Federation of European Accountants
Fédération des Experts comptables Européens

Background Paper

Standing for trust and integrity

March 2012

Improving the quality of audit: building on 10 years of lessons learnt

At the turn of the century, Enron, Worldcom, Parmalat and Ahold triggered a new wave of evolution in relation to the entire regulatory, financial reporting and corporate governance system. The accountancy profession recognised the seriousness of the questions raised about its role and undertook major efforts reflecting on and responding to the essential issues related to auditing practices.

Over the last 10 years, in conjunction with other stakeholders, including legislators and regulators, numerous actions have been taken by the accountancy profession to innovate auditing practices and to improve the quality of audits.

The future can only build on the past, therefore to further improve the quality of audit, it is important to consider the efforts made and lessons learned over the last 10 years. This short Background Paper sheds some light on recent developments that need to be understood to ensure future developments are relevant, effective and efficient.

The impact of the Statutory Audit Directive of 2006

It is crucial to note that, as a number of European Union (EU) Member States only transposed the Statutory Audit Directive of 2006 (2006/43/EC)[1] in 2010, it is too early for some of the benefits of these reforms to have fully materialised throughout the EU.

This was rightly highlighted by the European Parliament[2] in 2009. At that time, only 12 EU Member States had transposed the Directive in full. The introduction of a system of public oversight, the set-up of audit committees in public interest entities and the cooperation with third countries lagged behind. The "Doorn Report" very pertinently urged the European Commission to ensure immediate transposition and enforcement of the Directive in EU Member States and to adopt International Standards on Auditing (ISAs). The process was only completed in 2010; less than two years ago.

The performance of the audit and auditing standards

A major driver of the quality of audits are the standards by which the audits are performed. Consequently, the accountancy profession has put significant resources into improving the auditing standards over the past 10 years. It engaged with a wide range of stakeholders and invested heavily in global international auditing standards, as shown by the following events and notable actions:

- 10 years ago, less than 10 EU Member States[3] applied the International Standards on Auditing (ISAs) as published by the IAPC[4] of IFAC[5] in their statutory audits.
- In November 2001 FEE proposed that by 2005, EU national auditing standard setters should require auditors to perform ISA compliant audits for all companies subject to audit.
- The 2006 Statutory Audit Directive referred to ISAs but did not formally adopt them for use for all statutory audits in the EU, despite widespread support for this following a European Commission Consultation on the adoption of ISAs of June 2009[6].
- The IAASB[7] Clarity Project to incorporate latest best practice into the standards and to have more requirements than previously commenced in 2004 and was only completed in 2009. Consequently, auditors have only been using these clarified ISAs for audits of financial statements for periods commencing on or after 15 December 2009, i.e. for audits undertaken during the last two years. Some countries delayed this implementation and are, therefore, still to benefit from the improved standards.
- ISAs are commonly referred to as high quality auditing standards, enhancing confidence in the reliability, comparability and consistency of financial statements as well as the acceptance of audit reports. ISAs also address many issues arising from the financial crisis as reinforcing professional scepticism and requirements for group auditors and enhancing auditor's communication.
- Currently, 20 EU Member States apply ISA for all statutory audits in their jurisdiction. Many EU Member States which have adopted the ISAs for use in all their statutory audits have also adopted the International Standard on Quality Control 1 (ISQC1) "Quality control for firms that perform audits and reviews of historical financial information, and other assurance and related services engagements" which further encouraged the fundamental governance principles in audit firms.

As noted above, the clarified ISAs are still to be really embedded in practice as their earliest implementation was due for audits of financial statements for periods commencing on or after 15 December 2009. A few audit cycles will need to be completed and inspected before the real impact of the implementation of the clarified ISAs becomes tangible.

Quality assurance reviews and inspections

Another important driver of the quality of audits are quality assurance reviews. Therefore, to inspire public confidence, the accountancy profession established or, depending on the country, contributed significantly to the establishment of robust quality assurance systems for auditors as follows:

- FEE strongly supported the European Commission Recommendation on Quality Assurance of November 2000.
- Most, if not all, of the EU professional accountancy bodies already had, or introduced soon thereafter, quality assurance reviews with disciplinary consequences for their members.
- The Statutory Audit Directive of 2006 legislated the key elements of the EU Recommendation on Quality Assurance allowing for both 'monitoring reviews (undertaken by staff employed by the public oversight body)' and 'monitored peer reviews (organised and supervised by the public oversight body but undertaken by experienced and authorised practitioners of audit firms or statutory auditors)'.
- The December 2006 FEE Survey and Paper on "Quality Assurance Arrangements Across Europe" found that all countries surveyed except one had a system of external quality assurance in place that covered all audit firms or all statutory auditors.
- With this study, the profession demonstrated that it is fully committed to achieving consistent high quality in statutory audits in the public interest by well-functioning and effective systems of quality assurance.

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- The profession also supported the May 2008 European Commission Recommendation on 'External Quality Assurance for Statutory Auditors and Audit Firms Auditing Public Interest Entities', making quality assurance for public interest entity auditors more demanding and independent of the profession.

