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COMMISSION STAFF WORKING PAPER
EXECUTIVE SUMMARY OF THE 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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1. INTRODUCTION

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. Robust audit is key to re-establishing trust and market confidence.

The Commission took the lead in examining the audit market when it launched its Green Paper in October 2010, a consultation that elicited 700 responses from a wide group of stakeholders.

In its report of 14 September 2011 on the Green Paper the European Parliament supported the Commission's holistic approach and its main proposals on reshaping the audit market.

The United States is also considering important changes particularly in the domain of the independence of auditors. Serious consideration is being given to the mandatory rotation of audit firms to address what are perceived as serious shortcomings.

2. PROBLEM DEFINITION

The audit of companies' financial statements is a service provided in the public interest. Audit contributes to the credibility as well as reliability of financial statements. This service is the result of a statutory entrustment to a select group of qualified specialists on the one hand and is a statutory obligation for all companies on the other. Although not identical, certain elements of the audit market for large companies are similar to the market of Credit Rating Agencies (CRAs). While the former is dominated by "the Big Four" (PWC, KPMG, Ernst and Young and Deloitte), the latter is dominated by three large CRAs (S&P, Moody's, Fitch). Moreover, in both markets there is an 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.

It is important to acknowledge the need for appropriate calibration. Given the greater societal implications of large listed companies and financial institutions it is important to devise a more demanding and rigorous framework when auditing their financial statements. Therefore, certain concerns are more acute for entities that affect a very large number of stakeholders e.g. listed companies and those entities that carry out certain activities, especially in the financial services sector (referred to in our rules as Public Interest Entities (PIEs), are:

- The **expectation gap** between what stakeholders expect of an audit and what auditors actually do. Many have asked the question of how banks could fail only months after they had been given clean audit reports. Moreover, there is a distinct lack of communication between auditors and supervisors regarding apparent weaknesses in the financial solidity of audited entities, in particular in the financial sector.
- **Independence** is neither assured nor demonstrable in a paradigm where audit has effectively become one of a plethora of commercial services provided by auditors to their clients. The lack of regular tendering of audit services and periodic rotation of audit firms has deprived audit of its key ethos: professional scepticism. We find ourselves in a landscape where a large number of audited companies have effectively become comfortable with their auditor; this is a refutation of the very essence of independence.
- **Market concentration and lack of choice:** The market is so polarised that rare is the occasion when the auditor of a PIE is not a 'Big Four' firm. In the majority of Member States, the Big Four audit more than 85% of large listed companies (FTSE 350 equivalent). The 'comfort' factor amongst audited companies with their auditors combined with the perceptions in the market place have entrenched the predominance of the Big Four. There is reticence with regard to engaging non Big Four auditors even in the relatively rare occurrence of a tender for audit.

The combination of the above problems implies that investors and other stakeholders are unable to unreservedly trust the complete independence, and therefore quality, of the audit opinion. Inspections of auditors carried out by national audit supervisors in Member States (and also in the US) found too often that audit independence is lacking.

Although no stakeholder should rely solely on the audit report to form a view on the financial solidity of a company, it is nevertheless critical that a stakeholder should be able to trust the reasonableness of the financial statements that have been given a clean audit report. Stakeholders should particularly be able to rely on the ability of the audited entity to continue as a 'going concern' i.e. be in a position to meet its obligations to its creditors in the foreseeable future.

There are other concerns related to the audit market, which are not just confined to PIEs but relate to the sphere of all entities requiring audits. These are quite specific to the Union and need to be addressed to improve the efficiency of the internal market:

- Today, auditors need to be **'approved' in all Member States** in which they want to carry out statutory audits. For natural persons, approval requires passing an aptitude test in each Member State in which they want to perform audits and thus entails bureaucracy as well as costs.
- Neither audit practice standards nor auditor oversight is harmonised in the Union nor is the latter indisputably independent from the audit profession in all Member States; the independence of oversight is compromised by the presence of practising auditors in the inspections of audit firms. In addition, the big divergence in the resources available at the national level lead to a patchwork of **non-homogenous** supervision and weak cooperation at the European level. Furthermore, applicable auditing standards are not adapted to the size of entities, in particular medium-sized companies.
- There is currently a restriction on the **ownership of audit firms** which prevents wide ownership by non-auditors and restricts the capacity of mid-size audit firms to grow.

3. SUBSIDIARITY AND PROPORTIONALITY

Current EU rules leave considerable discretion to Member States even after the adoption of the Statutory Audit Directive in 2006. This has resulted in important differences within the Union.

The considerable margin of discretion allowed to Member States in the domain of qualifications for statutory auditors alongside the heterogeneity in the supervisory arrangements across Member States call for concerted intervention at the level of the Union.

