Public Company Accounting Oversight Board

Public Meeting

on

Auditor Independence and Audit Firm Rotation

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Houston, Texas

Written Statement

of

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Disclaimer

This document does not prejudge or represent any formal proposal or position of the European Commission and presents therefore my personal views.

Introduction

I am delighted to be here today and I would like to thank the PCAOB on behalf of Commissioner Michel Barnier and Director General Jonathan Faull for providing the opportunity to participate in this public meeting on auditor independence and audit firm rotation. First of all, I would like to commend and applaud the PCAOB on this initiative to further discuss the critical issues of auditor independence, objectivity and professional scepticism.

Last November, the European Commission adopted two proposals on audit policy. The main aim of these proposals is to help re-establish confidence, which is an essential ingredient for further investment and economic growth, by improving audit quality as well as by enhancing the single market and financial stability.

But I would like to start by taking a step back to explain the thinking behind the European Commission's proposals. The financial crisis highlighted certain shortcomings, especially with regard to the stability of the financial system. And auditors have an important role to play in that system. Many banks revealed huge losses from 2007 onwards. Several of them have been bailed out by Member States of the European Union. Many citizens and investors fail to understand how auditors could have given clean audit reports to their clients for those periods.

Audit, alongside stronger supervision and better corporate governance, should be one of the key contributors to financial stability. It provides assurance on the veracity of the financial statements of companies. This assurance should reduce the risk of misstatement. It should also reduce the costs of failure that would otherwise be suffered not only by the company's direct stakeholders but also by society at large. Moreover, audit plays a fundamental role in investor protection.

The European Commission has therefore taken the time to reflect seriously on the audit sector. We have also consulted widely on the issues involved and developed five main objectives of the reform brought forward:

- reinforce the independence and professional scepticism of auditors,
- clarify and define more precisely the contents of the audit report,
- improve the supervision of auditors,
- facilitate cross-border provisions of audit services and
- reduce unnecessary burdens for small and medium sized entities.

Auditor Independence

The independence of auditors is the condition *sine qua non* for a proper audit. In this area, perceptions are critical. In this context, it is important to stress that auditors have an important role to play and are entrusted by law to conduct statutory audits. This entrustment responds to the fulfilment of a societal role in offering an opinion on the truth and fairness of the financial statements of audited entities. In addition, the statutory audit of financial statements is intended as a safeguard for investors, lenders and business counterparties who have a stake or a business interest. The independence of auditors should thus be the bedrock of the audit environment.

Mandatory Audit Firm Rotation

To mitigate the risk of any potential conflict of interest due to a familiarity threat, the proposals on audit policy require all public-interest entities to change their auditor every six years in cases where one auditor has performed the statutory audit, and every nine years in cases where two auditors have carried out the audit.

As the financial crisis has highlighted shortcomings of statutory audits especially with regard to public-interest entities, the envisaged requirement to rotate is restricted to statutory audits of such entities which include listed undertakings, banks, insurance and other financial sector undertakings. Public-interest entities are of significant public interest because of their business, their size, their number of employers or because they have a wide range of stakeholders. Therefore, it is of utmost importance to ensure that audits in this sector are conducted independently.

In addition, inspection reports of Auditor Oversight Bodies in the European Union, namely in France[1], Germany[2], Italy[3], the Netherlands[4] and the United Kingdom[5] show that audit quality is not a given and that it must be considerably improved. For example, the Netherlands Authority for the Financial Markets (AFM) identified key deficiencies, which included failings of auditors to exercise sufficient and appropriate professional scepticism in the conduct of their audits. If audits are not conducted with professional scepticism, which is a key element of auditor independence, there is a high risk of material errors in the financial statements remaining undetected and of auditors incorrectly issuing unqualified audit opinions.

