EU Audit Reform Proposals – AFME Position Paper

Summary

AFME supports the overall thrust of the objectives of the proposed EU Audit Reforms, particularly the intention to "reinforce the independent and professional scepticism of the auditor" and to "make the top end of the audit market more dynamic" [1]. We believe, however, that the proposed mandatory rotation after six years (nine years if two audit firms are used) does not help achieve these objectives, and in some respects may even be counterproductive. In particular, it presents a high risk of:

- significant disruption of, and hence a potential reduction in the overall quality of, audits carried out on large complex multinational groups, a category which includes a significant number of AFME members; and/or

- severely inhibiting the ability of the Audit Committee to select the auditor whose resources and skill set are best suited to their firm.

A separate, but also substantial, concern lies around the restrictions on the provision of non-audit services, which we believe are too tightly drawn in several respects.

Mandatory rotation

Our most serious concerns relate to the proposals set out in Article 33 of the Proposal for a Regulation for the mandatory six-yearly rotation of auditors.

The operations of the typical large AFME member reflect the wide range of financial markets in which they operate and are accordingly complex, and also constantly evolving. It follows that it may take 2–3 years for a new team (even from within the existing audit firm) to acquire sufficiently detailed knowledge of the operations of the audited group to provide audit services of the highest quality; there is, in other words a "learning period" for a new team during which the quality of the overall audit may be lower than shareholders or senior group management would find desirable.

It is important in this context to note that the quality of the audit services provided to a large multinational group goes well beyond that which is visible to shareholders, who will typically see only the opinion on the consolidated group results. High quality feedback on such topics as the robustness of group reporting and control systems, and the consistency of

[1] The quoted objectives are taken from the Commission's 30 November 2011 Press Release "Reforming the Audit Market - Frequently Asked Questions"

adherence to corporate policies, is of great value to the Audit Committee, to senior financial and operational management, and a fortiori to shareholders. This feedback will have maximum effectiveness when there is a high degree of mutual confidence between management and audit staff: such confidence depends in turn on good working relationships which will typically take time to develop when a new audit team takes over.

The existing practice, where audit partners and team members are rotated on a phased basis, brings benefits in terms of a regular fresh look at the status quo, and so significantly reduces the risk of developing unhealthily "cosy" relationships; the phased rotation, however, enables any adverse effects from the learning period for new members of the team to be kept to acceptable levels. Such a phased approach to handover is impractical where a wholly new audit firm is brought in, and it follows that the overall quality of the group audit in the first year or two of a new firm may be lower than would normally be desirable. There is also a concern that there may be less focus on longer-term issues during the last one or two years of a six year audit term, with the possibility of lower quality of audit work towards the end of the period. In summary, we believe there is a significant risk that mandatory rotation in the form currently proposed would result in the highest quality audit service being delivered only during the middle part of a six-year term. Such a reduction would surely run directly counter to the aims of the proposed reforms.

The majority of large AFME members currently employ a single audit firm/network for all, or virtually all, of their global operations. The key reason for this practice is that the use of a single firm makes communication between the auditors of different group entities significantly more effective[2]; this, we believe, helps to ensure a consistent quality of audit across the group, and so to reduce the risk of inconsistent positions being taken, by different auditors of different group entities. A move to the use of joint auditors, which the EU proposals appear to encourage, could thus, in our view, risk reducing the effectiveness of the overall audit with a consequent risk of lower quality. Compliance with the current EU proposals would therefore entail a complete change of global auditors every six years.

A further, but perhaps less critical, point is that a Regulation-enforced change of auditors will not necessarily lead to better quality audits, even after the learning period referred to above, nor indeed to increased independence. The perceived need, at least for the very largest groups, for a single worldwide auditor will inevitably severely restrict the choice of an alternative auditor to those networks who can convincingly demonstrate the ability to deliver a top-class global audit service, which takes full account of

[2] For groups whose principal listing is in the US, the SEC/PCAOB requirements (AU Section 543) make it impractical for any material subsidiaries to be audited by an auditor other than the group auditor.

the complexity, and the rapidly changing nature, of the markets in which our members operate: even a generous assessment would today place no more than 6-8 audit firms in this bracket. Some of these, furthermore, are likely to be excluded from contention because they are major existing suppliers of non-audit services, because of competitor concerns, etc. Mandatory rotation could thus lead to Audit Committees being forced to make decisions which are not in the best interests of shareholders if the only practical way of complying with the Regulation is to appoint an audit firm with less expertise than their predecessor, with a consequent risk that they will deliver lower quality audits.

