Federation of European Accountants
Fédération des Experts comptables Européens

**To:**

**Co-legislators and other interested parties on Audit Reform Proposals**

Lithuanian Presidency Representatives
EU Member-State Representatives
Members of the European Parliament
European Commission Representatives

8 November 2013

**Ref: AUD/AKI/HBL/NRO**

Dear Sir or Madam,

**Re: Trialogue on Audit Reform Proposals**[1]

The co-legislators have made good progress on the audit proposals of the European Commission. Arriving at a workable and good quality compromise and finalising this dossier in the current legislature is now important. There has been significant uncertainty which has hampered planning and investment in an important sector of the economy that also provides significant employment opportunities.

Therefore, we are writing ahead of these strategic decisions to ensure that *some of the current proposals do not significantly harm the internal market and increase administrative burdens as in many instances they will be difficult to apply in practice.*

In this respect, we have included below our most significant concerns.

**A black list of prohibited non-audit services for statutory auditors is the right approach insofar as it is unambiguous, coordinated and internationally workable**

We are in favour of the black list approach for the prohibition of non-audit services that would pose a significant threat to auditors' independence and for which no safeguards exist. However to be workable such a list should be coordinated internationally. We

[1] European Commission (EC) proposed Regulation on statutory audits of Public Interest Entities and EC proposed Directive on statutory audits of annual accounts and consolidated accounts

therefore recommend incorporating the IESBA's list of prohibited non-audit services[2] into the proposed Regulation on specific requirements regarding statutory audit of public-interest entities (PIEs), not in the least as the content of this list is broadly in line with the proposals already made by the European Parliament's committee on legal affairs (JURI).

A "European list" could have negative extraterritorial impacts; a list to which each Member State can add may seem acceptable for the sake of achieving a political compromise but would lead to 28 unmanageable lists. Such gold-plating would preclude any level playing field, would add cost to European business and audit firms and go against economic recovery and the political objective of smart regulation. In addition, the administrative burden on audit firms to comply with such a patchwork of requirements will be disproportionate to their size.

It is striking and worrying that the use of a Regulation as a legal instrument will not lead to harmonisation but its exact opposite.

**The concept of materiality to financial statements will make the prohibitions more relevant and workable in real life**

Furthermore it should be noted that the IESBA's list of prohibited non-audit services is divided into two parts: those services that are always prohibited and those that are only prohibited if they are material to the financial statements.

We are convinced that this reference to materiality strikes the right balance between the importance of safeguarding independence and the undesirability of placing excessive restrictions on the provision of non-audit services.

For example, the auditor of a subsidiary in a small third country of an EU registered multinational might be requested locally to provide a prohibited service for a minimal fee so that the subsidiary can meet certain local deadlines. Without building in the concept of materiality to the financial statements for certain prohibitions (see below), this would necessitate the group auditor of the multinational to resign from the group audit, even if that were a few days before the expected issuance of the audit report on the group financial statements

We strongly recommend, therefore, that in Article 10, non-audit services like: the calculation of direct and indirect tax and deferred tax for the purpose of preparing accounting entries; the provision of tax advice where the effectiveness of the tax advice depends on a particular accounting treatment or presentation in the financial statements; and acting in an advocacy role in the resolution of litigation, be prohibited only if they are material to a company's or a group's financial statements.

[2] International Ethics Standards Board for Accountants (IESBA) – in particular section 290 on independence requirements: **http://www.ifac.org/sites/default/files/publications/files/IESBA%20High%20Level%20Summary%20of%20Prohibitions-Updated.pdf**

**A cap on non-audit services will add little to independence but much to administrative burdens**

We agree with JURI that the provision to PIEs of non-audit services other than those prohibited should not be restricted by means of an arbitrary cap. We believe that it would be rather difficult to reconcile any such cap with the proposed black list approach. In addition, the management of the cap will add to administrative burdens and legal uncertainty and will hamper the needs of business.

We remain convinced that those charged with governance within the audited entity – including the audit committee – are best placed to set appropriate policies regarding the purchase of authorised non-audit services from the statutory auditor or another provider.

**Legal certainty need to be ensured**

The provisions of the proposed Regulation must be clear and unequivocal: practitioners should be left in no doubt about the definition or scope of prohibited non-audit services.

We are of the opinion that proposing to prohibit for instance 'corporate finance services' is insufficiently precise and would thus be a source of legal uncertainty. We recommend instead that the proposed article be adapted in a way that incorporates the wording in the IESBA's list of prohibited services:

> 'Tax or corporate-finance advice that depends on a particular accounting treatment or financial-statement presentation with respect to which there is a reasonable doubt as to its appropriateness.'

