



Fédération des Experts
Comptables Européens

FEE POSITION ON THE PROPOSED AUDIT DIRECTIVE

17 November 2004

On 16 March 2004, the European Commission issued a proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and amending Council Directives 78/660/EEC and 83/349/EEC. FEE welcomes the opportunity to comment further in this paper on the proposed Directive and to draw the attention of the European Parliament, the EU Council and Commission on a limited number of outstanding issues requiring further discussion.

Executive Summary

FEE, the representative organisation for the accountancy profession in Europe supports the objectives of the European Commission to modernise the Eighth Directive and to harmonise further statutory audit in Europe.

The principle objectives of the draft Directive are to improve audit quality and restore public trust in the statutory audit process. FEE wholeheartedly supports these objectives and will continue to work with the European Institutions, national regulators and Member Bodies to achieve them.

FEE believes that the initial text of the Commission has been improved by the EU Council. However, further improvements are possible. The note develops proposals to:

- Omit the option to allow rotation of audit firms; (page 10)
- Establish the principle that statutory auditors must be appropriately responsible for their statutory audit but to no greater extent than is reasonable (page 11 and appendix 1)
- Recognise the need for a separate body to give effect to the cooperation between public oversight systems at Community level; (page 9 and appendix 3)
- Accept that it is unnecessary for Europe to develop a common audit report; (page 8)
- Delete disproportionate requirements related to audit documentation; (page 7)
- Revise the system of endorsement of International Standards on Auditing; (page 5)
- Acknowledge that ethics is not a suitable subject for comitology (page 7); however comitology is the best solution to implement the EC Recommendation on Statutory Auditors' Independence, which is the most appropriate way to achieve a European approach to this issue; (page 12)
- Progress should also be made in education requirements (appendix 2).

There is a separate FEE Discussion Paper on Mandatory Rotation of Audit Firms which is also attached.

FEE and its Action in the Areas Covered by the Directive

The Fédération des Experts Comptables Européens – the European Federation of Accountants (FEE) is the representative organisation for the accountancy profession in Europe. FEE's membership consists of 41 professional institutes of accountants from 29 countries. FEE Member Bodies represent more than 500.000 accountants in Europe. Roughly 45% of these accountants work in public practice, providing a wide range of services to clients. The other 55% work in various capacities in industry, commerce, government and education.

Auditing is central to the activities of FEE. Over the past years, FEE has developed a series of proposals aimed at enhancing trust in financial reporting for capital markets. It has made constructive suggestions to improve the quality of audit regulation and oversight. FEE has also been an active member of the EU Committee on Auditing. FEE published studies in the following areas, which Members of the European Parliament may download from the FEE website www.fee.be or receive on simple request:

- Statutory Auditors' Independence and Objectivity (1998-2001-2004)
- Mandatory Rotation of Audit Firms (2004)
- Proposed terms of reference for economic studies on liability and non-audit services (2004) (appendix 5)
- European Coordination of Public Oversight Mechanisms (2003)
- Education of Auditors (2003-2004)
- Auditing Standards and Audit Reports (1998-2000-2001)
- Free Movement of Auditors and Audit Firms in the EU (1998-2001)
- Continuous Quality Assurance (1998)

FEE remains committed to contributing the technical expertise of the audit profession to the European Institutions in order to ensure high-quality audit regulation in Europe. Therefore, FEE also commented on the proposed Directive in two documents:

- Policy paper “European Commission Proposed Directive on Statutory Audit of Annual Accounts and Consolidated Accounts” (31 March 2004)
- Proposed amendments to the proposed Directive on Statutory Audit (2 June 2004).

General Comments of FEE on Audit Regulation

The Eighth Company Law Directive 84/253/EEC of 10 April 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents deals primarily with the approval of statutory auditors in Member States. Although this Directive contains provisions on registration and professional integrity, it does not include requirements on how a statutory audit should be conducted and the degree of public oversight or external quality assurance which is needed to ensure high audit quality.

FEE welcomes the European Commission's initiative for a new Eighth Directive which is the result of a long reflection initiated by the Commission in its green paper on "the Role, Position and Liability of the Statutory Auditor in the EU" (1996). The objectives of a harmonisation of audit regulations have been extensively discussed in the EU Committee on Auditing which, in most areas, led to demanding solutions which enhance the credibility of statutory audit.

The EU Council is about to finalise its work on the proposed Eighth Directive and suggested amendments to the text of the European Commission. Most of these proposals effectively improve the proposals and are supported by FEE. On a limited number of issues however, FEE believes that further improvements are possible and in our view necessary. The profession is committed to pursue solutions that are best designed to deliver audit quality and we are convinced that our proposals will serve the public interest.

1. Global Standards Relevant to Audit

The general policy of FEE is to support global standards relevant to audit. The standard setting process needs appropriate arrangements to ensure that the resulting standards have widespread acceptance from political authorities, regulators, market participants and other stakeholders and are seen to be set in the public interest. Such arrangements have been proposed to guarantee the public interest in standard setting.

FEE welcomes the proposal by the European Commission to require the application of International Standards on Auditing and the possibility of a similar policy on professional ethics and education of statutory auditors.

Within Europe, in order to have consistent high quality of statutory audit, it is essential that Member States act within the common framework provided by the European Commission and do not diverge from European and global standards, except where there are specific national issues that need to be addressed. FEE welcomes the proposals made which prevent Member States introducing, even inadvertently, conflicting regulations with extraterritorial effect within the single market.

