

Point of view

Our perspective on issues of concern

About this *Point of view*

Welcome to Ernst & Young's *Point of view* series. These documents express our view on current public policy and regulatory matters of importance to our stakeholders, our profession and the capital markets.

European Commission legislative proposals on audit policy

"Ernst & Young believes that several of the European Commission's proposals, should they come into effect, would harm audit quality and provide little or no added value while increasing the cost of audit at a time of economic uncertainty. However, we do not oppose all of the EC proposals; we support those that would help improve the quality and relevance of audits, promote the important role of independent audit committees and enhance choice in the audit market. We look forward to engaging further in this important debate."

-- James S. Turley, Chairman and CEO, Ernst & Young

Context

On 30 November 2011, the European Commission (EC) issued a set of legislative proposals related to its Green Paper, *Audit Policy: Lessons from the Crisis*. The EC initiated the Green Paper consultation in October 2010 to reassess the role of the auditor, auditor independence and the structure of the audit market in Europe.¹ The EC received a substantial number of responses to the Green Paper from a broad range of stakeholders, the majority of whom rejected the EC's more extreme proposals.

The EC's proposed legislation is wide-ranging and comprehensive and, despite the weight of stakeholder response, includes some controversial proposals. These generally are directed at the audits of public interest entities (PIEs), which include listed companies and certain other organizations viewed as acting in the public interest such as banks, insurance companies, and other financial entities.² Non-European Union (EU) companies that have EU PIE subsidiaries, or who are themselves subsidiaries of EU PIEs, could also be affected. In addition, many non-EU countries are watching the EU debate closely. Therefore, stakeholders outside of the EU should stay engaged.

The EC process is still in its early stages, and final legislation is not expected for a couple of years. The European Council and the European Parliament will now begin parallel processes of deliberation. The EC, European Parliament and European Council all need to be in agreement in order for legislation to be adopted. As the proposed legislation moves forward, it is likely to continue to evolve substantially. We encourage investors, companies, audit committees and others to engage with policy makers to promote improvements rather than treating the proposals as a *fait accompli*.

¹ Ernst & Young responded to the Green Paper consultation and issued a corresponding *Point of view* on 8 December 2010.

² The EC proposed both a Directive and a Regulation. The Directive would apply to all statutory audits, while the provisions in the proposed Regulation would apply only to the audits of PIEs. An EU Regulation becomes law as soon as it is adopted and must be implemented as of the effective date in all 27 EU Member States. In contrast, Member States have two years after a Directive is adopted to implement it via national law.

In light of the importance of the issues addressed by the EC and interest in them outside the EU, Ernst & Young released a *Point of view* on 18 November 2011 setting out our high level views on current policy proposals.³ The purpose of this additional *Point of view* is to highlight the key EC legislative proposals.

Key proposals

While our analysis of the proposals and their potential implications continues, key aspects of the proposed legislation address auditor independence, audit market concentration, the role and relevance of the audit, and measures to enhance audit oversight within the EU. Of course, the “devil is in the details” and our analysis will continue. The following proposals would most significantly affect audits of PIEs.

Auditor independence

Auditors serve the public interest, and confidence in our independence is critical to investor confidence in financial reporting and the audit. Ernst & Young supports measures that promote auditor independence in fact and appearance. We oppose those measures that would be detrimental to audit quality or dilute the role of audit committees.

Strengthened audit committees. While the EC did not cover audit committees in the Green Paper, the proposed legislation includes provisions that we believe would strengthen audit committees by enhancing their independence, expertise and their oversight of the audit. The proposals would require both of the following:

- ▶ A majority of audit committee members to be independent; and
- ▶ At least one member to have competence in audit, and another one in auditing and/or accounting.

In addition, the proposed legislation specifies detailed responsibilities for audit committees, including monitoring the PIE’s financial reporting process, internal control and internal audit, overseeing the audit and the auditor selection process, and reviewing and monitoring the independence of the auditor.

Mandatory firm rotation. In spite of significant opposition, the EC not only moved forward with a proposed mandatory firm rotation proposal but actually made it more aggressive than anticipated. The proposed legislation would require that auditors of PIEs rotate every six years, although the period could be extended to eight years if approved by an audit regulator. While the provision for mandatory joint audits has been dropped, the EC continues to encourage joint audits by proposing that the time periods for rotation would increase to 9 and 12 years respectively if the PIE elects to have two auditors. We continue to oppose mandatory firm rotation, as it would remove the responsibility of the audit committee to decide whether or when to replace an audit firm. At the same time, it would neither reduce concentration nor enhance audit quality.

