



Fédération des Experts
Comptables Européens

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Current Draft of the EU Audit Directive Misses Opportunity To Enhance Audit Quality

Europe's accountants call for harmonisation
Inconsistencies in draft Directive need to be addressed

Brussels, 16 December, 2004: "The European accountancy profession wholeheartedly supports the principal objectives of the draft Audit Directive to improve audit quality and restore public trust in the statutory audit process. It is disappointing, therefore, that certain provisions of the current draft of the Directive may in fact serve to undermine the objective of high quality audit," said David Devlin, President of FEE, speaking today at the high level conference 'The New Era for Auditing' (see editor's note no. 1 for more about the event).

"The move to encourage more member state variations could result in inconsistent implementation across the European Union. Both audit quality and the internal market for audit services risk being undermined by this development.

The European accountancy profession is calling on legislators to support a common framework on auditor independence utilising the principles-based 'threats and safeguards' approach. This was the European Commission's original proposal for the Directive, which was based on their *Recommendation on auditor independence* of 2002.

The Recommendation combines universally applicable principles with relevant guidance, restrictions and prohibitions in a rigorous way. The principles-based 'threats and safeguards' approach allows for the necessary use of professional judgement by the auditor, in agreement with the audit committee. This is essential in the auditor's day-to-day work.

Specifically, the text introduced during consideration of the Council of Ministers on auditor independence conflicts with this approach," added the FEE President.

"FEE looks forward to working with the European Parliament as it considers the draft Directive. There are worthwhile opportunities for the European Parliament to improve the current text, following the Council agreement on a general approach. In its new paper **Position on the Proposed Audit Directive** FEE proposes solutions to some remaining weaknesses on issues such as mandatory audit firm rotation, auditor liability and oversight of the audit profession, in addition to auditor independence. FEE urges both the Council of the EU and the European Parliament to ensure that the final text of the Directive supports the goal of consistently high-quality audit and an internal market for audit services," added David Devlin.

Summary of the publication 'FEE Position On The Proposed Audit Directive':

As the European Parliament now starts to consider the proposed Directive, the **FEE Position On The Proposed Audit Directive** has developed proposals to: retain the threats and safeguards approach to auditor independence; 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; recognise the need for a separate body to give effect to the cooperation between public oversight systems at Community level; accept that it is unnecessary for Europe to develop a common audit report; delete disproportionate requirements related to audit documentation; revise the system of endorsement of International Standards on Auditing; acknowledge that ethics is not a suitable subject for comitology; and recognise that progress should be made in education requirements.

- **Retain the threats and safeguards approach to auditor independence (Article 22)**

A recent insertion into Article 22, paragraph 5 states: "Member states may set additional conditions to the Article, such as the scope of activities that auditors and audit firms may carry out." This addition allows member states to depart from the threats and safeguards approach to independence issues. This principles based approach was the European Commission's original proposal for the Directive, which was based on their Recommendation on auditor independence of 2002.

The Recommendation combines universally applicable principles with relevant guidance, restrictions and prohibitions in a rigorous way. The principles-based 'threats and safeguards' approach allows for the necessary use of professional judgement by the auditor, in agreement with the audit committee. This is essential in the auditor's day-to-day work.

Paragraph 5 should be deleted.

Furthermore, the text introduced in Article 22 (paragraph 2) is undesirable. It seeks to prohibit non-audit services based on the threat of self-review by the auditor. The European accountancy profession believes that such an approach is unworkable as the auditor will almost certainly have performed work related to the audit, which brings a threat of self-review.

- **Need to omit the option for Member States to require rotation of audit firms additionally to rotation of partners**

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.

FEE conducted a review of the most significant reports by governments, regulatory bodies and academics on this subject. The paper "Mandatory Rotation of Audit Firms" 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.

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, enhanced external quality control and proper oversight, which do not suffer the increased risk of audit failure when a firm's cumulative knowledge of a client is discarded.

- **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. The European Parliament should remind the European Commission of its public commitment to study this issue and to do so with adequate resources.

FEE believes that there are a number of solutions depending on the national liability system. Amongst others, proportionate liability and a legal cap on possible 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. The proposed Directive should encourage member states to address the issue of liability and adopt measures to contribute to the solution of this problem.

