

## **Auditing: Commission issues Recommendation on independence of statutory auditors**

***The European Commission has today issued a Recommendation on "Statutory auditors' independence in the EU". The Recommendation features a set of demanding, high level principles and in particular recommends that auditors should be prohibited from carrying out a statutory audit – one required by law - if the auditors have any relationship with their client that might compromise the auditor's independence. This may include any financial, business, employment or other link, or any situations where the auditors provide to the same client services additional to the audit. The Recommendation deals with two key independence issues raised by the collapse of Enron, namely "provision of additional services" by auditors and their "employment with the audit client". Although the Recommendation is not legally binding, it will serve as a clear benchmark of good practice that the Commission expects to be immediately applied throughout the EU audit industry. In three years time, the Commission will review how the Recommendation has been applied in practice and will consider whether binding EU legislation may then be required. However, the Commission may act earlier if it is not satisfied with Member States' application of the Recommendation.***

Internal Market Commissioner Frits Bolkestein said: "Trust in the independence and objectivity of auditors is vital for the efficient functioning of the EU's capital market. It is essential for business integrity, shareholder confidence and consumer and employee protection. Audits must be seen as adding credibility to financial statements. At present, the regulation of auditor independence in Member States differs significantly in scope and content. Although I am pleased that some Member States have already started implementing measures in line with this Recommendation, I now expect its rapid application throughout the EU. Let me be clear: if that does not happen, the Commission will not hesitate to propose more robust, binding measures."

The EU's Accounting Directives (the 4th Company Law Directive ([78/660/EEC](#)) and the 7th Company Directive ([83/349/EEC](#)) require companies' annual and consolidated accounts to be audited by a qualified auditor to ensure that they give a "true and fair view" of the financial position and performance of a company. The 8th Company Law Directive ([84/253/EEC](#)) contains minimum requirements concerning qualifications and professional integrity for auditors. However, the 8th Directive does not contain any specific guidance on auditor independence.

The Recommendation is a result of discussions within the EU Committee on Auditing, which is composed of representatives from the Member States and the European audit profession (see [IP/98/399](#)), and broad consultations launched in December 2000 (see [IP/00/1478](#)). The Recommendation (the result of 2 years' work) follows an innovative principles-based approach. The alternative to a principles-based approach, namely detailed rules, would quickly be overtaken by new developments and would be an easy target for those seeking to find loopholes.

## **Dos**

According to the Recommendation, statutory auditors should be required to consider and to document, for each individual audit engagement, any potential risks or threats to their independence, as well as the safeguards for mitigating those risks. The independence of auditors needs to be protected systematically. Threats to independence vary in nature and in seriousness and auditors need to put in place different safeguards depending on the circumstances. The ultimate safeguard ("prohibition") is not to enter into certain relationships or not to provide certain additional services to the audit client.

## **Don'ts**

The Recommendation also indicates clearly what is not acceptable. For example, auditors should not conduct a statutory audit:

- if they have any direct or significant indirect financial interest in the audit client
- a close family member working in a management position in the audit client or
- if they receive an unduly high proportion of their revenue from one client.

Also, partners involved in performing audits should not join the audit client before the end of a two year cooling-off period. Key audit partners must also "rotate" within seven years (in other words, they must not be involved in auditing the same client for more than seven years in succession). Member States would remain free to establish stricter rules than those laid down in the Recommendation.

The principles-based approach to auditor independence is combined with other broader safeguards set out in the Recommendation. These include the full disclosure, at least annually, of fees for audit and non-audit services, and a written declaration confirming independence, which must be made by the auditor to the audit client's governance body, for example a board of non-executive Directors or a supervisory board. Furthermore, all EU statutory audits should be subject to external quality assurance systems that require auditors to review compliance with ethical principles and rules, including independence rules, according to the Commission's existing Recommendation on "Quality Assurance for the statutory audit in the EU" (see [IP/00/1327](#) and

[http://www.europa.eu.int/comm/internal\\_market/en/company/audit/news/quality.htm](http://www.europa.eu.int/comm/internal_market/en/company/audit/news/quality.htm)

In the light of the Enron case, Commissioner Bolkestein reconsulted the EU Committee on Auditing in order to ensure that the text of the proposed Recommendation was appropriate, notably concerning the provision of non-audit services to audit clients, employment with an audit client and auditor rotation. The outcome of those discussions has been taken into account in finalising the Recommendation.

The Commission's initial response to the various aspects of the collapse of Enron is featured in a paper published recently on the Commission's website (see [IP/02/584](#) and

[http://europa.eu.int/comm/internal\\_market/en/company/company/news/ecofin\\_200404\\_enron\\_en.pdf](http://europa.eu.int/comm/internal_market/en/company/company/news/ecofin_200404_enron_en.pdf)

This paper indicates a series of measures to further improve the quality and credibility of the EU audit profession, including: the use of international standards on auditing, audit committees and improved oversight over the audit profession. The Commission Recommendation on Statutory Auditors' independence is an integral part of this strategy. EU Economic and Finance Ministers meeting informally in Oviedo in April called for rapid application of the Commission Recommendation.

The full text of the Recommendation is available on the Europa website:

[http://europa.eu.int/comm/internal\\_market/en/company/audit/index.htm](http://europa.eu.int/comm/internal_market/en/company/audit/index.htm)

For further information, see [MEMO/02/96](#).