



## Deloitte Audit Reform Briefing: Unprecedented reform proposed for the EU audit market

**Some of the European Commission's legislative proposals may have unintended negative consequences to businesses. A summary of the proposals is provided below, followed by the Deloitte<sup>1</sup> perspective**

### Background

On 30 November, the European Commission (EC) published proposed changes to audit regulations. These proposals are at an early stage in the legislative process and are currently being debated in the European Parliament (EP) and by the Council of Ministers (Council), comprising representatives from the 27 European Union (EU) Member States. A number of process steps are required for implementation, each of which could result in modifications to the proposals. Specialized committees within the European Parliament and a Council working group are currently discussing the proposals and forming their views, with an eye to adopting legislation in 2013. This review phase is necessarily lengthy and thorough, allowing for substantial dialogue and engagement of stakeholders to inform the decision-making process.

Within its proposals, the EC has recommended measures that could bring unprecedented change to the EU audit market and significantly affect businesses and their relationships with their auditors. It is important to note that some of the proposals do not reflect the opinions of the majority of those stakeholders who responded to the Green Paper Audit Policy consultation, issued in October 2010.

The proposals are set forth as a Directive and a Regulation. The Directive seeks to amend the current Statutory Audit Directive, applying to all statutory audits, and would need to be transposed into national law by each Member State. The Regulation includes new requirements governing statutory audits of public interest entities (PIEs) that, if passed, would apply throughout the EU without needing to be transposed into Member State law.

In its proposals, the EC has offered the following expanded definitions:

<sup>1</sup> Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited and its network of member firms.

*PIEs* – to include banks, insurance undertakings, and companies listed on regulated markets, in general, as well as investment firms, payment institutions, undertakings for collective investment in transferable securities (UCITS), electronic money institutions, and alternative investment funds.

*Large PIEs* – defined by each Member State as the 10 companies listed on a regulated market with the largest market capitalization and all issuers with more than €1 billion of market capitalization, credit institutions and similar with a balance sheet totaling more than €1 billion, and investment funds and UCITS with over €1 billion assets under management.

## EC proposals

A summary of the EC's core proposals are provided below. A copy of the full proposals can be found at: [http://ec.europa.eu/internal\\_market/auditing/reform/index\\_en.htm](http://ec.europa.eu/internal_market/auditing/reform/index_en.htm).

### Mandatory audit firm rotation

Audit firm appointments would last for at least a two-year term, renewable once. The maximum duration of an audit engagement could not exceed six years unless there had been joint auditors, in which case the maximum duration would be nine years. The audited entity could be permitted, on an exceptional basis, to request the competent authorities to extend the auditor appointment for a further two-year term (or three-year term if there are two auditors). A period of four years would need to elapse before the audit firm could undertake the audit of the entity again.

### Mandatory audit tendering

PIEs would be obliged to have an open and transparent tender procedure when selecting a new auditor. At least one firm invited to submit a proposal would need to have received less than 15% of the total audit fees from Large PIEs in the relevant Member State in the prior calendar year. Generally, this would mean at least one non-Big 4 firm would need to be invited to participate. The audit committee would be closely involved

in the selection process and would make a recommendation for appointment to the board. The recommendation would include at least two choices and the audit committee would express its duly justified preference. The board proposal to the shareholders would include the audit committee's recommendation and if the board's proposal departs from this recommendation, it would need to justify this.

### Non-audit services

The Regulation would allow very few non-audit services (NAS) to be provided to audit clients. NAS, which exclude "related financial audit services," have been split between:

- Those which are deemed to entail a conflict of interest in all cases and can never be provided and
- Those which might cause a conflict of interest and may be provided subject to prior approval by, in some cases, a competent authority (nominated by the Member State) or, in other cases, the audit committee.