Similarly, we believe that the clarity of proposing to prohibit 'services that involve playing *any part in the management or decision-making process* of the audited entity' would be significantly enhanced by the inclusion of the IESBA's wording:

> 'Assuming a management responsibility'.

Finally, we are concerned about potentially conflicting European Commission requirements for the involvement of statutory auditors with EU subsidies, grant claims or funds. Within the Seventh Framework Programme (FP7), it is explicitly permitted that the statutory auditor delivers the certificate on the financial statements and methodology for FP7 EU research funds. Therefore, prohibiting the statutory auditor from providing any service related to public subsidies in the black list of prohibited non-audit services goes against other requirements set by the European Commission.

**Auditor reporting needs to be enhanced with the needs of global markets and SMEs in mind**

We support EU Member States' efforts to require significant additional information on *key risks* and *going concern* in the public auditor reporting of all entities. FEE agrees with the overall objective to develop public auditor reports that are more informative and easier to understand but we have concerns, especially over required key risk reporting for SMEs.

However, there are impediments that will make these requirements impracticable:

- Internationally compatible solutions are required, especially in the light of the expected European adoption of the International Standards on Auditing (ISAs) as issued by the IAASB. However, in the upcoming IAASB audit report standard[3], additional information on *key risks* is not expected to be required for all entities, but only for listed (or public interest) entities.

- The obligation to set up an audit committee and thus the additional report to the audit committee will only apply to PIEs. For non-PIEs, the auditor would have to formally report to the public matters that would not have formed part of the required reporting to those charged with governance, for instance on the *key risks*. This is not only a worrying contradiction, it is also an additional burden on SMEs potentially further impeding their competitiveness.

- The auditor is well placed to give a view regarding conclusions drawn *in respect of management's use of the going concern assumption as included by management in the entity's financial statements*. However the audit report by itself cannot be an indication for an investor on whether a particular entity will continue as a going concern. Indeed, the auditor should not be 'assuming a management responsibility' which should be a prohibited service as a part of the black list (see above).

**Allowing Member States to set different periodicity for mandatory rotation of audit firms will severely fragment the internal market and will be unreasonably costly to operate in practice**

Views diverge on the principle, scope and frequency of mandatory rotation of audit firms for PIEs and we shall not comment on these aspects, however FEE has serious practical concerns about allowing a political agreement that would enable EU Member States to 'set a maximum duration of less than the maximum duration'. This will dangerously fragment the internal market: as Member States may set different durations and generate significant administrative burdens for no benefits at all. Worse: in fact the Member State that will set the lowest maximum duration would de facto impose it on other EU Member States and/or third countries.

For example, if a parent company were based in a Member State requiring mandatory rotation every three years, not only the statutory auditor of that parent and group's consolidated financial statements would be required to rotate every three years, but also the auditor of each of the parent company's subsidiaries in other Member States – regardless of the maximum duration set by those states.

Once more, the use of a Regulation as a legal instrument will not lead to harmonisation but its exact opposite.

[3] http://www.ifac.org/auditing-assurance/auditor-reporting-iaasbs-1-priority

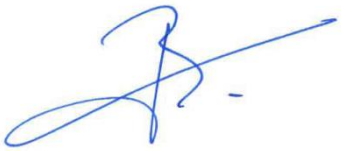
**To work in practice, rotation mechanisms need to be compatible**

The compatibility of mechanisms of internal audit partner rotation – proposed every seven years - and external audit firm rotation – proposed every ten years - should be considered very carefully to ensure they are manageable in practice. In this respect, it should be noted that internal partner rotation every five years on public interest entities is already customary in a number of audit firms. Therefore, it would be sensible that the duration of audit firm rotation is a multiple of partner rotation on public interest entities. This will obviously be further impeded if member states are allowed to set different periods for firm rotation.

The two co-legislators have a key role to rebalance the Commission proposals so that the adopted legislation promotes the supply of high-quality audit services, enhances investors' confidence through reliable, more stable and transparent financial markets, facilitates the development of a vibrant audit market and supports an independent and sustainable audit profession.

We are at your disposal to meet and discuss in more detail how we believe this can be done in the public interest.

Yours faithfully,



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**About FEE**

As the representative of the European accountancy and auditing profession, FEE is committed to advancing audit policy across the European Union (EU) and globally.

Drawing on our 45 Member Bodies across Europe and their wide experience across the whole spectrum of activities of the accountancy and auditing profession, from public practice, both large and smaller firms as well as sole-practitioners, to business and public sector, we are well placed to inform this debate. We do so from the viewpoint of the long term collective interest of the entire profession, taking into account the European public interest.