REPORT – ACCA-ecoDa event on Audit Reform

On 25 September 2012, Sajjad Karim, MEP, hosted a high level roundtable, organised by the ACCA (Association of Chartered Certified Accountants) in partnership with the ecoDa (the European Confederation of Directors' Associations), to discuss the various proposals linked to audit quality and transparency as well as those targeting independence and market structure. It brought together over 190 participants.

The main conclusions indicate that there is a general consensus that any reform needs to improve transparency and audit quality. It must help resolve the gap that exists between what auditors are asked to do and what stakeholders and citizens generally understand under "audit process". There are however diverging perspectives on the appropriate tools on how to make auditing more effective and relevant in the 21st Century, especially in the area of auditor independence and market structure.

The first panel on **transparency and quality, moderated by Sue Almond, Technical Director, ACCA** was comprised of **Liz Murrall**, Member of the European Fund and Assets Management Association (EFAMA) , **Jella Benner-Heinacher**, President of Euroshareholders, **Dan Montgomery**, Task Force Chair of the auditor reporting project , International Auditing and Assurance Standards Board- IAASB, **Laurent Degabriel,** Head of investment and reporting unit, European Securities and Markets Authority (ESMA) , **Hilde Blomme**, Deputy CEO of the Federation des Experts-comptables Europeens (FEE).

The second panel on independence and market structure, moderated by **Brendan Murtagh, IAASB board member** included **Sebastian Valentin Bodu, MEP**, shadow rapporteur for the EPP on audit , **Kristian Koktvedgaard**, Businesseurope, **Jos van Huut**, President of European Group of International Accounting Networks and associations (EGIAN), **Robert Peirce**, PwC Partner – Belgium and **Per Lekvall** , member of the European Confederation of Directors' Associations (ecoDa) . The European Commission was represented by **Nathalie Berger, head of the audit unit, DG MARKT**.

Main highlights

The European Commission believes that promoting independence and healthy competition, and ensuring the enforcement of legislation supervising the audit sector is key to restoring trust in this service, which plays a pivotal role in business by promoting the causes of transparency, accountability and sound financial management. The EU executive believes that confidence of stakeholders in the audits of financial statements is an essential ingredient for growth and competitiveness. With this in mind and in order to clarify and reinforce the role of audit, the EU executive, published on 30 November 2011 its legislative package, which comprises a new Regulation containing specific requirements for the audit of Public Interest Entities (PIEs) and a Directive to amend the current statutory audit Directive. The co-legislators - the European Parliament and the Council - are currently preparing their respective positions on the package.

Sajjad Karim, MEP

- Is the rapporteur in the European Parliament Committee on Legal Affairs (JURI) on two related draft reports on Statutory audits of annual accounts and consolidated accounts and Statutory audit of public-interest entities: specific requirements.

- He welcomed attendees to the standing-room-only event and introduced the debate with some thoughts following on from the presentation of his draft reports in the JURI Committee. He said that the issue of auditing is entering a critically interesting phase, so the timing of these reports and this event is very apt.

- His report follows a clear philosophy: audit quality, transparency and independence should be the foremost considerations when designing an audit regulatory regime. After the 2008 financial crisis the finance sector needs to win back the confidence of investors, who are looking for higher quality auditing, improved value of statutory audits, and more competition in the market.

- By combining greater information and availability of insight into the audit market with a reinforced opportunity to engage, he expects to see a much stronger attitude of involvement from shareholders and investors when it comes to a company's auditor engagement, as they find themselves much better placed to critically assess and comment on what they want to see from their auditors.

- MEP Karim proposes to keep the principle of mandatory rotation to avoid familiarity between the auditor and the audited company, but prefers an engagement limit of 25 years instead of the 6 proposed by the Commission, in order to avoid disruption and high costs. For the rappporteur, mandatory rotation is a backstop, and shareholders should become much more involved in the process through the work of each company's audit committee, namely through an annual review and the appointment by shareholders of the statutory auditor.

- MEP Karim's also considers that robust international standards and international convergence make sense as many of the companies classified as PIEs operate beyond the borders of the EU. On the controversial non-audit services area, looking beyond the 'blacklist' of services , the involvement of the audit committee in the approval of all other non-audit services is essential. MEP Karim also shares shadow rapporteur MEP Bodu's willingness to open up competition in the area of non-audit services to allow smaller firms to gain a foothold in the upper tiers of the market.

- Her recalled that we must remain conscious of the huge variety of domestic companies throughout the EU and the national markets in which they operate, a "one-size fits all" solution throughout could thus end up representing a "bad fit for all".

<u>Panel 1 on transparency and quality</u>

The moderator, **Sue Almond, ACCA Technical Director**, reminded the audience that it was critical to consider if the Commission proposals on auditing are hitting the required needs. Although there remain, understandably, areas of difference, it is interesting to see a number of areas of consensus - for example in the critical role of the audit committee in auditor appointment and independence, and in the need for more informative and transparent auditor reporting.

Liz Murrall, member of the **European Fund and Assets Management Association (EFAMA)**, was providing the investors' perspective on auditing.