2. Transatlantic Dialogue

The European Commission's proposal to modernise the Eighth Directive takes place against a backdrop of high profile scandals on both sides of the Atlantic. This demonstrates the necessity to adopt global solutions. However, recognising the differences that exist between regulatory frameworks, it is equally important to organise an effective dialogue between European oversight bodies and similar bodies around the world.

FEE supports convergence of standards and cooperation between oversight bodies but emphasises the need to develop workable solutions avoiding conflicts of laws, which can only be addressed by legislators and regulators themselves.

3. Audit Quality and Oversight

FEE strongly supported the European Commission's Recommendation of 15 November 2000 that Member States establish robust quality assurance systems for auditors, as they inspire public confidence. The Recommendation was implemented in most EU countries, but not all. It provides that quality assurance systems should have adequate public oversight consisting of a sufficient number of non-practitioners on the oversight board. Incorporating key elements of this Recommendation into European legislation will help guarantee that the quality assurance system is seen to be carried out in accordance with common European benchmarks, thus supporting the single market and also dialogue with regulators in other jurisdictions.

The current lack of confidence is partly based on a public perception that a self-regulating profession runs a serious risk of conflicts of interests in dealing with its shortcomings. Therefore, a credible element of public oversight over the audit profession is crucial. The proposed Directive sets requirements as to the responsibilities of the oversight bodies, the required transparency and the necessity to provide for adequate funding.

FEE has long been calling for the creation of a European-level body to coordinate oversight arrangements at Member State level. Our proposals have been summarised in a discussion paper in 2003. Unfortunately, the proposed Directive lacks clarity regarding the effective organisation of the European coordination. It is imperative that this coordination body be visibly structured in the public interest and involve all stakeholders appropriately. A summary of FEE's views on how public oversight could be more effectively organised is set out in Appendix 2.

4. Proportionate Regulation

Audit is central to ensuring the credibility and reliability of financial reporting. Therefore, the profession agrees that this activity must be adequately regulated in the public interest and submitted to public oversight.

However, the European Parliament should also consider that audit is a service provided by accountancy firms working in an economic environment. Regulation must be proportionate and guarantee that the firms are able to provide good services to their clients, remain effectively viable and attractive for both young graduates and more experienced accountants contemplating a long-term career in auditing.

The proposed Directive covers many areas directly, or indirectly through comitology, including registration requirements, ethics, independence rules, auditing standards, audit reports, quality assurance, oversight arrangements and cooperation with foreign oversight bodies. Secondary legislation needs to be limited to what is necessary to achieve the objective, which is to provide audit quality in the public interest.

FEE Comments on the Initial Proposals of the Commission

A. ISSUES OF REMAINING CONCERN AFTER COUNCIL’S DISCUSSIONS TO DATE

FEE believes that further progress is possible on seven main areas, on which neither the initial proposal of the Commission nor the text disclosed on the EU Council website are entirely satisfactory. Our proposals are to:

- Revise the system of endorsement of International Standards on Auditing;
- Acknowledge that ethics is not a suitable subject for comitology;
- Delete non proportionate requirements related to audit documentation;
- Accept that it is unnecessary for Europe to develop a common audit report;
- Recognise the need for a separate body to give effect to the cooperation between public oversight systems at Community level;
- Omit the option to allow rotation of audit firms;
- Establish the principle that statutory auditors must be appropriately responsible for their statutory audit but to no greater extent than is reasonable.

1. Revise the system of endorsement of International Standards on Auditing (“ISAs”) (Articles 2 and 26)

Article 26.1 of the proposed Directive states *“Member States shall require statutory auditors and audit firms to carry out statutory audits in accordance with international auditing standards adopted by the Commission in accordance with the procedure referred to in Article 49 (2).”*

FEE welcomes the proposal to harmonise auditing standards in Europe by implementing ISA. In November 2001, FEE proposed that EU national auditing standard setters should require auditors to perform audits in compliance with ISAs. FEE suggested that ISAs could, where necessary, be supplemented by additional standards covering issues connected to the national regulatory framework but that other existing differences in audit standards should be gradually eliminated. The aim of FEE’s 2001 proposals was to reduce variations in auditing and audit reporting practice.

FEE has three concerns related with the European Commission’s proposals to implement International Standards on Auditing in Europe:

- Article 2 defines “International Auditing Standards” too widely. The reference to “related statements” gives the wrong impression that purely supplementary guidance material should also become part of law. Inclusion of such material in the law would reduce the speed with which new guidance could be prepared in response to emerging trends, and is not necessary for the enforcement of standards or for deciding in any subsequent proceedings whether a particular audit had complied with standards. *We suggest deletion of the words “ and related International Audit Practice Statements” in Article 2 (9) (2.10 in the Council’s document)*

<u>Article 2.9 of the proposed directive</u>	<u>Proposed amendment of Article 2.9</u>
"International auditing standards" means International Standards on Auditing (ISA) and related International Audit Practice Statements, in so far as relevant to the statutory audit;	"International auditing standards" means International Standards on Auditing (ISA) (...) in so far as relevant to the statutory audit;

- FEE has consistently favoured endorsement of ISAs as a whole or endorsement of the international standard setting process and fears that endorsement of individual standards could undermine consistent and uniform application of the global audit standards. International Standards on Auditing represent an audit methodology that must be considered and applied in its totality in order to be fully effective in providing high quality audits. It is therefore difficult to imagine that it is ideal for standards to be endorsed one by one, possibly with omissions or variations. Intervention in Europe, after the due process has been completed, clearly risks undermining global standards and public confidence in European auditing.

