

Briefing Paper

Standing for trust and integrity

June 2014



PUBLIC OVERSIGHT OF THE AUDIT PROFESSION: Enhancing Credibility and Supporting Cooperation

Background

In the context of the new European audit legislation, FEE seeks to provide an overview of the changes included in the updated European Union (EU) provisions regarding public oversight of statutory auditors and audit firms. These provisions are included in the two following pieces of legislation:

- The **Directive 2014/56/EU**¹ amending Directive 2006/43/EC² on statutory audits (2006 SAD) and containing a

Timing

Both the Directive and the Regulation were published in the Official Journal of the European Union on 27 May 2014 and came into force 20 days later on 16 June 2014.

The Directive needs to be transposed by the respective Member States into their national legislation in order to become effective. Member states will have two years after entry into force to adopt and publish the provisions to comply with the Directive, i.e. by 17 June 2016.

With regard to the Regulation, it technically already entered into force on 16 June 2014. Nevertheless, most provisions will be applicable as from 16 June 2016, which ties in with the implementation date of the Directive.

Both the Directive and Regulation introduce a number of new or modified options⁴ in relation to the public oversight of auditors. FEE is committed to informing the choice of Member States and competent authorities with the objective of enhancing

series of amended and new requirements governing every statutory audit in the European Union (hereafter referred to as “the Directive”);

- The **Regulation (EU) No 537/2014**³ containing additional requirements that relate specifically to statutory audits of Public Interest Entities (PIEs) in addition to the ones stated in the Directive (hereafter referred to as “the Regulation”).

consistency of application throughout the EU as much as possible.

The fundamentals for oversight of the audit profession at national level are carried forward from the 2006 Statutory Audit Directive (SAD) where every Member State of the EU was already required to organise a public audit oversight system and to designate a competent authority to be responsible for the execution of oversight. The new EU legislation brings this transition a step further.

FEE acknowledges the need to enhance independent national public oversight within each Member State. FEE also agrees that cooperation between national oversight bodies on a European and global scale, where possible, is essential to advance the internal market objectives and reinforce credibility and quality of the audit profession at a global level. Nevertheless, the involvement of all relevant stakeholders, especially experts, is paramount to ensure meaningful oversight that incorporates up-to-date knowledge, expertise and practice.

¹ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014L0056&from=EN>

² <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0043:20080321:EN:PDF>

³ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32014R0537&from=EN>

⁴ FEE has prepared tables summarising the options available in the Directive and Regulation :
http://www.fee.be/images/publications/auditing/Option_Table_-_Audit_Directive_2014.pdf
http://www.fee.be/images/publications/auditing/Option_Table_-_Audit_Regulation_2014.pdf

Competent authorities

Designation, tasks and powers

As from the 2006 SAD, the system of oversight is to be organised by each Member State, but the responsibility for oversight should be delegated to one or more competent authorities designated by law. The appointment of the competent authority(ies) must be communicated to the European Commission. Member States shall designate one specific competent authority bearing the ultimate responsibility.

Although the legislative text does not include requirements for the composition of the competent authority, FEE supports an oversight system that reflects a wide range of stakeholders and not merely government officials, such as representatives of business, regulators and shareholders who are knowledgeable in the areas relevant to statutory audit. In addition, as set out below, practitioners may be engaged to carry out specific tasks and may also be assisted by experts when this is essential for the proper fulfilment of its mission. FEE also supports the position that competent authorities should have adequate funding and resources to undertake their activities.

Designated competent authorities have ultimate responsibility for the oversight of:

- The approval and registration of auditors and audit firms;
- The adoption of standards (professional ethics, internal quality control of audit firms and auditing), except for the adoption of standards, where those standards are adopted or approved by other Member State authorities;
- The continuing education of auditors; and
- The quality assurance, investigative and administrative disciplinary systems⁵.

Tasks to be delegated to professional bodies

Member States may delegate, or allow competent authorities to delegate, any of their tasks to other bodies and authorities⁶.