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

The European Commission should make a formal commitment to establish a body to give effect to the cooperation between public oversight systems at Community level within a reasonably short period and preferably the proposed Directive should be amended to require it.

To enhance the actual effectiveness and credibility of the oversight systems and guarantee that they are functioning consistently throughout the internal market, the proposed peer review system should be fully transparent. Implementation of effective oversight (and quality assurance) in each member state is vital and any shortcomings in implementation will undermine the reforms throughout Europe.

- **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 format and other content of audit reports is a matter for auditing standards. 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 from the selected international standards on auditing, which must be applied in their totality to be effective. As ISAs develop, so will reporting practice. The matter should be left to standard

setters, operating under approved public oversight, rather than using rigid and detailed legislation.

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.

- **Delete disproportionate requirements related to audit documentation (Article 27)**

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.

The EU Council of Ministers proposes to insert an additional paragraph, which FEE believes will lead to a very burdensome procedure, making the group auditors in all cases responsible for delivery of subsidiary audit documentation, which does not seem to be proportionate to the objective.

The EU Council's proposal is not convincing because it does not clearly establish the essential principles. FEE's proposal substantially revises Article 27.

- **Revise the system of endorsement of International Standards on Auditing ("ISAs") (Articles 2 and 26)**

FEE welcomes the proposal to harmonise auditing standards in Europe by implementing ISAs (International Standards on Auditing). FEE proposed in November 2001 that by 2005, EU national auditing standard setters should require auditors to perform audit procedures that comply with ISAs and to report on financial statements in accordance with the same international standards. FEE agreed that ISAs could be supplemented by additional standards covering issues connected to the national regulatory framework. However, other differences should be gradually eliminated. The benefits of increased transparency and comparability will not be attained if add-ons and carve-outs unrelated to the specifics of the national regulatory framework are encouraged at the national level. The aim should be to reduce variations in auditing and audit reporting practice. FEE is calling for the new Directive to ensure consistent implementation of ISAs in the EU.

FEE is concerned that in the proposal to implement ISAs in Europe:

- Article 2 defines "International Auditing Standards" too widely. Inclusion of supplementary guidance material in the law would reduce the speed with which new guidance could be prepared in response to emerging trends.
- Endorsement of individual standards could undermine consistent and uniform application of the global audit standards. ISAs 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.
- 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.

- **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.

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. 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. FEE considers that legislation by the application of the comitology procedure is not appropriate to deal with ethical judgments and requirements such as integrity, confidentiality, due care and professional competence.

- **Improve 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. However, there are good reasons to believe that the educational requirements of the Eighth Directive should be reviewed and substantially amended. The main reasons are to take full account of:

- The substantial changes that have taken place since 1984, when the existing Directive was enacted, in ethical, financial reporting and auditing standards.
- The international convergence in these ethical, financial reporting and auditing standards and ensure that the proposed Directive is robust in the light of any future changes.
- The new education standards issued by the International Federation of Accountants and to reflect the approach to curriculum content adopted by most professional bodies with a focus on the ability to perform the tasks and roles expected of a statutory auditor rather than simply enumerate a list of topics. As mentioned in the Introduction to International Education Standards of IFAC, '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'.

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Notes for Editors:

1. ***The New Era for Auditing*** was organised by FEE on the 16 December 2004 and featured presentations by: William J. McDonough (Chairman of the Public Company Accounting Oversight Board); Alain Joly (Chairman of the European Association for Listed Companies, Vice-Chairman of the European Round Table of Industrialists, Chairman of the Supervisory Board, Air Liquide); David Wright (Director of Financial Markets, Internal Market Directorate General, European Commission); and David Devlin (President of the Fédération des Experts Comptables Européens).
2. The ***FEE Position On The Proposed Audit Directive*** is available to download from: <http://www.fee.be/secretariat/Positionpaper.htm>
3. The recent FEE publication 'Discussion Paper on Mandatory Rotation of Audit Firms' conducted a review of the most significant reports by governments, regulatory bodies and academics on this subject. The overwhelming majority of studies found that the mandatory rotation of firms inadvertently threatens audit quality. Paper available from: <http://www.fee.be/publications/main.htm>
4. For more about the European Commission's proposal for a revised audit Directive: http://europa.eu.int/comm/internal_market/en/company/audit/official/index.htm
5. The **Fédération des Experts Comptables Européens** (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.