EGIAN
European Group of International Accounting Networks and Associations

AN EGIAN POSITION PAPER

EGIAN SUPPORTS ROBUST REFORM PROGRAMME FOR THE EUROPEAN UNION AUDIT PROFESSION

1 THE URGENT NEED FOR CHANGE

The creation of a more open vibrant market in the audit of large listed companies is needed to protect and advance the public interest. If no action is taken, the current levels of concentration in this segment of the audit market in nearly all Member States of the European Union will likely continue to rise even further, for example as a result of firms being taken over by their dominant Big 4 competitors in key markets.

Furthermore, the critical risk relating to the impact on systemically important and other large listed companies were one or more of the dominant networks unexpectedly to leave the market needs to be addressed.

Voluntary initiatives have not secured change and the proposed living wills are, on their own, an inadequate and untested response to the problems that would arise if there were even fewer firms in the market. The ability of regulators to maintain a robust system of regulation should the market further consolidate would almost inevitably be curtailed.

As in other sectors, an audit market structure where more firms have meaningful market share would be expected to foster innovation and continuous improvement of audit quality.

We recognise that investors and others are calling for more extensive public reporting, such as of key issues discussed by the auditor with the audit committee and for more high quality information on risk and other issues in narrative reporting. The latter may give rise to changes in the scope of the audit.

Within the scope of the reform programme which we are proposing we think that further debate is now needed to develop a fair system of audit liability in the European Union.

2 THE PRINCIPLES WHICH SHOULD UNDERPIN THE CHANGE PROGRAMME

Targeted regulatory intervention is now essential in the European Union and we welcome the European Commission's declared intention to seek broader international action where beneficial. We believe that if such intervention follows the principles for reform set out below this will advance the public interest which must be the overriding consideration in determining future audit policy.

June 2011

Changes should be:

- **visionary**, creating a picture of a more sustainable audit market structure against which aspirational proposed measures can be evaluated;
- **proportionate,** focusing on the audit of large listed companies where the degree of concentration, and the problems caused by it, are greatest;
- **pan European Union**, establishing targeted actions at the EU level but recognising that Member States should be encouraged to implement these actions in an appropriate way which is based upon the national listed and audit market structures;
- **progressive,** leading to significant cumulative change over a relatively short period, perhaps 3 to 5 years, such that by the end of it a significant percentage of the volume of audit work for larger listed companies would be performed by a wider range of audit firms than it is presently
- **quality driven,** facilitating enhanced emphasis on the undertaking of high quality audits, which is clearly in the public interest;
- **growth orientated,** taking care not to impose additional costs or limitations on the freedom of action and of choice on smaller listed companies and unlisted companies on whom strong reliance is being placed for future economic growth and growth of employment in the EU.

3. THE KEY ACTIONS TO IMPLEMENT THE PROPOSED REFORM PROGRAMME

EGIAN supports:

- **Disclosure of key issues discussed by the audit committee and management with the auditors.** This should be provided in the audit committee's report in the case of large listed companies and the auditors should indicate whether they concur with these disclosures.

- **Review of narrative reporting and related audit scope with particular reference to risk-related issues.** A review should be undertaken, with significant investor involvement, of the narrative reporting requirements and, related to these, the scope of the audit of large listed companies. The review should consider whether there is merit in an extension of the scope of the audit to cover, for instance, assurance on statements related to the principal risks and risk management.

- **Placing a limit on the market share of dominant audit firms**. Regulators should act, in conjunction with investors and other market participants in the individual Member States as appropriate, to reduce progressively the concentration in the audit market for large listed companies. A limit could be established on the market share which could be held by any firm auditing large listed companies at any given time. Where this was exceeded, the firm(s) would progressively reduce their share to a level deemed appropriate from the perspective of regulatory risk.

- **Regular and fair tendering.** This should be phased in with respect to the audits of large listed companies. We would generally expect tendering to take place at intervals of around 8 to 10 years. This is more appropriate than requiring the mandatory rotation of auditors.

- **Introduction of audit consortia or joint audits.** Regulators should act, in conjunction with investors and other market participants in the Member States as appropriate, to increase progressively the number of large listed companies that appoint audit consortia or joint auditors, which should include at least one non-dominant firm in each instance. This should be phased in and the proportion held by the firm holding the smaller share of the total audit work for the group should progressively increase until there is a balanced share between members of the audit consortia or between the joint auditors. This is the most certain way of reducing concentration in this part of the market in the medium term.

In the case of joint audits, two or more auditors, usually two, jointly express their opinion on the consolidated financial statements of the group.

In the case of consortia audits, one firm is responsible for the opinion on the group's consolidated financial statements with one or more other firms participating in the audit of certain subsidiaries.

- **Curbing institutional bias in favour of the Big 4.** Measures to be introduced should include an end to restrictive covenants in loan agreements and similar clauses requiring the appointment of specific auditors. There should also be greater transparency in relation to the personal and commercial relationships between firms and the companies they audit and with respect to key appointments of current and former partners of firms to regulatory and professional bodies.

- Rigorous examination at EU or Member State level of proposed acquisitions that include firms active in the large listed audit market. Proposed transactions should be examined by competition authorities not just in the context of the impact on concentration at the EU or Member State level but also with regard to the potential negative impact globally on an audit network being able to continue credibly in the large listed audit market.

- **Focusing auditor independence requirements on the IFAC/IESBA Code of Ethics.** The IFAC/IESBA Code of Ethics is widely respected as a means of addressing conflicts of interest and independence issues in the conduct of audits, and is recognised as being "fit for purpose". To the extent that further restrictions on the provision of non-audit services to audit clients are considered to be necessary they should be restricted to large listed companies and implemented as far as possible through amendments to the IFAC/IESBA code. Any residual concerns over independence on the part of the Commission can be addressed through additional corporate governance disclosures by those companies in relation to the nature of non-audit services provided, the reasons for selecting the auditors to provide them and pre-clearance policies put in place by the audit committee.

- **Support for introduction of ISAs.** Clarified ISAs, along with ISQC1, which have been developed after extensive due process and are widely respected, should be introduced across the EU as they would promote harmonisation of quality auditing practices.

June 2011

- **Support for development of a European passport for audit firms.** To promote the creation of a Single Market in audit services in the EU, firms should be given the option to register and be regulated on an EU-wide basis subject to their having people with the necessary understanding of the business and regulatory environment and the requisite language skills to operate effectively in their chosen Member States. Such an approach may encourage the emergence of new players as well as the coming together of firms in existing networks.

To implement the above reforms, definitions of large listed companies will need to be determined by Member States and/or the European Union perhaps by reference to leading indices in particular countries.

Examples of these indices are:

- France: the CAC 40 and the SBF 120
- Germany: the DAX 30, the MDAX 50, TecDax 30 and the SDAX 50
- The United Kingdom: the FTSE 100, the FTSE 250 and the FTSE 350

June 2011