According to the legislative text, specific criteria need to be met for this purpose:

- Conditions for delegation and tasks to be delegated should be specified;
- The issue of conflict of interest is to be addressed prior to the delegation;
- When the competent authority itself has effectively delegated, the competent authority shall be able to reclaim the delegated competences on a case by case basis when necessary.

The legislation provides for the delegation of certain oversight tasks from the competent authority to professional bodies. However, there are restrictions with regards to PIE audits⁷. Reference is made to the table below:

OVERSIGHT OF	non PIEs	PIEs
Approval and registration of statutory auditors and audit firms	may be delegated	may be delegated
Adoption of relevant standards	may be delegated	may be delegated
Continuing education	may be delegated	may be delegated
Quality assurance system	may be delegated	may NOT be delegated
Investigative and administrative disciplinary system	may be delegated	Member States are provided with an option to delegate the tasks related to sanctions and measures, but only to a body independent from the profession ⁸ .

This possibility to delegate certain tasks provides a level of flexibility to Member States and their competent authorities, which are best placed and sufficiently competent to make qualified judgements about the level of delegation that is appropriate to their own specific market conditions. It also

⁵ Directive, Article 32 (4)

⁶ Option available in Article 32 (4b) of the Directive

⁷ Option available in Article 24 (1) of the Regulation

⁸ Option available in Article 24 of the Regulation

Briefing Paper

enables competent authorities to operate more cost efficiently and helps ensure that these tasks are performed with the highest level of up-to-date experience and expertise while applying the criteria and conditions specified in the Directive and Regulation. FEE supports the application of this Member State option.

According to FEE, an appropriate balance between the need for independence from the audit profession and the skills and knowledge required for the task of supervising the audit profession should be sought.

A proper separation of powers according to the “trias politica” principle may be seen as another argument in favour of the delegation to professional or other bodies where the three powers of “legislation”, “investigation” and “sanctions” need to function independently.

According to the options available in Article 32 (4b) of the Directive and in Article 24 (1) of the Regulation, delegation of tasks is possible from competent authorities to professional bodies under certain conditions. FEE supports the use of this option as it allows for practical solutions focused on operational effectiveness and cost efficiency, whilst leveraging of the experience of the professional bodies and enabling proper separation of powers.

Involvement of experts and practitioners

The public oversight system must be independent from the auditors and audit firms and has to be governed by non practitioners who have thorough knowledge and expertise in the relevant areas. The Regulation specifies that all persons involved in the governance and decision making of the competent authority cannot, during their involvement or in the course of the three previous years⁹:

- Carry out statutory audits;
- Have voting rights in an audit firm;
- Have any membership of the administrative, management or supervisory body of an audit firm; and
- Have any contractual relationship with an audit firm (including being a partner or employee).

However, the option that allows Member States and competent authorities to consult experts and practitioners¹⁰ in some of the oversight tasks was retained from the 2006 SAD. Experts, including practitioners, may be contracted for certain tasks assigned to competent authorities, including certain oversight tasks for the auditors of PIEs, where delegation is not permitted for quality assurance review, investigations and disciplinary matters.

FEE encourages the implementation of this option by Member States and competent authorities: it will ensure that oversight bodies have an appropriate mechanism to set up expert groups. This will allow the oversight body to identify, assess and use relevant up-to-date expertise and experience from practitioners regarding the workings of the audit profession and the conduct of statutory audits. The involvement of experts and practitioners could be effected by creating an advisory committee to the supervisory body¹¹.

According to the option available in Article 32 (3) of the Directive, competent authorities may engage practitioners or contract experts when necessary under the condition that they are not involved in any decision making. FEE supports the use of this option.

In compliance with the option available in Article 24 (1) of the Regulation, delegation of tasks related to inspections of auditors of PIEs is not possible. Nevertheless, according to the option available in Article 21 of the Regulation, competent authorities may consult experts to carry out specific tasks. The use of this option would secure an appropriate mechanism to identify, assess and use relevant up-to-date expertise and experience from practitioners regarding the workings of the audit profession and the conduct of statutory audits.

