FEE
Federation of European Accountants
Fédération des Experts comptables Européens

Briefing Paper
Standing for trust and integrity

June 2011

Future Supervision of the Audit Profession – Further Cooperation

Against the background of the financial crisis, all economic players need to assess, learn and see how they can contribute to economic stability. Auditors are expected to bring transparency and reliability in company reporting. How can the quality and sustainability of audit firms be ensured? Cooperation and harmonisation of supervision systems on a European and international level, where possible, is essential to advance the internal market objective and for public credibility.

FEE encourages further integration and cooperation of audit firm supervision at European level. FEE recommends that the EGAOB is transformed into a new Level 3 Committee to achieve much closer cooperation between national oversight authorities. FEE believes that this committee could also consider the establishment of colleges of audit oversight bodies for the oversight of pan-European audit firms whose registration also covers a number of EU Member States.

Current systems of public oversight

National supervision

Currently, the supervision of audit firms in the European Union (EU) is regulated by the Statutory Audit Directive of 17 May 2006[1] which mandates the EU Member States to set up a system of public oversight for auditors and audit firms. This national public oversight system is *ultimately responsible* for the oversight of auditors and audit firms, including their approval and registration, the adoption of standards relating to auditing, ethics, internal quality control of audit firms and external quality assurance, continuing education, the systems for conducting investigations and disciplinary measures. This public oversight system must be fully *independent* from the auditor and audit firm and has to be governed by non-auditors who have thorough knowledge and expertise in the area[2].

Although the public oversight system is *ultimately* responsible for the oversight of audit firms, it may delegate certain tasks, such as, for example, providing education, setting standards and conducting inspections to other organisations and institutions, which could be a professional accountancy body. This flexibility causes the organisation of supervision to differ significantly across the EU Member States. Even though there are differences from Member State to Member State, the new public oversight system instituted under the Statutory Audit Directive constituted a major improvement compared to the situation before the Directive. Previously, there was no requirement to have an independent public body being ultimately responsible for oversight of the audit profession, making the latter a self-regulated profession in a significant number of Member States.

Supervision under the Directive is based on the home country control principle, meaning that the Member States' authorities are best placed to judge according to their own specific market conditions. Inspections are thus conducted and decisions taken at national level.

European cooperation

Currently, co-operation and co-ordination of oversight activities at EU level are to be ensured by one entity in each Member State responsible for EU cooperation sending a representative to an EU discussion forum – the European Group on Auditors' Oversight Bodies (EGAOB). The EGAOB, under the responsibility of the European Commission, was established with the explicit aim of ensuring effective co-ordination of the new audit oversight systems by sharing knowledge and enhancing co-operation between its members with the aim of informing the Commission on possible regulation for implementing the Directive. However, in practice, its current primary role is to inform the Commission on the varying levels of participation of national Member State authorities and, therefore, does not result in promoting sufficient co-ordination of the national oversight and inspection activities. The implementation of its original mission could thus be greatly improved.

Supervision of pan-European audit firms?

The principle that a Member State is best placed to supervise its auditors and audit firms and that EU harmonisation can be enhanced by an EU forum – the EGAOB – where national cases are discussed with the purpose to issue guidelines and reach coordination is the correct approach. However, it does not provide supervision of audit firms and auditors working at a pan-

[1] Directive 2006/43/EC of the European Parliament and the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directives 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC.

[2] The Statutory Audit Directive foresees that a minority of practitioners in the governance of the oversight system is allowed in order to ensure the presence of expertise.

FEE • Av. d'Auderghem 22-28, 1040 Bruxelles • tel: +32 (0) 2 285 40 85
Fax: +32 (0) 2 231 11 12 • email: secretariat@fee.be

European level – audit firms registered in one country but working in several countries as one firm – which in a globalised world will increasingly be the case. Unfortunately, as a consequence of each oversight authority working independently, in the past year we have seen a national supervisory authority of one Member State evaluate an audit firm working at EU level positively where a national supervisory authority of another Member State evaluates the same audit firm negatively. It does not need further elaboration to say that similar outcomes are not only problematic for the credibility of national Member State authorities but also for public confidence in the system as a whole.

As it currently stands, no provisions for oversight of pan-European audit firms are available and, therefore, only harmonisation of supervision methods and activities at EU and ultimately, at international level, will be able to enhance public confidence permanently.

