

EGIAN supports a rebalancing in the set of measures proposed for the much needed reform of the European audit market

1. Introduction

The European Group of International Accounting Association of Networks and Associations (EGIAN), which represents nearly all of the major networks and associations of audit firms apart from the Big 4, welcomes the publication by the European Commission of the draft regulation on specific requirements regarding statutory audit of public interest entities and of the draft Directive amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts.

EGIAN welcomes in particular the fact that the measures to create a more diversified audit market in the EU can now be discussed through a transparent and democratic process. The merits of some of these measures can now be openly debated with valid arguments.

Finally, we believe that, as the proposed legislation currently stands, a proper balance has not been reached between the various regulatory tools aiming at achieving more competition and choice. The purpose of this paper is to propose a pragmatic way forward to achieve an efficient and competitive EU Single Market for audit.

2. Regulatory intervention essential

EGIAN believes that regulatory intervention is essential to bring about the necessary change in the audit market relating to public interest entities across the European Union. Change is urgently needed to meet the needs of shareholders, to whom the audit opinion is addressed, and the wider public interest. Voluntary initiatives have not secured any significant changes and regulatory intervention is therefore now unavoidable. Without it the situation will continue to deteriorate further and would be severely aggravated were one of the four dominant players to leave the market, a concern regularly voiced by regulators.

3. The problems with the current audit market

There are a number of problems with the current situation which have been identified by the European Commission and by a number of reports in some Member States. These include excessively high degrees of concentration among the four dominant players in the market in nearly all Member States with the lead firm having a very high market share in some jurisdictions; low rates of switching and tendering; high barriers to entry for firms seeking a presence in the audit market for public interest entities (PIEs), especially large PIEs; worries about the low level of innovation and, more broadly, concerns that the current model is not meeting the needs of shareholders or the wider public interest.

4. Key features of a more open vibrant market

To address the problems outlined above, we must create a much more open vibrant market for the audit of listed companies and other PIEs with more competition and lower levels of concentration. Such a market will possess the following key features:

- ***Additional players***

Merely creating a more competitive environment among the current dominant players will not lead to the change in culture that is necessary to bring about greater innovation and transparency in the audit market for listed companies and to guard against the exit from the market of one of the current dominant players.

- ***Progressive***

The changes introduced must be progressive such that within a reasonably short timeframe, say 3 to 5 years, the additional players will be able to compete on an equal footing and collectively gain a significant share of the market.

- ***Quality driven***

A healthy market for the audit of listed companies and other PIEs will have quality at its heart and will promote a culture of continual enhancement in quality with an emphasis on professional values being placed ahead of business interests. There will also be a strong focus on *innovation* at firm and profession-wide levels and *independence* with particular reference to avoiding conflicts of interest.

- ***Transparent***

There will be much greater transparency in a reformed market whether one is considering the reporting of key issues on the audit, details relating to the period of incumbency of the current auditor, when the audit was last put out to tender, the tendering process or the provision of information relating to the audit firm.

- ***Proportionate and growth-orientated***

Attention will be paid to avoiding the imposition of unnecessary burdens on smaller listed companies as well as on unlisted small and medium-sized undertakings. In doing this account will be taken of their particular needs having regard to their having less access to in-house resources and to the vital role they play *in securing economic growth and new jobs* across the European Union.

- ***Pan-European***

The market will have advanced from being a series of separate national markets to a single European market where firms and individuals can work across frontiers more effectively, subject to appropriate safeguards being in place.

- ***Sustainable***

The combined effect of the reforms will be to have created a market that is sustainable and more stable than it is currently.

5. Overview of key reforms needed

We believe any reforms proposed should be tested against the criteria set out in Section 4 above. In this section, we identify the key reforms we believe are necessary with reference to the European Commission's current proposals and in the Appendix we discuss other

measures in the order in which they appear in the draft regulation and draft amended directive respectively.