Non-audit services would include:

- Services that proposed Regulation deems entail conflict of interest in all cases:
  - 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 procedures related to the preparation and/or control of financing information included in the financial statements and advice on risk
  - Valuation services, providing fairness opinions or contributions-in-kind reports

- Actuarial and legal services, including the resolution of litigation
  - Designing and implementing financial information technology systems for the following PIEs— credit institutions, insurance undertakings, payment institutions, electronic money institutions, investment firms, alternative investment funds, UCITS, central securities depositories, and central counterparties
  - Participating in the audit client’s internal audit and, generally, the provision of services related to the internal audit function
  - Broker or dealer, investment advisor, or investment banking services
- Services that proposed Regulation deems may entail conflict of interest and require prior approval by audit committees:
    - Human resource services, including recruiting senior management
    - Providing comfort letters for investors in the context of the issuance of an undertaking’s securities
  - Services that proposed Regulation deems may entail conflict of interest and require prior approval of the competent authority designated by the Member State:
    - Designing and implementing financial information technology systems for non-financial institutions
    - 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 of a financial or corporate transaction
- There is no reference in the proposals to a fee cap on the services that might be allowed.
- Related financial audit services**
- Audit firms would be able to provide “related financial audit services” to the PIEs they audit. Fees for such permitted services would be capped at 10% of the total fees paid by the audited entity for the statutory audit. “Related financial audit services” contemplated in the EC proposals are:
- Audit or review of interim financial statements
  - Assurance on corporate governance statements and corporate social responsibility matters
  - Assurance on or attestation of regulatory reporting to regulators of financial institutions beyond the scope of the statutory audit and designed to assist regulators in fulfilling their role, such as on capital requirements or specific solvency ratios determining how likely an undertaking will be to continue meeting its debt obligations
  - Certification on compliance with tax requirements where such attestation is required by national law
  - Any other statutory duty related to audit work imposed by EU legislation to the statutory auditor or audit firm
- Audit-only firms**
- Audit firms that generate more than one-third of their annual audit revenues from Large PIEs AND that belong to a network whose members have combined annual audit revenues in excess of €1,500 million within the EU would neither be permitted to provide NAS to any PIEs nor belong to an audit network providing NAS in the EU.

### **Audit firm ownership**

The majority of voting rights in an audit firm would no longer need to be held by auditors (and Member States would be prohibited from requiring this), but the majority of members of the management body of an audit firm would still be required to be auditors.

### **Audit committee**

Each PIE, subject to certain limited exceptions, would be required to have an audit committee composed of non-executive members with the majority of members being independent. At least one member would need to have competence in auditing and another in auditing and/or accounting. The audit committee members, as a whole, would need to have competence relevant to the sector in which the audited entity is operating. In its role as overseer to the statutory audit, the audit committee would be required to inform the administrative or supervisory body of the audited entity of the outcome of the audit, explain how the audit contributed to the integrity of financial reporting and what its role was in the process, and authorize on a case by case basis the provision by the auditor of certain NAS that are still permitted.

### **Audit report**

The formal, external audit report would be extended significantly to cover an assessment of the audited entity's internal control system, including significant internal control deficiencies identified during the statutory audit as well as the bookkeeping and accounting system. The report would not be longer than four pages or 10,000 characters.

### **Audit committee report**

Auditors would also be required to prepare a longer report for the audit committee. This report would provide more detailed information on the results of the audit carried out and material findings, together with necessary explanations.

### **European supervision of the audit sector**

The EC proposes auditor supervision activities to be coordinated within the framework of the European Securities and Markets Authority (ESMA).

### **European passport for the audit profession**

A single market for statutory audits would be created with the introduction of a European passport for the audit profession. This would allow audit firms to provide services across the EU under international auditing standards and under certain conditions.

### **Compliance and International Standards on Auditing (ISA)**

Member States would have to ensure auditors comply with ISA insofar as they are relevant to the statutory audit and as long as these standards conform to the proposed Directive itself and the proposed Regulation on statutory audits of PIEs.