Enhancing harmonisation of supervision at EU level

The European Commission (EC), in its Green Paper on Audit Policy – Lessons from the Crisis, made several proposals for enhancing cooperation of audit supervision and achieving more integration and harmonisation, namely:

- Transform the existing EU forum with national representatives – the EGAOB - into a new so-called Level 3 Committee;
- Incorporate the EGAOB into one of the existing Level 3 Committees; or
- Create a new European supervisory authority where decision-making power is being transferred from the national to the EU level.

Comparison of existing institutional mechanisms at EU level

	Expert Group	**Level 3 Committee**	**EU Agency (Authority)**
Example	EGAOB	CESR	ESMA
Legal Entity	No	Yes (Member State law)	Yes (EU public law)
Created by	EC Decision	EC Decision	EU Council and Parliament Regulation
Funding	EC	Contribution from members and EC subsidy	Contribution from members, EC subsidy and fees
Role EC	Chair	Observer	Non-voting member
Role in regulation and standard setting	Advisory role on preparation of implementing measures	- Advise the EC on Directives and Regulations - Non-binding guidelines by consensus of members	- Delegated and Implementing acts endorsed by EC - Recommendations and Guidelines decided with Qualified Majority Voting
Role in supervision	Exchange of good practices	<u>In addition to Expert Group:</u> - Coordination - Mapping and peer reviews	<u>In addition to Level 3 Committee:</u> - Contributing to functioning of colleges of supervisors
Binding individual decisions	All decisions at Member State level	All decisions at Member State level	- Mediation - Registration and inspection at EU level with possible delegation of some powers to competent authorities for Credit Rating Agencies

New Level 3 Committee

The three existing Level 3 Committees today transformed into EU authorities ESMA[3], EBA[4] and EIOPA[5] are respectively responsible for the supervision of securities, banking and insurance companies. A new Level 3 Committee would be responsible for the supervision of audit firms. The most distinct difference of the current EGAOB with a Level 3 Committee is that the latter works fully independently from the Commission and the co-ordination of supervisory activities at EU level is achieved by discussing national cases, developing best practices/guidance on working methods and informing audit oversight bodies of experiences and decisions taken by others.

Transforming the EGAOB into a Level 3 Committee would thus imply that the EGAOB's original mission would receive the needed resources to be fully implemented and that effective coordination and harmonisation of oversight activities at EU level could be enhanced while maintaining the decision-making power at national level.

Incorporation into a European Supervisory Authority

As this transformation will require some time to install the new committee and will require new resources (financial and moreover technical), the option of incorporating the EGAOB in one of the European Supervisory Authorities was suggested. An existing authority might have an infrastructure in place but the possible synergies and benefits do not outweigh the shortcomings this proposition implies.

EBA and EIOPA only supervise banking and insurance companies while audit firms perform the audit of all companies within the scope of the Fourth and Seventh Directives. In addition, the three authorities focus primarily on

[3] European Securities and Markets Authority: http://www.esma.europa.eu/
[4] European Banking Authority: http://www.eba.europa.eu/
[5] European Insurance and Occupational Pensions Authority: https://eiopa.europa.eu/

listed companies and/or public interest entities. Consequently, this entails significant differences in the scope of supervision both with regard to the companies supervised and the areas of supervisory responsibilities.

In the case where audit oversight would be incorporated into ESMA, it is not certain whether audit oversight would receive the same attention as ESMA's current responsibilities such as investor protection, transparency and market surveillance. Moreover, there is a risk of a conflict of interest between the oversight of audit and the other supervisory responsibilities including the enforcement of International Financial Reporting Standards (IFRS), where auditors play a role of ensuring reliability and transparency of the financial statements.

The oversight of audit firms requires experts with up–to-date technical expertise and market knowledge and, as a consequence, the existing Level 3 Committee chosen will need to recruit such experts and would not be able to rely on its existing personnel. Realising synergies is therefore not as evident due to the specialist nature of audit oversight. Another concern is that, as ESMA focuses on listed entities, there would be the risk that the audit profession will be split up into first and second class auditors, namely those auditing public interest entities and those auditing other entities. This would be dangerously counterproductive as it would create additional barriers for the entry of smaller audit firms into the audit market of public interest entities.