⁹ Directive, Article 32 (4)

¹⁰ Options available in Article 32 (3) of the Directive and Article 21 of the Regulation

¹¹ Refer to the section on 'Cooperation and coordination of oversight activities at EU level' for further information.

Quality assurance

Quality assurance reviews (QAR) are one of the major elements of oversight. Every statutory auditor and audit firm has to undergo a QAR at least every six years (which is consistent with the 2006 SAD) and every three years for the auditors of PIEs. In addition, both the Directive¹² and Regulation¹³ require that QARs are performed more often if considered necessary by a “risk analysis”. Reviewers performing QAR need to comply with educational, experience and independence requirements¹⁴.

According to the Directive, the overall scope of the QAR, as well as the requirements placed upon the reviewers, should be appropriate and reflect the scale and complexity of the activity of the reviewed statutory auditor or audit firm, also taking into account the scale and complexity of the business of the audited entity¹⁵. FEE supports the adoption of appropriate proportionality measures in the design and application of QARs.

The Regulation refers to QARs as “inspections” and defines the term of “inspector” as a person contracted by the competent authority to perform the review¹⁶. The Regulation is stricter on the criteria for the appointment of inspectors, who, in addition to the requirements placed upon reviewers, cannot be practising statutory auditors or be associated with any statutory auditors or audit firm in any way. However,

competent authorities are given an option to contract experts for carrying out specific tasks for the inspections¹⁷.

According to the option available in Article 26 (5) of the Regulation, competent authorities may contract experts for carrying out specific tasks for inspection purposes. FEE supports the use of this option as it enables competent authorities to involve relevant up-to-date practical expertise relating to the application of accounting and auditing standards and experience from practitioners who use their professional judgement and comply with documentation requirements.

The Regulation defines the minimum scope of inspection as¹⁸:

- An assessment of the design of the internal quality control system of the statutory auditor or audit firm;
- Adequate compliance testing of procedures and review of audit files of PIEs in order to verify the effectiveness of the internal quality control system; and
- In the light of the findings from the above testing, an assessment of the content of the most recent annual transparency report.

Imposing sanctions

Type of sanctions and breach reporting mechanism

The matters of investigations and sanctions were briefly mentioned in the 2006 SAD: it was stated that Member States shall establish an effective system of penalties for statutory auditors and audit firms that do not perform the audit in accordance with all legal requirements, and that the system, as well as the penalties imposed, shall be made publicly available.

The Directive introduces detailed requirements on the sanctioning powers of the competent authority¹⁹. The competent authority should be provided with certain sanctioning powers,

which should be separated according to the “trias politica” principle, and at least the following²⁰:

- A notice requiring the natural or legal person responsible for the breach to cease such conduct and to abstain from any repetition of that conduct;
- A public statement, which indicates the person responsible and the nature of the breach, published on the website of the competent authorities²¹;
- A temporary prohibition of up to three years banning:
 - o The statutory auditor, the audit firm or the key audit partner from carrying out statutory audits and/or signing audit reports;

¹² Directive, Article 29 (1), (h)

¹³ Regulation, Article 26 (2)

¹⁴ Directive, Article 26 (2)

¹⁵ Directive, Article 29 (3)

¹⁶ Regulation, Article 26 (1)

¹⁷ Option available in Article 26 (5) of the Regulation

¹⁸ Regulation, Article 26 (6)

¹⁹ Directive, Articles 30, 30a-f

²⁰ Directive, Article 30a (1)

²¹ Refer to the section ‘Publication and Communication of sanctions’ for further information.

Briefing Paper

- o A member of an audit firm or a member of an administrative or management body of a PIE from exercising functions in audit firms or PIEs;
- A declaration that the audit report does not meet the EU requirements;
- Administrative pecuniary sanctions on natural and legal persons.

Member States have the option to add other sanctioning powers to the list above²².