In this context we note that a number of countries that have in the past implemented mandatory auditor rotation subsequently abolished the requirement after finding that it failed to meet the intended public policy goals[3].

Despite these concerns, we acknowledge the perception that "there are obvious risks to having the same auditor for 50–100 years" [4], but we believe that this problem would be more productively addressed by an approach which focuses on mandatory tendering, after a maximum period of perhaps ten years; in addition to the requirements set out in Article 32, the audit committee should, we believe, provide shareholders with a summary of the results of the tendering process, combined, in the event that the existing auditor is to remain in place, with a full explanation of the reasons for this decision.

Such mandatory tendering process could also be supplemented with provisions requiring the Audit Committee:

- to provide evidence of annual considerations in respect of actual independence of the audit firms, appropriateness and sufficiency of processes at the audit firms to monitor independence and audit quality, as well as sufficiency of an independence function internally at the audited group to monitor independence and quality procedures; and

- at least bi–annually to discuss and challenge management as to retention, tendering or potential rotation of the audit firm, with clear evidence retained to support related decisions.

[3] We understand that Austria, the Czech Republic, Latvia and Spain have all at some point abolished mandatory rotation of auditors, as have Canada (which had a specific audit rotation requirement for domestic banks) and Turkey.

[4] Commission's 30 November Press Release "Reforming the Audit Market - Frequently Asked Questions"

In summary, we believe that the compulsory rotation of auditors is at best unlikely to produce the stated objectives of the proposed reforms, and would introduce a significant risk of lower quality audit, at least for those firms with genuinely global operations. Should the Council of Ministers conclude, despite these risks, that mandatory rotation should remain in the Regulation, we regard it as essential that a much longer period – say a minimum of twelve years - should be allowed before a change is required.

Provision of non audit services

We have a number of secondary, but still very significant, concerns around the restrictions on the provision of non-audit and related financial audit services which are set out in Articles 9 and 10 of the Proposal for a Regulation:

- We believe the requirement (set out in Clause 2 of Article 9) that the fees for "related financial audit services" should not exceed 10% of the corresponding statutory audit fee to be significantly too restrictive, and that a limit of 20%, perhaps combined with a greater degree of Audit Committee disclosure, would provide a practical degree of flexibility.

- It is particularly important, we believe, that firms have the flexibility to buy from their group auditors certain non-audit services, including those set out in Clause 3(b) of Article 10 that "may entail conflict of interest", such as human resource services, providing certain comfort letters, designing and implementing financial IT systems, and due diligence relating to acquisitions and disposals. The proposed derogation mechanism recognises the fact that the group auditor may in many cases be able to provide services in this category of higher quality and more efficiently than an external firm without the detailed knowledge that the auditor would normally have.

- We are also concerned that the proposal (in Clause 5 of Article 10) that the largest audit firms should be prohibited from providing <u>any</u> non-audit services, and the probable practical consequence of producing one or more "audit-only" firms, will artificially distort the audit market and will in practice result in a reduction of the available choice of auditors able to provide high quality audit services to the largest global firms. A related concern is that a move to an audit-only firm may well result in a loss of top-quality staff and corresponding diminished quality of audit services.

Quality assurance

Noting the proposals in Article 40 for Competent Authorities (i.e. audit supervisory bodies) to carry out regular quality reviews of each audit firm, we believe it would be very helpful if audit supervisors were required to provide timely feedback to the Audit Committees/Boards of firms whose financial statements audit have been selected for review of their conclusions regarding the quality of the audit carried out. This independent information would greatly assist Audit Committees/Boards in ensuring that their auditors maintain the highest audit quality, and would reinforce the mutual trust which is central to the audit process. The same result could alternatively be realised through a requirement for auditors to disclose the major points of a quality review to their relevant clients on a timely basis.

The international dimension

Many AFME members, including a high proportion of those with the very largest operations within the EU, are ultimately owned by parent companies based outside the EU, particularly in Japan, in Switzerland, and in the US. It is essential, we believe, that the EU recognise the risks associated with applying severe constraints on the audit of the EU subsidiaries of these groups which conflict with the approach taken by the corresponding authorities in the jurisdictions where the parent companies are based[5]: such conflicts could lead to lower quality audit, and potentially to a lower degree of control of some aspects of these large groups.

We would therefore very strongly encourage the European Commission to liaise closely with the corresponding legislative and supervisory bodies in these other jurisdictions to ensure that any new EU legislation does not conflict with legislation elsewhere in such a way as to produce a reduction in the overall quality of audit.

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[5] See, for example, the SEC/PCAOB requirements referred to in Footnote 2 above.