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Reforming the Audit Market - Frequently Asked Questions

I. Context and key messages

1. Why is audit important?

The role of audit is to contribute to the credibility and reliability of financial statements. For this reason, it is an integral part of the financial reporting environment and its importance is reflected in statute (Fourth and Seventh Company Law Directives) with a requirement for certain companies to have an audit. Moreover, only approved auditors can undertake these statutory audits.

Statutory audit refers to the mandatory annual audit of companies and is aimed at providing an accurate reflection of the veracity of a company's financial statements to stakeholders.

2. What are the existing rules on audit?

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

The main EU instrument, dating from before the 2008 crisis, is the Statutory Audit Directive ([2006/43/EC](#)). The Directive sets out the duties of statutory auditors and introduced a requirement for public oversight of the audit profession and co-operation between regulatory authorities in the EU.

3. What are the main weaknesses facing the audit market?

The audit market faces a number of weaknesses:

- a lack of choice for audit clients resulting from high concentration levels (in essence an oligopoly);
- systemic risk if one of "the Big Four" (Deloitte, Ernst & Young, KPMG and PwC) collapses. In that case, there would be even more concentration at the top end of the audit market;
- possible conflicts of interest and issues around the independence of auditors;
- doubts around the credibility and reliability of the audited financial statements of banks, other financial institutions and listed companies. These came in for heavy criticism during the crisis.

For example, more recently, there has been considerable media coverage of apparent audit failures (e.g. Anglo Irish Bank, BAE Systems, Lehman, Satyam and Olympus). This would strongly suggest that audit is not working as it should and has seriously dented the credibility of auditors.

4. What are the main objectives of audit reform?

The legislative proposals follow an extensive consultation process which included the Commission's Green Paper on Audit Policy (see [IP/10/1325](#)). The proposals address issues revealed by the crisis and aim to restore confidence in the audits carried out in the EU.

The main objectives of the reform are to:

- clarify and define more precisely the role of the auditor;
- reinforce the independence and professional scepticism of the auditor;
- make the top end of the audit market more dynamic;
- improve the supervision of auditors;
- facilitate the cross-border provision of statutory audit services; and
- reduce unnecessary burdens for SMEs.

In more detail:

- Mandatory rotation of the audit firm after 6 years (9 years if two audit firms used). A cooling off period of 4 years will be applicable.
- Prohibition of Big 4-only contractual clauses (clauses requiring that the audit is undertaken by one of the Big 4 firms).
- Mandatory tendering for audit mandates.
- Stricter rules on the appointment of auditors with an increased role for the audit committee.
- The audit committee's recommendation for the appointment of an auditor should be discussed at the general meeting of shareholders. The audit committee's independence and technical competence should be reinforced: at least two of its members must be independent and at least one should have knowledge of audit.
- Auditors will be prohibited from providing non-audit services to audit clients. The provision of non-audit services to non-audit clients is allowed.
- Large audit firms will be required to separate their audit activities into pure audit firms i.e. a complete ban on the provision of non-audit services by the large audit firms.
- EU-level cooperation by the European Securities and Markets Authority (ESMA).
- National audit supervisory authorities would be strengthened. The mandate, powers and independence requirements for audit supervisors would be established at EU level, but supervision would be carried out nationally.
- European certification of audit firms recognising their aptitude to perform high quality audits of listed companies. The certificates would be issued by ESMA.
- Regular dialogue will be held between auditors, audit committees and supervisors.
- Mutual recognition of statutory auditors approved in Member States to ensure cross-border mobility of auditors.
- The content of the audit report will be expanded to provide more information to all stakeholders.

- An additional more detailed audit report for the audit entity itself which will provide detailed information on the audit carried out to the audit committee and management.
- Establishing additional requirements on the internal organisation and governance of audit firms.
- Compliance with the International Standards on Auditing (ISAs) by all statutory auditors and audit firms. Member States should ensure that the audit standards are adapted to the size of the audited entity to ensure a proportionate and simplified audit for SMEs.

5. What share of the European audit market do the Big Four have?

The market share of the Big Four for audits of listed companies exceeds 85% in the vast majority of Member States. In the UK, the Big Four audit 99% of the FTSE 100 companies and more than 95% of the FTSE 350 companies (1995-2004). In Germany, two Big Four firms have the audit mandates for 90% of the companies listed on the DAX 30 (KPMG and PwC). In Spain, all IBEX 35 companies are audited by the Big Four.