When determining the level and type of a sanction, the competent authority should consider all relevant circumstances²³, including the gravity and duration of the breach, the degree of responsibility and the level of cooperation of the person involved. Every decision made by the competent authority in relation to sanctions can be subject to appeal²⁴.

To enable the competent authority to impose sanctions when needed, it is important that an effective mechanism for reporting breaches is established within each Member State.

Such mechanism should satisfy the following criteria²⁵:

- The reporting of breaches and the follow-up process should be executed in accordance with specifically defined procedures;
- Personal data of all persons involved in the process of reporting the breach are protected;
- The person accused of a breach must be enabled to execute the right to a defence and to be heard.

Specific procedures for reporting breaches via internal channels should also be established within audit firms²⁶.

Publication²⁷ and communication of sanctions

The information about the person responsible for the breach and the nature of the breach should be published on the competent authority's website as soon as possible and should remain available to the public for at least five years.

Sanctions, which are still subject to appeal, may be published based on permission from the Member State²⁸. The outcome of any appeal needs to be provided as soon as possible.

The competent authority should ensure that the publication of sanctions does not violate the right to respect private and family life and the right of protection of personal data²⁹. The information may be disclosed anonymously by application of the Member State option not to include personal data³⁰.

The annual overview of all sanctions imposed and administrative measures taken by the competent authority should be communicated to the Committee of European Auditing Oversight Bodies (CEAOB), which will include this information in its annual report. The imposition of a ban on a statutory auditor or the audit firm as described in the list of sanctioning powers above should be communicated to the CEAOB immediately³¹.

FEE recognises that the improved clarity in the provisions related to sanctions included in the Directive is a contribution to enhancing audit quality. However the implementation of additional Member State options should be very carefully considered.

Enhancing communication between auditors and competent authorities

The new audit reform adds further requirements for the communication between competent authorities and statutory auditors or audit firms carrying out the audit of PIEs³². The auditor must report to the competent authority immediately after becoming aware of information which could be connected to or lead to:

- The refusal to issue an audit opinion or the issuing of an adverse opinion;
- Material breaches of laws, regulations or other relevant legislative provisions;
- Threats to the going concern of the audited entity.

²² Option available in Article 30a (3) of the Directive

²³ Directive, Article 30b (1)

²⁴ Directive, Article 30d

²⁵ Directive, Article 30e (2)

²⁶ Directive, Article 30e (3)

²⁷ Directive, Article 30c

²⁸ Option available in Article 30c (1) of the Directive

²⁹ Refer to the 'Charter of Fundamental Rights of the European Union'

³⁰ Option available in Article 30 (3) and Article 30c (3) of the Directive

³¹ Directive, Article 30f

³² Regulation, Article 12

The competent authorities overseeing credit institutions and insurance undertakings and the auditors of these entities should establish an effective dialogue and share the responsibility to do so. In order to facilitate this dialogue, the EBA and the EIOPA should issue guidelines specific to the oversight of credit institutions and insurance undertakings.

The European Systemic Risk Board (ESRB) should be informed about all significant matters relating to systemically important financial institutions. The issues are to be communicated in a meeting with statutory auditors and audit firms of all global systemically important institutions. Such a meeting is to be organised by the ESRB together with the CEAOB.

In general terms FEE recognises the importance of developing communication and dialogue between auditors and competent authorities. The exchange of information should in principle, be in the form of a three-way communication between the competent authority, the auditor and the audited entity. There may however be cases where it might not be appropriate to involve the audited entity.

Greater communication and cooperation between auditors and competent authorities would not only result in improved audit quality, but also in more meaningful and efficient supervision carried out by the relevant competent authorities in the EU.

Cooperation and coordination of oversight activities at EU level

Currently, cooperation and coordination of oversight activities at EU level are ensured by one representative of each Member State participating in an EU discussion forum – the European Group of Auditors’ Oversight Bodies (EGAOB). The Regulation³³ provides for a new body to be established to ensure closer cooperation and harmonisation of oversight at EU level – the CEAOB.

