended audit report);
- the auditor/audit firm increases the communication with the audit committee and with the supervisors of the audited entity (thus eliminating the need for a structured dialogue in both cases);
- the auditor/audit firm does not provide NAS to the audited entity which could constitute a threat to his/her/its independence (e.g. by continuing approving the provision of NAS,

⁴⁰⁹ The other policy options rather deepen or reinforce existing obligations: e.g. regarding the content of the audit report, the existence and powers of the audit committee etc.

thus eliminating the need for the prohibition of the provision of NAS to the audited entity);

- the selection of the auditor/audit firm is fair (thus eliminating the need for better framing the procedure for the appointment of auditors) and
- the work of the auditor/audit firm would be monitored (thus eliminating the need for mandatory rotation of audit firm).

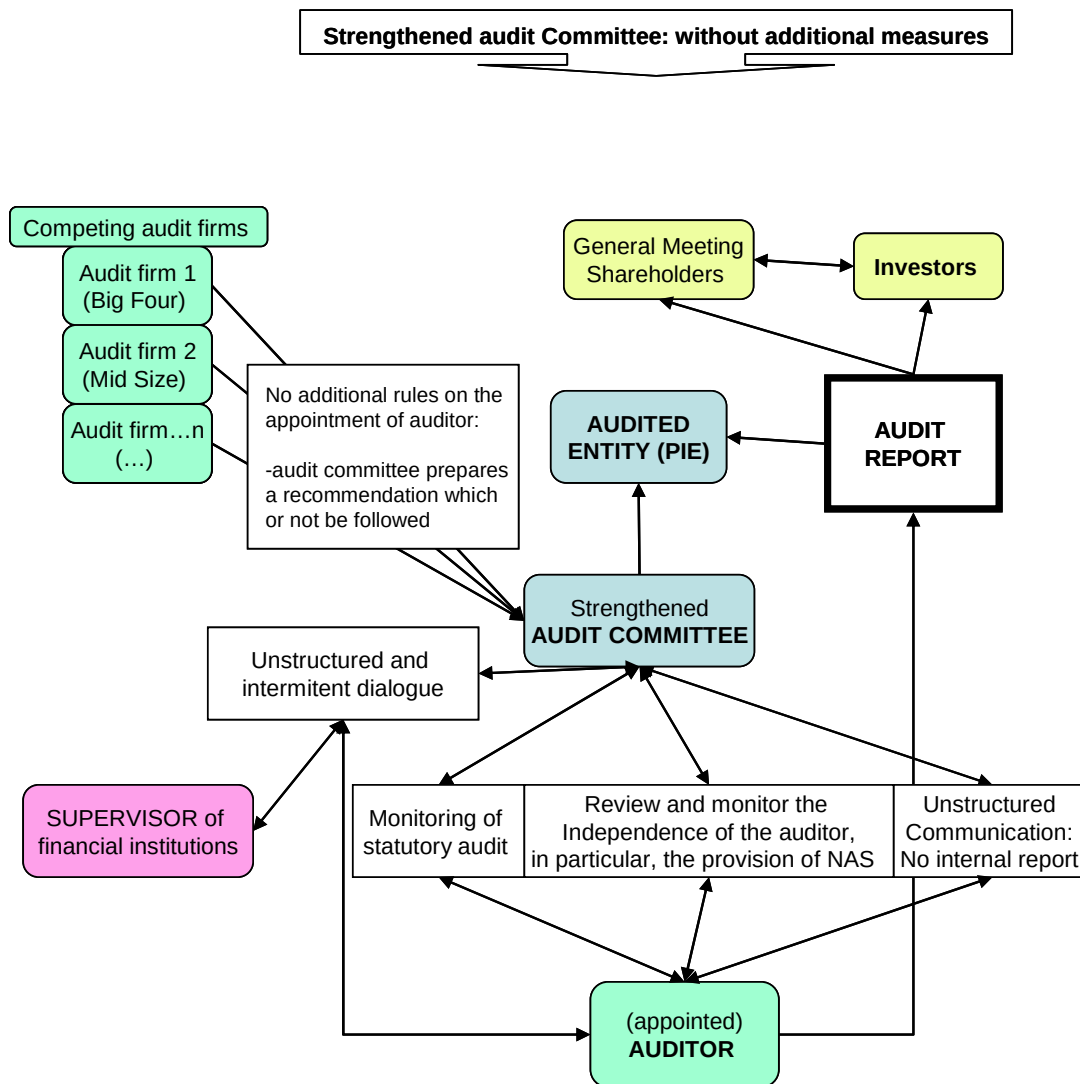


Figure A19.1 – Strengthened audit committee without additional measures

This question, however, raises the issue of whether behavioural solutions (based on the persuasion of the audit committee) should be preferred to structural ones (framing the activity of the audit committee).

More responsible audit committees composed of more qualified members are certainly needed. However, further reliance on the audit committee would result in a large shift of responsibility towards its members, which appears disproportionate and unfair. Audit committee members are not employees of the audited entity nor are their assignments full-time ones. Therefore, it is questionable whether the audit committee would have sufficient time to devote to all issues.

Over-reliance on the audit committee, even if a strengthened one, is not a long term sustainable solution to address the threats to independence. Outcomes would largely depend on behavioural solutions and therefore on the quality of the persons appointed. Structural solutions would facilitate the tasks of the audit committee, which could focus more on the substance of the audit work (i.e. monitoring the financial reporting channels within the audited entity and the work of the external auditor with regard to audit) and on having more influence on the selection of the auditor) rather than on making case-by-case assessments as to whether there are threats to independence (e.g. those that could arise from the provision of certain NAS or those resulting from the familiarity threat).

Such over-reliance on the audit committee would put audit committee members under pressure to obtain certain results (e.g. influencing management in relation to the selection of auditors, more information by auditors to shareholders or the audit committee itself) which may or may not be achieved, since auditors and management have different interests from those of the audit committee members. Therefore, such results would depend on the persuasive force of the members of the audit committee. Hence, different audit committees will have largely different outputs. Nevertheless, those identified results can be easily framed by structural solutions: i.e. rules requiring management to explain to shareholders whether managers depart from the recommendations made by the audit committee or requiring auditors to provide more information. Therefore, structural solutions ensure that certain conduct will be carried out, thus allowing the audit committee to focus on the review of the substantive audit work.

Therefore, the strengthening of the audit committee needs to be completed with structural measures to support its functioning and ensure that results are delivered (see [figure A19.2](#)).

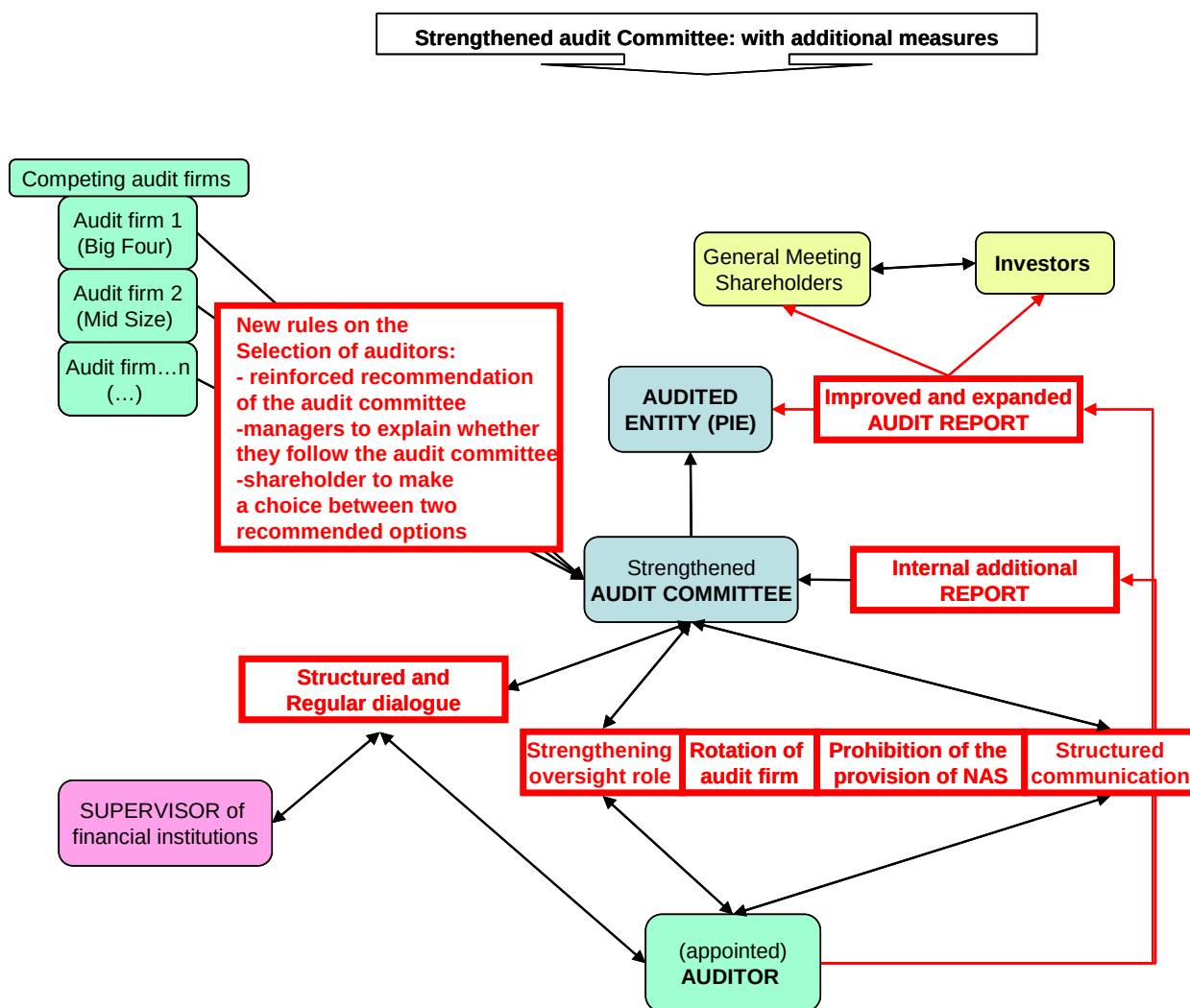


Figure A19.2 – Strengthened audit committee with additional measures

The need to request the publication of more detail on the content of the audit report

It could be argued that a more competitive market created by the removal of barriers to access (see policy options regarding objective 3) could make the requirement to provide more and better information in the audit report unnecessary, since this result would be delivered voluntarily by market participants.

However, several factors point in a different direction. There is already legislation in place with regards to the content and format of the audit report. The result is template reports. From one year to the other, only the date changes. Investors have no means to understand what work is behind the audit report.

Only in France are reports longer and contain more detail. However, this is the result of national requirements rather than voluntarily developments in France. Despite the existence of inter-connected networks of audit firms, it has not resulted in this "best practice" being extended.

Fear of liability certainly stands as a key concern for audit firms preventing them from disclosing more information.

Therefore, it is highly unlikely that audit firms would voluntarily disclose more information in the audit report in the absence of a change in legislation. Therefore, requiring the extension and improvement of the audit report appears proportionate in this regard.