- Her main concerns are twofold: the impact on audit quality and independence (i.e. the term of office, limited players and non-audit services) and the level of accountability and transparency :
- On the impact on audit quality and independence, investors are still concerned at the potential impact on the community and shareholders because of how long auditors can be with one client. One particular issue of interest is the appointment of auditors. Rotation after 6 years is to too frequent and disruptive, investors' preference would be for a transparent ten year tender or an explanation as to why the tender should be extended. In either case, there should be an outer limit, with a maximum of 15 to 20 years, as the limited number players in the field of auditing throughout the EU risks removing the barriers to growth. EFAMA does not believe in joint audit. During the Q&As she indicated that she was not in favour of mandatory rotation, due to its impact on quality. A lot of time has been spent on learning about recruitment, and there appears to be little incentive to introduce a mandatory system. She was echoed by Euroshareholders, who prefer regular tendering.
- Non-audit services (NAS) require a compromise between independence and objectivity: NAS could be banned when there is conflict, they should be subject to audit committee approval or a 50% limit on audit fees.
- On transparency and scope, investors deplore a lack of transparency of the audit process and findings. Investors feel excluded from the process and want a more enlightened audit report, describing the current audit report as binary, a not useful enough pass/fail boilerplate. Some reports can also be published months later, making them too little and too late. An improved report could be two-four pages long, including the audit process and real findings. Either the Audit Committee or the auditor must give more info on accounting judgements and valuations.

Accounts are the responsibility of the company and the board. Audit committees are required to do a report, which extends the auditors' responsibilities and ensures enhanced disclosure guidelines. We need more on the accounting judgements and their debates with the auditors – and then for auditors to report on the AC statement.

- She called on the investment community to be considered, to alleviate their fear of reducing rather than improving audit quality in the future.

Jella Benner-Heinacher, **President of Euroshareholders, the organisation of European shareholders associations:**

- Shareholders have high expectations for the improvement of auditing services namely on a clear statement on company status, reliable bookkeeping and an expression of a true and fair value of the company. The reality was somewhat different, the fair value assessment is forward-looking, but rest is backwards-looking, and essentially written for directors not shareholders. On audit quality, shareholders would greatly appreciate an understandable explanation, in order to deal with the key risks, judgements and major topics that might come up.
- More independence is needed, improvements could include clear limits on NAS, with a blacklist of services (based on the German model) that would be based on harmonised rules applicable to all EU Member States. A limit on fees (50%) and regular tenders/beauty contests could be put in place every five-seven years. 25 years audit tenure is a "dinosaur", a maximum length of mandate of 15 years would be better.
- Auditors should give a judgement on the underlying financial assumptions used by company. A written declaration of independence could be signed before an auditor is introduced.
- Shareholders also support giving more power and expertise to the Audit Committee, with the possibility of an own budget for the Audit Committee, the prior approval of NAS and involvement in the selection procedure (on the tender, the number of candidates and explanations of the selection).
- She indicated during the Q&As that the joint audit system is not currently available in Germany, but she was not aware of any extra value (except that it is definitely more expensive).

Dan Montgomery, **Taskforce Chair of the auditor reporting project**, **International Auditing and Assurance Standards Board (IAASB)**

- Auditor reporting is of high interest globally, there are many initiatives in the wake of the global financial crisis, including the EC proposed regulation. We can observe common themes in the calls for change, but diverse views on how best to address

- IAASB endeavours to put together a high quality framework, with extensive discussion and debate among stakeholders. Influences on high quality include values of auditors, training, experience, engagement, exploration of auditors' reports, reporting of management and reports by audit regulators. The contextual factors are to be considered, but the discussion documents are expected to be approved by the end of 2012 or start of 2013.

- For IAASB, the auditor reporting project is the number one priority. It has issued an Invitation to Comment (ITC), unanimously approved, which sets out the IAASB's indicative direction and rationale, and describes the IAASB's perspectives on value and impediments

- There are currently two key areas of change:

  - Auditor commentary, which would take the form of a new section aimed at improving informational value of the auditor's report and hhighlight matters that are, in the auditor's judgment, likely to be most important to users' understanding of the audited financial statements or the audit. It would provide a "roadmap" to help users better navigate complex financial reports, additional context to the matters highlighted and information about key judgments made by the auditor to provide more transparency regarding how the audit was conducted. This call is coming through louder in the EU than in other parts of the world.

- o On the going concern assumption, he said that there are mixed views on the values of statements. Consistent with ISA 570, the ITC suggests a requirement for all auditor's reports to include a conclusion about appropriateness of management's use of going concern (GC) assumption and a statement about whether material uncertainties relating to GC have been identified. Clarification of guidance on GC likely will be necessary, as we need a common understanding of terms such as "material uncertainty," significant doubt," and "foreseeable future", and also to better comprehend the relationship (or distinction) between "use of GC assumption" and "ability to continue as a GC" . Suggested improvements included a new section on inconsistencies, an explicit statement of compliance and a robust description of auditors' responsibilities. These are the building blocks to allow flexibility. More information is also needed on internal controls and fraud

- Coordination with IASB is highly desirable, certain clarifications are to be discussed by IFRIC in November 2012

Laurent Degabriel, Head of investment and reporting unit, **European Securities and Markets Authority (ESMA)**, said that in terms of audit quality, transparency and independence, ESMA welcomes the improvements within the Draft EP report.