Enhanced tendering requirements. In addition to mandatory firm rotation, the proposed legislation would require auditors to be appointed for a two-year minimum period, and would enable a PIE to renew the engagement only once. The legislation would impose detailed and transparent tendering procedures for selecting a new

³ Ernst & Young *Point of view: Views on current public policy proposals affecting the audit profession*, 18 November 2011.

auditor, including requiring that at least one of the firms invited to tend be a smaller firm.⁴ It also would require that the audit committee recommend at least two auditors to the general meeting of shareholders and justify their preference. In an attempt to discourage the undue dismissal of the auditor, the proposed legislation also would require the PIE or the auditor to notify regulators of the auditor's dismissal or resignation and the reasons.

Significant restrictions on non-audit services. The proposed legislation would add significant new restrictions on an auditor's ability to provide non-audit services to a PIE audit client. The legislation prohibits the provision of most non-audit services to PIE audit clients, including nearly all tax services. It would, however, permit the provision of a very narrow category of services, referred to as, "related financial audit services." These include audits of interim financial statements, providing assurance on corporate governance statements, and other types of assurance services. Fees for such "related financial audit services" would have to be limited to 10% of the audit fees paid.

Certain other non-audit services would be permitted to be provided to a PIE audit client, but only with pre-approval:

- ▶ By the audit committee: certain human resource services, and the provision of comfort letters;
- ▶ By the regulator: financial IT system design and implementation, and due diligence services.

Audit-only firms. The proposed legislation would prohibit "large" audit firms from providing non-audit services at all to a PIE, either to audit or non-audit clients. Large firms would be defined as those firms which generate more than one third of their total audit revenue from large PIEs (measured on a country-by-country basis) and belong to networks with annual audit revenues in the EU above €1.5 billion. While this provision may not apply to many firms, we nevertheless believe it would be harmful. In our view, a multidisciplinary service model, particularly when combined with an engaged and effective audit committee, improves audit quality, helps the profession attract the best talent and fosters the provision of high quality services to companies around the world.

Addressing audit market concentration and systemic risk

Ernst & Young supports measures that would increase choice, strengthen the audit market and enhance audit quality. We also support those measures that would reduce the threat of a large firm exiting the market, or mitigate the impact of such an event so as to ensure continuity of audit services. To promote financial stability, we support increased interaction and a genuine two-way dialogue between auditors and prudential supervisors of financial institutions.

⁴ "Smaller firm" would be defined as a firm that has not received more than 15% of the total PIE audit fees in the relevant Member State. In the case of banks and insurance companies, the prudential regulator would be able to veto the recommended choice of auditor.

Removing barriers for smaller firms. The proposed legislation would take several measures to remove barriers to audit firm growth (in addition to the tendering requirements mentioned above):

- ▶ **Liberalizing ownership restrictions.** The current restrictions on audit firm ownership would be relaxed and the requirement that a majority of the voting rights or a minimum of capital of an audit firm be held by licensed accounting practitioners would be eliminated. The requirement for the majority of members of the management board would remain. Measures that would allow for alternative audit firm ownership structures, provided appropriate controls for independence are in place, would enable greater access to external capital.
- ▶ **A pan-European passport for auditors.** Auditors would be permitted to provide statutory audits under ISAs in Member States other than the Member State in which they have been approved (although the key audit partner leading the audit would be required to be approved as an auditor in the concerned Member State).
- ▶ **Prohibition of “Big 4 only” clauses.** Contractual clauses with third parties limiting the choice of the auditor would be prohibited. It has long been our position that such clauses should be eliminated.
- ▶ **European quality certificate.** A voluntary pan-European audit quality certificate would be created to increase the visibility, recognition and reputation of audit firms with the capacity to conduct high quality audits of PIEs.
- ▶ **Publication of individual audit firm inspection reports.** EU audit regulators would be required to publish firm-specific inspection reports. As with the European quality certificate, enhanced transparency around inspection findings could provide the market an important input as well as promote competition on quality.

Strengthened two-way dialogue between auditors and prudential supervisors.

The EC recognizes the value of a two-way dialogue between auditors and prudential supervisors, including on facts or decisions that could impair the continuity of the audited entity. The proposed legislation supports the communication already taking place and would formalize it by requiring supervisors of financial institutions to establish a regular dialogue with the auditors of institutions they supervise.

Contingency plans for the largest firms. To contain potential market disruption should the continuity of a large audit firm be seriously threatened, the proposed legislation would require contingency planning at the country level for the largest audit firms in each Member State (at least the six largest audit firms in terms of statutory audits of large PIEs). We believe that audit firms should work with regulators to develop contingency plans aimed at helping prevent the failure of an audit firm or at helping to resolve any significant disruptions in the provision of audit services should this occur.