Ethical standards and independence of auditors and audit firms

Integrity, objectivity, ethical behaviour and independence underpin the audit. The accountancy profession has tirelessly worked to have practitioners comply with ever more stringent ethical and independence principles and requirements. It has also gradually increased the prohibition of the provision of certain non-audit services to especially public interest entity audit clients, while acknowledging for some the principle of materiality to the financial statements. Actions taken were as follows:

- In July 1998, a comprehensive paper on "Statutory Audit - Independence and Objectivity" was published by FEE. The paper advocated that the accountant must conscientiously consider whether the engagement involves threats which would, either in fact or in appearance, impede the observance of the fundamental principles which must always be observed. Where such threats exist, the professional should put safeguards in place that eliminate the threats or reduce them to clearly insignificant levels. This threats and safeguards approach prohibits relationships and situations, including the provision of non-audit services, which compromise auditors' objectivity.
- The profession's and professional accountancy bodies' commitment to the fundamental principles established by the Code of Ethics of the IFAC was re-affirmed when the Code was amended in November 2001. The Code outlined appropriate measures concerning integrity, objectivity and professional behaviour.
- In 2002, the European Commission published a Recommendation on Statutory Auditors' Independence, which applied this approach.
- The Statutory Audit Directive of 2006 embraced a principles-based threats and safeguards approach to independence issues, supplemented by some requirements, and legislated the key elements of the EU Recommendation on Independence.
- In March 2006, FEE issued a Survey on "Implementation of the EU Recommendation on Independence" which indicated that in 20 EU Member States the main principles and many other features of the EU Recommendation were implemented. The remainder of countries had their own local ethical and independence regulation.
- In the meantime, about one third of EU Member States or their professional accountancy bodies have adopted the IESBA[8] Code of Ethics of 2009.

Public oversight of the audit profession

One of the most important innovations in audit practice was the move from a self-regulated profession to a profession which is under the supervision of a public oversight system. This transition, largely supported by the profession itself and enabled by professional bodies, happened gradually, as follows:

- 10 years ago, only 10 of the EU Member States[9] had established a public oversight body supervising auditors and audit firms.
- This number had grown to about half of the 27 EU Member States[10] having set up such a body by the time the Statutory Audit Directive was issued mid 2006.
- FEE strongly supported public oversight bodies at EU Member State level which, while having the ultimate responsibility, allow for delegation to the profession. It was also considered important to have all stakeholders represented in a public oversight body whereby each of its members should be competent and knowledgeable in the areas relevant to auditing.
- Currently, all 27 EU Member States have established a public audit oversight body which takes at least ultimate responsibility for the education, qualification, quality assurance and disciplining of statutory auditors and audit firms as well as for relevant standard setting.

Governance of audit firms

Good governance of audit firms is another driver of the quality of audit. Recently, more attention was placed on this additional contributing factor and the implementation of such measures has started in some larger audit firms as well as in a limited number of EU Member States. However, the foundations for this have been laid, as follows:

- The 2006 Statutory Audit Directive did not include specific measures for audit firm governance but required the publication of transparency report by audit firms auditing public interest entities, which the profession supported.
- For audit firms auditing public interest entities, the accountancy profession agrees that additional financial transparency and enhanced internal governance could be envisaged, for example, the publication of financial statements of audit firms, a statutory audit of such financial statements, the appointment of independent directors in the board of an audit firm and embedding corporate governance principles in audit firms.

Qualification of auditors and audit firms

The education, qualification, approval, registration and continued professional development of statutory auditors are essential pillars to sustain the quality of audits. These matters were regulated by the Eighth Council Directive of 1984 regarding the approval of persons responsible for carrying out the statutory audits of accounting documents. The Statutory Audit Directive of 2006 updated and refined the qualification of statutory auditors and audit firms to incorporate best practice which had already been applied in the majority of EU Member States.

Conclusion

As can be seen, much has been achieved over the past 10 years. FEE is committed to continue supporting change and innovation that improve the profession's contribution to society. We believe that progress and effectiveness will be best ensured and harmful unintended consequences and disruptions will be best avoided by learning the lessons from the past and building on the *acquis* while continuing fostering a holistic modernisation of the whole governance and financial reporting system in the private and the public sector alike. In contrast the European Commission proposals fail to recognise that, firstly, more time is required to benefit fully from the changes already made and, secondly, the profession is continually driving ahead with change to improve the quality of audits. This will continue in the years to come.

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1 http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:2006L0043:20080321:EN:PDF
2 Report of Rapporteur Bert Doorn on the Implementation of the Statutory Audit Directive (2008/2247 (INI)) of 26 January 2009
3 Bulgaria, Cyprus, Finland, Hungary, Latvia, Romania, Slovak Republic and Slovenia
4 IAPC, the International Auditing Practices Committee
5 IFAC; the International Federation of Accountants
6 http://ec.europa.eu/internal_market/consultations/docs/2009/isa/consultation_ISAs_en.doc
7 International Auditing and Assurance Standards Board, an independent board under the auspices of IFAC setting the global standards for auditing
8 IESBA, the International Ethics Standards Board of Accountants, an independent board under the auspices of IFAC setting the global ethical and independence standards for auditors
9 Belgium, Denmark, Finland, Greece, Ireland, Italy, Malta, Spain, Sweden and United Kingdom
10 In addition to footnote 3: Austria, France, Germany and in October 2006, the Netherlands