The need for a quality certificate considering the impact of the liberalisation of the conditions for accessing the profession (e.g. recognition of audit firms etc) and the enhancing of the supervisory rules

It could be argued that a pan-European quality certification system (policy option regarding objective 3.2) would no longer be necessary because the process for mutual recognition of audit firms is improved and the regulatory and supervisory requirements increasingly harmonised (see policy options regarding objectives 4 and 5)

However, it should be noted that the quality certification would essentially be a tool to address the reputational deficit from which non-Big Four audit firms suffer.

The mutual recognition of a national licence will not address the reputational problem, in the same manner as the national licence does not address it either. It is not because a firm is allowed to provide services in more than one country that the perception (by market participants) of the quality of its services will necessarily be increased.

The strengthening of supervision could indeed result in similar effects to a quality certification. But the outcome of supervision is less observable for the outside world than a certification on quality, which can (and should) take account of the publicly-available outcomes of supervision.

The alternative to the quality certification system would be to establish a special licence for the audit of PIEs. However, this would result in a barrier to growth and development of audit firms that audit small PIEs. For instance, when an unlisted company becomes listed, if a special licence for the audit of PIEs is required, this could imply that the auditor of this company could no longer be able to provide its services and automatically banned from the market for PIEs.

Therefore, a voluntary certification system has the advantage of addressing the reputational issue while not becoming a barrier to entry/growth for smaller audit firms.

(2) Assessment on the proportionality of selected policy options

These preferred policy options are the minimum necessary to achieve the following objectives:

- (a) On the one hand, objectives 2.1 (prevent any conflict of interest arising from the provision of non-audit services to PIEs) and 3.3 (increase the choice of audit providers for PIEs); and
- (b) On the other hand, objectives 2.3 (mitigate the risk of any potential conflict of interest due to a "familiarity threat" and 3.1 (facilitate switching of an audit firm).

Indeed, these preferred policy options have cumulative effects resulting in positive synergies for more than one objective (see also Section 8.1). Figure A19.3 provides an overview of the impact of such policy options regarding those objectives.

Figure A19.3

Policy option	Objectives	Effectiveness				Convergence	Cost-effectiveness
		Objective 3.1: facilitate switching of an audit firm	Objective 3.3: increase the choice of audit providers for PIEs	Objective 2.1: prevent any conflict of interest arising from the provision of non-audit services to PIEs	Objective 2.3: mitigate the risk of any potential conflict of interest due to "familiarity threat"		
<i>Baseline scenario (general principles on the provision of non-audit services; high market concentration for the audit of large PIEs; single firm audit; long audit firm tenure and rotation of key audit partner within audit firm;)</i>		0	0	0	0	0	0
Pure audit firms			+	++	≈	+	+
Joint audits			+	≈	≈/+	+	+/-
Joint audits by pure audit firms			+	++	≈/+	+	+/~
<i>Prohibition on the provision of any non-audit services to the audited entities</i>			≈	+ / ++	≈	+	+ / ≈
Regular tendering		+ / ≈			+ / ≈	+ / ≈	≈
Mandatory rotation of an audit firm		+			++	+	+
Mandatory rotation of an audit firm via tendering		++			++	+	+ / ++

(a) Objectives 2.1 (prevent any conflict of interest arising from the provision of non-audit services to PIEs) and 3.3 (increase the choice of audit providers for PIEs).

In the case of objective 2.1, the baseline scenario (general principles on the provision of non-audit services) is not a credible alternative. As described in Section 6.2, the prohibition of any non-audit services to the audited entity by the audit firm would be effective in preventing conflicts of interest but could have undesired effects regarding the availability of eligible audit firms for the audit of large PIEs, thus not addressing objective 3.3. It must be noted in this regard that statutory audit is carried out in the public interest, while non-audit services are not.

Therefore, the option of pure audit firms appears to be the only one that produces positive combined effects on both objectives, and therefore proportionate from that perspective. Joint audits would present positive impacts mostly as regards objective 3.3, in so far as it would provide opportunities to smaller firms to get exposure, demonstrate their capability and build reputation over time, so that they become real competitors to the current Big Four audit firms both in size and expertise. Joint audits would also have positive effects on the reinforcement of the professional scepticism (see above [Annex 12](#)), therefore preventing the emergence of conflicts of interest. Also, the conflict of interest problem leading to undermined independence of the auditor (as described in the problem definition), cannot be solved if there is a limited choice on the market. The option of introducing joint audit would increase the choice. Joint audits would produce similar results whether combined with pure audit firms or not.

At the same time, it must be recognised that market concentration, which is the problem addressed by objective 3.3, is lower regarding the audit of PIEs of smaller dimension. Therefore, in terms of proportionality, it would appear appropriate to limit both the joint audit and the pure audit firms policy options to the statutory audit of either large PIEs or Financial Institutions only

(see below). This way, negative effects of both options would be avoided, in particular: cost of joint audit for smaller PIEs⁴¹⁰ and possible entry barrier effect for smaller audit firms (which do not audit PIEs or audit very few PIEs) resulting from the pure audit firm requirement⁴¹¹.

As already explained in Annex 16 regarding the impact on SMEs, this adjustment could be done as follows:

- Joint Audit: this option would only be foreseen for the statutory audit of large PIEs or only large PIEs in the financial sector (in case of mandatory requirement) or for all PIEs if introduced on a voluntary basis. Large PIEs should be understood as those having a market capitalisation (or balance sheet total if the PIE is not listed) above €1 billion.
- Pure audit firms: the pure audit firm requirement would only apply to firms that obtain at least one third of their audit fee revenues from large PIEs (see above for the threshold). Below this threshold, only the prohibition on the provision of non-audit services would apply. Specific safeguards would need to be applied in this regard.

It should be noted that, although they may have a small positive effect compared to the *statu quo* in addressing objectives 2.3 and 3.1 (notably because of the effect of joint audit on the reinforcement of the professional scepticism), pure audit firms and joint audit do not really address by themselves objectives 2.3 and 3.1.

Concerning joint audit, another issue arises regarding the level of detail that EU legislation would require to ensure that a joint audit rule could be smoothly applied. In France, where joint audit is legally required, there is a specific professional standard that takes account of the specificities of joint audit. Similarly, it would be necessary that the European supervisory authorities develop technical standards on this issue, so that the joint audit rule could be properly enforced.

(b) Objectives 2.3 (mitigate the risk of any potential conflict of interest due to a "familiarity threat") and 3.1 (facilitate switching of an audit firm).

The option of tendering without rotation of an audit firm would hardly have any impact, or a marginal one only, if the audited entities decided to systematically prolonge audit mandates. At the same time, if rotation of the firm is not ensured, it would be necessary to organise regular tendering procedures within relatively short timeframes (e.g. five years or less), so that audited entities reassess their position regularly and a judgement of the risk of familiarity threat is made (e.g. at least every 5 years). This would result in increased costs associated with tendering procedures. Additionally, if tendering does not result in change of auditor, tendering costs may be disproportionate considering the results.

⁴¹⁰ The cost of audit (not necessarily joint audit) for smaller PIEs is, in proportion to turnover, higher than for a large PIE. The additional cost of joint audit (estimated at 10% of a standard audit) could be felt by smaller PIEs as disproportionate to them, considering their size and impact in the financial markets. For instance, concerning issuers of shares admitted to trading in regulated markets, issuers with less than €1 billion capitalisation account for more than two thirds of the listed companies in number but their combined capitalisation hardly amounts to 7% of total capitalisation. See Annex 16(2.1).

⁴¹¹ Smaller audit firms whose revenues are largely audit and non-audit fees from non-PIEs may find little interest in trying to audit PIEs if they have to convert into pure audit firms, thus losing part of their revenues from non-PIEs.

On the other hand, rotation of audit firms without tendering would have a real impact *per se* in addressing these objectives. The drawback is that, with regard to the selection of the new audit firm (cf. objective 3.1 on the switching of an audit firm) its impact is more limited: as such, the rotation of firm does not contribute to facilitating the emergence of new entrants and in addition it does not contribute either to an objective selection of an audit firm (thus does not have synergies with objective 3.2).

However, as explained in sections 6.2 and 6.3, the combination of mandatory rotation of audit firms and tendering would have very positive synergies. Thus, the benefits resulting from the combination of these options would compensate for the costs incurred, particularly those regarding tendering.

In this context, it is crucial to find the right balance between the appropriate duration of the mandate of the auditor to ensure that disproportionate costs due to very short mandates are avoided⁴¹² (including the cost related to the fact that getting to know a company requires high initial investment by the auditor), while addressing the familiarity threat. To the extent that the rotation of audit firms would be ensured after a certain period, it could be possible to reduce the frequency of tendering procedures and allow for longer, more stable periods. Therefore, tendering procedures could coincide with the timing of the rotation of firms. Currently the Statutory Audit Directive sets the rotation of key audit partners (within the audit firm) every 7 years and in Italy the rotation of audit firms is every 9 years. A similar duration for the rotation of the audit firm could be considered. Therefore, a rotation of audit firm (and tendering procedure) every 7 to 9 years would appear proportionate⁴¹³.

As a result, the combination of mandatory rotation and tendering appear proportionate to address objectives 2.3 and 3.1.

At the same time, recognising the cost of tendering procedures for smaller PIEs, it would be proportionate to alleviate such cost at least for the PIEs which are SMEs. Thus, PIEs which are SMEs should not be obliged to tender for their audit service (although they may do so) and may directly negotiate with a potential service provider. Waiving the obligation to invite at least one non-Big Four audit firm during the tendering procedure would not have negative effects: smaller PIEs are likely to address smaller audit firms anyway rather than Big Four audit firms. See [Annex 16](#).

However, the rotation of audit firms would need to apply in all circumstances as otherwise the above objectives are not achieved.

Figure A19.4 provides a summary of the proportionality assessment. It also takes account of issues address in [Annex 16](#) regarding SMEs and [Annex 13](#) regarding the definition of PIEs.

⁴¹² Tendering procedures with short mandates may have uncompetitive effects, as described in Billard et al. (2011).

⁴¹³ The combination of tendering and rotation would thus contribute to reduce the costs otherwise entailed by regular mandatory tendering within shorter timeframes: e.g. instead of every 5 years, tendering could take place every 9 years.

Figure A19.4 – Summary of the proportionality assessment

Audited entities (PIES)	Audit Committee	Extended audit reports and internal audit reports	Rotation of audit firm	Tendering	Voluntary joint Audit	Prohibition on the provision of non- audit services to audit client	Pure audit firm	Organisational requirements for firms	Transparency Report for audit firms	Access to European Quality Certificate	Auditor/ audit firm
Large PIE in the Financial sector*	✓	✓	✓	✓	✓	✓	✓				
Large PIE*	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓	Large audit firm***
Medium-sized PIE	✓	✓	✓	✓	✓						
Small PIE**	x	✓	✓	x	✓	✓	x	✓ obligation adapted to size of firm	✓ obligation adapted to size of firm	✓	Smaller audit firm

* PIEs with more than €1 billion market capitalisation (if listed company) or balance sheet (if unlisted financial institutions)

** PIEs which are SMEs (i.e. less than 250 employees, balance sheet not exceeding €43 million and annual turnover not exceeding €50 million) or, for listed companies, companies with a reduced market capitalisation within the meaning of the prospectus directive (market capitalisation not exceeding €100 million)

*** Audit firm which obtains at least one third of its audit fees from large PIEs.

**** Certain types of financial entities are excluded from the obligation to have an audit committee because of their nature: e.g. investment funds (whether UCITS or alternative funds), issuers of asset-backed securities or certain types of non-quoted banks which only issue high-value denominated debt securities.

