

# EC proposals on Auditing

*Presentation to the IAASB  
CAG*

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*These will strictly be our personal views.*

*This presentation is limited to the proposed measures which are linked to issues this CAG and the Ethics CAG deal with.*

# Content

- 1. Introduction (definitions and structure)*
- 2. Main measures for all statutory audits*
- 3. Main measures for Public Interest Entities*
- 4. Supervision*

# 1. Introduction - definitions

## *Statutory audit:*

- Required by Union law
- Required by Member State law as regards small undertakings
- Audits of small undertakings

## *Public-interest entities (PIEs):*

- Listed companies
- Credit institutions
- Insurance undertakings
- Other financial institutions

# 1. Introduction - structure of proposals

*Two step approach:*

- 1. Rules for all statutory audits (Directive)*
- 2. Stricter rules for statutory audits of PIEs (Regulation)*

## 2. Main measures for statutory audits

*2.1. Liberalisation of ownership rules*

*2.2. ISAs*

*2.3. Prohibition of Big 4 only clauses*

*2.4. Simplified audits for SMEs*

## 2.1. Liberalisation of ownership rules

- *No restrictions on voting rights (at present the majority remains with approved audit firms or registered auditors)*
- *Maintaining existing requirement that the majority of the members of the audit firm's administrative or management body are audit firms or auditors*

## 2.2. International Standards on Auditing

- *Member States shall ensure that auditors carry out audits in accordance with the International Standards on Auditing*
- *Add-ons are possible*
- *Carve-outs disallowed*



## 2.3. Prohibition of Big 4 only clauses

- *Prohibition of clauses through which a third party suggests, recommends or requires the audited entity to appoint a specific statutory auditor, audit firm or a Big Four firm.*

## 2.4. Simplification for SMEs

- *No statutory audit required for small enterprises (in line with new proposal reforming the EU Accounting Legislation)*
- *Member States shall ensure that the application of auditing standards is proportionate to the scale and complexity of the business of SMEs*

## 3. Main measures specifically for PIEs

*3.1. Prohibition of non-audit services*

*3.2. Pure audit firms*

*3.3. Audit report*

*3.4. Additional report to the audit committee*

*3.5. Communication with supervisors of PIEs*

*3.6. Audit Committee*

*3.7. Audit firm rotation*

*3.8. Contingency planning*

## 3.1. Prohibition of non-audit services to audit clients

- *Provision of related financial audit services are always allowed ("white list") but limited to 10 % of the fees paid by the audited entity (e.g. audit or review of interim financial statements or providing assurance on corporate governance statements).*
- *Non-audit services that in all cases entail conflicts of interest are prohibited ("black list")*
- *Non-audit services that may entail conflict of interest may be provided after the approval either of the competent authority or the audit committee ("grey list")*

## 3.1. "Black list" of non-audit services

- Expert services unrelated to the audit, tax consultancy, general management and other advisory services
- Bookkeeping and preparing accounting records and financial statements
- Designing and implementing internal control or risk management procedure related to the preparation and/or control of financing information included in the financial statements and advice risk
- Valuation services, providing fairness opinions or contribution-in-kind reports
- Actuarial and legal services, including the resolution of litigation
- Participating in the audit client's internal audit and the provision of services related to the internal audit function
- Broker or dealer, investment adviser, or investment banking services

## 3.1. "Grey list" of non-audit services

*Services that may be provided after approval of audit committee:*

- Human resources services, including recruiting senior management
- Providing comfort letters for investors in the context of the issuance of an undertaking's securities

*Services that may be provided after approval of the competent authority*

- Designing and implementing financial information technology systems
- Due diligence services to the vendor or the buy side on potential mergers and acquisitions and providing assurance on the audited entity to other parties at a financial or corporate transaction

## 3.2. 'Pure' audit firms

- *Two cumulative requirements:*
  1. National criterion: Generation of more than 1/3 of annual audit revenues from large PIEs
  2. European criterion: Belonging to a network whose members have combined annual audit revenues which exceed EUR 1 500 million within the EU (from PIEs and non-PIEs)
- *Large PIE:*
  - ❖ the 10 largest issuers of shares in each Member State by market capitalisation
  - ❖ all issuers of shares with an average market capitalisation of more than EUR 1 000 million