Currently, Italy is the only Member State of the European Union that requires mandatory audit firm rotation. In Italy, public-interest entities are obliged to change their auditors every nine years. The Italian authorities consider that this long-term appointment guarantees that the rotation system functions well. In addition, the duration of the engagement allows the auditor to have enough time to recover the higher investment (e.g. to understand the audited entity etc) in the first years of the audit engagement. Concerning the question of independence, according to a study, conducted by the Bocconi University to investigate the impact of the mandatory rotation rule in Italy, 69 % of managers of listed companies approve of rotation. 14 % consider it negatively[6]. The supporters of mandatory rotation take a positive view mainly because they believe that, over the years, auditors tend to concentrate on routine activities and pay less attention to making

[1] Haut Conseil du Commissariat aux Comptes, *Rapport Annuel 2009*, available at: http://www.h3c.org/fiches/rapport_2009.htm.

[2] Abschlussprüferaufsichtskommission, *Report of the Auditor Oversight Commission on the results of the inspections according to § 62b WPO for the years 2007-2010*, 6 April 2010.

[3] Consob, *Annual Report 2009*, 31.3.2010, and *Relazione per l'anno 2010*, 31.3.2011

[4] Autoriteit Financiële Markten, *Report on general findings regarding audit quality and quality control monitoring*, 1.9.2010, available at: http://www.afm.nl/layouts/afm/default.aspx~/media/files/rapport/2010/report-regarding-audit-quality-quality-control-monitoring.ashx

[5] Financial Reporting Council, Audit Inspection Unit of the UK's Professional Oversight Board ("the Oversight Board"), *2009/10 Annual Report*, 21.07.2010.

[6] SDA Università Bocconi, Corporate Finance and Real Estate Department and Administration and Control Department, *The impact of mandatory audit rotation on audit quality and on audit pricing: the case of Italy*, April 2002.

suggestions/improvements. The people contacted in the survey generally agreed that the current existing mandatory rotation in Italy constitutes a mechanism to guarantee auditor independence.

Mandatory audit firm rotation presents advantages in terms of meeting potential conflicts of interest and thereby improving audit quality:

- **Re-enforce professional scepticism** – In a long term audit relationship, the auditor will tend to identify too closely with the management. Proper professional scepticism will be diluted and auditors will be more likely to smooth over areas of difficulty in order to preserve the relationship. Auditors may become stale and view the audit as a simple repetition of earlier engagements. This staleness fosters a tendency to anticipate results rather than keeping alert to subtle changes in circumstances which could be significant.

- **Providing a "fresh view"** - A similar effect is alleged in "self-revision" cases, those in which the auditor must report negatively on his previous work. In these contexts, by bringing a "fresh view" and forcing an in-depth review, rotation of the auditor might help in such circumstances.

- **Review of the work by the new auditor** – The fear that reputation will be affected, when discovery of an unreported breach is made public, will also enhance audit quality. Mandatory rotation will make it possible for auditors to control each other's work. The knowledge that another auditor will scrutinise the auditor's work within a short period of time will encourage auditors to do their best. Mandatory rotation will also minimise the risk that errors in the audit procedure continue due to the fact that the auditor looks upon the audit engagment as a reiteration of last year's audit.

- **Address shortcomings of "partner rotation" scenario** – According to the currently existing legal framework in the European Union, the key audit partner(s) responsible for carrying out the statutory audit of a public-interest entity on behalf of the audit firm needs to rotate from the audit engagement within a maximum period of seven years. However, the key partner rotation seems to be insufficient to solve the existing problems. On the one hand, the threat of familiarity is not resolved. The "partner rotation scenario" with no rotation of the audit firm risks perpetuating the syndrome of decades-long audit engagements, where the partner of a firm's long standing audit client naturally remains under pressure not to lose the client. Moreover, in case of partner rotation only, a new partner is likely to feel obliged to live with decisions and agreements made by the previous partner; he/she may have little flexibililty to reopen them. The partner of an incoming firm does not have that problem.