If, however, it is considered by the public authorities that some system for endorsement of individual ISAs is necessary, FEE considers that it should:

- give full weight to the existence of agreed public interest oversight of the standard setting process when implemented¹;
- operate on the rebuttable presumption that the standards should be endorsed without amendment;
- amend any standard before endorsement only in entirely exceptional circumstances where this is considered necessary in the public interest and, even then, only after first requesting that such proposed amendment be considered by the standard setter concerned.

FEE is ready to contribute to the evolution of such an endorsement system, if it is considered necessary.

We prefer, however, to suggest amending the first sentence of Article 26.2. to introduce the words “a set of” before international auditing standards.

<u>Article 26.2 of the proposed directive</u>	<u>Proposed amendment of Article 26.2</u>
Member States shall require statutory auditors and audit firms to carry out statutory audits in accordance with international auditing standards adopted by the Commission in accordance with the procedure referred to in Article 49 (2).	Member States shall require statutory auditors and audit firms to carry out statutory audits in accordance with a set of international auditing standards adopted by the Commission in accordance with the procedure referred to in Article 49 (2).

- FEE believes that Member States, or national standard setters, should not impose additional audit requirements which are not justified by their regulatory environment. It would not be appropriate for the internal market if one Member State were to regard its standards as superior to those of another. FEE supports the proposals of the Commission and advises the European Parliament to resist the unnecessary extension of additional requirements by national standard setters.

¹ Unanimously adopted by IFAC in November 2003 and with the support of worldwide regulators, the reforms (which are expected to be implemented soon after last reflections) include the following:

- the establishment of a Public Interest Oversight Board to oversee IFAC’s standard setting and compliance regimes;
- increased transparency with respect to IFAC governance and its international standard setting activities;
- broad-based public participation in IFAC standard setting activities; and
- a more formal process for maintaining ongoing dialogue with international regulators

2. Acknowledge that ethics is not a suitable subject for comitology (Article 21)

Article 21 of the proposed Directive deals with professional ethics. FEE supports the principle that Member States shall ensure that all statutory auditors and audit firms are subject to principles of professional ethics. The accountancy profession worldwide has been proactive in this area. The International Federation of Accountants has approved a Code of Ethics to which all its professional bodies, including all Member Bodies of FEE, have subscribed.

Ethical behaviour is governed by enduring general principles such as integrity, confidentiality, due care and professional competence. The ethical issues which may be encountered in professional practice do however evolve continuously in response to economic developments and social norms. The detailed elaboration of ethical guidance in the contemporary environment requires that codes of professional ethics are constantly reviewed and updated, so that in individual cases the necessary professional judgments can be made in conformity with the general principles of ethical behaviour. This approach not only supports members of the profession in upholding ethical requirements but also assists in applying disciplinary sanctions where necessary.

These considerations lead FEE to the view that the profession should continue to take responsibility under public oversight, to develop detailed ethical standards and codes in accordance with the general principles underlined above. FEE therefore considers that legislation by the application of the comitology procedure is not appropriate to deal with ethical judgements and requirements such as integrity, confidentiality, due care or professional competence. *For these reasons, FEE suggests deleting the second paragraph of Article 21.2 of the proposed Directive. (first sentence of the second paragraph in the text of Council)*

<u>Article 21.2 of the proposed directive</u>	<u>Proposed amendment of Article 21.2</u>
The Commission may adopt implementing measures on professional ethics, in accordance with the procedure referred to in Article 49 (2).	delete

3. Delete disproportionate requirements related to audit documentation (Article 27)

The initial proposal of the Commission required the group auditors to obtain and keep a full copy of all the documentation of the audit work performed by auditors of subsidiaries. FEE believes that only documents which are necessary to support the audit report at the level of the group should be maintained by the group auditors. This will indeed include documentation of their review of the audit work performed by other statutory auditors or audit firms on subsidiaries which are material to the consolidated financial statements. These issues are addressed in auditing standards, in particular ISA 600, which is under revision, with input from the European Commission.

FEE agrees that the group auditors should (and do) carry out a review and maintain documentation of their review of the audit work performed by other auditors for the purpose of the group audit (Paragraph (b)).

The EU Council of Ministers proposes to insert an additional paragraph (c); A very burdensome procedure would make the group auditors in all cases responsible for delivery of subsidiary audit documentation, which does not seem to be proportionate to the objective. Further, even if the auditor of the group has access to the working papers of the auditor of a subsidiary, he may not be authorised

to take copies of them. The EU Council’s proposal is not convincing because it does not clearly establish the essential principles.