ANNEX 20. SUMMARY ESTIMATES OF THE COSTS AND FINANCIAL BENEFITS OF THE PREFERRED POLICY OPTIONS (INCLUDING ASSESSMENT OF ADMINISTRATIVE BURDEN)

This annex presents estimations of the costs and benefits of the preferred policy options. In some cases the new legal obligations (to be introduced by the preferred policy measures) will entail some additional administrative costs for business entities in providing additional information to public authorities or to private parties. These administrative costs are estimated under the respective policy options, while the cost estimates for the individual policy options are presented under the respective specific objective.

The annex comprises 3 sections:

- Section (1) introduction;
- Section (2) describes the costs and benefits for each of the preferred policy options; and
- Section (3) presents a summary assessment.

(1) Introduction

Costs

There are 23 policy options addressing the 5 specific objectives and 14 operational objectives.

- For 10 of these options, quantitative estimations are presented regarding costs in section (2) of this Annex. This is particularly the case regarding the two measures that result in higher costs for PIEs and audit firms: tendering and joint audits. This is also the case regarding the measures regarding audit reporting or that involve a strengthened audit committee.
- For the remaining 7 options, a qualitative assessment is done, due to difficulties in the collection of data or to quality thereof. This is particularly the case as regards the cost implications for national authorities, which depend very much on the structure in place and the size of markets.
- In the case of 6 options, there are no direct costs implications (e.g. the clarification of the rules do not result in additional costs) or the costs would have been incurred anyway by audit firms.

Having said this, due to the lack of comparable data and to some quality data considerations, it is not possible to provide a reliable estimation of the aggregate costs of the package. Therefore, the costs are in most cases estimated at the level of an average PIE or an average audit firm.

Benefits

Concerning the benefits of the package, their quantification is not an easy task.

The main expected benefit of the package of measures is the increase in audit quality, which in turn should lead to increased investor trust in the financial statements of the PIEs. It is, however, almost impossible to provide a quantitative estimate of the benefit of such an increase in trust.

The cost of capital is lower for companies with well audited and reliable accounts. Therefore, the benefits could be estimated as an average reduction in the cost of capital. However, other factors influence investors' decisions: first of all, the perspectives of the audited company itself. Statutory audit is indeed ancillary to the main business activity. Therefore, we cannot quantify the possible reduction in the cost of capital for the audited entity due to the increase in audit quality.

Moreover, audit quality is not synonymous with profits generated by the audited entity. Indeed, the likelihood of issuing or the number of going concern opinions issued by auditors is often used by academic literature as a proxy to measure audit quality. Therefore, it could also be argued that the benefits of audit quality could instead be estimated as the savings on future losses that will not be incurred thanks to increased audit quality. These losses could be investors' losses due to fraud (e.g. a Madoff-type scenario) or due to underperforming businesses (e.g. a Lehman Brothers- or Fortis-type scenario); or general losses incurred as a result of the financial crisis: e.g. cost to the taxpayers due to the need to inject money into the economy (e.g. the rescuing of banks scenario) or costs of lost output (e.g. reduction of GDP etc).

Commission approved measures to support banks during the crisis, including aid schemes and ad hoc interventions, amounted to EUR 4 588.9 billion for the period between October 2008 and October 2010. For 2009, aid approved accounted for 39 % of EU-27 GDP. The large amounts of support to banks approved under schemes can be explained by the fact that some Member States adopted blanket guarantee schemes which covered all their banks' debt. Member States relied mainly on guarantee measures.

The case of the impact of derivatives in the financial crisis

The European Commission services⁴¹⁴ explained that one way to estimate the economic impact of OTC derivatives on the financial crisis is to look at the economic costs of the financial crisis first. The costs of a financial crisis were measured by evaluating the fiscal costs or the costs of lost output.

Since OTC derivatives have played a role in the financial crisis, the Commission considered that, as such, at least part of the costs of the crisis can be attributed to them. The Commission services made a very conservative assumption on the share of the costs (i.e. 1%). This meant that more than €10 billion of costs could be attributed to OTC derivatives.

The benefits arising from the harmonisation due to the introduction of the ISAs are quantified in section (2) of this Annex.

For a summary assessment on benefits, see nevertheless section (3) of this Annex.

⁴¹⁴ European Commission (September 2010), Annex 7.

(2) Cost and benefits of the preferred policy options

Specific objective 1: Clarify and define the role of the statutory auditors generally as well as with specific regard to PIEs

Clarify and specify the scope of statutory audit in the EU rules (without enlarging it) to reduce the expectation gap.

There are no direct cost implications arising from the clarification of the scope of statutory audit.

The requirements regarding the important tasks to be undertaken when performing the audit work (i.e. appointment of adequate staff; organisation of audit file; market integrity and fraud prevention; responsibility of group auditors; internal quality control or record keeping) are largely a codification of existing practice framed by the auditing standards. Therefore, it is not expected that audit firms would incur additional costs.

In terms of benefits, this measure should result in increased audit quality (see above on the question of measuring the increased on audit quality).

Improve and expand the content of the audit report disclosed to the public.

Since the information contained in this report is the result of the audit work itself, the only direct cost arising from this obligation would be the administrative cost of preparing the report. This would be a cost for the audit firm auditing the PIE (costs are assumed to be transferred partially or in full to the audited client).

Considering that most of the information will be based on the additional internal audit report, the administrative cost of preparing the audit report is estimated to be low: around 8 hours for a single audit report.

If these 8 hours are charged at audit partner rate, the total cost of a single audit report can be estimated at 4,800 euro (the cost of an average partner hour is estimated at 600 euro).

Require the preparation of a longer and more detailed report for the audited entity (additional internal report).

Since the information contained in this report is the result of the audit work itself, the only direct cost arising from this obligation would be the administrative cost of preparing the report. This would be a cost for the audit firm auditing the PIE (costs are assumed to be transferred partially or in full to the audited client).

Based on the feed-back from Germany, where such a report is legally enforced, it could be estimated that the administrative burden from the preparation of the report, depending on the size of the audited entity would be as follows:

- For a mid-size company the preparation of such a long form report takes about 40 hours for annual accounts and 30 hours for the consolidated accounts. The use of electronic support programmes and sample long form reports could reduce the time;
- For smaller and less complicated engagements this can go down to 6 hours;

- In the case of large audited entities and financial institutions, the administrative burden could increase to about 80 hours.

Table A20.1 summarises the potential costs per type of entity if these hours are charged at audit partner rate.

Table A20.1

Type of PIE	Estimation hours	of	Estimation hourly rate (€)	of	Total cost per PIE (€)
Small PIE - uncomplicated engagement	6		600		3.600
Mid-size company	40		600		24.000
Large PIE	80		600		48.000

Strengthening of the audit committee*

* The audit committee is directly involved in four policy options: enhanced communication between the auditor and the Committee (under objective 1); procedure for the appointment of the auditor and monitoring of the audit work (under objective 2); and tendering procedure (under objective 3).

The strengthening of the Audit Committee to enable it to successfully fulfil its enhanced tasks under the policy options mentioned above will imply additional costs to be covered by PIEs. Those costs will result from the need to increase the involvement of the supervisory board members (additional expert days) as well as from increased remuneration costs due to the hiring of more audit committee members with relevant technical profiles. In addition, the requirements under these policy options will also involve an increased engagement by key audit partners and audit managers. These costs would not arise for those audited entities which already today have robust and efficient audit committees.

It is difficult to quantify precisely the overall cost since the increase in remuneration and input of expert days will depend very much on the specifics of the PIE. These differences are mainly due to the divergent remuneration rates applied for audit partners/ audit committee member as well as due to the specifics of the PIE (it will require a different number of working hours to enforce these policy options in different type of PIEs).

However, an indicative estimate of the overall additional cost has been made (based on official data provided by FSA as well as the informal feed-back received from other stakeholders on costs regarding the participation of audit committee members). Based on the data from FSA, it is estimated that in the case of large PIEs the participation cost for one audit committee member would be about 1.000£. The available data from the FSA⁴¹⁵ also shows that in the case of important PIEs, the cost of organising a meeting between audit committee members and auditors would cost about 4.000£ for the audit partner, 2.280£ for the audit

⁴¹⁵ FSA Market and regulatory failures, benefits and costs.

manager, 900£ for the PIE management cost, and 1.000£ for the PIE Audit Committee member (feed-back from other EU stakeholders supports this assumption, while it could be estimated that such cost ranges from 1000 to 1500 euro). The basis for calculating these costs is 6 working hours per meeting (2h meeting + 4h preparation). The hourly rates charged are respectively 675£ for the audit partner, 380£ for the audit manager, 200£ for the audit committee member, and 150£ for the PIE management cost.

Using the same indicative number of working hours, translated into the average costs for the EU (estimated average rates per hour are respectively; audit partner- 600 euro, audit manager- 300 euro, PIE management⁴¹⁶- 100 euro, audit committee members- 200 euro), we can estimated that the average cost for a single meeting would be about 7,200 euro. At the same time, it could be considered that a normal dialogue between auditors and audit committee members would entail 2 or 3 such meetings per year, whose total cost would range from 14,400 to 21,600 euro. Obviously, those costs could be higher if more regular meetings are held. It can be assumed that these costs will eventually be passed on to the PIE through audit fees.

In addition to above mentioned costs, it is estimated that there will be an additional cost related to the increased involvement of audit committee members in monitoring the tender for the selection of auditors as well as the validation of the choosen audit firms. For this estimation, it is considered that audit committee members will spend as an average about 20 extra working days on studying tender documentation, preparation of the opinion of the audit committee on the selection of the audit firm, analysing the reports from auditors as well as any additional input needed to fulfil their tasks.

Table A20.2 summarises the estimated additional cost for individual PIEs, resulting from enlarging and deepening of the role of the audit committee (these costs would not arise for those audited entities which already today have robust and efficient audit committees).

Table A20.2			
Type of cost	units	Estimation (€)	Total cost per PIE (€)
Regular (additional) meetings between auditors and audit committee members on yearly basis	3	7.200	21.600
Additional number of expert days for audit committee members	20	1.600	32.000
Total			53.600

Enabling (in law) and recommending regular dialogue between auditors and supervisors of PIEs: no breach of confidentiality rules if auditors engage in a regular dialogue with the supervisors of PIEs.

The type of costs and estimated rates mentioned under the previous point also apply to the enforcement of this policy option.

⁴¹⁶ The rate for PIE management reflects only the cost, while audit firm's hourly rates include profits as well.

Using the estimated rates presented under the previous point, it could be estimated that a bilateral meeting between auditors and supervisors would cost 5.400 euro. This estimate covers only costs for the audit partner and audit manager. The costs on the side of the supervisor are not taken into account since they will not be passed on to PIE and would be business as usual for the respective supervisors. Taking this into account, it could be estimated that the enforcement of this policy option would have a minimum cost of 10.800 euro (cost of 2 bilateral meetings), while the cost of the trilateral meeting is covered under previous option.

The above costs could be larger if more than two meetings are organised per year and/or additional ways of communication are established. As under the previous option, it can be assumed that these costs will be eventually passed on to the PIE through audit fees.