The necessary key reforms include two different sets of measures. The first one is a package of “interconnected” measures capable of producing palpable change to the audit market structure. The second is composed of measures creating more integrated and fluid EU Single Market for audits:

5.1. A “Market Structure Package” that creates an open, fair and diversified market

a) Compulsory rotation of firms (art. 33)

We are not persuaded that the need to have compulsory rotation of firms will bring new players into the market. On the contrary, we believe that it tends to increase rather than reduce concentration. The provision of this article could be onerous for firms willing to enter the market. A strict rotation of partners is the best way to reduce familiarity risk. Fair and regular tendering (see below) associated with regular rotation of the signing partner is a sufficient step forward. This being said, should the rotation of firms prevail, a significantly longer period before compulsory rotation should apply in case of Joint Audit (18 years).

b) Pure audit firm’ proposals

It is a misnomer to call the proposal that if large firms/networks earn more than one third of their audit income from large public interest entities then they must only provide audit services to their clients a ‘pure audit firm model’. It is purely within the dominant firms’ control to remain within the proposed limits and so be able to remain multi-disciplinary if they believe that is a better form of organisation for the firm. It is very important to bear in mind that with the draft proposals on joint audit not having found their way into the draft regulation this is the only measure that ensures the unacceptably high levels of concentration in the market are reduced. Most of the other proposals may just lead to more competition among the existing players.

c) Provision of non-audit services

We understand the concerns that arise when the fees for non-audit services are a significant proportion, or even exceed those for the audit, especially in the case of large public interest entities. We are concerned however, that the 10% cap on those for audit related services appears quite unrealistic and not necessary as none of the services included in the allowed list poses a threat to the auditor’s independence. It is also important to recognise that smaller PIEs are more likely to need help from their auditor from time to time. In addition, in the case of Joint Audit, as each auditor assesses the non-audit services provided by the other, more flexibility could be introduced under the oversight of the Audit Committee.

d) Joint audit

Joint Audit of large public interest entities has the effect of ensuring a reduction in concentration and providing protection to large listed companies against the risk of a dominant player leaving the market unexpectedly. In the current proposed text, the provisions relating to joint audit appear only as a very modest encouragement to adopt joint audit with the proposed basic period before compulsory rotation being extended from 6 years in the case of sole audits to 9 years for joint audits. We strongly believe that

compulsory Joint Audit should be part of the set of measures to diversify the market. This can be done in a more pragmatic and flexible way than the one originally envisaged by the Commission (flexibility in the choice of the two auditors, progressive sharing of tasks...).

If joint audit is just to remain an encouragement, the incentives to adopt it should be markedly increased, eg a greater differentiation in the number of years before compulsory rotation (implying therefore longer periods before tendering is required), less restrictions on the provision of non-audit services as each joint auditor will need to assess the non-audit services provided by the other with regards to their impact on independence and the possibility of not computing Joint Audit fees for the calculation of the “Pure audit firm” thresholds.

5.2. A more fluid and integrated EU Single Market

a) Creating a single European market for audit

We believe it is essential that a single market for Europe be created and therefore support the proposed introduction on a voluntary basis of the European quality certificate and of the move to home country supervision coupled with a European passport to make it more easy for audit firms and auditors in the European Union to work across Member State frontiers. We do, however, believe that for the later it is important that where the ‘adaptation’ procedure is adopted and that care is taken to ensure the auditors involved have the necessary understanding of relevant laws and regulations in their host country and possess the necessary language capabilities.

b) Regular and fair tendering

We support regular and fair tendering for audits and would suggest that audits could be subject to tender at periods between 8-10 years. We also consider that the tendering process should be fair and clearly open to a range of firms with the necessary skills in addition to the dominant players. Moreover, there should be transparency on when the auditor was first appointed; when the last competitive audit tender was held; how the tendering process was conducted, where applicable; and the reasons the successful firm was chosen. Full information should also be provided of links between the audited entity and the auditor.