A new European supervisory authority

A third option is creating a new European supervisory authority responsible for audit oversight at EU level. This authority would have decision-making powers compared to the national oversight bodies as before. However, it could still delegate operational work to the national level. Oversight and decisions would be fully harmonised by the supervisory authority. This option would allow for the EU oversight of the pan-European audit firms active in several Member States thus eliminating the risk of diverging inspection conclusions. The previous options of creating a new Level 3 Committee or incorporating audit supervision into an existing European supervisory Authority do not provide an ideal solution for this pan-European supervision problem.

However, there are some potential shortcomings. Would this European supervisory authority have a feeling for national circumstances in the case of audit firms working only at national level? Will valuable national experience not be lost? Should any European audit oversight focus only on public interest entities and leave oversight of Small and Medium-sized Practitioners (SMPs) and others to the Member States? Moreover, creating this new authority would need additional resources and may require some time to develop its operating model as it will probably need a lot of negotiations to transfer Member States' national powers to the supra-national level, to consolidate it in national legislation and to set up the authority itself.

A hybrid solution?

In the *short term*, the best option could be to create an efficient independent EU body consisting of national representatives with the mission of enhancing cooperation and harmonisation of audit supervision while leaving decision-making power at national level. Such a new independent EU body could be a Level 3 Committee (as CESR) or a European Supervisory Authority (as ESMA), as discussed above. For the sake of simplicity, the proposed FEE model refers to a "new Level 3 Committee" in which the recently established informal European Audit Inspection Group (EAIG) including most EU public oversight bodies could be integrated.

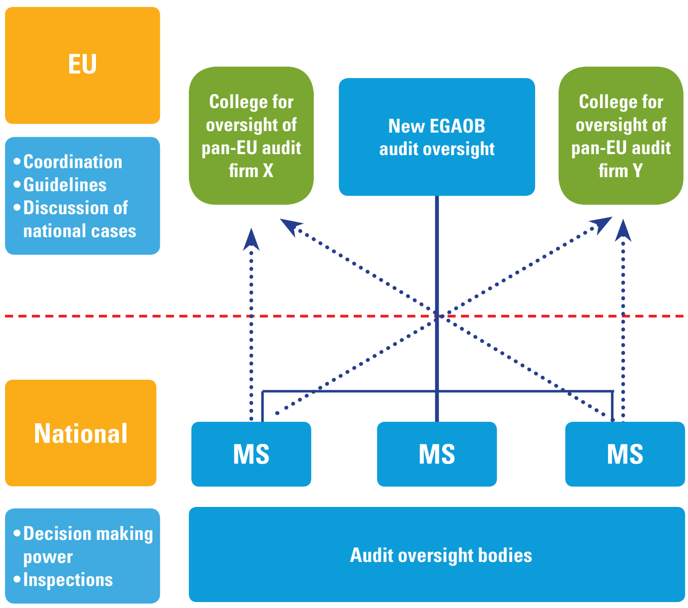
The supervision of audit firms working at pan-European level could be performed by 'colleges' for each pan-European audit firm, set up by the new Level 3 Committee, like the colleges of regulators informally established by the UK Audit Inspection Unit (AIU). The Colleges would consist of the supervisors of the Member States and would have the responsibility for:

- Planning and performing common inspections of their pan-European audit firms;
- Exchanging information and communicating each other's assessments of significance, risks and relevance;
- Promoting harmonisation of approaches, coordinating input to major supervisory decisions taken by individual authorities and drawing conclusions where appropriate;
- Coordinating the colleges' activities and establishing supervisory plans for the mitigation of risks.

Pan-European supervisory colleges can be found in ESMA (for credit rating agencies until mid 2011), and in EBA and EIOPA[6]. Structural differences between the entities they supervise and audit firms should be noted though.

The model is set out in the diagram below.