These costs, however, would not arise for those financial institutions and auditors which are today engaging in regular dialogue with the financial supervisors.

Specific objective 2: Reinforce the independence and professional scepticism of statutory auditors and audit firms in the provision of statutory audit to PIEs

Prohibition of the provision of any non-audit services to the audited entities
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This policy option will have no direct cost on the auditor or on the audited entity. There could be some indirect costs for the audited entity since it could face higher costs for either the audit or the NAS. There could also be an indirect financial impact for the auditor due to the potential loss of expected revenue regarding NAS.

However, these indirect costs cannot be estimated since they largely depend on the overall restructuring of the market segments of statutory audit and NAS as a result of the whole package of policy options. It could also be expected that consolidating the market segment for NAS would result in an overall decrease in the prices for NAS for PIEs. In the same way, the fractional loss of revenue for audit firms no longer able to provide NAS to the audit client could be compensated by expanding their market share of NAS to non-audit clients (provision of NAS to other clients is still possible). It should be mentioned that due to potential conflicts of interest the provision of NAS to audit clients is already prohibited in the Member State (partially or in full).

Pure audit firms (approved audit firms should only be allowed to provide statutory audit services and be unconnected to firms providing certain non-audit services to audited entities)

It is expected that the application of this measure will result in a restructuring of the audit market, while companies will have to split their activities, respectively adapting their cost structure and focusing on the provision of either statutory audit or non-audit services. The direct cost for audit firms will be mainly related to legal and associated costs that result from splitting the firm.

Therefore, audit firms will not lose revenue from the NAS business (revenues from NAS account for about 40-50% of the revenues of Big 4 and Mid-tier audit firms), because these revenues will go to the new entity. The indirect cost for the audit firm is the loss of synergies with the NAS side of the firm.

Mandatory rotation of an audit firm: audit firms would step down after a certain number of years of engagement and would only be allowed to take a new engagement with the same audited entity after a cooling-off period.

The change of statutory auditor will entail the cost of organising the tender and costs on the side of both the auditor and PIE due to the initial investment needed for the in-coming auditor to familiarise themselves with the audited client. This will normally result in costs on both the side of audit firm and PIE (additional resources to support the auditor mainly during the first year of the assignment). The cost of tendering has been presented under the policy option on tendering (see also analysis on tendering under objective 3).

As far as the initial cost of the investment by the incoming auditor in understanding the entity to be audited is concerned, it should be noted that it will be significantly off-set by the requirement for the out-going auditor to prepare a detailed hand-over file for the new auditor. In addition, it could also be estimated that there will be a positive synergy in costs in this respect, since the new auditor will have the opportunity to accumulate an initial knowledge about the PIE during the preparation of the tender. Taking into account that such costs would largely depend and vary upon size of the PIE and the sector of activity, it is not possible to quantify such potential costs.

Establishing additional requirements on the internal organisation and governance of audit firms.

Due to the fact that audit firms already have such procedures/policies, this measure reflects somewhat existing practices. Therefore, its cost (if any) will be only marginal.

Specific objective 3: Improve market conditions for audits of PIEs with a view to increasing audit quality.

Regular tendering (with mandatory rotation). Audited entities would invite a minimum number of auditors/firms to participate in a tendering procedure, including an audit firm which is not among the four biggest players in the market.

It is considered that there will be some initial costs for audit firms in the first year of a statutory audit mandate to better understand their new audit client as well as the costs for both PIEs in organising a tender and audit firms in preparing/ submitting the bid.

From the information provided by different stakeholders, the Commission services conclude that in the vast majority of cases tendering costs for audit firms would range (at current rates) from 0.1 to 1 million euro. Those costs depend on the size of the PIEs, the complexity of tender documentation and client requirements, as well as the need to cover a range of preparatory activities involving key audit partners communication (partner hours and travel costs) with PIEs (Audit Committee and/or CFO – CEO). These costs on the side of audit firms can be higher, when preparing tenders for certain PIEs. For a very large multinational company (with a market capitalisation in excess of €40 billion) it is reported that the price was in excess of €5 million (5,000 partner/hours at the estimated average cost of 1,000 €/h). The cost for an extremely large and complex financial institution with substantial operations in most countries in the world, was around 7 million euro (7,000 partner/hours at the

estimated average cost of 1,000 euro/h)⁴¹⁷. On the basis of the scarce data available to Commission services tendering costs could be estimated at around 5% of annual audit fees.

Under the assumption that companies would have to organise a tender periodically, the annual tendering cost for the majority of PIEs would be less than 1% of the audit fees if audit tendering takes place every 9 years. The longer the engagement period, the lower the impact of the cost of tendering on the audit firm.

There are also matching costs on the PIEs side (preparation of tender documentation and carrying out of the tender). Our cost estimates in respect of PIEs are based on data provided by BUSINESS EUROPE. It presented cost simulations for 13 case studies of PIEs across Europe, all with different sizes and representing different sectors. Although the total costs presented varied based on the specifics of each company (mainly its size and the number of subsidiaries in different jurisdictions), it could be estimated that a listed entity with a turnover of about 2 billion euro would need about 150-200 working days to prepare and implement a tender process. If we apply the maximum hourly wage envisaged by ESTAT for the category of managers (50 euro/ hour including overheads- 400 euro/ working day), this would result in a cost range of 60.000- 80.000 euro. The maximum cost mentioned by a company in the simulation is about 1.000 working days, which would result in a total cost of 400.000 euro (total cost could be slightly higher if more senior management working days are involved).

Based on the information provided in the different case simulations, it is noted that some of the PIEs have acknowledged their limited experience in organising tenders due to the fact that there has been no such obligation. Therefore, we should expect a reduction of these costs for consecutive tendering procedures. This would be the result of accumulating practical experience and know-how in organising tenders for audit services, which will streamline the process and the preparation of tendering documentation. Respondents also reported reductions of audit fees as a result of a first tender exercise. In one case there was a reduction of 15-20% of the audit fees, which off-set the opportunity cost of the preparation of the tender. Although it cannot be expected that each re-tendering would have such an effect on the audit fees, it could be assumed that the first rounds of tenders will have important mitigating effects on the costs to PIEs.

Table A20.3 summarises the estimated additional costs on both sides (PIE and audit firm), resulting from the introduction of mandatory tendering (preparation and undertaking of the tender process). Cost estimates are cumulated and presented at the level of individual PIE for three cathegories of PIEs, which are concerned by the measure. Data in the table takes also account of the frequency of tendering (every 9 years).

Table A20.3: cost for individual tender		
Type of PIE/cost	Cost on the PIE side (€)	Cost on the audit firm side (€)
Very Large PIE	400.000	From 5M to 7M
	[44.444 on an annual basis]	[600.000 on an annual basis]

⁴¹⁷ Data provided by stakeholders

Table A20.3: cost for individual tender

Type of PIE/cost	Cost on the PIE side (€)	Cost on the audit firm side (€)
Large PIE	60-80.000 (on the basis of 150-200 working days estimated at average rate of 400 euro/ day) [8.889 on an annual basis]	From 1,06M to 1,08M [120.000 on an annual basis]
Medium PIE	Up to 60.000 euro (on the basis of 150 working days estimated at average rate of 400 euro/ day) [6.667 on an annual basis]	About 160.000 (according to estimation provided by EGIAN) [17.778 on an annual basis]

Prohibit contractual clauses limiting the audit firms choice (e.g. clauses between the audited entity and a third party (such as a bank) requiring that the statutory audit is performed by a "Big-Four firm" only).

This option should not result in direct costs.

Increase transparency on audit quality and on audit firms: Audit firms auditing PIEs will disclose their financial statements and more information in their transparency reports that they are currently required to publish annually. They will also report information on fees to supervisors. Competent authorities will disclose the results of inspection reports by firm.

More information in the transparency report and publication of audit firms' financial statements. The direct costs (administrative burden) will result from: the preparation of the additional information for the transparency report and the preparation and the publication of the audit firms' financial statements. These costs will be moderate. Concerning the transparency report, the additional information is limited, therefore leading to a marginal increase. Concerning the financial statements, audit firms in many cases (e.g. if organised as limited liability companies) already prepare and disclose audited accounts⁴¹⁸; or, at least, prepare them even if they are not audited and disclosed. Regarding the publication, the requirement is only for publication on the audit firm's website. Audit firms are currently required by the Statutory Audit Directive to publish their transparency report on their website. Therefore, the cost of publication would be marginal since the financial statements would only be required to be easily accessible on the audit firm's website.

Provision of information to audit regulators on the fees received from PIE clients. This is limited information that supplements the transparency report. It would only imply a marginal administrative burden, which can be estimated at: 8h/year/audit firm.

Concerning the publication of the inspection reports, the overall administrative burdens would be the cost of publication on the authority's website (the oversight authority would have to prepare the inspection report anyway, whether published or not). This publication cost is

⁴¹⁸ In the UK, publication of annual accounts by audit firms is done regardless of their legal form.

marginal, as publication can be done on-line. It is estimated that such costs could be 8h/inspected audited PIE).

Establish an audit quality certification. A pan-European system that would certify that an auditor or firm meets some quality requirements enabling them to carry out high quality statutory audits of PIEs.

Direct costs of this proposal will affect both audit firms and competent authorities.

This audit quality certificate will involve two types of costs for the applicant audit firms:

- 1) adapting to the conditions for obtaining the certificate; and
- 2) the administrative cost of submitting the application.

However, with regard to the costs of adapting to the conditions for obtaining the certificate, it has to be taken into account that such conditions would normally match the EU and ISA requirements. Therefore, the adaptation cost would be marginal or non-existent as it would have been incurred anyway as a result of other measures.

Additionally, this certification will be voluntary. Therefore, costs may be avoided by the audit firms which will not attach value to such a certificate.

The audit quality certificate will involve administrative costs for the competent authorities involved in providing the certificate, whether ESMA or at national level (examination of applications etc).

In any event, the details of the cost of this measure will depend on secondary legislation to be prepared by the European Supervisory Authorities. Therefore, it will be more appropriate to estimate the costs at the time of preparation of the secondary legislation by ESMA

Concerning the benefits, it is estimated that this audit quality certification will contribute to improving the reputation of audit firms that obtain this certificate in the market and facilitate the opening of the European market to firms. This improved reputation is, however, not measurable.

Joint audits: cost estimates in terms of additional costs for the audited entity concerned are valid regardless of whether joint audits are introduced on a mandatory or voluntary basis.

The estimation of the potential increase in costs due to the enforcement of joint audit is based on the two cost simulations submitted by CNCC and the case-studies provided by the French audit firm Mazars (based on real examples of joint audits of CAC 40 PIEs in which they have participated).

Although more than 1 auditor is performing the statutory audit, this does not result in a doubling or tripling (in case of 3 audit firms) of its cost. This is due to the fact that the 4-eyes principle is only applied on certain areas of the audit, mainly related to strategic preparation of the audit and the analysis of its results. Increased communication and coordination costs (between audit firms) are the second source of cost increase. According to data provided in the Mazars case studies, increases due to increased coordination costs ranges from 2,5% to

5% of total audit costs, (overall audit costs increase by 10-15% with coordination costs accounting for ¼ to 1/3 of this increase).