Composition of the CEAOB

The competent authority of each Member State will appoint one representative as a Committee Member; one Member will also be nominated by the European Securities and Market Authority (ESMA), the latter having no voting rights. While the EGAOB is chaired by the European Commission, the CEAOB will be chaired by an elected representative of a Member State and vice chaired by a member appointed by the European Commission. The governance of the Committee will therefore be independent from the European Commission. The CEAOB may request assistance from ESMA, the European Banking Authority (EBA) or the European Insurance and Occupational Pensions Authority (EIOPA) when necessary.

Main tasks

The Committee ought to assume the existing role of the EGAOB and will be responsible for coordinating the activities of the national regulators, including the following coordinating activities³⁴:

- Facilitation of the exchange of information, expertise and best practices for the implementation of the Directive and Regulation;
- Providing expert advice to the Commission as well as to the competent authorities, at their request, on issues related to the implementation of the Directive and Regulation;
- Contribution to the technical assessment of public oversight systems of third countries and to the international cooperation between Member States and third countries in that area³⁵;
- Contribution to the improvement of cooperation mechanisms for the oversight of PIEs’ audit firms or the networks to which they belong;
- Contribution to the technical examination of International Standards on Auditing (ISAs), including the processes for their elaboration, with a view to their adoption at EU level.

³³ Regulation, Article 30

³⁴ Regulation, Article 30 (7)

³⁵ For additional information, refer to the FEE Factsheet on Cross-border audit oversight updated in June 2014: http://www.fee.be/images/Factsheet_Cross_border_audit_oversight_1406.pdf

Briefing Paper

The CEAOB may also adopt non-binding guidelines or opinions in order to enhance consistent application of the Directive and Regulation. These guidelines are to be published by the European Commission.

Since one of the goals of the audit reform is to move towards greater harmonisation across EU Member States, FEE welcomes the creation of the CEAOB as a dedicated independent committee responsible for the cooperation and coordination of the oversight of the audit profession.

Considering the activities of the CEAOB, FEE believes that the creation of subgroups or advisory bodies comprising a wider range of stakeholders including representatives of business, investors, the audit profession and regulators would be beneficial in a number of areas, especially regarding ISA adoption and other matters such as supervision coordination at international level.

Enhanced cooperation

The basis for cooperation between competent authorities of each Member State remains the same as in the 2006 SAD. The competent authorities of the Member States should cooperate with each other, where necessary, for the purpose of carrying out their oversight duties regarding statutory audits, mainly via the exchange of relevant information. A new Member State option allowing competent authorities to share confidential information with a number of other institutions³⁶, as long as it promotes the execution of their tasks, is introduced.

The cooperation should be enhanced, especially with regards to the quality assurance reviews, investigations and on site inspections. However, information which could adversely affect the sovereignty, security or public order of the requested Member State³⁷ does not have to be provided to the requesting competent authority. If a competent authority becomes aware of non-compliance with the Regulation of a statutory auditor or audit firm operating in a different Member State, the competent authority of the latter Member State should be alerted. Any investigations or on site inspections should be carried out under the authority of the competent authority of that Member

State in which the inspection takes place. Some personnel from different competent authorities may accompany the team charged with such investigation.

FEE believes that closer cooperation and sharing of information across Member States can contribute to more effective detection of breaches. Moreover, both the time and the resources invested in oversight can be saved. Increased dialogue between EU audit oversight bodies should be encouraged on a regular basis by exchange of views and experience regarding planning, performance and results of the oversight activities carried out.

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Colleges of competent authorities³⁸

A special form of cooperation as described by the Regulation is represented by colleges of competent authorities. A college can be described as a coalition of competent authorities from more than one Member State, representing a specific pan-European audit firm, established within the jurisdiction of a Member State participating in the college and registered in a number of Member States.

The colleges should be created upon a request submitted by competent authorities of Members States where the given statutory auditor, audit firm or a network operates. The request is submitted to the CEAOB.