FEE believes that if an additional paragraph (c) needs to be inserted, it should be substantially revised and apply the following principles:

- Management of the audited group should be required to make *reasonable efforts* to have each of its subsidiaries provide consent for access by the group auditors to the subsidiary auditors documentation concerning the subsidiary;
- The statutory auditors of the group should be required to make *reasonable efforts* to obtain from the audited company the authorisation to deliver documents in their possession as auditors to public oversight authorities;
- The statutory auditor should not be required to provide any further evidence of legal impediments to the delivery of documents when the audited company does not allow him to deliver such documents.
- Further, the group auditors should not have to establish any further procedures, including particulars of any legal impediments, in order to gain access to audit documentation unless specifically requested to do so by the oversight authority.

<u>Article 27 of the proposed directive</u>	<u>Proposed amendment of Article 27</u>
(c) when a component of the group is audited by an auditor or audit firm that is not approved in a Member State, the group auditor retains a copy of the documentation of the audit work performed by the other auditor or audit firm, including a copy of the audit working papers, solely for the purpose of the group audit.	(c) Management of the audited group must make reasonable efforts to have each of its subsidiaries provide consent for access by the group auditors to the subsidiary auditors documentation concerning the subsidiary.
	(d) <u>when a component of a group of undertakings is audited by auditor(s) or audit entity(ies) from a third country that has no co-operation agreement as referred to in Article 47, the group auditor must make reasonable efforts to obtain from the audited company, the authorisation to deliver documents in their possession as auditors to public oversight authorities.</u> <u>If the competent authorities require the group auditor, to pass the documentation from a third country retained by the group auditor the group auditor shall provide evidence of any legal or other impediments preventing audit working papers to be passed.</u>

4. Accept that it is unnecessary for Europe to develop a common audit report (Article 28)

Article 28.2. of the proposed Directive states: “The Commission may, in accordance with the procedure referred to in Article 49 (2) adopt a common standard audit report for annual or

consolidated accounts which have been prepared in accordance with approved International Accounting Standards.”

The substance of audit reports is already defined in the Fourth (Article 51a.) and Seventh (article 37.2.) Directives and if it requires amendment, this should be done through amendment of those Directives.

The format and other content of audit reports, which must evolve as standards and financial reporting change, is a matter for auditing standards dealt with in article 26. International Standard on Auditing 700 “The auditor’s Report on Financial Statements” already deals with the topic of audit reports on financial statements. Legislating for a common European audit report would represent a departure for the selected international standards on auditing, which must be applied in their totality to be effective. As ISAs develop, so will reporting practice. These are the reasons for leaving the matter to standard setters, operating under approved public oversight, rather than using rigid and detailed legislation.

Our understanding is that Article 26 of the proposed Directive provides for the necessary mechanism to influence the international auditing standard setter if needed. This additional power therefore seems a needless and undesirable duplication. If the Commission chooses to use this provision to develop a common audit report for Europe different from that in all other countries applying ISAs, users around the world may be confused as to the standards applied in the audit. It is surely quite unnecessary to envisage a separate European version of the audit report.

For these reasons, FEE suggests deletion of Article 28.2 of the proposed Directive.

<u>Article 28.2 of the proposed directive</u>	<u>Proposed amendment of Article 28.2</u>
The Commission may, in accordance with the procedure referred to in Article 49 (2) adopt a common standard audit report for annual or consolidated accounts which have been prepared in accordance with approved international accounting standards.	Delete

5. The need for a separate body to give effect to the cooperation between public oversight systems at Community level (Article 32)

We understand that there may be technical and legal reasons justifying why the Directive does not establish a separate body to give effect to the cooperation between Member States. However such a body would be a preferable solution. We would like the Commission, in the public interest, to make a formal commitment to establish such a body within a reasonably short period and preferably the Directive should be amended to require it. Pending this step, it is important to enhance the actual effectiveness and credibility of the oversight systems and guarantee that they are functioning consistently throughout the internal market. For this purpose the peer review system provided for in the last sentence of this Article should be fully transparent. In particular, the European Commission should report regularly on the results of this review.

We consider that implementation of effective oversight (and quality assurance) in each Member State is vital and any shortcomings in implementation will undermine the reforms throughout Europe, as recent scandals have shown.

For these reasons, FEE suggests the following amendment to the text of Article 32 of the proposed Directive:

<u>Article 32 of the proposed directive</u>	<u>Proposed amendment of Article 32</u>
<p>Member States shall ensure that regulatory arrangements for systems of public oversight enable effective cooperation at Community level between oversight activities of Member States. To that extent, Member States shall make one entity specifically responsible for ensuring the co-operation. Such cooperation shall include the possibility for a review of the system of public oversight of each Member State by other Member States.</p>	<p>Member States shall ensure that regulatory arrangements for systems of public oversight enable effective cooperation at Community level between oversight activities of Member States. To that extent, Member States shall make one entity specifically responsible for ensuring the co-operation. Such cooperation shall include the possibility for a review of the system of public oversight of each Member State by other Member States. The Commission shall ensure that an annual report on the result of this review is prepared and published.</p> <p>The Commission shall facilitate the establishment of a European body for the purpose of co-ordination of national public oversight systems with defined objectives limited to co-ordinating activities including co-ordination of investigations on cross-border audits.</p>

6. Omit the option for Member States to require rotation of audit firms additionally to rotation of partners (Article 40)

The proposed Directive, if adopted, would establish a special regime for public interest entities, including a requirement that the audit partner should be rotated periodically. The proposed Directive also includes the option for Member States to require audit firms to rotate within a maximum period of seven years.