This increase of coordination cost is mainly due to joint work performed on activities related to:

- Understanding the PIEs environment;
- Assessing the level of risk that financial statements contain errors;
- Determining materiality thresholds;
- Defining and documenting the audit approach to ensure concerted audit approach, when conducting analytical procedures;
- Reviewing the procedures performed by the partner joint auditor;
- Ensuring the information provided at the time the financial statements are approved presents a true and fair view of the audited entity and is consistent with those financial statements.

The feed-back from CNCC broadly supports the data provided from Mazars, where it considers potential cost increases from 5% to 10% of the total audit cost. For this cost estimation we have taken the more conservative figure of a 10% increase. The above estimation is based on the assumption that the audit fees of the two partners remain at similar levels compared to the fees of the incumbent auditor. For a large PIE, the incumbent auditor is likely to be a Big Four audit firm or another large audit firm. Big Four audit firms, however, are generally more expensive than other networks (see [section 2.3](#), *in fine*, of this impact assessment). Therefore, if a mid-size audit firm is part of the audit consortia, the audit fees charged by this firm could be lower than those that would be otherwise charged by a large audit firm. Although, possible savings from lower fees rates are difficult to estimate, it could be expected that audit fees charged by non-big 4 audit firms would be as low as 60% of the fee rate charged by the larger audit partner.

Lift restriction on ownership of audit firms. Lifting any restrictions currently preventing investors from non-audit backgrounds to buy shares and invest in audit firms.

This measure should not result in direct costs.

Concerning benefits, it will improve the chances of growth of mid-sized and smaller audit firms and contribute to a more competitive and efficient audit market.

Specific objective 4: Avoid unnecessary additional compliance costs for audited SMEs as well as for audit providers in a cross-border context

Mutual recognition of audit firms: an audit firm approved in a Member State would automatically be approved in all Member States, provided that the key audit partner leading the audit is approved as an auditor in the Member State concerned

This measure should not result in direct costs.

Concerning benefits, savings will result from the avoidance of the administrative costs of applying for a new licence in each Member State where the firms wants to provide services. In addition, it will create a true access to audit markets in 27 Member States.

In terms of indirect benefits, audit firms could more easily consolidate with other firms at cross-border level, thus facilitating the development of stronger and larger actors. Also, for existing groups, the need to keep different legal persons in each Member State is avoided. Therefore, this could lead to some savings in the administrative structure of the audit firm and to a more efficient organisation.

Also, it should be easier for audit firms to provide services in a cross-border context, which should lead to increased choice for audited entities regarding audit firms. For instance, it could be easier for an SME to keep its audit firm in case the SME creates a subsidiary abroad.

Mutual recognition of statutory auditors approved in a Member State (for auditors providing occasional cross-border services)

This measure should not result in direct costs.

Concerning benefits, savings will result from the avoidance of the administrative costs of applying for a new licence in each Member State where the auditor wants to provide services. In addition, it will create a true access to audit markets in 27 Member States. In terms of indirect benefits, auditors could avail of additional business opportunities. Audited companies could benefit from more competition.

Introduction of an adaptation period scheme and increased convergence, transparency and predictability in the aptitude test.

This measure should not result in direct costs for the auditor seeking to establish in a new Member States compared to the baseline scenario (aptitude test only).

It may result in costs for the competent authorities that need to improve the aptitude test. However, this is estimated to be a business as usual cost for those authorities. Therefore, no quantification of these costs is provided.

Concerning benefits, this measure will open new markets to statutory auditors since it will be significantly easier for them to be approved and provide services in other Member States. This will also benefit the statutory auditors employed by audit firms (e.g. possibility of relocation within audit firms).

Introduction of clarified ISAs: ensure that auditing standards are the same across the EU. National additions would be acceptable, where necessary.

An external study commissioned by the Commission and published in 2009⁴¹⁹ undertook an assessment of the possible costs and benefits arising from the adoption of the ISAs in the EU.

A number of possible adoption strategies may be considered. The possible advantages and disadvantages of each approach are set out in Table A20.4.

⁴¹⁹ See [Köhler](#) et al. (June 2009).

Table A20.4	
Type of Option	Description
1. Baseline- No policy change	No change. Each MS is free to require auditors to conduct an audit in accordance with the national auditing standards or may have to comply with the clarified ISAs, international standards of auditing developed by the International Assurance and Auditing Standards Board (IAASB), an independent standard-setting board under the auspices of the International Federation of Accountants (IFAC).
2. Introduction of Clarified ISAs with possible add-ons	Legal enforcement of the "clarified ISAs" to make sure that audit standards are the same across the EU. Member States would be allowed to add new requirements.
3. Introduction of Clarified ISAs with possible carve-outs	Legal enforcement of the clarified ISAs. Possibility for individual MS to carve out parts of ISAs.

In assessing the costs and benefits of ISA adoption by means of a binding instrument, the above-mentioned study concludes that, on balance, an adoption of the ISAs in the EU would result in quantitative and qualitative benefits for companies, investors and regulators.

For this study, the recurrent benefits would outweigh increases in audit costs:

- On one hand, the recurring costs of an audit could increase by approximately 6% to 10% per engagement. Nevertheless, the actual changes would vary widely depending on the individual audit firm, audit engagement (and in particular by audit client type) and member state. In total, they are estimated at about €246 M per year.
- On the other hand, market participants would benefit from improvements in audit quality, a lower cost of capital and increased business opportunities at international level. From an economic point of view, an adoption of the ISAs by the EU can be treated as an investment – that is, the total recurring benefits can be regarded as a return on the adoption of the ISAs by the EU. Such recurring benefits cannot be substituted by any action taken by other parties, including audit firms. The total recurring benefits would be about €2,248 bn.

This is the sum of the net benefits from the regulation effect regarding PIEs covered by the Forum of Firms (1,763 euro), PIEs covered by firms not in the Forum of Firms in jurisdictions with ISA compliant auditing standards (96 million euro), PIEs covered by firms not the Forum of Firms in jurisdictions without ISA compliant auditing standards (143 million euro).

- On balance, the total recurring net benefits from the adoption of the clarified ISAs by the EU for the EU economy as a whole through lower costs of capital are estimated to likely exceed €2 billion (€2,248bn - 246M). Since these net benefits are recurring, the present value of the net benefits in perpetuity can be estimated at €40 billion (if using an assumption of a long-term discount rate of 5%).

The study provides further data and evidence.

Adapt audit standards to the size of the audited entity: request Member States to ensure a proportionate and simplified audit for SMEs.

This measure could result in direct costs for a public authority or a professional body to establish guidance at national level on proportionate application of the applicable auditing standards. Since there is already guidance on the application of the ISAs to SMEs, the cost of this measure is considered rather moderate or even marginal.

There is likely to be a cost for the auditors/audit firms resulting from the need to familiarise themselves with this guidance and the associated training. These costs would be of a one-off nature. We consider them, however, to be part of the costs associated with the introduction of ISAs (see above) and, therefore, we do not estimate them again in detail here.

An additional indirect cost is the likely diminution of audit fees received by auditors from companies subject to the audit obligation.

In terms of benefits, the proportionate application of audit standards to the size of SMEs should result in cost savings for the audited entity without a diminution of audit quality.

These savings are difficult to estimate as the practical application of the standards would be done on a case-by-case basis and will depend on the size and complexity of the business of the audited company. As explained in [Annex 16](#), the French experience with small companies shows that potential savings in audit fees for a given company could be around 40% on average. However, these figures cannot be extrapolated as such to the medium-sized companies which are subject to the auditing obligation under EU law and which are much bigger than the companies targeted by the French experience. As a result, we do not provide a quantification of these potential benefits.

Another benefit is the possibility for the auditor to provide better value for money to audit clients. This is likely to entail a diminution of audit fees received from companies which are subject to the audit obligation (see above). However, it may also allow the auditor to try to convince smaller companies, not subject to the auditing obligation, to nevertheless have an audit.

Specific objective 5: Improve the effectiveness, independence and EU-wide consistency of the regulation and supervision of auditors

Strengthening national audit supervisory authorities.

There will be additional costs for some national authorities. This is difficult to estimate as costs would depend on the current structure and dimension of the authorities. Some of the larger ones (considering the size of their financial markets and therefore the number of PIEs concerned: e.g. in FR, IT, NL, ES, UK) have established robust and independent (from the profession) oversight systems. Therefore, such additional costs should not be significant. Other authorities, however, will have to invest time and resources to upgrade their audit supervision systems. It is likely that some authorities will need to increase their staff. At the same time, it is expected that these costs would be proportional to the size of the audit market: for example, Member States with smaller audit markets could consider integrating their

auditor supervision into the existing structures of financial supervision in order to obtain economies of scale and synergies.

In terms of benefits, independent, robust and effective national supervisory practices (and their coordination at the EU level) should give companies assurance that the audits provided to them are of high quality and should lead to increased trust in the audited financial statements. This should contribute to ensuring an efficient functioning of markets for audits of PIEs. This should have a positive impact on audit quality and ultimately will be conducive to financial stability.

EU-wide cooperation within ESMA, in cooperation with EBA and EIOPA.

There will be direct costs for ESMA (and to a lesser extent EBA and EIOPA). Taking into account that facilities already exist, it is considered that the equivalent of 2 persons would be enough to cover the additional tasks in an initial period: i.e. organising the cooperation between the national authorities and the preparation of technical standards regarding joint audit, and subsequently, guidelines on other issues⁴²⁰. These two positions should normally be drawn from existing resources within the European Supervisory Authorities and/or from the staff expansion foreseen in these initial years.

There will be indirect costs for national authorities if the cooperation is reinforced as more resources may need to be devoted to this cooperation.

In terms of benefits, the EGAOB will disappear. This represents annual savings in terms of organisation of meetings (costs of the meeting room, interpretation⁴²¹ and secretariat) and the expenses associated with the national representatives (the Commission pays the travel expenses and some allowances for one representative per country). In 2009, the expenses for the national representatives, for 3 EGAOB meetings, were €27,854.47. The resources allocated by the Commission to the EGAOB (secretariat etc) will not be saved, but rather transferred since the Commission services would also be involved in the activities of ESMA.

(3) Summary assessment

Better audits and more informative audit reports will enhance confidence in the markets while also informing stakeholders of any problems with regards to any particular entity. The direct beneficiaries of such confidence will not only include investors and creditors but also the company itself (as well as its employees). There would also be more differentiation with regard to the quality and reliability of the financial information presented by the audited entities. This would have an impact on the cost of doing business e.g. working capital requirements for companies: a creditor would be more willing to extend better terms to a more reliable entity.

Costs

⁴²⁰ This assessment does not estimate the possible resources needed to set up a quality certificate. Such an estimate would be done when developing the technical standards defining the procedure for the granting of the quality certificate.

⁴²¹ The cost of the meeting room and interpretation are not estimated.

Measures such as the strengthening of audit committees, more extensive audit reports and a formal internal report, the tendering of audit services, the rotation of audit firms will entail additional costs on the **audited entities**.

Although difficult to put exact figures to these measures, we broadly estimate that for public-interest entities with a market capitalisation or a balance sheet total in excess of €100 million, such costs, depending on the size of the company and the audit committee, could range from €90 thousand to €150 thousand per annum.