According to the Statutory Audit Services Survey by the United Kingdom Competition Commission, for 80 companies switching was said to have resulted in a change in quality, with 70 saying that the change was positive. The most frequently mentioned improvements were: better audit processes and planning; higher quality and better skilled staff; better sector experience and understanding of the client's business; a more thorough approach; and better quality reporting and feedback[7].

[7] United Kingdom Competition Commission, *Statutory Audit Services Survey*, July 2012

On the other hand, certain concerns have been raised with regard to a potential loss of knowledge, a lack of choice and an increase of costs:

- **Loss of knowledge** (mainly in the first year of the audit engagement)**? –** We do not believe in the loss of know-how argument;if we did we would have to consider all new audit engagements and all first year audits as being of poor quality. The envisaged handover file is an additional and practical tool to facilitate the smooth transition to the incoming auditor and facilitate him/her in climbing the learning curve of the new engagement. However, current audit practice shows that normally auditors put more resources (in quantitative and qualitative terms) into the audit work in the first years of a new audit mandate in order to meet the expectations of the audited entity and deliver good quality audit reports.

- **Lack of choice? –** Some stakeholders are opposed to the introduction of mandatory firm rotation fearing that it may lead to a lack of choice when appointing a new auditor. First of all, by introducing transitional periods for introducing mandatory firm rotation, only a certain number of auditors rotate at the same time. Moreover, auditors that have not been previously engaged in certain segments of the market could participate in the selection procedure in order to obtain such engagements. Once there is an established rotation system, the right incentive (the possibilty of obtaining new engagements) is created and will be in place for other firms to invest in capacity to respond to new opportunities.

- **Increasing costs?** - The costs regarding public-interest entities are mainly related to organising a tender and putting in more resources to help the incoming auditor within the first year to build up knowledge of the audited entity. The costs regarding auditors are mainly linked to the need to provide more resources in the first year of the audit engagement as well as resources allocated to prepare a bid. However, as demonstrated above, there are expected benefits of introducing mandatory audit firm rotation that will outweigh the costs. In addition, the handover file from the incumbent auditor will support a smooth and less cost intensive transition.

To conclude, there are obvious reasons and good grounds on which the introduction of mandatory audit firm rotation can be based. It would strengthen the independence of auditors by mitigating the familiarity threat. Let us please remind ourselves that regulated professions are regulated in the interest of the public. It is only natural, therefore, that the privileges accorded to those who are entrusted in law with the conduct of audit respect their responsibility to the public. We have to ensure that we have robust custodians of information as well as total integrity in the performance of such custodianship, especially when related to financial information. We strongly believe that this total integrity is achievable only if there is complete and undisputable independence with no semblance whatsoever of any conflict of interest.

European Commission

Public Meeting on Auditor Independence and Audit Firm Rotation

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Houston, 18 October 2012

Nathalie Berger, Head of Unit, Audit and Credit Rating Agencies,
DG Internal Market
European Commission

Internal Market and Services

Agenda

- Main findings from Inspections performed by European Auditor Oversight Bodies
- Mandatory rotation v. voluntary rotation
- Current EU Legislation
- Proposals for the reform of the EU audit market

Findings from Inspections performed by European Auditor Oversight Bodies

Country	N° of inspections	% of material findings
France	272	12 %
Germany	125	25 %
UK	107	13%

Source: H3C (2009), APAK (2007 – 2010), AUI (2009 – 2010)

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Main findings

- Weaknesses in the internal control procedures to identify conflicts of interest
- Insufficient professional skepticism
- Over-reliance on management declarations

Main findings

- Lack of evidence to support the audit opinion
- Insufficient audit control procedures linked to going concern assumption, valuation of assets and debts, completeness of revenues

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Mandatory rotation v. voluntary rotation