A few countries in the world, such as Italy, already apply mandatory rotation of firms. The arguments in favour of mandatory audit firm rotation concern whether the independence of an audit firm is adversely affected by its long-term relationship with the client and the desire to retain the client. Concerns about the potential dangers of mandatory audit firm rotation include the risk to audit quality arising from the loss of company specific knowledge with each change of auditor. Many other countries have considered rotation of firms and concluded that the benefits for perceived independence can be achieved through other safeguards, such as partner rotation, quality control and proper oversight, which do not suffer the increased risk of audit failure when a firm’s knowledge of a client is discarded.

FEE conducted a study to review the most significant reports by governments, regulatory bodies and academics on this subject. The paper “Mandatory Rotation of Audit Firms” issued recently and which is attached, concludes that the overwhelming majority of studies from Italy, Spain, the UK, the US and Australia found that the mandatory rotation of firms inadvertently threatens audit quality.

Given the clear risks to uniform audit quality throughout group audits and to the important concept of the full responsibility of the group auditors (Article 27.a), FEE considers that the inclusion in the

proposed Directive of even the option of mandatory rotation of firms gives unwarranted credibility to the concept.

FEE strongly suggests that the European Parliament and the Council delete the proposed explicit member states option, which implies EU support for rotation of firms. This will not prevent any Member States where such a system exists, namely Italy, from retaining it if it wishes to do so, although it might provoke undesirable effects in the case of groups of companies with material subsidiaries subject to conflicting national rotation requirements.

For these reasons, FEE suggests deleting the words in the initial text of Article 40(c) “or alternatively, the audit firm shall rotation within a maximum period of 7 years”.

<u>Article 40 (c) of the proposed directive</u>	<u>Proposed amendment of Article 40 (c)</u>
(c) the statutory auditor or the key audit partner responsible for carrying out the statutory audit on behalf of the audit firm, shall rotate from the statutory audit engagement within a maximum period of five years, or alternatively, the audit firm shall rotate within a maximum period of seven years;	(c) the statutory auditor or the key audit partner responsible for carrying out the statutory audit on behalf of the audit firm, shall rotate from the statutory audit engagement within a maximum period of five years (...).

7. Establish the principle that statutory auditors must be appropriately responsible for their statutory audit but to no greater extent than is reasonable.

The European Commission acknowledged that auditors’ liability is an issue in its Communication of 21 May 2003 and announced that an analysis of the economic impact of auditors liability regimes should be carried out. No initiative has yet been taken in this respect. **The European Parliament should remind the European Commission of its public commitment to study this issue and to do so with adequate resources.** FEE is convinced that the economic study will demonstrate that there is indeed a problem in countries which have not taken appropriate measures to address the issue. (See appendix 4)

FEE believes that there are a number of solutions depending on the national liability system. Amongst others, proportionate liability and a legal cap on the damages (or a combination of these measures) are the most often considered solutions. **The European Parliament should request the European Commission as a matter of urgency to propose to the Council and European Parliament acceptable means by which the auditors’ liability issue could be addressed at Member State level.** Member states should also be encouraged to address the issue of liability and adopt measures to contribute to the solution of this problem.

Since a cap on liability exists in several Member States the Directive offers an opportunity to address the liability issue. A new article should establish the principle that statutory auditors must be appropriately responsible for their statutory audit but to no greater extent than is reasonable.

B. PROPOSED AMENDMENTS IN THE EU COUNCIL WHICH ARE SUPPORTED BY FEE

The working documents published on the EU Council website show that some articles have been substantially amended in Council's preparatory discussions. These amendments meet concerns previously expressed by the profession. FEE hopes that the European Parliament will accept the views of Council especially on five important aspects:

- Definition of public interest entities
- Merging of the chapters related to ethics and independence
- Confidentiality of information shared by public oversight bodies
- Disclosure of the circumstances connected to dismissal of auditors
- Oversight of public interest entities

1. Definition of public entities (Article 2)

FEE believes that the initial proposal of the European Commission is ambiguous. It should include banks, other financial institutions and insurance undertakings which are covered by other EC Directives.

Member States should be allowed to exempt smaller public interest entities from some requirements of chapter XII of the initial proposal which can be burdensome for them.

FEE supports the amendments introduced by the Council which amend article 2 and insert a new article 37.a. in the Directive.

2. Merging the chapters related to ethics and independence (Articles 21 to 29)

FEE agrees that the structure of the original proposal for the Directive would be improved if chapters IV and V related respectively to ethics and to independence are merged. As explained above (see p.7), our view is that applying comitology to ethical principles is undesirable. By contrast, the European Commission has approved a Recommendation on Statutory Auditor's Independence which is supported by FEE. The amendments proposed by Council are appropriate because they allow further development of the principles without diverging from the robust principles developed in this Recommendation.

However, FEE would have major reservations about considering Article 22 of the Directive concerning auditors' independence (or the provisions agreed upon under the comitology procedure) as minimum rules. Firstly this would not be consistent with the principles-based approach, which is the essence of this part of the Directive, and, secondly, this would undermine the single market approach, which lies at the basis of the proposed Directive. Additional comments on this issue may be provided later in view of the text proposed by the Council of Ministers.

FEE also welcomes the introduction of the word "significant" in article 23.2 (22.3 in Council's new numbering) which requires the auditor to document significant threats to his independence and related safeguards.