A facilitator of the college is to be selected by its members within three weeks of its establishment and coordination agreements have to be specified within the next two weeks regarding the following³⁹:

³⁶ Competent authorities charged with oversight of PIs, the European System of Central Banks and the European Central Bank, in their capacity as monetary authorities, the European Systemic Risk Board (Option available in Article 36 (4a) of the Directive)

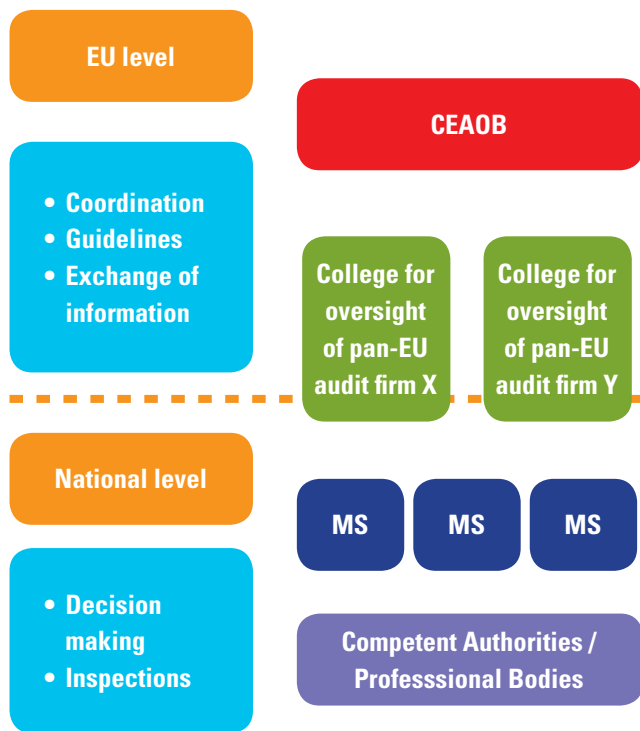
³⁷ Regulation, Article 31 (3)

³⁸ Regulation, Article 32

³⁹ Regulation, Article 32 (6)

- Information to be exchanged between competent authorities;
- Cases in which the competent authorities must consult each other;
- Cases in which the competent authorities may delegate their oversight tasks.

The following schema summarises the cooperation that will be put in place:



FEE recognises the benefits of oversight of pan-European auditors via colleges. Specialised colleges could facilitate the exchange of information, as well as the coordination of activities, such as on-site inspections.

Enhancing harmonisation of supervision at international level

Beyond what is required by the Regulation, greater cooperation at an international level – including with public oversight bodies outside the EU borders – should be promoted, especially through increased dialogue between the CEAOB and the International Forum of Independent Audit Regulators (IFIAR).

IFIAR⁴⁰ is an organisation of independent audit regulators whose members:

- Share knowledge and practical experience with a focus on inspections;
- Promote cooperation and consistency by updating each other on their work on issues related to current market conditions, including actions taken to focus their inspection activities and to issue guidance;
- Provide a platform for dialogue with other organisations interested in audit quality where views on audit quality, on structural risks of the audit market and on audit firm transparency and governance are exchanged.

Auditing is following the trend of globalisation and audit firms work increasingly in a global environment. FEE believes there is an increased need for consistent application of international auditing and quality control standards, as well as a closer dialogue and communication between independent public oversight bodies globally. These measures will enhance audit quality as well as the consistent monitoring thereof through the independent inspection process.

About FEE

FEE (Fédération des Experts-comptables Européens – Federation of European Accountants) is an international non-profit organisation based in Brussels that represents 47 institutes of professional accountants and auditors from 36 European countries, including all of the 28 EU member states.

FEE has a combined membership of more than 800,000 professional accountants, working in different capacities in public practice, small and large accountancy firms, businesses of all sizes, government and education – all of whom contribute to a more efficient, transparent and sustainable European economy.

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⁴⁰ <https://www.ifiar.org/Members.aspx>