6. Why propose a regulation and amend the Statutory Audit Directive?

Public Interest Entities (PIEs)¹ often have cross-border activities and their auditors also operate at EU level. In such cases, audits should be performed on the basis of a harmonised framework and the supervision of audit networks should be carried out at EU level in order to be effective. This can best be achieved through a Regulation which would be directly applicable, therefore providing a higher level of harmonisation and legal certainty.

The amendments to the Directive concern all audits and not just the audits of PIEs.

7. Why act now when the existing Directive is only in force since mid-2008?

Some of the weaknesses, shortcomings and potential failures that came to light during the crisis had not been anticipated by previous legislation and to this extent further revision in this domain has become necessary.

The fact that European and global economies are still experiencing turbulence is all the more reason to take action now, especially if markets are to regain credibility, trust and confidence.

Maintaining the *status quo* will not bring about stability in the market. Indeed, the 700 replies to the consultation and other contacts with stakeholders demonstrate that there is an appetite for change, albeit to varying degrees. Many of the proposals will build on or reinforce existing provisions in the Directive.

¹ PIEs are banks, other financial undertakings and listed companies in general as defined in the Statutory Audit Directive 2006/43/EC. As the financial sector evolves, new categories of financial institutions are created under EU law and thus the definition of PIEs was amended by the proposal for a Directive amending Directive 2006/43/EC to also encompass investment firms, payment institutions, undertakings for collective investment in transferable securities (UCITS), electronic money institutions and alternative investment funds.

8. Why is the audit reform not being handled under the European Commission's antitrust arm?

Because we are talking about regulatory changes whereas competition policy is about the enforcement of existing rules to deal with mergers (the Merger Regulation), restrictive practices (Article 101 of the EU Treaty) or suspected abuses (Art 102). In the absence of a merger which would meet the threshold of EU merger control, the European Commission (Directorate-General for Competition) is only entitled to intervene when it has suspicions of antitrust infringements (collusion or abuses of dominant position).

9. Why does the reform concern audits of all listed companies and not only banks and financial institutions?

Considering the importance of listed companies, as well as banks and financial institutions, it is vital that high quality audits are conducted on their financial statements to strengthen investors' confidence in the market as a whole.

II. Impact of the proposals

10. Will the proposals damage audit quality?

Audit quality derives from independence, professional scepticism and technical competence. All of these elements will be enhanced by the proposed reforms and consequently, audit quality as a whole will be improved.

11. Will the measures proposed lead to increased costs? What about job losses?

The Commission's better regulation principles ensure that a rigorous impact assessment is conducted for all legislative proposals.

Some of the measures (such as mandatory tendering and rotation) will entail increased costs for the audited entities but these will be outweighed by the positive effects, such as enhanced independence leading to better quality audits and a more effective audit environment. The proposals will make the top segment of the audit market more dynamic.

The Commission broadly estimates that for public interest entities with a market capitalisation or a balance sheet total in excess of €100 million, costs, depending on the size of the company and the audit committee, could range from €90 000 to €150 000 per annum.

For smaller public interest entities (including those which are SMEs), the additional costs would be less than €10 000 per annum especially as there would be no obligation to either have audit committees or to tender for auditors.

Furthermore, the reform may lead to some restructuring and better allocation of resources. In the case of pure audit firms, audit clients may still use consulting and non-audit services of other providers. The European passport and certificate will facilitate more cross-border opportunities for auditors and firms.

12. What are the benefits of the proposals? Who will benefit?

Although no single component of the financial system can be solely blamed for the financial crisis, it is important to ensure that each component is examined in detail to ensure that improvements are made with a view to the future. The predominance of 'clean audit reports' for banks throughout a crisis during which the European Union committed €4.6 trillion between October 2008 and October 2010 to support banks - such aid amounting to 39% of the Union's GDP for 2009 - renders a serious overhaul of the existing system inevitable.

Many of the benefits of these proposals will accrue at a macro-economic level e.g. stability and confidence in the market.

Furthermore, more informative audit reports will reinforce confidence in robust companies and the latter will eventually enjoy a lower cost of capital and access to better business opportunities when compared to a company where the audit reveals deficiencies. Moreover, such benefits will be of a recurring nature.