### **Nullity of contractual clauses limiting choice**

Any contractual clause agreed by the audited entity and a third party (e.g., a bank) limiting the entity's choice of auditor would be null and void.

### **Transitional agreements**

Transitional agreements have been drafted, but would depend on the date of adoption and the date of entry into force of the proposed Regulation.

For example, if the proposed Regulation is adopted in December 2013 and comes into force from April 2014, any audit contract entered into before December 2013 that is still in force in April 2014 would remain applicable for a maximum period of four years after April 2014. Any contract entered into in the period from December 2013–April 2014 would remain applicable for a maximum period of five years.

In addition, if these contracts were to expire or be terminated, the PIE would be able to renew them only once with the same statutory auditor or audit firm. The duration of this renewal—in the range of one to five years—would depend on the length of the existing audit relationship.

## Deloitte perspective

Deloitte is committed to helping to restore the public's trust in the capital markets and confidence in the role of the auditor, in particular. To this end, Deloitte supports efforts to bring about change that will enhance audit quality and trust in financial reporting, strengthen the independence of the auditor and role of the audit committee, and foster enhanced competition to mitigate concentration risk.

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In our view, the EC proposals, taken in the aggregate, have strayed from the appropriate focus on developing measures to improve audit quality and help prevent another financial

crisis. Given the extraordinarily challenged global economy, it is critical that proposals regarding the audit regime and regulation remain focused on building greater confidence in the capital markets and restoring economic growth.

## Deloitte supports ANY change that demonstrates improvement in audit quality

Deloitte has given much thought to positive change. We believe the following ideas (some of which are included in the EC proposals) have great merit and are worth pursuing in collaboration with the profession and other stakeholders:

### Audit committees

- A stronger role for those charged with governance and oversight of audit appointments, the conduct of the audit, and auditor independence, particularly audit committees
- Strengthened audit committee auditor oversight, including setting audit fees, and increased audit

committee independence from company management

### Reporting

- More informative audit reports that would provide investors and other stakeholders with greater transparency, including enhanced disclosure about the audit process, key business risks, and assumptions that underpin estimates in the financial statements
- Additional reporting from the auditor to the audit committee and increased, two-way communication between the regulators and the auditor
- Enhanced public reporting of the results of regulatory inspections of the individual firms, subject to client confidentiality

### Standards and processes

- Adoption of ISA throughout the EU to ensure consistency in audit quality
- EU-wide governance code that would require audit committees to conduct periodic, transparent evaluations of auditor performance against specified standards
- Full transparency in the auditor selection process would enhance independence
- Harmonized approach to the provision of NAS that includes a clear demarcation between audit services and NAS, and a list of prohibited NAS that an auditor may not provide to the audited entity (audit committees should have the right to pre-approve all permissible NAS)

### Competition and concentration

- Remove any artificial barriers to entry, such as legal covenants which require the use of certain categories or lists of audit firms, to enable smaller audit firms to compete on a level playing field

- Review audit firm ownership restrictions to allow small- and medium-sized practitioners easier access to capital
- Require audit firms auditing PIEs to establish contingency plans aimed at ensuring the continuity of the provision of audit services to PIEs and communicating these plans to the relevant authority
- Introduce European passports to increase mobility for suitably qualified audit professionals in the EU and to benefit small- and medium-sized practices, in particular

These targeted reforms are focused on key issues and would produce positive changes without artificially altering the structure of the audit market and creating unintended consequences, including a potential negative effect on audit quality, limits to choice, and increased cost and complexity for business and society.

## Focus reform on banks

Some have criticized the role of auditors in the past financial crisis and questioned the appropriateness of some bank auditors' opinions issued just prior to the financial crisis. There is no evidence to suggest the vast majority of auditor opinions were not in keeping with existing professional guidelines; however, there are always lessons to be learned as we look to the future.

Deloitte has been developing, in consultation with the profession and other stakeholders, alternative measures that would enhance risk communications between auditors, financial supervisors, and other regulators such as announced protocols, clearer disclosures and reporting for banks, and a better reporting model for bank auditors.

