

Statutory audit of public-interest entities: specific requirements

2011/0359(COD) - 30/11/2011 - Legislative proposal

PURPOSE: to strengthen the requirements for the statutory audit on the financial statements of public-interest entities (PIEs).

PROPOSED ACT: Regulation of the European Parliament and of the Council.

BACKGROUND: since 1984, EU rules have partially regulated statutory audit when a directive (Directive 1984/253/EEC) harmonised the procedures for the approval of auditors. Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, was adopted in 2006 and considerably broadened the scope of the former Directive.

The financial crisis has highlighted weaknesses in the statutory audit especially with regard to Public-Interest Entities (PIE), such as banks insurance companies and listed companies. Given that many banks revealed huge losses from 2007 to 2009 on the positions they had held both on and off balance sheet, it is difficult for many citizens and investors to understand how auditors could give clean audit reports to their clients (in particular banks) for those periods.

Statutory auditors and audit firms play an important role in society. They are entrusted by law to conduct statutory audits of public-interest entities with a view to enhancing the degree of confidence of the public in the annual and consolidated financial statements of such entities. In view of the public interest, **better audit quality would contribute to the orderly functioning of markets by enhancing the integrity and efficiency of financial statements.**

IMPACT ASSESSMENT : the impact assessment resulted in the following preferred policy options:

- the scope of statutory audit should be clarified and specified and the information that the auditor provides to users, the audited entities, audit committees and supervisors improved;
- the prohibition of the provision of non-audit services to the audited entities and even the prohibition of the provision of non-audit services in general would effectively address the need to reinforce independence and professional scepticism. Moreover, stricter rules in the procedure for the appointment of auditors and the introduction of mandatory audit firm rotation would contribute to higher quality audits;
- in order to facilitate an objective choice of an audit provider, contractual clauses limiting audit firm choice should be prohibited, the transparency on audit quality and on audit firms should be increased and an audit quality certification should be established;
- ownership restrictions should be lifted in order to increase the choice of audit providers;
- national audit supervisory authorities should be strengthened and an EU-wide cooperation within the European Securities and Markets Authority ([ESMA](#)) should be set up.

LEGAL BASIS: Article 114 of the Treaty on the Functioning of the European Union (TFEU).

CONTENT: this proposal lays down conditions for carrying out the statutory audit on the financial statements of PIEs. Directive 2006/43/EC already deals with certain requirements which apply to the statutory audit of PIEs. Those requirements will no longer be comprised in the Directive, but integrated (and further developed) in this Regulation.

The main points are as follows:

Conditions for carrying out statutory audit of public-interest entities:

- an auditor should establish adequate policies and procedures to ensure compliance with the obligations under the Regulation **regarding independence, internal quality control systems and the supervision of employees;**
- former auditors, key audit partners or their employees are not allowed to take up a key management position in the audited entity, to become a member of the audit committee of the audited entity, to become a non-executive member of the administrative body or to join the supervisory body of the audited entity **within two years after the termination of the audit engagement;**
- the statutory auditor, audit firm or member of the audit firm's network will be **prevented from providing certain non-audit services to their audited entities.** For other non-services that are not fundamentally incompatible with the audit services, the audit committee or the competent authority will be empowered to assess whether or not they may be provided to the audited entity;
- **audit firms of significant size** should focus their professional activity on the carrying out of statutory audit and should not be allowed to undertake non- audit services;
- the **content of the audit report disclosed to the public** is expanded so that it: (i) explains the methodology used, especially how much of the balance sheet has been directly verified and how much has been based on system and compliance testing, the levels of materiality applied to perform the audit, the key areas of risk of material misstatements of the financial statements; (ii) explains whether the statutory audit was designed to detect fraud and, (iii) in the event of a qualified or adverse opinion or a disclaimer of opinion, explain the reasons for such a decision;
- the auditor should also prepare a **longer and more detailed report** for the audit committee. This report would provide more detailed information on the audit carried out, on the situation of the undertaking as such (e. g. going concern) and the findings of the audit combined with the necessary explanations;
- the auditor should keep certain documents and information for a period of five years.

The appointment of statutory auditors or audit firms by public-interest entities:

- in order to reinforce the independence and capacity of the audit committee, the latter should be composed of non-executive members, at least one member should have **experience and knowledge** in auditing and another one in accounting and/or auditing;
- the proposal for the appointment of the auditor to the meeting of shareholders should be based on a **recommendation of the audit committee.** Unless it concerns the renewal of an audit engagement, the recommendation should contain at least two choices (excluding the incumbent auditor) and the audit committee should express a justified preference for one of them. The

recommendation of the audit committee should be made after the **completion of a due tendering process**;

- the proposal introduces **mandatory rotation of audit firms after a maximum period of 6 years** that may be, under certain exceptional circumstances, extended to 8 years;
- where a public-interest entity has appointed **two or more statutory auditors** or audit firms, the maximum duration of the engagements will be 9 years; on an exceptional basis, such duration may be extended to 12 years. It also provides for a cooling-off period before the audit firm is able to carry out the statutory audit of the same entity again.

Surveillance of the activities of auditors and audit firms carrying out statutory audit of public-interest entities:

- each Member State should **designate a competent authority** responsible for the supervision of auditors and audit firms auditing PIEs. The proposal requires that the EU-wide cooperation between competent authorities takes place within ESMA;
- a **'voluntary' pan-European audit quality certification** is introduced to increase the visibility, recognition and reputation of all audit firms having capacities to conduct high quality audits of PIEs. ESMA should publish the requirements for obtaining the certificate along with any administrative and fee implications.

Supervisory measures and penalties: administrative pecuniary sanctions on auditors and PIEs for identified violations are envisaged. Authorities should be transparent about the sanctions and measures they apply.

BUDGETARY IMPLICATIONS: the Commission's proposal has no direct or indirect impact on the European Union budget. In particular, tasks that would be entrusted to EU supervisory bodies as mentioned in the proposal would not entail additional EU funding.

DELEGATED ACTS: the proposal contains provisions empowering the Commission to adopt delegated acts in accordance with Article 290 of the Treaty on the Functioning of the EU.