The introduction of common auditing standards at the level of the Union should result in total recurring net benefits for the EU economy as a whole through lower costs of capital which are estimated to exceed €2 billion. Since these net benefits are recurring, the present value of the net benefits in perpetuity can be estimated at €40 billion (if using an assumption of a long-term discount rate of 5%).

Stakeholders, investors, shareholders and companies will primarily benefit from better quality audits and restored credibility and confidence in financial information. Next tier audit firms (i.e. those who are not members of the largest networks) will benefit from a reduction in barriers to entry to the top segment of the audit market and new cross-border opportunities. Member States, auditors and supervisors will benefit from more harmonised requirements, legislation and standards. Finally, society as a whole and the European taxpayer, who is ultimately footing the bill for the bank bailouts, will benefit from the stronger role of auditors in the prevention of future crises.

13. What is the Commission doing to bridge the expectation gap (the gap between what stakeholders expect of an audit and what auditors actually do)?

We are making clearer what an audit is and what should be expected of it. Closer cooperation between the auditor, the audit committee and supervisors will also help to clarify and meet the expectations of stakeholders.

The new measures will also require auditors to report more information, including any risks identified, to the management and audit committee of the audited entity. The auditors will also be required to communicate more with supervisors. There should, however, be no confusion between the role of the auditor and that of supervisors, credit rating agencies or market analysts.

14. Will the proposals stifle competitiveness or hinder growth (of PIEs)?

These proposals will have a positive impact on the economy and financial stability by strengthening investors' confidence in the financial statements of PIEs. Not only will they not damage growth, they will help to restore confidence in the financial market by increasing the ability of PIEs to attract investment for future expansion and growth.

15. How will the proposals impact on SMEs?

SMEs fall into two categories: SMEs who are audited entities and SMEs who are statutory audit providers (the so-called SMPs).

The proposals do not impose any new burdens on SMEs who are audited entities as they are exempt from most measures. Mandatory tendering and rotation will apply to SMEs who are PIEs but these are generally larger SMEs and are generally already subject to additional sector related regulatory requirements. Member States will have to ensure that the application of the auditing standards to the statutory audit of medium-sized companies is proportionate to the scale and complexity of the business of those companies. This could potentially decrease the costs of such audits.

In addition, the on-going revision of the Accounting Directives is proposing simpler accounts for smaller entities as well as increasing the threshold under which an audit is required (see [IP/11/1238](#)). Therefore, there would no longer be an EU requirement for small companies to have an audit.

For SMEs who are audit providers, the proposals will increase the opportunities to provide cross-border services and reduce the associated cost of providing such services. In addition, the measures aimed at lifting market entry barriers will have a positive effect on SME audit providers and facilitate expansion of their activities.

III. More detail on key elements of the proposals

16. How will the initiatives encourage new players at the top end of the market?

The proposals would introduce European certification of audit firms. This will recognise the audit firm's capacity to undertake audits of large listed entities. The certificates would be issued by the European Securities and Markets Authority (ESMA). Regular tendering and rotation of audit firms would give the next tier of audit firms more opportunities to win audit mandates in the top end of the audit market.

17. What means will the national oversight bodies have to effectively oversee the statutory auditors and audit firms?

The national oversight bodies will be strengthened, as they will be given more powers such as more investigative powers and their independence from the audit profession will be reinforced i.e. they will no longer be allowed to delegate inspections to the professional bodies.

18. Why is audit supervision being integrated into ESMA?

The oversight will still be undertaken at national level in the first instance. However, cooperation and coordination at European level to ensure effective supervision of audit firms operating across the EU is best served by an Authority such as those recently established for supervision in the areas of banking, insurance and pensions. ESMA will take over the current functions of the European Group of Auditor Oversight Bodies (EGAOB). ESMA will also issue standards and guidelines to harmonise supervisory practices. ESMA will additionally be responsible for the issuance of the European Quality Certificate

19. What is the rationale for proposing mandatory rotation of the auditor?

There are obvious risks to having the same auditor for 50 or 100 years as does happen today. Such a long professional relationship undermines the auditor's independence and negatively impacts on his/her professional scepticism. Rotation of the key audit partner is an important improvement which was introduced in previous legislation but is insufficient because the main focus remains client retention. A new partner would be under pressure to retain a long standing client of the firm. And it would be unlikely that he/she would criticise the work of the previous audit partner (his/her colleague).