EU-wide adoption of International Standards on Auditing (ISAs). The proposed legislation would require, as we have long been advocating, that audits throughout the EU be carried out in accordance with ISAs, which would enhance audit quality and support the provision of EU-wide audit services. At the same time, however, the legislation makes clear that EU legislative requirements would supersede ISAs where there is a conflict. This could create unfortunate divergences and hinder harmonization with international auditing standards.

Role and relevance of the audit: the auditor's report and audit firm transparency

Ernst & Young supports efforts under way to consider the role and relevance of the auditor's work, including enhancing the auditor's report. We support certain enhancements to audit reports for public interest entities, including those that would enhance understanding by shareholders and others of the audit process, especially as it relates to the key audit areas and risks in the financial statements. We believe that comparability is important for global investors and global markets; therefore, the auditor's report should be as consistent as possible across jurisdictions.

Auditor reports. In addition to proposing specific audit and documentation procedures, the proposed legislation would expand the current auditor's report. While we support some of the proposed changes, we believe they are better made in the context of the standard-setting process, which would promote global consistency and comparability. Therefore, the EC and its Member States should collaborate with the International Auditing and Assurance Standards Board's (IAASB) current initiative on auditor reporting, especially as the EC is proposing to adopt ISAs. The proposed legislation also would require auditors to issue a separate, longer and non-public report to the audit committee, which would provide more detailed information about the audit. This report could be made available to regulators upon request.

Enhanced audit firm transparency. The proposed legislation would carry over the existing EU annual audit firm transparency reporting requirement, with some additional disclosures:

- ▶ A list of PIE entities from which the audit firm receives more than 5% of its annual revenue;
- ▶ A description of the firm's policy concerning the rotation of key audit partners and staff;
- ▶ Where an audit firm generates more than one-third of its annual revenues from large PIEs, a statement on the firm's own corporate governance; and
- ▶ The firm's audited annual financial report and, where the firm belongs to a network, audited consolidated financial statements for the network.

Contacts

Global Public Policy

Beth Brooke +1 202 327 8050

Felice Friedman +1 202 327 6253

Americas

Les Brorsen +1 202 327 5968

Asia-Pac

Tony Smith +612 6267 3997

EMEIA

Jeremy Jennings +32 2 207 1472

Japan

Makoto Usui +81 3 3503 1113

Further resources

Ernst & Young summary of EU legislative process

Ernst & Young *Point of view: Views on current public policy proposals affecting the audit profession*

Ernst & Young *Point of view: European Commission Green Paper, Audit Policy - Lessons from the Crisis* and EY comment letter

European Commission proposed legislation:

- ▶ Regulation on specific requirements regarding the statutory audit of public interest entities
- ▶ Directive amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts

Enhancing audit oversight in the EU

Ernst & Young continues to support strong, effective and independent audit oversight recognizing its positive contribution to audit quality and investor confidence. We support enhanced coordination among our regulators in order to harmonize oversight, promote coordinated inspections (including through colleges of supervisors) and reduce duplication.

Harmonizing the roles and responsibilities of independent audit regulators.

Independent audit regulators in the Member States would be required to have specified responsibilities (including inspection, surveillance, enforcement and sanction authority), which could not be delegated to any association or body affiliated with the accounting or audit profession.

Enhancing the capabilities and resources of independent audit regulators within the EU would enhance their effectiveness and thus contribute to audit quality.

Establishing a central role for the European Securities and Markets Agency (ESMA).

Under the proposed legislation, ESMA would be given significant responsibilities to coordinate EU-wide cooperation among audit regulators as well as set guidance for audit regulation across the EU. This would include establishing guidelines for the auditor's report, the report of the auditor to the audit committee, the oversight role of the audit committee, as well as for the audit firm transparency report. In addition, ESMA would play a central role in coordinating colleges of regulators.

Greater cooperation between audit regulators across the EU. The proposed legislation would call for audit regulators within the Member States to cooperate with each other for the purpose of carrying out their supervisory duties regarding statutory audits. The proposed scope of cooperation would include exchange of information, cooperation with regard to quality assurance reviews, and assistance in investigations related to the carrying out of statutory audits of PIEs. It also would support the creation of colleges of competent authorities.

What's next?

There is a significant degree of opposition to some of the EC's more extreme proposals, and throughout the legislative process there will be opportunities for change. Investors, companies, audit committees and others within and outside the EU should reach out to EU national governments and members of the European Parliament to share their views, and, to the extent possible, provide concrete information to assist them in their deliberations. For example, EU-based companies can provide information on the implications of the proposals, including their costs and how they would affect the role of audit committees and choice in the audit market. Non-EU companies can provide insights on the extra-territorial aspects of legislation (e.g. mandatory firm rotation) and encourage national governments to engage with EU member states on a bilateral basis.

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