FEE Proposed Model



[6] http://www.eba.europa.eu/cebs/media/Publications/Other%20Publications/Supervisory%20Colleges/10-common-principles.pdf

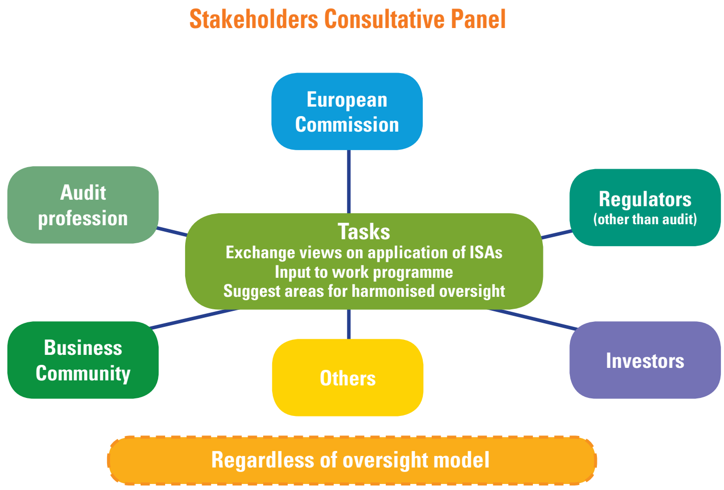
Briefing Paper

Confidence in a system of oversight is also dependent on the involvement of all relevant stakeholders. A *stakeholders consultative panel for audit oversight* where investors, regulators, audit regulators, business representatives, national audit standard setters, the European Commission, as well as the audit profession itself can

- exchange views regarding the application of auditing standards;
- suggest areas where harmonisation and coordination can be improved; and
- provide input into the work programme at EU level

would be beneficial and could operate under the newly established Level 3 Committee.

In the *long term*, a pan-European oversight authority with decision-making power - as discussed above - could be considered for the oversight of the pan-European audit firms replacing the 'Colleges' having no decision-making power.



Enhancing harmonisation of supervision at international level

Greater cooperation on international level – including with public oversight bodies outside the EU borders - should be promoted in the short term as well as in the long term. As auditing is expected to follow the globalising trends and audit firms are expected to work increasingly at international level and as only the consistent application of international auditing standards will ensure their effectiveness, there will be an increasing need for close supervision, cooperation and effective international audit oversight.

The Statutory Audit Directive foresees that the European Commission assesses and decides upon the *equivalence* and *mutual recognition* of third country public oversight systems. Member States may, however, assess the equivalence of each oversight system as long as the Commission has not taken such a decision. A unified approach is essential to avoid diverging outcomes. The Commission recognised the equivalence of the audit oversight systems in ten third countries in its January 2011 decision[7] enabling the possibility for the Member States to mutually rely on inspections of audit firms of and to exchange audit working papers with these countries.

With the current equivalence procedures and decision on mutual recognition being appropriate measures, on executive level, further cooperation could be enhanced through increased dialogue between the EU audit oversight bodies in the new Level 3 Committee and the International Forum of Independent Audit Regulators (IFIAR).

IFIAR[8] 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.

IFIAR is herewith an international forum already working in this respect and ready for increased cooperation. However, IFIAR is an organisation on a voluntary basis and has no decision-making power. Also, as not all EU Member States are a member and as the organisation sets its own rules and there are some restrictions on acquiring membership, fully enhanced cooperation through IFIAR is still not entirely workable for the EU in its entirety.

An organisation at international level equivalent to the new-to-establish Level 3 Committee at European level with all its powers and where all the appropriate countries are represented would be the envisioned forum for enhanced international cooperation on audit supervision, at which the new-to-establish European Level 3 Committee for audit oversight could represent the EU in its entirety.

About FEE

FEE (Fédération des Experts-comptables Européens - Federation of European Accountants) represents 45 professional institutes of accountants and auditors from 33 European countries, including all 27 EU Member States. In representing the profession, FEE recognises the public interest. FEE has a combined membership of more than 500.000 professional accountants working in different capacities in public practice, small and larger firms, business, public sector and education, who all contribute to a more efficient, transparent, and sustainable European economy. Based on the practical experience gained in this daily involvement in all aspects of the economy and the set of values underpinning the profession's practice, FEE believes it has a contribution to make in this public policy debate.

[7] Commission Decision of 19 January 2011 on the equivalence of certain third country public oversight, quality assurance, investigation and penalty systems for auditors and audit entities and a transitional period for audit activities of certain third country auditors and audit entities in the European Union.

[8] IFIAR members are independent of the audit profession, they are engaged in audit regulatory functions in the public interest and are responsible for the system of recurring inspections of audit firms auditing public interest entities. IFIAR currently has 37 members (countries) and 7 observers (organisations).