- Transparency is needed for good quality auditing, in addition to a strong effective audit committee. Independence is a key driver in the audit process, which is still organised at international level.
- ESMA's main task is to issue standards and best practices in certain areas, and engages in supervisory measures with other countries. It has also developed external experiences, in order to create a substantial role in establishing its presence in third countries. This should be considered further, as there are other issues to be addressed (for example, the creation of an audit standing committee). He looked forward to the outcome of the final text.

Hilde Blomme, **Deputy CEO of the Federation of European Accountants (FEE)**:

- FEE welcomes MEP Karim's report , as it is more balanced than the initial Commission proposals, which were too prescriptive in areas such as how to achieve increased independence and reporting
- Other areas however need to be considered further, such as the question of the PIE definition, which is of utmost importance.
- The role of professional bodies is close to the heart of FEE and has an impact on the whole of the accounting profession. it is essential that professional bodies continue to be involved in the activities of the profession under the supervision and oversight of Member States' competent authorities, which are best placed and sufficiently competent to judge about the level of delegation to professional bodies. There are three main fillers: underpinning the continued development of the profession, enhance quality within the profession (with quality control reviews) and instilling values, integrity, independence, balance and discipline. These are especially important for smaller practitioners.
- In practical terms, it is recommended that for delegation to professional bodies under the oversight and supervision of the competent authority:

    - o Approval and registration of auditors includes the whole process of education, initial qualification and continued professional development as well as the organisation of the public register, to underpin the continued development of the profession

    - o Quality assurance reviews for non-public interest entities is reinstated, to enhance quality and instil discipline in members

- The robust international standard in the areas of auditing, internal quality control, ethics and independence are recommended to be adopted at European level, whereby professional bodies can play a role to provide additional guidance suited for national needs and in the national language. In this respect, the IAASB initiative to enhance the transparency of the auditor's report is applauded.

- If FEE was to make amendments to the Commission proposals, it would come up with something close to the Karim reports, which should be recommended for adoption at EU level, as this was the way forward for auditing.

Panel 2 on independence and market structure

The session was moderated by **Brendan Murtagh**, IAASB board member, who reminded that Commissioner Barnier has said himself that the confidence of stakeholders in the audit market is key for growth and competitiveness. Independence is a key element of building that trust, as well as the quality of audits and financials statements.

Sebastian Valentin Bodu, MEP, Shadow rapporteur for the EPP

- there seems to be consensus that the role of audit committees should be strengthened, namely in making them responsible for approving NAS performed by the same firm that provides audit services. In the Commission revision, there are related, audit and non-audit services (the latter being divided into conflicts of interest and 'may entail' conflicts of interest). It should be up to the audit committee to decide whether another firm should perform the task.
- External rotation is a sensitive issue, his position is the same as in the previous green paper, ie it is not needed, preferring instead strengthened internal rotation. None of these procedures are perfect, but at this moment, internal rotation can ensure the desired level of independence.
- Splitting the firms into purely audit and non-audit would have more negative implications than positive ones. Having discussed the quasi-monopoly problem in Spain, Germany and the UK, he felt that splitting audit firms into in two in these countries would not help competition amongst the audit firms as it would lead to big audit and non-audit firms.
- He intends to table an amendment to put a double cap (a percentage figure calculated on the revenues from the previous financial year) on the turnover from non-audit services provided by the Big Four to public interest entities (PIEs), allowing room for smaller firms to grow and allow them to create a brand name and grow naturally into the audit arena. The proposed figures for this cap are yet to be decided. He knows this is an indirect way of enhancing competition and to increase more penetration of smaller audit firms in the market, but he could not find a solution to concentration in a direct way so far. A firm does not need a good team, a large team, or a network, but just a good idea to do this kind of work. He expects smaller firms would grow into auditing services if they develop in these other ways.
- Joint audit is not a solution, it would increase costs, which are not welcome at this time.

Kristian Koktvedgaard, BUSINESSEUROPE, explained that BUSINESSEUROPE's starting point on this issue is ensuring efforts to allow access to high quality audits, thus welcoming institutional efforts but warning that they should not pose a threat to quality.

- Most of the measures related to PIEs should be in line with international standards and codes of ethics on auditing.
- BUSINESSEUROPE agrees that the rules on provision of non-audit services need to be harmonized in Europe but we should base the legislation on the Code of Ethics. BUSINESSEUROPE doe not believe in the 10% cap, is in favour of an increased role of the audit committee (but not for its professionalization), which should be able to choose and set up policies and services. Businesseurope would not support the cap on turnover suggested by MEP Bodu. The key interests for businesses are: access to high quality audits, general knowledge, general access, and sector specific knowledge across the world. Once a firm has invested in these things, it should be able to use them for non-audit services to non-audit clients. There needs to be a market for that knowledge.