For smaller public-interest entities audited entities (including those which are SMEs), the additional costs would be less than €10 thousand per annum especially as there would be no obligation to either have audit committees or to tender for auditors. Mandatory rotation of the audit firm would normally entail initial additional costs for the incoming audit firm. To what extent they will be passed on the audited entity is difficult to gauge.

Public interest entities with a market capitalisation or a balance sheet total of more than €1 billion would be required to engage joint auditors. Based on the French experience, it is estimated that the additional work required by joint audit could result in a 5% to 10% increase in audit fees if the two audit firms charge a similar rate; however, the combination of a top tier and a next tier firm should facilitate a certain convergence of the respective higher and lower rates charged by top and next tier firms.

Table A20.5 summarises the estimated additional direct costs for individual PIEs, resulting from the enforcement of the set of preferred policy options. There are four categories of PIEs considered for the estimation:

- Very Large PIE (total turnover more than 40 billion euro⁴²²);
- Large PIE (total market capitalisation of more than 1 billion euro/ total turnover more than 2 billion euro);
- Medium PIE (total turnover more than 50 million euro)
- Small PIE (total turnover less than 50 million euro)

Table A20.5

Type of cost	Additional direct costs (€)				
	Very PIE	Large	Large PIE	Medium- PIE	Small PIE
Strengthening of Audit Committee (including enhancing its technical capacity and workload & cost of participation in regular meetings - These costs would not arise for those audited entities which already today have robust and efficient audit committees)*	53.600		53.600	53.600**	**

⁴²² E.g. Unilever Plc with a turnover of 44,262 billion euro

Table A20.5

	Additional direct costs (€)			
Cost of 2 Bilateral meetings with supervisors (only for PIEs which are financial institutions ; these additional costs would not arise if financial institutions are already holding bilateral meetings with supervisors)	10.800	10.800	10.800	10.800
Mandatory rotation learning curve cost (see section on mandatory rotation above)	Not quantifiable	Not quantifiable	Not quantifiable	Not quantifiable
Tendering costs for PIEs (tendering every 9 years)	44.444	8.889	6.667	N.A.
	[400000 every 9 years]	[80000 every 9 years]	[60000 every 9 years]	
Preparation of additional internal report	48.000	48.000	24.000	3.600
Improved and expanded audit report	4.800	4.800	4.800	4.800
Joint Audit*** (This cost will be applicable only for large PIEs in the financial sector)	900.000	170.000	N.A.	N.A.
Overall Estimated Cost Increase on a yearly basis (if PIE is a financial institution)	1.061.644	296.089	99.867	19.200
Overall Estimated Cost Increase on a yearly basis (if PIE is NOT a financial institution)	1.050.844	285.289	89.067	8.400

* Audit Committee: it is assumed that the audited entity has an Audit Committee.

** No request in legislation to have an audit committee if less than 100€ capitalisation

*** Joint Audit: In the case of Large PIEs, the 10% increase in cost is applied to total audit fees (Audit fees represent about 0,085%, applied on 2 billion turnover). Therefore, total audit fees for a large PIE are estimated at 1.700.000 euro with a respective increase of 170.000 euro. In the case of very large PIEs, the proportion of fees to total turnover is lower, therefore the 5% increase is applied (e.g. Unilever 18M euro audit fee is 0,042% of 44,262 billion turnover; 5% audit fee increase due to joint audit would be 0,9M). These figures do not take into account that if a mid-size audit firm is part of the consortium, the audit fees charged by this firm could be lower than those that would otherwise be charged by a large audit firm (see above).

Concerning the direct costs for **audit firms**, the impact of the tendering rule could be high, especially in jurisdictions where there has been no statutory requirement to have regular tendering (see table A20.6). It has been particularly difficult to gather information from audit firms and audited companies since they are reluctant to unveil what they consider sensitive commercial information. However, we were provided informal information that, for example, responding to the tender for the audit of a large PIE (with a market capitalisation above €1 billion) cost €1 million; for a particularly complex and geographically extended company with a market capitalisation in excess €40 billion, the cost reported was in excess of €5 million.

Given that a tender for a given company would take place every 9 years, costs would be amortised to almost a tenth of the above amounts. Of course not all responses to a tender would result in a mandate and to this extent some of these costs would prove fruitless. This may sound like a step increase in jurisdictions with little tendering over the past decades but

will in effect only be bringing the audit world into line with normal business practice in other fields including other financial services.

In any case, marketing costs such as tendering costs have to be seen in the context of the potential reward: in France, the average annual audit fees for CAC40 companies for 2009 / 2010 were around €17 million. For the most complex companies, audit fees were above €40 million. In the UK, the average audit fees for FTSE 100 companies in 2008/2009 were around £5.5 million; the fees for some companies exceeded £30 million.

In the case of medium-sized PIEs, tender costs would be significantly lower: on average €160 thousand (roughly €18 thousand per annum). To put this into perspective, it is worth noting that the average audit fees for such companies are £766 thousand (FTSE 250 companies in 2009) in the UK and €700 thousand for French listed companies in the B and C segments of the French stock exchange (2010).

The above indication of costs does not take into account any mitigating aspects for both 'clients' and auditors: tendering will obviously result in competitive bidding; this may in turn temper any additional costs for audited entities. For firms, increased and repeat experience with tenders will streamline and institutionalise the process thus lowering the costs of preparing tenders.

Table A20.6

Type of cost	costs (€)				
	Very PIE	Large	Large PIE	Medium-PIE	Small PIE
Tendering costs for audit firms, per bid (yearly basis, assuming a frequency of tendering of 9 years)*	600.000		120.000	17.778	N.A
	[total costs estimated at 5.400.000]		[total costs estimated at 1.080.000]	[total costs estimated at 160.000]	

* Those costs do not necessarily result in additional costs for the PIE itself: firstly, bidding cost may or not be directly reflected in the bid, depending on the marketing strategy of the audit firm; secondly, the tendering process may lead to lower audit fees compared to today's ones (see explanations above).

Benefits

Although no single component of the financial system can be solely blamed for the financial crisis, it is important to ensure that each component is examined in detail to ensure that improvements are brought with a view to the future. The predominance of 'clean audit reports' for banks through a crisis during which the Union committed €4.6 trillion between October 2008 and October 2010 to support banks, such aid amounting to 39% of the Union's GDP for 2009, renders a serious overhaul of the existing system inevitable.

In terms of benefits, the main benefits will be higher quality audits; these in turn will create confidence in the market in general while also alerting the market to any deficiencies in the audited company.

It has to be noted that as a result of the various measures more players will emerge at the top end of the market. It is difficult to predict if they will compete mainly on price thus moderating some of the cost increases referred to above or whether the current charge out

rates will be preserved with the competition being exercised exclusively on grounds of quality.

More informative audit reports will reinforce confidence in robust companies and the latter will eventually enjoy a lower cost of capital and access to better business opportunities when compared to a company where the audit reveals deficiencies. Moreover, such benefits will be of a recurring nature.

There is also the attractive prospect of positive spillover effects of the restrictions on the provision of non audit services by auditors for other service providers, mostly SMEs, e.g. lawyers, consultants, IT providers, tax advisors, etc. who are currently losing out business to audit firms because of the latter's captive business window through audit. We expect such firms to be able to compete on a like for like basis. This more competitive environment should result in lower prices for companies buying such services.

The introduction of common auditing standards at the level of the Union should result in total recurring net benefits for the EU economy as a whole through lower costs of capital, which are estimated to likely exceed €2 billion (€2,248bn - 246M). Since these net benefits are recurring, the present value of the net benefits in perpetuity can be estimated at €40 billion (if using an assumption of a long-term discount rate of 5%).

The removal of existing cross border obstacles within the Union via the mutual recognition of audit firms or the audit quality certificate, will reduce the currently administrative burdens for the provision of audit services in other Member States. It will give audit firms complying with the necessary requirements the possibility to provide services in all 27 Member States. Administrative burden of SMEs will also be reduced, in particular because Member States will have to adapt audit standards to the size of the audited entity and ensure a proportionate and simplified audit for SMEs.

ANNEX 21. TRANSITIONAL ISSUES REGARDING ROTATION OF AUDIT FIRMS AND TENDERING

The introduction of the rules on mandatory audit firm rotation and tendering for new audit contracts will raise two important issues in the short term:

- (1) the treatment of contracts for statutory audit services which will be in force at the time of the entry into force of the future legislation, should such legislation be adopted;
- (2) the impact of the new rules in terms of timing: will all (or a vast majority of) PIEs be calling for tenders at the same time?

Concerning the first issue, it would be desirable that any future legislation respects existing contracts, provided that they were entered into in good faith and do not undermine the objective of the new legislation. For instance, in France it is normal that audit contracts are signed for 6 years. At the same time, there are countries (e.g. the UK) where audit contracts are normally signed for only 1 year. It would be strange in both cases that right before the entry into force of the future legislation, audit contracts for 10 years are signed.

Concerning the second issue, it would be desirable that the tendering and rotation rules apply progressively to different types of entities, so that there is a smooth transition to the new system:

Therefore, a **transitional arrangement** could be established. This arrangement should respect the following **principles**:

- Existing contracts for the provision of audit services should in principle be respected, provided they were concluded in good faith, so as to avoid a retroactive effect of the future legal text;
- A distinction should be made between (i) contracts signed before the presentation of the Commission proposal; (ii) contracts signed after the presentation of the Commission proposal but before the entry into force of the legal text adopted by the Council and Parliament (it is assumed that entry into force of the text would be the day following the publication in the OJ) and (iii) contracts signed after the entry into force of the legal text but before the termination of the transposition/transitional period (in principle, two years. This period would be needed to ensure that all requirements on Member States regarding supervision are in place). For the second type of contracts, the PIE and the auditor should have been in a position to know that new rules would be applicable soon. For the third type of contracts, the legal text would directly foresee the applicable rule, so no retroactivity issue would arise;
- When the existing contract comes to an end, the situation could be treated as a renewal of the audit contract and the mandatory rotation and joint audit rule would not apply immediately. The PIE and the auditor would be in a position to renew the existing contract once (as in the case of a normal contract under the proposed measures). However, it would be inappropriate to allow for a renewed 5 year contract in all cases, considering that the auditor would normally have been in place for a long period.

- The duration of the renewed contract should therefore be adapted depending on the tenure of the existing auditor: the longer the tenure, the shorter the new contract. This would also allow for a progressive entry into force of the new provisions on tendering and joint audit.

