

Brussels, 13 October 2010

European Commission Green Paper on Audit Policy - frequently asked questions

Why has the European Commission decided to launch a public consultation on audit policy?

Audit is an integral part of the financial environment. Statutory audit refers to the audit of companies under European law and is aimed at providing an accurate reflection of the veracity of a company's financial statements to stakeholders.

However, the financial crisis highlighted weaknesses in the system. Although audits of some large financial institutions just before or during the crisis resulted in 'clean' audit reports, there remained serious intrinsic weaknesses in the financial health of the institutions that had been audited.

In view of learning all the lessons from the crisis and in the context of the regulatory reform stemming from those lessons, it is important to have a comprehensive debate on the role of audit to ensure that any 'expectation gap' between auditors and stakeholders is addressed.

What are the existing rules on audit?

A number of instruments exist at EU level, both binding and non-binding rules and guidelines for the conduct of audits required by EU law, requirements to be met by auditors and the supervision of the latter.

The main EU instruments for audit are:

- **The Statutory Audit directive (2006/43/EC)**: aims to ensure that investors and other interested parties can rely on the accuracy of audited accounts and to enhance the EU's protection against the type of scandals that occurred in companies such as Parmalat and Ahold (i.e. cases of fraud not discovered by the auditors). The Directive sets out the duties of statutory auditors and certain ethical principles to ensure their objectivity and independence, for example where audit firms are also providing their clients with other services. It introduced a requirement for external quality assurance, ensure robust public oversight over the audit profession and improve co-operation between regulatory authorities in the EU. The Directive provided also a basis for balanced and effective international regulatory co-operation with third country regulators such as the US Public Company Accounting Oversight Board (PCAOB).
- **There have been two further Recommendations in 2008** aimed at giving more responsibilities to the public oversight bodies and enhancing transparency of audit results. The second Recommendation encourages Member States to limit civil liability of auditors (see [IP/08/897](#)).

Although these instruments have improved the audit environment, the Commission's assessment is that they have not fully delivered on their promises and there are still potential failings in the audit environment which need to be discussed further.

Furthermore, the Commission is also aware of recent inspection reports by national regulators/supervisors where audits conducted by different firms, large and small, have been criticised, some for serious shortcomings. This would also suggest that further progress towards a greater quality of audits is still possible. The Commission's aim is for the highest standards possible to apply in the conduct of audits throughout the EU.

What are the objectives of the Green Paper?

The Green Paper submits the following considerations for public consultation:

- Determining whether there are possible ways to lower any gap between what investors expect from an auditor and what the auditor actually delivers, and **whether the role of the auditor should be revisited**;
- Exploring possible ways to **improve the auditors' communication to stakeholders and regulators** on what work they have carried out and what they have 'discovered' during their audit;
- Examining whether there are **conflicts of interest** in the current system e.g. when a firm both audits a company's results and offers it consultancy services; if so, what would be the appropriate manner to eliminate such intrinsic conflicts of interest so as to ensure complete auditor independence;
- Ensuring **effective and independent supervision** throughout the EU;
- Identifying if the current system entails any systemic, too big to fail risks because of the **concentration in the audit market**. What impact would the failure of one of the big audit firms have on the rest of the financial system? How could such accumulation of such risks be addressed?
- **Improving the internal market** of audit by ensuring further mobility for audit professionals and firms within the EU, possibly by creating a European Passport in this area;
- Addressing the proportionality of the application of regulatory requirements to **reduce administrative burden for SMEs** where possible.

Why is action needed when auditors were not responsible for the banking crisis?

The Green Paper is not about determining the causes for the crisis. But the crisis did highlight failings in the audit system across Europe. The Commission believes that there are important questions which need to be addressed in an open manner. Auditors have an important statutory role to play and this consultation provides an appropriate platform to have a comprehensive and constructive debate for real change.

How does the Green Paper fit with other Commission initiatives in response to the financial crisis?

This Green Paper is an integral part of the crisis related financial market reform and raises important questions on the lessons learnt from the crisis with regard to the role of audit, its independence and the accumulation of systemic risk. This last point is particularly important - the Commission is keen to address further potentially systemic risks proactively rather than reactively.

Does the Green Paper fit with the work being carried out in the field of corporate governance of financial institutions?

The ideas explored in the Green Paper are complementary to the ideas explored in the context of corporate governance. The corporate governance consultation covered certain elements of audit ([see IP/10/656](#)); the Green paper on Audit Policy covers all aspects of audit policy in a comprehensive manner.

Does the Commission favour any particular configuration of the audit market?

No, the Commission does not favour any configuration but wishes to examine evidence of any concentration in the market as well as a lack of choice with regard to providers of statutory audits.

Is action at a European level really necessary? After all, some European supervisors seem to be very active already in their inspections of audit firms.

The Commission welcomes the fact that European supervisors are starting to draw lessons from their oversight activities and looks forward to discussing those findings. While robust supervision within Member States is key, certain matters can be best dealt with at the European level, for example the potential future European passport allowing auditors, individual and firms, registered in one Member State to provide audit services in other Member States without further registration. Moreover, if the concentration of the audit market raises systemic risk issues, these would relate to the EU as a whole and not just to any one Member State, especially given the global reach of auditors. This also raises the issue as to whether supervision at a European level might add value to purely national supervision.

What are other regions in the world doing in this field?

The Commission is keen to take the lead in the area of audit because we believe it is a key lesson which needs to be learnt from the crisis. The issues will naturally be discussed in international fora; but for this to happen it is important to carry out a broad, all encompassing consultation to determine what the EU issues are and what options may be considered as a way forward. Then the EU will have a solid platform to enter into constructive discussions with its international partners. We encourage all interested parties, including our international partners, to respond to the consultation.

Outside the EU, the Commission is not aware of any immediate initiative similar to the comprehensive debate we would like to facilitate. Notwithstanding, audit represents a very substantial activity in the EU and to this extent it would be appropriate to take the lead. Our aim is not to cause any distortions when compared to other non EU jurisdictions but, as explained above, to use this initiative to solicit debate and constructive discussion with our international partners. It has to be noted that at present, there are substantial differences internationally in terms of audit rules.

Why is the European Commission considering appointment and remuneration of an auditor by a third party?

Auditors are currently appointed and paid by the company they audit.

The Green Paper asks whether it would make sense that in some cases, the auditor should be appointed by a third party, perhaps the national regulator / supervisor, and not chosen by the company requiring audit services. From the point of view of complete independence between auditor and client, in particular in the cases of very big companies, this is an idea that can be explored.

Would ideas such as mandatory rotation of audit firms and joint audits not prove detrimental to the quality of audits performed?

In many instances, audit firms continue to audit the company for many years, in certain cases even decades. This may seriously impair the independence of the auditor vis-à-vis its 'client'. The Green paper thus explores the possibility of making a change in audit firms compulsory on a regular basis. Joint audit relates to the formation of an audit team / consortium including more than one audit firm: this could not only increase independence but could also provide for continuity if one of the audit firms were to fail.

Why does the Green Paper not raise the issue of the access of audit working papers by the US, for example?

The Commission addressed this issue by adopting two decisions this year allowing Member States to negotiate such access with the US, Japan, Switzerland, Canada and Australia (see [IP/10/1083](#) and [IP/10/136](#)).

What will be the follow-up to the public consultation? Will there be any legislative proposals?

The consultation is open for responses until 8 December 2010. This will be followed by a conference in Brussels on 10 February in 2011. The Commission will decide thereafter in 2011 on the need for any measures as a follow-up to the present consultation.