3. Confidentiality of information shared by public oversight bodies (Article 34)

As mentioned earlier, FEE fully supports increased cooperation between public oversight bodies. The difference between the national systems could however have consequences for the possible use of confidential information shared by oversight bodies.

FEE supports the Council's amendments requiring professional secrecy to apply to information exchanged between oversight bodies.

4. Dismissal of the auditor

The initial proposal required that the audited entity and the auditor inform the authorities about the dismissal or resignation of the auditor. FEE agrees that it is useful to prevent the audited company from putting the auditor under pressure or forcing out of office a strong auditor in difficult circumstances.

The Council clarified the text by saying that the information is required only when the dismissal or resignation takes place during the term of an appointment, which can be supported.

FEE, however, still suggests an indication that this information must be a written statement, setting out any circumstances connected with the dismissal or resignation that the auditor considers should be brought to the attention of the authorities. The statement should be a matter of public record and be brought to the attention of the shareholders.

5. Oversight of public interest entities (Article 42)

The initial proposal suggests that the public oversight body should be composed only of non-practitioners in the case of public interest entities. FEE believes that oversight bodies, to be effective, also need significant auditing expertise. This provides the oversight mechanism with a better insight into the working of the environment of the auditing profession. It is important that oversight mechanisms can be confident that proposals they make or decisions they implement will represent practical solutions to improve audit quality. Furthermore, the initial proposal of the Commission was not in line with legislative reforms introduced recently in several Member States.

FEE welcomes Council's proposal to delete article 42.

Appendix 1

Auditors' Liability

The proposal for a Directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts does not address the issue of auditors' liability.

Those who have studied the system of civil liability imposed on statutory auditors in many countries recognise that it is not fair that the damages claimed can far exceed any amount reasonably related to the consequences of unsatisfactory audit performance. Several countries in the EU (Germany, Austria, Greece, Italy, UK) and worldwide (Australia) have adopted or are discussing solutions to this problem.

We contend that reform is a major issue in the public interest. It is essential that auditors' liability fairly and reasonably relates to the consequences of unsatisfactory audit performance.

In order to perform high quality audits, the audit profession needs to attract and retain individuals of the highest personal qualities, able to address the many complexities of financial reporting and auditing. Such persons need to be able to understand properly the businesses which they are auditing and possess the personal qualities of integrity and character necessary to report with candour. Such individuals need to see in auditing the potential for an attractive career with opportunities for undertaking a variety of work and in a framework of reasonably balanced personal risk.

The European Commission acknowledged that auditors' liability is an issue in its Communication of 21 May 2003 and announced that an analysis of the economic impact of auditors' liability regimes should be carried out. No initiative has yet been taken in this respect. **The European Parliament should remind the European Commission of its public commitment to study this issue and to do so with adequate resources.** FEE is convinced that the economic study will demonstrate that there is indeed a problem in countries which have not taken appropriate measures to address the issue. (See appendix 4)

FEE believes that there are a number of solutions depending on the national liability system. Amongst others, proportionate liability and a legal cap on the damages (or a combination of these measures) are the most often considered solutions. **The European Parliament should request the European Commission as a matter of urgency to propose to the Council and European Parliament acceptable means by which the auditors' liability issue could be addressed at Member State level.** Member states should also be encouraged to address the issue of liability and adopt measures to contribute to the solution of this problem.

Since a cap on liability exists in several Member States the Directive offers an opportunity to address the liability issue. A new article should establish a principle that statutory auditors must be appropriately responsible for their statutory audit but to no greater extent than is reasonable

Such a general requirement should be introduced into the Directive. Being fully aware that individual Member States may prefer different solutions appropriate to their circumstances and legal frameworks, the article should be drafted so as to facilitate it. This approach would therefore lead to:

- urgent action by the Commission to propose acceptable and viable means of addressing the issue at Member State level, supplemented in due course by the outcome of the study;

all Member States addressing the issue by taking some specific measures, after due deliberation.

Appendix 2

Improving education requirements

The proposed Directive on Statutory Audit of Annual Accounts and Consolidated Accounts does not substantially amend the existing provisions of the Eighth Directive. There are very good reasons to believe that the existing Eighth Directive should be reviewed and substantially amended. The main reasons are:

- a) To fully recognise the substantial changes that have taken place since the Directive was originally drafted in ethical, financial reporting and auditing standards;
- b) To take full account of the convergence in these ethical, financial reporting and auditing standards and ensure that the Directive is robust in the light of any future changes;
- c) To take full account of the new education standards issued by the International Federation of Accountants and reflect the approach to curriculum content adopted by most professional bodies with a focus on the ability to perform the task and the roles expected of a statutory auditor rather than simply a list of topics. As mentioned in the Introduction to International Education Standards of IFAC (paragraph 15), “increased emphasis needs to be placed on a set of professional knowledge, professional skills, and professional values, ethics and attitudes broad enough to enable adaptation to constant change”.

FEE has proposed to redraft Articles 6, 7 and 8 as follows:

Article 6

A natural person may be approved to carry out statutory audits of the documents referred to in Article 1(1) only after having attained university entrance level, then completed a course of theoretical learning, undergone practical training and passed an assessment of professional competence and skills organised or recognised by the Member State. The learning and assessment must be at a level at least equivalent to a three-year university first degree; significant parts of the learning and assessment will be at second-degree level i.e. equivalent to more than a three-year university first degree.