Moreover, the question of risks emanating from the current market configuration and the need for more firms at the upper end of the market have not been addressed in the current legal framework.

By its very nature, statutory audit is a requirement under EU law and to this extent any changes to address the main problems will have to be accomplished by means of legal instruments in the Union.

4. OBJECTIVES AND POLICY OPTIONS

Initiatives in the domain of audit would complement advances in other domains of financial regulation, such as: corporate governance, accounting and credit ratings.

General Objective of the changes in audit: 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 and meaningful information, at an acceptable cost, about the veracity of financial statements of companies.

The set of policy options on substantive requirements presented in this section aims at addressing the problems analysed above. The preferred options are highlighted in **bold**.

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

1.1 Options to improve the awareness of business preparers/market about the scope of audit generally.	
0.	Baseline scenario.
1.	Clarify and specify the scope of statutory audit in the EU rules (without enlarging it).
2.	Redefine the scope of statutory audit to fill the expectation gap: the auditors should carry out a rigorous examination of the "going concern" premise of an entity.
1.2 Options to improve the information that the auditor provides to users and audited entities (PIEs).	
0.	Baseline scenario.
1.	Improve and expand the audit report to provide more information to the public.
2.	A more detailed report for the audited entity itself (to audit committee and management).
3.	Improve communication between auditor and audit committee.
4.	Combination of options 1 to 3.
1.3 Options to improve the communication channels between auditors and supervisors of PIEs.	
0.	Baseline scenario: obligation to report breaches of rules in certain cases.
1.	Recommending regular dialogue between auditors and supervisors of PIEs.
2.	Requiring regular dialogue between auditors and supervisors of PIEs.

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 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.
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 <u>audited</u> entities.
3.	Pure audit firms: only allowed to conduct statutory audit and unconnected to firms providing non-audit services.
2.2 Options to reduce and mitigate the risk of any potential conflict of interest due to the existing system of "auditee selects and pays the auditor".	
0.	Baseline scenario: 'light' intervention of the audit committee in the appointment of auditors.
1.	Stricter rules in the procedure for the appointment of auditors with an increased role for a strengthened Audit Committee (at least two of its members must be independent and at least one should have knowledge about audit).

2.	Appointment of auditor by a third party (i.e. a regulator).
2.3 Options to reduce and mitigate the risk of any potential conflict of interest due to "familiarity threat".	
0.	Baseline scenario: only key audit partner rotates.
1.	Mandatory rotation of an audit firm after a certain period of engagement .
2.	Strengthening of the role of the audit committee in overseeing the work of the auditors.
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 the audit of PIEs with a view to increasing audit quality

3.1 Options to facilitate switching of an audit firm.	
0.	Baseline scenario: no requirement to tender for or engage a new auditor.
1.	Regular tendering. Audited entities would invite a minimum number of firms to participate in a tendering procedure, including a non-Big Four firm.
2.	Mandatory rotation of an audit firm after a certain period of engagement.
3.	Combination of options 1 and 2.
3.2 Options to facilitate an objective choice of an audit provider.	
0.	Baseline scenario. The reputation of Big Four audit firms will continue to deter the consideration and selection of alternatives.
1.	Prohibit contractual clauses between the audited entity and a third party (such as a bank) limiting the choice of audit firm.
2.	Increase transparency on audit quality (publication of inspection reports) and on audit firms (e.g. disclosure by firms of their financial statements).
3.	Establish a pan-European audit quality certification for auditors or firms meeting certain quality requirements that endorse their ability to carry out high quality statutory audits of PIEs.
4.	Combination of options 1 to 3.
3.3 Options to increase the choice of audit providers for PIEs.	
0.	Baseline scenario: Large PIEs remain restricted in their choice of audit firms.
1.1	Pure audit firms. PIE audits will be performed by firms that provide only audit services.
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 ones. Both audit firms will have joint responsibility for the audit.
1.3.	Mandatory joint audit applied only to large PIEs in the financial sector
1.4	Mandatory joint audit to all large PIEs conducted by pure audit firms
1.5	Mandatory joint audits applied to large PIEs in the financial sector conducted by pure

	audit firms
1.6.	Voluntary joint audit for all PIEs: creates incentives for audit providers and audited entities to use joint audit on a voluntary basis.
1.7	Voluntary joint audit for all PIEs by pure audit firms
2.	Lift restriction of ownership by non-auditors on audit firms, while maintaining safeguards of independence.
3.	Establish a ceiling of market shares (20%): regarding the statutory audit of large listed companies.
4.	Combination of options 1 and 2.

