IP/04/340

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Audit of company accounts: Commission proposes Directive to combat fraud and malpractice

The European Commission has proposed a new Directive on statutory audit in the EU. The objectives are to ensure that investors and other interested parties can rely fully on the accuracy of audited accounts and to enhance the EU's protection against the type of scandals that recently occurred in companies such as Parmalat and Ahold. The proposed Directive would clarify the duties of statutory auditors and set out certain ethical principles to ensure their objectivity and independence, for example where audit firms are also providing their clients with other services. It would introduce a requirement for external quality assurance, ensure robust public oversight over the audit profession and improve co-operation between regulatory authorities in the EU. It would allow for swift European regulatory responses to new developments by creating an audit regulatory committee of Member State representatives, so that detailed measures implementing the Directive could be rapidly taken or modified. The proposal also foresees the use of international standards on auditing for all statutory audits conducted in the EU and provides a basis for balanced and effective international regulatory co-operation with third country regulators such as the US Public Company Accounting Oversight Board (PCAOB). The proposal will now be sent to the EU's Council of Ministers and the European Parliament for adoption under the so-called co-decision procedure.

Internal Market Commissioner Frits Bolkestein said: "Auditors are our major line of defence against crooks who want to cook the books. Parmalat was a reminder of what happens when that defence fails. Faith in financial reporting and in the markets is destroyed. Unless it is swiftly restored, investment, jobs and growth will be lost. We cannot let that happen. No-one is naive enough to think any Directive will stop accounting fraud at a stroke – you cannot abolish crime - but what we are proposing would inject more rigour and a stronger dose of ethics into the audit process, bolstering that defence on which all market economies rely. At the same time it will remove some unnecessary restrictions on ownership and management of EU audit firms and lay the foundations for agreements to limit red tape for European audit firms working outside the EU."

Helping auditors to resist inappropriate pressure from managers

Some of the provisions in the proposed Directive would help auditors to resist inappropriate pressure from managers of the company they are auditing. For example, audited companies would have to set up an audit committee, with independent members, which would oversee the audit process, communicating directly with the auditor without going through management.

That committee would also select the auditor and propose the appointment to shareholders. In addition, if a company dismissed an auditor it would need to explain the reasons to the relevant authority in the Member State concerned.

A clear chain of responsibilities

The proposed Directive would also set out a clear chain of responsibilities in situations where groups of companies are audited by several different firms in a large number of locations worldwide (as was the case with Parmalat). The proposed Directive would specifically require that the group auditor of the consolidated accounts of a group of companies take full responsibility for the audit of those consolidated accounts. In doing this, the group auditor would be obliged to review and document the work of other auditors.

Raising the quality and transparency of auditing

The introduction of international auditing standards as required by the proposal would enhance and harmonise audit quality throughout the EU. Those standards would have to be endorsed, after appropriate consultation, by the Commission in cooperation with Member States. Compulsory continuing education of audit staff would help ensure good knowledge of such standards. Furthermore, all auditors and audit firms would be obliged to undergo quality assurance reviews. Audit firms which audit listed companies, banks or insurance companies would have to publish annual transparency reports allowing an insight into the audit firm, its international network and other non-audit services provided by it. This report would cover among other things a governance statement, a description of the internal quality control system and a confirmation of its effectiveness by the management of the audit firm.

Strengthening the regulatory framework and its enforcement

Further elements of the proposal would reinforce oversight of auditors. The proposed Directive would set out common criteria for public oversight systems, in particular that they should predominantly be led and staffed by non-practitioners, but including sufficient number with experience and/or expertise in audit. At EU level the proposed Directive would create an audit regulatory committee of Member State representatives, so that detailed measures implementing the Directive could be rapidly taken or modified and to allow for continuous monitoring of and responses to new developments. The proposal lays out a concept for a model for cooperation between the relevant authorities of Member States, on the basis of “home country control” – in other words regulators in the country where an audit firm is established would take full responsibility for supervising it, and on that basis it could work throughout the EU. However, individual audit staff would need to prove their aptitude and knowledge of the relevant country’s legislation before they could undertake statutory audits in another Member State. The proposed Directive would also establish procedures for the exchange of information between oversight bodies of Member States in investigations. In order to lay the foundations for better cooperation with foreign oversight bodies such as the US PCAOB, the proposed Directive would allow reciprocal co-operation with third countries, also based on the “home country control” principle.

New opportunities for audit firms

Finally, as well as cracking down hard on malpractice and negligence, the proposal would provide new opportunities for the vast majority of honest, conscientious and competent auditors. It would, for example, allow auditors from any Member States to own and manage audit firms in all the others. This would facilitate further integration of European audit firms and help open up the market.

For further details of the proposed Directive, see MEMO/04/60 (frequently asked questions).The full text of the proposal is available at:

http://europa.eu.int/comm/internal_market/en/company/audit/index.htm