These principles could, in practice, be applied as follows:

- (1) an audit contract was signed before the date of adoption of the Commission proposal and it is still in force when the new legal text enters into force: the contract should be respected provided that the contract will only remain in force for 4 full accounting years after the entry into force of the new legal text. This should ensure that bona fide French contracts (of 6 years) are respected;
- (2) an audit contract was signed after the presentation of the Commission proposal but before the entry into force of the new legal text: the existing contract should only be valid for a maximum duration of 5 full accounting years after the entry into force of the new legal text. This should ensure that bona fide French contracts (of 6 years) are respected. However, one should bear in mind that in most cases (e.g. in DE or UK) audit contracts are for 1 year only;
- (3) any contract under (1) or (2) is terminated: a single renewal of the contract with the same auditor (no tendering) would be possible. Such renewed contract should be subject to a maximum duration as follows:
 - 1 year: if the auditor has been providing audit services to the audited entity for 101 or more years;
 - 2 years: if the auditor has been providing audit services to the audited entity for 51 to 100 years;
 - 3 years: if the auditor has been providing audit services to the audited entity for 21 to 50 years;
 - 4 years: if the auditor has been providing audit services to the audited entity for 11 to 20 years;
 - 5 years: if the auditor has been providing audit services to the audited entity for 10 or less years;
 - By way of derogation from the previous criteria, the contract could remain in place until the end of the first accounting year ending after the end of the transitional/transposition period for the new legal text, so that the tendering rules could apply immediately afterwards.
- (4) when the contract renewed under (3) is terminated, the audit firm rotation, mandatory tendering and joint audit rules would fully apply.
- (5) a new PIE needs to appoint an auditor in the period between the entry into force of the legislative text and the end of the transposition/transitional period: the rules of the new text would apply regarding the maximum duration of the audit contract, but no obligation to conduct a tendering process would arise until the end of such a contract (maximum 9 years).

By derogation from the rules in (3), it is necessary to provide for a safeguard mechanism that could allow for adjusting, at national level, the timing of the tendering to avoid too many companies tendering in the same year. Therefore, competent authorities may allow audited entities to extend the duration of the audit contract for one more year if necessary for the adjustment of the timing of tender procedures.

The chart below provides a summary view of these situations.

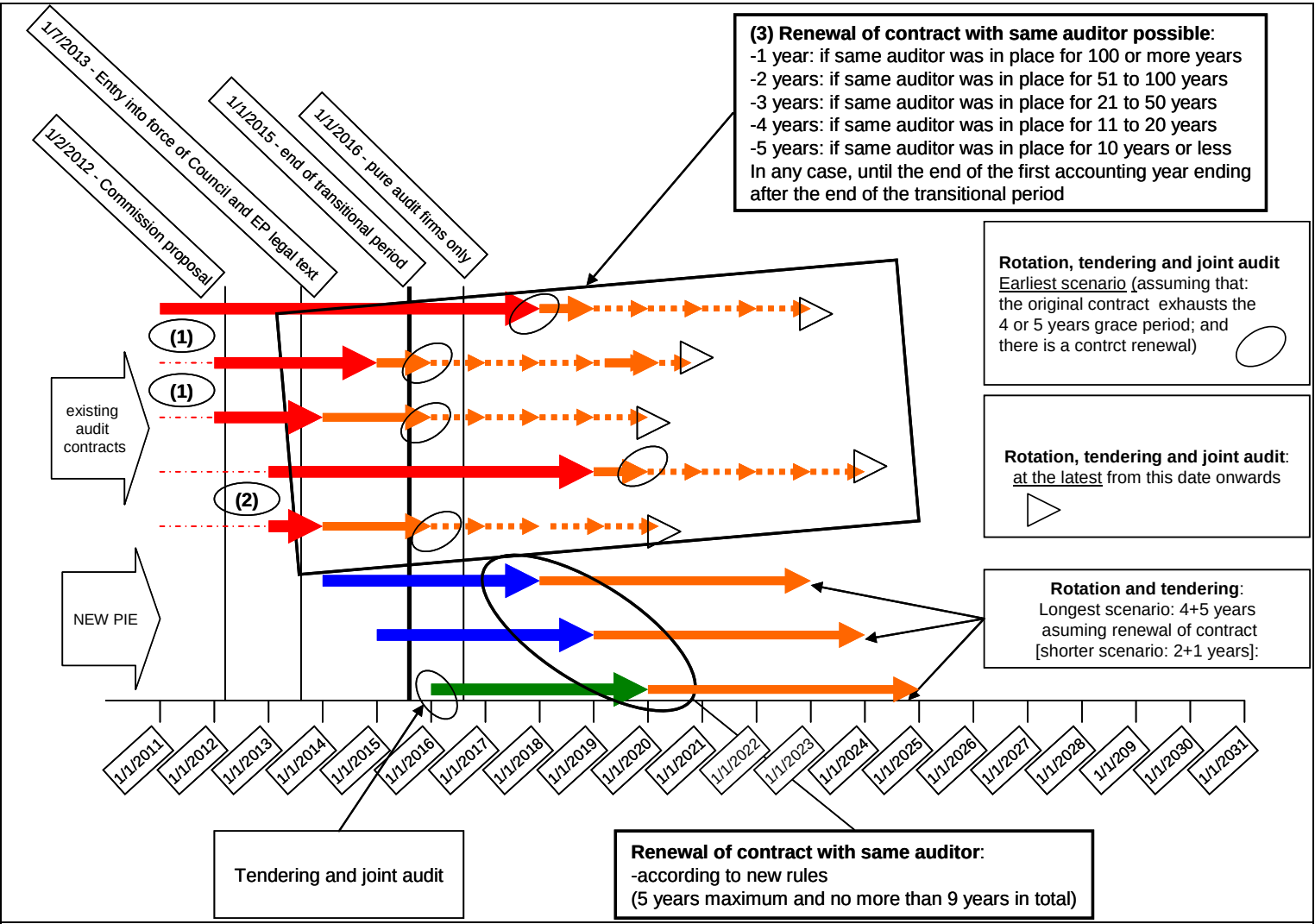


Figure A21.1

ANNEX 22. SANCTIONS REGIME

In terms of compliance with the rules, it appears appropriate to provide for a **specific sanctioning regime** as regards the measures which specifically concern the audit of PIEs and are directly applicable⁴²³. Given that the rules on the audit of PIEs would be directly applicable, it appears appropriate that the sanctioning regime is harmonised.

Such regime, without prejudice to the provisions of criminal law, would include rules on:

- the identification of the key violations;
- the identification of the types of sanctions that, at a minimum, should be applied (by the authorities charged with the supervision of the audit market or other national authorities);
- the supervisory measures that, at a minimum, should be available to the competent authorities charged with the supervision of the audit market. Certain supervisory measures are particularly important to respond adequately to key violations of the rules. It should, therefore, be ensured that all competent authorities have at their disposal those powers: e.g. the possibility to temporarily prohibit the auditor from carrying out statutory audit of PIEs; requiring the auditor or the PIE to bring an infringement to an end; declare that the auditor does not meet the legal requirements; require auditors to amend their transparency report; refer matters for criminal prosecution to the relevant national authority;
- the minimum level of the maximum amount of administrative fines: the amount of fines which can be applied to the key violations should be sufficiently high to ensure that the fine has a deterrent effect. The levels of fines provided for in national legislation vary across Member States and may be too low in some Member States compared to the benefits that could be realised by infringing the rules, for example carrying out an audit when the independence requirements would otherwise prohibit it;
- the criteria to determine the sanctions to be imposed in a particular case: some criteria are particularly important to adapt the sanction to be imposed, and particularly the level of the administrative fine, to the seriousness and the consequences of the violation and to the personal conditions of the author of the violation, which would help ensuring the effectiveness, proportionality and dissuasiveness of the sanctions actually applied;

⁴²³ This would be consistent with European Commission (December 2010). In this Communication, the Commission presented policy action orientations on how to promote convergence and reinforcement of national sanctioning regimes in the financial services sector. In fact, the review of those regimes carried out by the Commission, along with the Committees of Supervisors (now transformed into European Supervisory Authorities), has shown a number of divergences and weaknesses which may have a negative impact on the proper application of EU legislation, the effectiveness of financial supervision, and ultimately on competition, stability and integrity of financial markets and consumer protection. Therefore, the Communication suggested setting minimum EU common standards on certain key issues of sanctioning regimes, to be adapted to the specifics of the different sectors and EU legislative acts in the financial services area.

- the publicity of sanctions: publication of sanctions is considered to be one of the most deterrent tools to prevent violations, particularly because of the reputational damage that the author of the violation will incur. The introduction of a general obligation to publish sanctions would ensure that sanctions are published on a systematic basis in all Member States.

The following **fundamental rights** of the EU Charter are of relevance for these measures: the right to an effective remedy and fair trial (Art. 47), presumption of innocence and right of defence (Art 48), freedom to conduct a business (Art 16), data protection (Art 8), consumer protection (Art 38), and – even though Art. 49 on the legality and proportionality of criminal offences and penalties may not be directly applicable to all of the administrative sanctions envisaged – the general principles of legality and proportionality underpinning the Charter.

In relation to these fundamental rights, the measures envisaged would ensure that a violation of reporting and notification requirements would be subject to the same type of administrative sanctions across the EU. These uniform rules would particularly ensure that the types and levels of administrative sanctions that can be imposed are proportionate to each specific violation across all Member States. This option will not harmonise the national liability regimes and will not affect the procedure for the imposition of administrative sanctions. Therefore, it will preserve Member States' current arrangements for ensuring compliance with procedural rights such as the right to an effective remedy and to a fair trial (Art. 47), the presumption of innocence and the right of defence (Art.48). The obligation to publish sanctions may have a negative impact on the right to protection of personal data (Art. 8) with regard to the individuals concerned. However, publication of sanctions is an important element in ensuring that sanctions have a dissuasive effect on the author of the violation and is necessary to ensure that sanctions have a dissuasive effect on the general public.

This option will not create an **administrative burden** on auditors, audit firms or PIEs, which are currently subject to sanctioning regimes in all Member States. More uniform sanctioning regimes throughout the EU may in fact lead to reduced compliance costs for market participants through the simplification of the legal framework for cross-border financial institutions.

Annex 23. Monitoring and evaluation: detailed plan

First of all, it should be noted that some of the policy choices envisaged would be included in a directive requiring the adoption of national transposition measures: i.e. those regarding access to audit markets in different Member States; the audit standards to be used, including when auditing SMEs; and the supervisory issues. Other preferred policy options would be integrated in a directly applicable legal instrument (i.e. those containing obligations for PIEs and for auditors of PIEs). However, important transitional issues must be taken into consideration even in the case of a Regulation (e.g. conversion into pure audit firms, rotation of audit firm/auditor for existing contracts; when to organise a tender for the first time etc). See [Annex 21](#) on this issue. Therefore, a *vacatio legis* period would be established for the regulation, matching the transposition period of the directive. The monitoring and evaluation plan should take account of this situation.

The monitoring and evaluation plan will consist of 3 steps:

- (1) a transposition/transitional period plan;
- (2) the on-going monitoring activity; and
- (3) the evaluation of the policy.