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

4.1 Options to facilitate the cross-border recognition of auditor competence.	
0.	Baseline scenario: auditors and audit firms should be approved in all Member States in which they want to carry out statutory audit.
1.	Mutual recognition by all Member States of audit firms approved in a Member State. The key audit partner leading the audit must be approved as an auditor in the concerned Member State.
2	Mutual recognition of statutory auditors approved in a Member State (for the cross-border provision of services).
3.	An adaptation period scheme with increased convergence, transparency and predictability in the aptitude test (in case of establishment).
4	Combination of options 1 to 3.
4.2 Options to streamline audit standards on practice, independence and internal control of audit firms across the EU.	
0.	Baseline scenario: auditing standards may differ according to Member States.
1.	Introduction of International Standards on Auditing (ISAs) across the EU. National additions would be acceptable, where necessary.
2.	Introduction of ISAs, allowing for Member States derogations.
4.3 Options to ensure that statutory audit is adapted to SMEs needs.	
0.	Baseline scenario: auditing standards apply irrespective of the size of the audited entity.
1.	Request Member States to ensure that a proportionate and simplified audit for SMEs is possible.
2.	Introduce limited reviews for SMEs instead of statutory audit.

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

5.1. Options to ensure independence and effectiveness of supervision of national statutory auditors and audit firms.	
0.	Baseline scenario. Audit profession closely involved through their professional bodies in audit supervisory matters.

1.	Establishment of an independent EU oversight authority responsible for the supervision of 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 established at the EU level, but supervision carried out nationally.
5.2 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. Group of experts (EGA OB) composed of representatives of national public oversight authorities and led by the Commission.
1.	Cooperation within a level-3 Lamfalussy-type committee. Independent legal status to the EGA OB which would decide on its own work, with the Commission as observer only.
2.	EU-wide cooperation on auditor supervision matters within ESMA (in cooperation with EBA and EIOPA).
3.	New European Authority of audit supervisors specifically devoted to the supervision of the audit market.

5. ASSESSMENT OF IMPACTS

Cumulative impact

The preferred policy options, taken together, will contribute to financial stability by securing the veracity of financial information through robust audits and meaningful audit reports. Complete independence, a key requirement for robust audits, will be delivered by a series of measures such as mandatory rotation of audit firms, the prohibition of the auditor from providing non-audit services to the audited entity (including a restructuring of auditors into pure audit firms). Moreover, such measures will create a healthier market with more firms gaining exposure and building reputation in the audit of large PIEs. The application of internationally recognised auditing standards and the removal of barriers to cross-border provision of audit services should lead to a more integrated European audit market. Any improvement to statutory audit would have to be accompanied by more independent and effective supervision across the Union including regular dialogue amongst supervisors themselves as well as between supervisors and auditors.

Economic impact

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 and Benefits

Measures such as the strengthening of audit committees, more extensive audit reports and a formal internal report, the tendering of audit services and the rotation of audit firms will entail additional costs for both, audited entities and audit firms. Even if it is difficult to present a reliable figure of total costs, the impact assessment shows that the incremental costs as a percentage of overall costs are capable of being absorbed by audited entities and audit firms alike.

In terms of benefits, also difficult to quantify, the proposals will enable higher quality audits and more confidence. More informative audit reports could lower the cost of capital. Audit rates may also decrease as more players will emerge at the top end of the market.

The restrictions on the provision of non audit services by auditors will create a level playing field for other service providers, mostly SMEs, e.g. lawyers, consultants, IT providers, tax advisors, etc. This more competitive environment should result in lower prices for companies buying such services.

There will also be direct recurring net benefits for the EU economy as a whole due to the introduction of common auditing standards at the level of the Union.

Social and environmental Impacts

Discussions at the European Economic and Social Committee have highlighted the importance of robust financial information with regard to the solidity of the entity from the perspective of employees. Although 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.

Administrative burden

There would be additional costs from tendering, rotation and joint audits both for audited entities as well as auditors. On the other hand, the removal of cross border obstacles and the introduction of common standards within the Union will reduce the current administrative burdens for the provision of audit in other Member States. Administrative burden for SMEs will also be reduced, not least because Member States will have to ensure a proportionate and simplified audit for SMEs.

Legal instruments, transposition and compliance aspects

The combination of a directive and a regulation will consolidate the improvements to the existing legislation and lay out a harmonised framework for critical changes.

Monitoring and evaluation

The monitoring and evaluation of the preferred policy options will be carried out in 3 steps: (1) a transposition/transitional period; (2) monitoring by the Commission, the national authorities and ESMA and (3) the evaluation of the policy, within a longer time horizon.