In order that rotation and tendering are carried out with sufficient frequency to ensure enhanced independence and better audit quality, the Commission proposes to set mandatory rotation after 6 years.

Mandatory rotation is the '*sine qua non*' of the whole package of proposals as the other measures in isolation will not be sufficient to reinforce independence and professional scepticism.

20. What is the rationale for mandatory tendering?

Mandatory tendering will increase transparency and openness in the award of audit mandates. It will give mid-tier firms more opportunities to bid for audit mandates at the top end of the market. It will also facilitate more involvement of the audit committee in the selection of the auditor

21. Wouldn't a strengthened audit committee be sufficient to address issues of independence?

Audit committees are currently not always in a position to influence the appointment of the auditor.

A strengthened audit committee will have a positive impact on audit quality by better overseeing the selection and work of the auditor. However, this measure alone will not be sufficient to tackle key shortcomings. The other proposals are necessary to allow the audit committee the opportunity to exercise a stronger role.

22. Why propose a ban on the provision of non-audit services to audit clients?

There are obvious issues of potential conflicts of interest when the same audit firm offers both audit and other services to the same client. A ban on the provision of any non-audit services to audit clients will ensure that high quality audits are the primary focus of the audit provider. It will prevent potential conflicts of interest, as well as reinforcing independence and professional scepticism.

23. Why are pure audit firms only proposed for the larger audit firms?

Big firms represent a very large proportion of PIE audits. It is critical that such audits are conducted in an independent manner without any 'pollution' from other commercial interests.

In addition, in the case of a change of auditor, large audited entities can face a limited choice between just one or two audit firms as the others are disqualified by virtue of providing non-audit services. This has resulted in a shift of bargaining power to the large firms remaining in the market. This problem has recently been highlighted in the consultation paper on mandatory rotation by the American auditor supervisor.

24. Will pure audit firms be able to attract top talent?

Yes. Professional training requires minimum periods of supervised audit experience. There would be no limitation on people leaving the audit firm for other lines of business. Currently people can move from audit to other fields within the same firm. People also leave to join other firms.

25. Is the modification of the ownership rules incompatible with the measures aimed at enhancing auditor independence?

Broader ownership rules whereby we eliminate the requirement to keep the majority of the capital of an audit firm in the hands of auditors. This will give audit firms more access to capital which may increase the number of audit providers and encourage new entrants into the market. The requirement that a majority of the members of the administrative or management body of an audit firm are audit firms or statutory auditors will be maintained. This, in addition to other safeguards, will ensure that the shareholders do not intervene in any way that would jeopardise the independence and objectivity of the auditors. Investors should not be able to have a controlling influence on the audit firm.

26. Why are the big established players opposed to reform?

The big players wish to retain the '*status quo*' on market-related issues and they fear that the proposals will harm their business. However, it is important to note that the proposals are not an attack on the larger players but an attempt to overcome the lack of perceived independence of such players, to enhance the quality of audits performed in the EU and to remove barriers for smaller players.

IV. Wider context

27. Is the reform of audit an isolated event?

The Commission is working on several fronts to address the problems revealed by the financial crisis. A number of areas have already been reviewed or are under review as part of our objective to ensure that all financial actors are appropriately regulated (e.g. banks, insurance companies, investment funds, credit rating agencies etc.). Audit is an important element of the financial environment and cannot be overlooked if the benefits of all other regulatory changes are to be achieved and maximised.

28. Is the Commission acting alone on audit reform?

While the Commission took the lead when it launched its Green Paper on audit in October 2010, a number of other actors are also examining the needs to reform audit.

The United States of America is considering important changes particularly in the domain of the independence of auditors and transparency of audits. Serious consideration is also being given to the mandatory rotation of audit firms to address what are perceived as grave shortcomings.

In the UK, the House of Lords' enquiry on audit concluded that there were serious problems in the way audits of banks had been carried out during the crisis. The enquiry found the auditors to be "disconcertingly complacent" and even spoke of a "dereliction of duty". Serious concerns were raised about the concentration levels of the audit market.

The UK Office of Fair Trading has referred the market for the supply of statutory audit services to large companies in the UK to the Competition Commission for a market investigation based on concerns that the market is highly concentrated, with low levels of switching and substantial barriers to entry.

The international Financial Stability Board is considering audit as one of its future work streams.

More information:

http://ec.europa.eu/internal_market/auditing/reform/index_en.htm