

## **Commission Recommendation on external quality assurance for statutory auditors and audit firms auditing public interest entities: Frequently Asked Questions** (see [IP/08/734](#))

### **1. Why has the Commission issued the Recommendation?**

There were two reasons for issuing the Recommendation.

First of all, recent international developments and tendencies in the oversight of auditors and audit firms, particularly those who audit listed companies, have been marked by the establishment of external quality assurance systems. These systems are managed independently from the audit firms, while the inspections are performed by non-practising auditors. The United Kingdom, Netherlands and Germany have already set up such systems. Due to possible conflicts of interest, inspections should no longer be left exclusively to the audit profession, but – as in the area of financial services - to independent oversight bodies. These developments are also relevant with regard to the US, Japan and Canada, who are currently examining the recognition of the EU oversight bodies.

Second, the criteria for the quality assurance system are laid down in the Directive on Statutory Audit (2006/43 EC). However, the Directive still allows for considerable differences in the way external quality assurance systems for statutory auditors and audit firms are set up in the Member States. Moreover, co-operation between Member States is not only a matter of mutual recognition, but also of mutual trust: it needs to be built on the basis of a common understanding on how public oversight and inspections should work.

### **2. Why does the Recommendation address the audits of public interest entities, but not others?**

In light of the free movement of capital in the EU, co-operation between Member States on audits of public interest entities, such as listed companies, is a priority. The Recommendation does not focus on inspections of the audit files of non-public interest entities, even if an inspected audit firm audits both public interest and non-public interest entities. For the audit of non-public interest entities, the organisation of quality assurance reviews should be decided by Member States within the framework set in the Directive on Statutory Audit (2006/43/EC).

### **3. What are the main features of the Recommendation?**

First, the Recommendation suggests strengthening the role of the public oversight authorities in inspections. In order to enhance the quality of audits within the EU, the European Commission finds that independent oversight bodies should play an active role in the inspections of audit firms. Professional associations should no longer take the lead in organising inspections, but an active involvement of persons governing a public oversight system is necessary. The public oversight system should be in a position to organise co-operation with other countries. For more information see the reply to question 4.

Second, the Recommendation invites Member States to strengthen the independence of the inspection system and inspections teams. Inspections should be led by inspectors. Practicing auditors can not act as inspectors, but could assist them, should there be an essential need for specific expertise.

The Recommendation suggests that the necessary policies and procedures have to be in place to make sure that inspectors, experts and the management of the quality assurance system are objective and independent in performing their duties. This also means that any funding arrangements, including the level of funding, for the quality assurance system should be set independently from the profession. For example, it should not be allowed that the inspectors or the accompanying experts are paid by the reviewed statutory auditors, audit firms or their network.

Finally, the Recommendation suggests Member States to enhance transparency on the outcome of the inspections in a reasonable way. For more information see the reply to question 8.

#### **4. What should be the role of the public oversight authority?**

In order to enhance the quality of audits within the EU, independent oversight bodies should play an active role in the inspections of audit firms. The public oversight authority should assume the ultimate responsibility for the quality assurance system. The public oversight authority should conduct inspections on its own or together with another appropriate body. In a case where the tasks related to the execution of inspections are delegated to another appropriate body, the Recommendation provides a list of responsibilities and rights that should remain within the public oversight authority. For instance, the public oversight authority should approve inspection programmes, inspection manuals or even amend them if it considers it appropriate. Moreover, the public oversight authority should have the right to participate in inspections and get access to inspection files, audit working papers and other relevant documents.

#### **5. Could the inspections of statutory auditors and audit firms still be conducted by the professional associations? What should the relationship between the public oversight authority and a professional association be?**

Professional associations should be allowed to assist in inspections, but they should be fully accountable for their activities to a public oversight authority and the latter has to retain a number of key responsibilities and rights that are listed in the Recommendation, such as the responsibility to approve inspection programmes, inspection reports, inspectors and other participators in inspections.

#### **6. What should be the requirements for inspectors and will the public oversight authority manage to recruit the sufficiently qualified staff?**

Inspectors should have appropriate professional education and relevant experience in statutory audit and financial reporting combined with specific training on quality assurance reviews. The Directive on Statutory Audit (2006/43/EC) sets out all of the necessary requirements.

Some Member States may find it a challenging task to recruit inspectors. Therefore, the Recommendation suggests some flexibility to Member States in coping with this issue. First, if a public oversight authority considers that specific expertise is essential for the proper conduct of an inspection, inspectors are allowed to be assisted by experts. Second, when an insufficient number of inspectors is temporarily available in a Member State to carry out on-site inspections, experts

could also be allowed to perform on-site reviews if they have appropriate education and experience, but they have to be fully accountable to the public oversight authority.

## **7. What should be checked during inspections?**

Each inspection should consist of at least three components. First, the inspectors should assess the design of the internal control system in the inspected audit firm. Second, they have to evaluate the effectiveness of the firm's internal control system not only by checking compliance with internal control procedures, but also by reviewing individual audit files, at least part of which should be selected on the basis of the risk analysis. Finally, inspectors should assess the transparency report published by the audit firm against their inspection findings.

## **8. The Recommendation suggests enhancing transparency about the results of inspections in individual audit firms. What are the main elements, how does this fit into the Directive and why is this necessary?**

Transparency needs to be handled in a very careful way in order to avoid market disruptions. The recommendation focuses on 3 cases:

- i. If due to serious misconduct of the statutory auditor or audit firm, disciplinary actions are taken or penalties are imposed on them, the public should be aware of these measures or penalties, major deficiencies identified during the inspection as well as the names of auditors or audit firms.
- ii. If the transparency report published by an audit firm contains information that a public oversight authority considers significantly misleading compared to the findings of the inspection, the public oversight authority should ensure that the report is amended accordingly.
- iii. The Recommendation does not suggest an immediate disclosure of deficiencies after inspection. Deficiencies in the internal quality control system of the audit firm should only be disclosed when the audit firm does not appropriately follow up to the recommendations within 12 months from the issuance of the inspection report.