Member States shall ensure that such approved persons also demonstrate the maintenance of these competences and skills through continuous professional development.

The further specification of these requirements is set out in Articles 7, 8, 9 and 10.

Article 7

The natural person approved to carry out statutory audits should be able to carry out a statutory audit of company or consolidated accounts according to laws, regulations and standards that are relevant to that audit.

The assessment of professional competence and skills referred to in Article 6 should evaluate the ability of the person being assessed to

- plan, perform and report on an audit of company or consolidated accounts in conformity with relevant laws, regulations, standards and professional codes of ethics

- understand how to account for transactions and other events in both legal entity and consolidated accounts of business enterprises according to relevant laws, regulations and standards
- understand the legal, taxation and business environment in which firms operate
- understand those aspects of strategic and business management, particularly financial management and information technology that are relevant to the audit of the company or consolidated accounts
- understand the processes, systems and controls of the business to the extent required to assess risks to the business and to the audit.

Article 8

The assessment should evaluate the ability of the person being assessed to

- apply relevant theoretical knowledge in practice and integrate knowledge and experience
- exercise the skills of analysis, evaluation, professional judgement and professional scepticism
- act in the public interest in accordance with relevant professional codes of ethics

A significant part of the assessment must be written (including computer based).

It should ensure that the person being assessed has knowledge sufficient for the performance of an audit in the areas of

Audit

- assurance engagement concepts, processes and management
- international standards and national laws, regulations and standards relating to the statutory auditing of accounting documents and to those carrying out such audits
- analysis and critical assessment of financial statements

Accounting and financial reporting

- financial accounting and reporting
- management accounting
- management control
- international standards and national laws, regulations and standards appropriate to the preparation of company and consolidated financial statements and to methods of valuing balance sheet items, of computing profits and losses, reporting cash flows and changes in equity.

The legal, taxation and business environment

- business and commercial law, civil law, the law of insolvency and similar procedures, and the fundamentals of the laws governing capital markets and employment
- business valuations
- taxation and its impact on financial and management decisions
- information technology
- business systems and controls
- organisational and business knowledge including
 - general and financial economics
 - corporate governance
 - management science (including quantitative methods)
 - organisational behaviour
 - financial management
 - international business and globalisation

A substantial part of the knowledge in the areas of audit and accounting and financial reporting must be at second-degree level. The other parts will be at a level at least equivalent to a three-year university degree.

Appendix 3

Coordination of Public Oversight Mechanisms

In November 2003, FEE published a discussion paper on “European Coordination of Public Oversight”. The following objectives were proposed concerning institutional aspects of the coordination:

“An agreement on principles for public oversight should be reached at EU level. To make the national systems effective and fully recognised in the internal market and internationally, these arrangements should be appropriately co-ordinated.

FEE considers that in the medium term, such co-ordination of EU public oversight co-ordination can only be fully effective if legally established; for example an organisation could be formed under law for this purpose. For convenience, in the remainder of this paper we will refer to it as the European Co-ordination Audit Oversight Board (ECAOB).

If public oversight is to be fully effective, it is necessary to think about the sanctions that should be taken against any Member State which does not implement in time the European principles and benchmarks. For example, the failure to implement a directive could result in an action before the European Court of Justice in the case of an apparent breach of Community law (art. 226 of the Treaty).”

Differences in legislation in the European Member States mean that the organisation of the public oversight structure will be most effective when organised at national rather than at European level. Other reasons may be found in the characteristics of the different national environments within the EU (such as scope of the oversight systems, legal regime of sanctions, and different languages). However, in order to ensure that oversight mechanisms are indeed equally effective throughout the single market, the essential principles and scope of oversight activities should be established by common European principles and benchmarks. Oversight of statutory auditors needs to be of equivalent quality throughout Europe even if institutional arrangements may vary between Member States.

FEE recommends the establishment of a privately organised body with delegated powers to perform well-defined co-ordination functions on oversight activities. The responsibilities of this body should be clearly defined. It should be enabled to exercise the limited agreed co-ordination functions including the assessment of the work of national systems but also the co-ordination of investigations on cross-border audits.

The European Co-ordination Audit Oversight Board (ECAOB) should meet criteria such as:

- Be visibly structured in the public interest
- Involve all stakeholders appropriately
- Be able to exercise the limited agreed co-ordination functions effectively
- Be credible to other oversight bodies

It should also:

- Be established as a legal entity to build confidence
- Be recognised in national laws in due course
- Be quickly established – if necessary on an interim basis
- Have a small secretariat

Even if an interim solution using an EC Committee with appropriate stakeholder involvement is likely to be necessary, FEE recommended another solution in the medium term:

- A privately organised body with delegated powers to perform well-defined co-ordination functions
- All stakeholders (national oversight mechanisms, CESR, profession, others but not EU Commission) as shareholders – general assembly
- A supervisory board to monitor its funding, administration and discharge of its functions
- A relatively small board to exercise the co-ordination functions
- Board members nominated by stakeholders with selection by independent appointment panel of persons of high public standing
- Board membership – a part time role

Appendix 4

DRAFT TERMS OF REFERENCE FOR EU STUDY OF ECONOMIC IMPACT OF THE ALTERNATIVE AUDITOR LIABILITY REGIMES

To undertake a detailed examination of the economic impact:

- of unlimited auditor liability on the auditing market and on wider economic sectors

Explanation: The key issue here is not simply to look at the auditing market (as this might be perceived as primarily of interest to auditors) but also to widen the scope to look at impact on other economic sectors.