An improved reporting model would address the discord between the desire of taxpayers and investors for a clear picture of risk and the public interest priority to maintain confidence in banks

and the financial system. Disclosure that could lead to a loss of confidence, potentially resulting in a run on banks, does not serve the public interest. This is a key lesson learned from the financial crisis and a complex problem that the EC proposals do not address. Deloitte is participating in many forums that are tackling this issue and making progress, such as the Financial Stability Board's April 2012 announcement of initiatives to enhance the audit process.

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## Some of the EC proposals will produce unintended negative consequences without tangible benefit

A number of the EC's specific proposals not only lack empirical support linking them to positive change, but are unduly prescriptive, inflexible, and carry the risk of damaging side effects, such as making the global operation of companies more costly and complex. For example:

- **Mandatory audit firm rotation and tendering** would force companies to change auditors periodically, limiting the discretion of the board of directors and the audit committee to choose the most capable auditor and putting additional financial and administrative burdens on companies. While this measure may provide the perception of greater independence and competition, in countries where these measures have been implemented, there is NO evidence they have improved audit quality, auditor independence, or competition.

Companies would need to continually educate new auditors on their businesses and risks.

The detrimental effect of such measures would be most severe for financial institutions, which present the most complex audit challenges and require specialized skills and experience, and would be counterproductive to the original objectives.

Additionally, a multinational company (MNC) would have difficulty putting mandatory audit firm rotation into practice as it needs to select auditors that have the relevant capabilities to implement consistent quality audits in ALL of the markets in which the MNC operates.

The negative consequences of these proposals are exacerbated when the interval between rotations is short.

- **A near ban on the provision of NAS**, by an audit firm to entities it audits, is unnecessary as it seeks to address an issue that does not exist. The level of NAS that incumbent auditors provide to their clients is historically very low due to audit committees' intervention, based on critical assessment against existing standards, when they deem the provision of these services to jeopardize auditor objectivity or independence. Effective measures already exist, such as combining audit committee monitoring of auditor independence (based on clear principles) with an appropriate list of prohibited services (such as those defined in the IESBA Code of Ethics Prohibitions). In many cases audit clients, particularly smaller companies, value the efficiency and effectiveness of appropriate NAS being provided by the auditor.
- **Forcing the creation of audit-only firms** would have an adverse effect on the economic independence of audit firms from companies they audit and

on the long-term attractiveness and sustainability of the auditing profession. Cutting the audit firm from the multidisciplinary capabilities that currently exist in the larger networks could reduce the competencies required to perform a complex audit, like large company audits that require specialized expertise from non-audit professionals. Multidisciplinary competence should be encouraged, not banned, as this is a key source of innovation in the profession.

These wide-ranging and drastic proposals threaten to create an audit regime in Europe inconsistent with those in other markets, further increasing complexity and costs for global companies and undermining European competitiveness at a time when European resources should be particularly devoted to innovation and growth.

## Broader considerations are needed

Beyond the EC proposals, there is a need for the profession and stakeholders to consider the broader public policy issue that centers on the future of the audit and the role of the auditor. The public is looking for auditors to help identify risks in the business model of a given client, industry or sector— critical, socially relevant issues that have the potential to destabilize a company, economy, or society. However, auditors are charged with dealing in historical financial information and their judgment is reliant on the accuracy of information provided by management.

So, what is the future of the audit and the role of the auditor? If the goal is to achieve real, lasting improvements in audit quality, there must be room in the current debate for this discussion and for innovative solutions. The audit profession is fully engaged in efforts designed to

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enhance audit quality and the public trust in the financial system and Deloitte stands ready to expand its role to meet evolving social expectations.

## Additional information

If you would like more information on the EC proposals or are interested in updates on legislative developments, please contact your Deloitte member firm Lead Client Service Partner.

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