c) Prohibition of Big 4 only contractual clauses

We strongly support the prohibition of Big 4 only contractual clauses in loan and other agreements (in particular tendering), a proposal for which there seems to be widespread acceptance. The tougher challenge is how to eliminate the unwritten institutional bias that favours the dominant players. The transformational nature of the legislation adopted by the EU in the end will play a significant role in changing the mind-set.

d) International Standards of Auditing

We support the proposal that auditing should be undertaken in accordance with international standards of auditing and, in full respect of the Union sovereignty, would welcome it being clear that this reference is to the IAASB’s clarified International Standards of Auditing which have been developed after extensive due process and are widely recognised and, if adopted, would increase harmonisation.

e) Modification of ownership rules

We are not against the relaxation of ownership rules so that auditors are not required to own a majority of the voting rights but we do not think it will have a substantial impact in practice as firms have generally been able to access the capital they need for investment purposes to date and there is no evidence of this ceasing to be the case in the future.

6. Conclusions - Within the EU Single Market, the audit market is lagging behind in terms of diversification and integration

The current review of the audit market in the European Union provides a once-in-a-generation opportunity to tackle problems with its functioning that have built up over many years and which if not addressed will continue to get progressively worse. Moreover, whether one analyses the current situation from an audit regulatory or a competition perspective the issues giving rise to concern and the proposed remedies, such as the need for new players in the large listed audit marketplace, are the same. The current audit market is not meeting the needs of shareholders or the wider public interest, nor those of the Single Market, as it is much less diversified and integrated than other financial activities. Legislative reform is needed.

Appendix 1

EGIAN's initial views on other key proposals in draft regulation and directive

Draft regulation

(a) Internal quality control review (Articles 19, 22 and 23) (is it the case?)

We have serious concerns about the proposal in Article 22.2(m) which calls for the audit or to report on the internal control system. Whilst we understand this was not the intention there is a risk that such a proposal will lead to significant extra costs for the audited entity without commensurate benefits and move in the direction of the Sarbanes-Oxley approach in the US which would be most unfortunate

(b) Disclosure of financial information by auditors (Article 26)

We support the proposals for increased transparency on the financial affairs of firms and networks including the proposal that their financial statements should be audited

(c) Corporate Governance Statement (Article 28)

We support the proposals that audit firms with significant revenues from large PIEs should publish corporate governance statements

(d) Audit Committee (Article 31)

The Audit Committee has an important role in supporting audit effectiveness. In this context we support the audit committee being composed of non-executive members of the governing body of the audited entity but we believe that all and not just a majority should be independent. We agree that at least one member of the Audit Committee should have relevant accounting and/or auditing expertise. We are not sure, however, that it also needs to be specified that another member should have auditing expertise

(e) Contingency Planning (Article 43)

Whilst we support contingency planning for the largest firms we do not believe it is a sufficient response on its own to address the risk of one of the dominant players leaving the market unexpectedly. Moreover, the contingency planning should take account on the need for concentration in the market not to be increased following such an exit. Creating the conditions for additional players to win a significant market share collectively is the best way to address the issue of a dominant player exiting the market

(f) European Quality Certificate (Article 50)

We support the idea of establishing a European quality certificate for those carrying out statutory audits of public interest entities and are also broadly supportive of the draft proposals relating to it contained in the draft regulation.

(g) Sanctioning powers (Article 62)

Whilst welcoming the statement in Article 61 that sanctions shall be proportionate as well as effective and dissuasive and the list of factors to be taken into account when determining appropriate sanctions as set out in Article 63, we do have concerns that some of the potential sanctions set out in Article 62 are potentially very severe and do not distinguish between different Articles which may have been breached

Draft Directive**(h) Abolition across the EU of the need for small undertakings to have a statutory audit (Article 43)**

We support the proposal not to allow Member States to require small undertakings to have a statutory audit

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