- and of alternative options including unlimited auditor liability excluding catastrophic liability, liability limited as a proportionate basis and limited liability up to a specified amount.

Explanation The key here is to ensure that alternative options are evaluated.

The study should:

- Define the nature of the audit services under review taking account of the fact that the scope of the audit may vary between countries. If alternative definitions alter the assessment of the economic impact this should be specified.

Explanation It is important for comparative purposes to understand any differences in the nature of audit services provided.

- Assess the liability risk for the financial position of audit firms, whether incorporated or not, in a company (or partnership) with or without limited liability, taking into account the effects of different liabilities of different players in the financial reporting and economic supply chain.

Explanation The liability risk is at the core of this study and assessing this risk for different types of practices in different environments is essential.

- Examine whether there would be any difference in audit quality in a scenario where there was unlimited liability on auditors compared to a scenario where auditors were liable only on a proportionate basis or there was a cap set on auditor liability. This analysis should take account of any potential impacts of alternative liability regimes on individuals entering the profession.

Explanation As the intention is to uphold the quality of audits, it is essential to examine objectively the validity or otherwise of the contention that unlimited liability is a driver of audit quality.

- Consider whether an economic analysis of auditors' liability needs to operate a segmentation of the audit market (for instance "listed and non listed companies" or "large audit networks, second tier networks and smaller audit firms operating in a pure national environment") or type of information on which assurance is provided.

Explanation This task is needed as the impact of alternative liability regimes may vary between different segments of the auditor market.

- Identify any constraints which the auditing profession faces in obtaining insurance cover for very large and catastrophic loss, considering the evolution of the claims in number and in size and the extent of any withdrawal of insurance companies in the market.

Explanation The focus of this is to identify any constraints which the auditing profession faces. If this was not examined important issues impacting on implementation would be missed.

- Review the trend in the costs of, and availability of, insurance cover for very large and catastrophic loss in the auditor profession.

Explanation The issue of availability of insurance cover is clearly important but even more important is at what cost. This is what this bullet point is focused on.

- Examine the extent to which liability requirements represents a barrier to entry in the auditing market (at EU or Member State level).

Explanation Barriers to entry are of interest to Competition Authorities throughout the EU and elsewhere as well as to the European Commission. Increasing barriers to entry reduces numbers and increase costs.

- Examine the economic impact on new entrants and exits, on recruitment and retention of staff and partners, and on audit quality in the auditing professions of alternative options in relation to auditor liability.

Explanation The main issue here concerns the impact on new entrants and exits. The quality of people carrying out statutory audit is important to respond to the market needs. Opinion outside the profession may be divided on whether liability issues would dramatically impact on recruitment but this would need to be examined.

- Assess how the impact on market access and concentration should be modelled.

Explanation The extent of concentration in the sector could be influenced by proposals. Concentration is a key aspect of the structure of the market and impacts on performance and on prices.

- Evaluate the impact on the sector, on the investors' position and on the economy of changes in auditor liability (for instance the introduction or maintenance of a cap on liability) including estimates of impact on the cost of auditing, on investment and on GNP.

Explanation This is attempting to ensure the study covers all the key economic impacts.

**DRAFT TERMS OF REFERENCE FOR EU STUDY OF THE ECONOMIC IMPACT
OF ALTERNATIVE OPTIONS FOR THE AUDITING PROFESSION RE THE
PROVISION OF ADDITIONAL SERVICES**

To undertake a detailed examination of the economic impact of alternative options in relation to the scope of services provided by auditors in EU countries to their audit clients and taking account of safeguards in the corporate governance structure. This examination should consider the alternative options including the authorisation of non audit services (to the extent allowed by the principle of independence) to the total prohibition of these non-audit services.

***Explanation** The main focus of this section is to ensure that all relevant alternatives are examined.*

The study should inter alia:

- Examine the experience of countries which have implemented different approaches in relation to the services permitted to be provided by auditors and the impact on cost and audit quality.

***Explanation** Examining the experience of countries who have implemented different approaches is of key importance.*

- Quantify the significance in terms of value and employment of auditor involvement in non-audit services and the impact of restrictions on employment and on the cost of non-audit services.

***Explanation** This element is essential in evaluating the impact of any changes both on the sector and also on the cost of non-audit services. The latter is a key public policy issue.*

- Identify what share of the market auditors hold of non-audit services in different EU countries, considering the different categories of non-audit services other than audit related services and the size of audit firms wherever relevant.

***Explanation** This is designed to consider how the impact would vary between EU countries and between different sized audit practices.*

- Examine the impact on competition of alternative options in relation to restricting auditor involvement in providing services; an analysis of the impact on SMEs should also be undertaken.

***Explanation** Competition is the key potential problem with restricting auditor services. This is the focus of this point.*

- Examine the likely implications for the price for EU business consumers of alternative restrictions on non-audit services.

***Explanation** The price impact is the most important potential impact which needs to be examined.*

- Examine the overall economic impact of alternative options including all services allowed under certain conditions and all services prohibited.

Explanation *This bullet point is focused on considering wider economic impacts of all key options.*