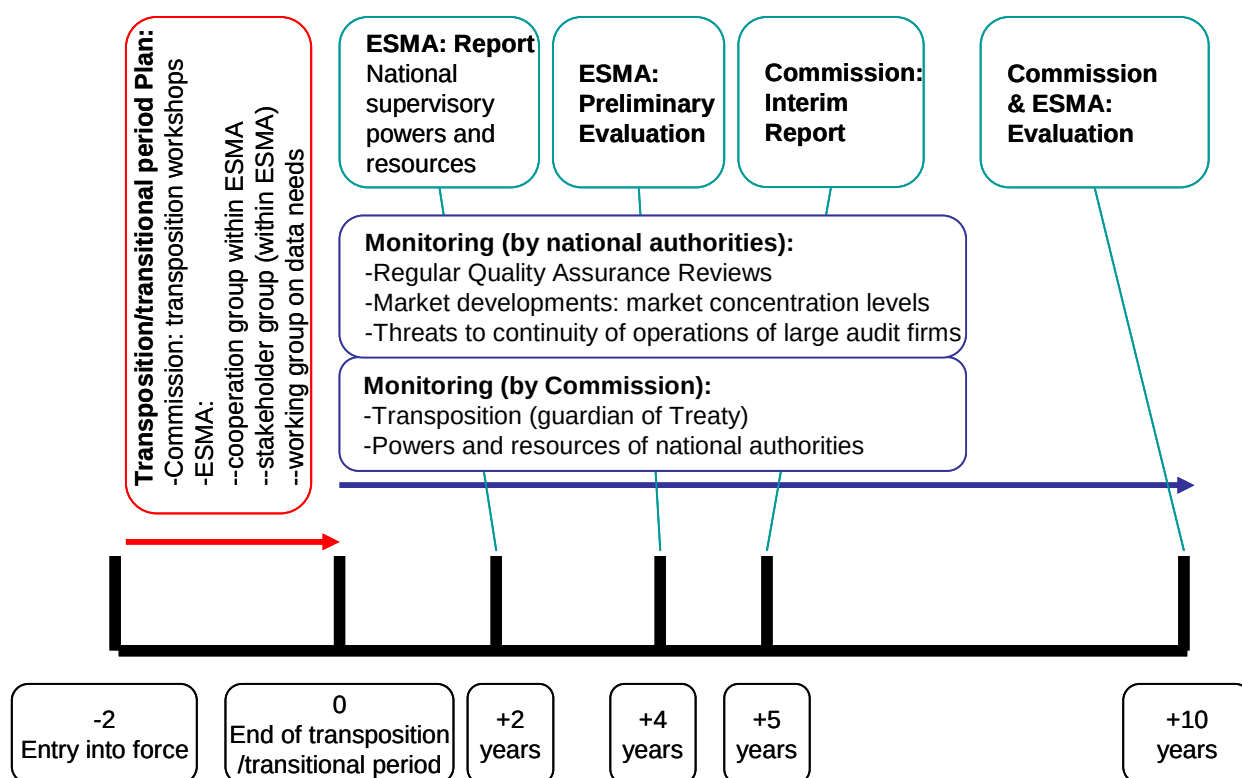


Figure A23.1

(1) The transposition/transitional period plan.

A transposition/transitional period plan, running for 2 years after the adoption of the legal texts, will be established.

The transposition/transitional period plan should focus on the following issues:

- organising **transposition workshops** dealing with changes to the rules on: the approval of audit firms; the aptitude test and the adaptation period; and on the empowering of supervisors;
- setting up the **cooperation group of audit supervisors within ESMA**, which shall prepare a detailed work programme on regulatory and supervisory cooperation;
- **stakeholders group**, which could be set up by the Commission or by ESMA, to discuss regulatory issues arising in the transitional period with stakeholders;
- a **working group**, possibly organised within ESMA, which should define, before the end of the transposition/transitional period the **data needs for the future monitoring of the application of the new rules and any subsequent evaluation**. This group would also set a strategy for the collection of such data. The interaction with professional organisations should be ensured.

The cooperation of national authorities will be sought, both the policy makers represented at the Audit Regulatory Committee and the Audit Supervisors currently within the EGAOB but who shall be integrated within ESMA.

(2) The on-going monitoring activity

The monitoring of the application of the new rules is in-built in the preferred policy options and would essentially be carried out by the national competent authorities and ESMA on an ongoing basis.

Monitoring activities by national competent authorities and ESMA. One of the policy options is to reinforce public supervision of the audit market. Hence, the national competent authorities will be entrusted with and empowered to undertake this task. This includes the following requirements:

- (i) regularly undertake **quality assurance reviews** of statutory audits carried out by audit firms and statutory auditors (each firm/auditor auditing PIEs should be reviewed at least every 3 years). See above Annex 8, policy options in relation to objective 5;
- (ii) regularly **monitor market developments**, in particular (but not exclusively) in relation to market concentration levels, including at the level of specific sectors; and assessing the need for structural measures to mitigate any risk arising from high concentration, such as: establishing caps on market shares, requiring the deconsolidation of audit firms or carving-out part of the sectoral expertise of large audit firms;

- (iii) regularly monitor the possible **threats to the continuity of operations of large audit firms**, including the risks arising from high concentration, as they could disturb the market and have effects on financial stability; and requiring large audit firms to establish contingency plans to address such threats.

There should be cooperation among authorities at EU level within the ESMA framework, where the Commission is also represented.

The particularly important role of national competent authorities is without prejudice to the **role of the Commission** as guardian of the Treaty. The Commission will monitor whether Member States transpose the relevant obligations into national law. It will monitor, in cooperation with ESMA, whether the competent authorities are sufficiently empowered and have adequate resources to carry out their tasks since this is one of pillars of the reform.

ESMA will be requested to prepare a report on this issue (the powers of the competent authorities) within 4 years of the adoption of the legislation (2 years after the end of the transposition/transitional period).

(3) The evaluation of the policy

A full **evaluation of the effects of the policy choices** could, however, only be undertaken in the longer term. Some of the important policy choices will need time to have any impact, particularly (but not only) as regards market concentration levels: e.g. conversion of audit firms into pure audit firms, maximum duration (9 years) of audit engagements with an obligation to change statutory auditor/audit firm; joint audits etc.

It would be necessary, therefore, to carry out such an evaluation in two steps.

The 2 steps evaluation.

- **(1) Preliminary examination**. ESMA will be required to present, 4 years after the end of the transposition/transitional period, a report on selected issues : changes in audit market structure; changes in the patterns of cross-border activity (e.g. functioning of the aptitude test and adaptation period, effect of mutual recognition of audit firms); interim assessment of the improvement in audit quality; impact of the changes regarding audit of SMEs. Based on this report and additional information, the Commission could prepare its own report one year later.
- **(2) Evaluation**. This evaluation would need to be undertaken 10 years after the end of the transposition/transitional period to ensure that the effects of the maximum duration of audit engagements rule (9 years) could be evaluated. This evaluation would reassess the issues examined in the preliminary examination and also evaluate the effects of the policy choices on market concentration and supervisory activity. This evaluation is without prejudice to the monitoring activity described above.

The second step in the evaluation could be undertaken by ESMA or conducted externally. This choice could be made after the results of the first step (the preliminary evaluation) are known.

Concerning the possible indicators to be used in the evaluation of the policy, some could already be identified.

Possible indicators to be used in the evaluation, to assess:

- **the improvement in audit quality:** evolution of qualified audit opinions; evolution of the quality of audit reports; audit committee satisfaction (e.g. with the additional internal report); assessment of quality assurance reviews by supervisors; auditors/firms obtaining the European quality certificate; investors perception on audit quality and the reduction/elimination of the expectation gap; increased transparency of audit firms;
- **the levels of market concentration and competition:** number of firms able to audit large listed companies and financial institutions;
- **supervisory activity:** number of sanctions and administrative measures; quality assurance reviews carried out and qualitative assessment of such work; investigations carried out; intra-EU cooperation activity.

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MIFID Implementing Directive: Commission Directive 2006/73/EC of 10 August 2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive, OJ L 241, 2.9.2006, p. 26

Payment Services Directive: Directive 2007/64/EC of the European Parliament and of the Council of 13 November 2007 on payment services in the internal market amending Directives 97/7/ECC, 2002/65/EC, 2005/60/EC and 2006/48/EC and repealing Directive 97/5/EC, OJ L 319, 5.12.2007, p. 1.

Seventh Company Law Directive: Seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts, OJ L 193, 18.7.1983.

Solvency II Directive: Directive 2009/138/EC of the European Parliament and of the Council of 25 November 2009 on the taking-up and pursuit of the business of Insurance and Reinsurance (Solvency II), OJ L 335, 17.12.2009, p. 1.

Statutory Audit Directive: Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC, OJ L 157, 9.6.2006, p. 87.

Transparency Directive: Directive 2004/109/EC of the European Parliament and of the Council of 15 December 2004 on the harmonisation of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market and amending Directive 2001/34/EC, OJ L 390, 15.12.2004, p. 38.

UCITS Directive: 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), OJ L 302, 17.11.2009, p. 32.

ACRONYMS AND ABBREVIATIONS

AB3C – Central Chamber of Commerce of Finland

AFM – Netherlands Authority for the Financial Markets

AIU – Audit Inspection Unit (AIU), part of the Professional Oversight Board

AMF – Autorité des marchés financiers

APB – Audit Auditing Practices Board

Big Four audit firms – PwC, Ernst & Young, Deloitte & Touche, KPMG

CAC40 – French stock market index that tracks the 40 largest French stocks based on market capitalization on the Paris Bourse (stock exchange)

CESR – Committee of European Securities Regulators

CEBS – Committee of European Banking Supervisors

CEIOPS – Committee of European Insurance and Occupational Pensions Supervisors

CEO – Chief Executive Officer

CFO – Chief Financial Officer

CMVB – Comissão do Mercado de Valores Mobiliários

CNCC – Compagnie Nationale des Commissaires aux Comptes

CNDCEC – Consiglio Nazionale dei Dottori Commercialisti e degli Esperti Contabili

CONSOB – Commissione Nazionale per le Società e la Borsa

CSSF – Commission de Surveillance du Secteur Financier

DAX 30 – Deutscher Aktien IndeX, formerly Deutscher Aktien-Index (German stock index), consisting of the 30 major German companies trading on the Frankfurt Stock Exchange

EBA – European Banking Authority

EIOPA – European Insurance and Occupational Pensions Authority

ESMA – European Securities and Markets Authority

EESC – European Economic and Social Committee

EGAOB – European Groups of Auditors' Oversight Bodies

ESA – European Supervisory Authority

FEE – Fédération des Experts Comptables Européens

FTSE 100/ 250/ 350 – 100/ 101st to 350th/ 350 largest companies listed on the London Stock Exchange

G8 – The countries of Canada, France, Germany, Italy, Japan, Russia, the United Kingdom, and the United States

G20 – The Group of Twenty (G-20) Finance Ministers and Central Bank Governors. The G-20 is made up of the finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, Republic of Korea, Turkey, United Kingdom, United States of America. The European Union, who is represented by the rotating Council presidency and the European Central Bank, is the 20th member of the G-20

H3C – Haut Conseil du Commissariat aux Comptes (French supervisor for audit)

IAASB - International Auditing and Assurance Standards Board

IAB – Impact Assessment Board

IBEX35 – The official index of the Spanish Continuous Market, which is comprised of the 35 most liquid stocks traded on the market

ICAEW – Institute of Chartered Accountants in England and Wales

IFAC - International Federation of Accountants

IFRS – International Financial Reporting Standards

ISA – International Standards on Auditing

LACA – Latvian Association of Certified Auditors

LCA – Lithuanian Chamber of Auditors

MTF – Multilateral Trading Facility

NAS – Non-audit services

OFT – The Office of Fair Trading

PCAOB – Public Company Accounting Oversight Board

PIE – Public Interest Entity

QKB – Qualitätskontrollbehörde

SCE – European Cooperative Society

SEC – Securities and Exchange Commission

SIFI – Systemically Important Financial Institutions

SME – Small and Medium Enterprise

SMP – Small and medium-sized practitioner

TEC – Treaty of the European Community

TFUE – Treaty on the functioning of the European Union

WPK – Wirtschaftsprüferkammer