



CHECK AGAINST DELIVERY

European Parliament - Public Hearing of 27 March 2012

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HOW TO BEST IMPROVE THE QUALITY OF AUDIT?

Thank you, Mr Chairman

Let me start by thanking you for your invitation to FEE to speak at this important hearing.

To put my presentation into context, FEE is the Federation of European Accountants and represents 45 institutes of professional accountants and auditors from 33 European countries, including all of the 27 EU Member States. Consequently, I am not here to speak on behalf of any section of the profession but for the profession as a whole.

The debate on audit policy is important. Audit is a means to enhance integrity, transparency and sustainability in markets. At a time when we are all legitimately concerned by recession, strained public finances and social unrest, the European Parliament has an important opportunity to contribute to restoring trust and stability in the economy.

I have been asked to look at **'How the Quality of Audit can Best be Improved?'**.

The profession has long been committed to improving the quality of audits. We have recently produced a FEE Background Paper in which we highlight the efforts made to improve audits over the last 10 years. Over this period regulators, the profession and professional accountancy bodies have worked together to achieve this goal. Copies of our paper are available in the room.

We have made significant progress but there is still room for improvement with regard to quality, and this is part of the task that we have set ourselves. It is in this respect that we have expressed our concerns regarding the proposals put forward by the European Commission as we feel some are detrimental to audit quality.

This afternoon I would like to address some of the key drivers relating to the improvement of the quality of audit:

- The use of high quality international standards;

- The independence and expertise of auditors; and
- Auditor's reporting;

A major driver of quality in auditing is the quality of the standards by which audits are performed. International Standards on Auditing (ISAs) are **high quality auditing standards** which are developed using up-to-date best practice and are already used in over 100 countries worldwide. They enhance confidence in the reliability, comparability and consistency of financial statements.

The new ISAs address many issues arising from the financial crisis but, unfortunately, they have not yet been fully implemented in all European countries.

Therefore, we recommend that the European Parliament supports the European Commission proposal to adopt ISAs for all statutory audits in the European Union together with the related International Standard on Quality Control for audit firms.

The Commission rightly recognises the proportionality of ISAs for audits of Small and Medium-sized Entities. The European Parliament should, however, not accept a proposal which may result in 27 different solutions on the proportionate application of ISAs.

FEE is convinced that **independence and expertise** form the bedrock of an audit. Therefore, a similar step should be taken regarding independence as is being taken on auditing standards. We recommend that the European Parliament requires all EU auditors to apply the principles and requirements of the International Code of Ethics instead of the independence proposals of the Commission.

The international Code:

- Is developed by an independent Board comprising many regulators and external stakeholders
- Is robust for all auditors but even more stringent for public interest entity auditors;
- Is balanced and practicable for both business and auditors; and
- Is more stringent in some instances than the Commission's own proposals.

The European Commission proposals on:

- The introduction of pure audit firms;
- The requirement for mandatory rotation; and
- The total prohibition on the provision of non-audit services to public interest entity audit clients

will isolate Europe on the world stage, will increase administrative burden but, most importantly of all, will reduce the expertise and knowledge within audit firms. This latter point is against the interest of all stakeholders and should be avoided at all cost. It will make the profession less attractive to the high quality people we need to recruit and retain at a time when the work which an auditor undertakes becomes more demanding and more complex.

Similarly, by limiting so-called related financial audit services to 10% of the audit fee, the Commission's proposals go against many national supervisors' and regulators' demands for insightful and useful reporting from the statutory auditor.

Turning to **auditor reporting**, I believe we have an information gap rather than an expectation gap. Users of financial statements call for better and more extensive auditor reporting on the financial statement audit not more work. In my view, to provide more information would enhance the usefulness of the audit and thus leverage the quality of the audit. This also relates to reporting internally to those charged with governance and more can be done in this area.

Therefore, FEE recommends that the European Parliament supports the European Commission's idea to enhance auditor's public communication for public interest entities but improves the proposals to make them more practicable and useful. Currently there are a number of matters that are too prescriptive or too detailed. In addition, in relation to internal controls, the proposal is contrary to the agreed European position that auditors should not report on the effectiveness of internal control as prescribed in the Sarbanes Oxley Act in the United States.

When discussing reporting, an important principle should be kept in mind: the auditor is not an information provider (unlike Credit Rating Agencies); what auditors do is give assurance on the information provided. They therefore have secondary responsibility.

The primary responsibility to provide information – such as financial statement and going concern assumptions – belongs to management.

The auditor can be more explicit in the area of going concern but it must be based on the level of information provided by management.

The current international projects on auditor reporting should not be ignored by the European Parliament as global markets need global solutions. These projects take into account many of the matters raised by the Commission but in a more considered way.

It must be remembered that the quality of audit also depends on **high quality corporate governance and a high quality financial reporting framework**

- The audit is but one part of the reporting system;

- The auditor cannot fill in for the shortcomings in corporate governance and financial reporting which became apparent during the financial crisis;
- Auditors do, and should, take their share of the responsibility for improving the quality of audits;
- Therefore, a holistic approach to the whole corporate governance framework and financial reporting chain is the way forward.

Most of what will be discussed today relates to the proposed Regulation but we must not forget the Directive as there are a number of matters which could impair audit quality.

As I mentioned at the outset, professional accountancy bodies have played, and continue to play, a key role in helping small and medium sized practices enhance their expertise, methodologies, independence and professional discipline. In many Member States they also help, under the ultimate authority of the public oversight body, to control the quality of audit and audit firms.

These benefits risk being lost as the Directive excludes professional accountancy bodies from any activity other than the registration and approval of auditors.

Before closing let me summarise what I think will be essential in relation to our work:

- Auditors must communicate more and better, both internally to the client and externally. This is, from my perspective, a key aspect of improving both the quality and the usefulness of audit
- Both the company and the auditor should communicate more in relation to going concern
- Audit Committees need to play a bigger role in the reporting and governance process
- Europe should adopt ISAs for all audits
- Similarly, regarding auditor independence, Europe should rely on the International Code of Ethics; and
- Parliament should reject proposals for excessive and counter-productive regulatory intervention such as an absolute ban on non-audit services, breaking up of audit firms and mandatory rotation. This action would remove much valued and much needed knowledge and expertise from audit firms.

I have indicated the proposals that will improve the quality of audit but if we go the route of a significant number of the Commission's other proposals we may end up with more concentration in the audit market and a reduction in audit quality. This would definitely not be in the interest of society as a whole.

Thank you