## 3.2. 'Pure' audit firms - consequences

- Audit firm shall not belong to a network which provides non-audit services in the EU (e. g. no common brand name)
- Any entity providing non-audit services shall not hold more than 5 % of the capital or of the voting rights in the audit firm (if there is more than one such entity holding capital or voting rights they shall have not more than 10 % together)
- 'Pure audit firm' shall not hold more than 5 % of the capital or voting rights in an entity that provides non-audit services



## 3.3. Audit Report - content

- ❖ Describe the used methodology, including how much of the balance sheet has been directly verified and how much has been based on system and compliance testing
- ❖ Explain any variation in the weighting of substance and compliance testing when compared to the previous year
- ❖ Lay out the details of materiality
- ❖ Identify key areas of risk of material misstatement including critical accounting estimates or areas of measurement uncertainty
- ❖ Provide a statement on the situation of the audited entity, especially an assessment of the entity's ability to continue as a going concern

## 3.3. Audit report – content (continued)

- ❖ Assess the internal control system
- ❖ Explain to what extent the audit was designed to detect irregularities, including fraud
- ❖ Indicate and explain any violation of accounting rules or violation of laws or the articles of incorporation, accounting policy decisions and other matters that are significant for the governance of the entity
- ❖ Audit opinion
- ❖ Emphasis of matter

## 3.4. Additional report to the Audit Committee

- *Additional (internal) report to the audit committee with the possibility to transmit it to the management*
- *The auditor shall provide more information such as:*
  1. Describe the appointment procedure
  2. Indicate and explain judgements about material uncertainty that may cast doubt about the entity's ability to continue as a going concern

## 3.4. Report to Audit Committee (continued)

3. Determine in detail whether the bookkeeping, the accounting, all audited documents, the financial statements and possible additional reports show appropriateness
4. Indicate and explain in detail all instances of non-compliance, including non-material instances as far as it is considered to be important to the audit committee in order to fulfil its tasks
5. Provide full details of all guarantees, comfort letters, undertakings of public intervention and other support measures that have been relied upon when making a going concern assessment
6. Indicate whether all requested explanations and documents were provided by the audited entity

## 3.5. Communication with supervisors of PIEs

- *Auditor shall report promptly any fact or decision regarding:*
  - A material breach of rules governing the PIE
  - The impairment of going concern of the PIE
  - Auditor's refusal to certify the financial statements or expression of his reservations
- *Competent authorities supervising credit institutions and insurance undertakings shall establish a regular dialogue*

## 3.6. Audit Committee

- *Composed of non-executive members, at least one member shall have competence in auditing and another in accounting and/or auditing*
- *A majority of the members shall be independent*
- *New Tasks:*
  - Supervise the completeness and integrity of the draft audit reports
  - Be responsible for the selection procedure of the auditor and recommend the auditor to be appointed
  - Authorise the provision by the auditor of non-audit services (see grey list)

## 3.7. Audit firm rotation

- *Initial engagement not shorter than 2 years*
- *Renewal once*
- *Maximum duration of the two combined engagements not longer than 6 years*
- *Cooling off period of 4 years*
- *In case of a joint audit throughout the continuous engagement– maximum duration becomes 9 years*

## 3.8. Contingency planning

- ❖ *identify measures to avoid disruption*
- ❖ *indicate the level of liability of each partner and the extent to which legal liability can spread to other audit firms belonging to the same network*
- ❖ *identify measures to prepare an orderly failure of the firm*



## 4. Supervision

- ❖ *Each Member State shall have only one authority responsible for supervision which includes the following tasks:*
  - approval and registration
  - ethical standards
  - internal quality control
  - continuous education
  - quality assurance (= inspections of audit firms)
  - Investigations and disciplinary measures
- ❖ *Only approval and registration may be delegated by law to other authorities or bodies.*
- ❖ On EU level: cooperation between competent authorities via the European Securities and Markets Authority (ESMA)