Market stagnation - low switching of audit firms

Country	Average Length of audit tenure
31% of EU companies	> 15 years
UK FTSE 100	46 years
UK FTSE 250	36 years
UK- Other listed	25 years
Germany 2/3 of DAX 30	20 years
US 60% of Fortune 1000	> 10 years
US 10% of Fortune 1000	≥50 years

Sources: London Economics (2007), House of Lords (2011), German Public Register of Companies, Aubin (2011)

Mandatory rotation v. voluntary rotation

Voluntary change of auditor may be associated with:

- Auditor-issuer disagreements (e.g. DPAM 1996 - stock evaluation, Olympus 2009 - goodwill estimation)
- Scandals related to the audit firm's network (Arthur Andersen)
- Economic issues (increase in audit fees)

"When you see an accident on a road, you think that the driver is guilty. When you see several accidents at the same place, you are wondering about the quality of the road. This is the case today. »

Joseph Stiglitz

Nobel Prize in Economics (2001)

How to fix the road?

Keeping the status quo is not an option

Current EU Legislation

Member States shall ensure that the key audit partner(s)responsible for carrying out a statutory audit rotate(s) from the audit engagement within a maximum period of seven years from the date of appointment and is/are allowed to participate in the audit of the audited entity again after a period of a least two years.

(Article 41 of Directive 2006/43/EC)

Mandatory audit firm rotation

Mandatory rotation of audit firms with a **maximum duration of 6 years** (two combined engagements, renewal once) or 9 years (joint audit)

- Initial engagement no shorter than 2 years
- Gradual rotation mechanism
- Cooling off period: 4 years
- Derogation on an exceptional basis upon approval from the competent authority
- Hand-over file

Mandatory audit firm rotation - advantages

- Eliminates threats to independence (reinforcing professional skepticism)
- Addresses shortcomings of "partner rotation" scenario
- Avoids repetition of existing errors (rotation of team members and internal experts)
- Creates more competition in the market

Mandatory audit firm rotation - impact on audit quality

"In 80 companies (including 22 FTSE 350 companies) switching was said to have resulted in a change in quality, with 70 saying that the change was positive and 10 saying that the change was negative at least in the first year."

The most frequently mentioned changes were: better audit processes and planning; higher quality and better skilled staff; better sector experience and understanding of the client's business; more thorough approach; and better quality reporting and feedback.

Source: Survey of UK Competition Commission 2012

Mandatory audit firm rotation - costs

- Limited increase in costs but
  - Estimated benefits will outweigh increase
  - Requirement of a hand over file

- Survey of UK Competition Commission 2012:
  - 59% of surveyed companies in the UK- no increase of internal company costs after switching
  - 41% reported a decrease of audit fees.

Proposals for the reform of the EU audit market

Two legislative instruments :

- A draft Directive amending the current Directive on statutory audits of annual accounts and consolidated accounts
- A draft Regulation on specific requirements regarding audits of public-interest entities

Definition of Public-Interest Entities

- Listed companies
- Credit institutions
- Insurance undertakings
- Payment and electronic money institutions
- Investment firms and alternative investment funds
- Undertakings for collective investment in transferable securities (UCITS)
- Central securities depositories
- Central counterparties

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Auditors' independence

- Mandatory rotation
- Prohibition of "Big 4 only contractual clauses"
- Prohibition of the provision of certain non-audit services
- Pure audit firms

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Transparency

- More detailed audit report
- Additionnal audit report to the Audit Committee
- Regular reporting and dialogue with supervisors of audited entities
- Compliance with the International Standards on Auditing (ISA)

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Open up the audit market

- European passport for audit firms
- European Quality Certificate
- Mutual recognition of statutory auditors approved in Member States

Strengthen audit supervision

- National audit oversight authorities strengthened: more independence from the audit profession and more powers
- Regular dialogue between auditors, audit committees and supervisors
- EU-wide oversight coordinated by the European Securities and Markets Authority (ESMA)

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More information can be found at:

http://ec.europa.eu/internal_market/auditing/index_en.htm