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Auditor independence - frequently asked questions

(see also IP/02/723)

Why has the Commission issued this Recommendation?

Auditor independence is crucial for the credibility of published financial information and hence important for trust in the functioning of EU capital markets, not only for investors but also for other stakeholders such as creditors and employees.

The EU's 8th Company law Directive (84/253/EEC), regulating the approval by Member States of persons carrying out statutory audits, establishes the principle that auditors should not conduct statutory audits if they are *not* independent. However, the Directive does not indicate what has to be understood by "independence". At the time of the adoption of the Directive the Commission made a statement that it noted with regret that auditor independence had not been sufficiently harmonised.

Although at present there exist in all Member States regulations on auditor independence, these differ in approach, scope, terminology and substance. This situation makes it difficult to provide investors and other stakeholders in EU companies with a uniformly high level of assurance that statutory auditors perform their audits independently throughout the EU. Therefore, the objective of the Recommendation is to drastically improve harmonisation of auditor independence within the EU at the highest possible level which could serve as a basis for a future common approach. Moves towards such harmonisation were unthinkable even five years ago.

In terms of approach, scope, terminology and substance, the Recommendation constitutes a significant improvement with regard to the regulation of auditor independence in virtually all Member States.

The 1998 Communication "The statutory audit in the European Union; the way forward" (see [IP/98/399](#)) proposed the creation of a Committee on Auditing which would develop further action in close co-operation between the accounting profession and Member States. This Communication identified auditor independence as one of the main issues to be dealt with. Consequently a Recommendation on auditor independence had been included in the Financial Services Action Plan (FSAP - see [IP/00/1269](#)), endorsed by the Lisbon and Stockholm European Councils as a key element in the making Europe's economy the most competitive in the world by 2010.

The importance of auditor independence was further underlined in relation to the collapse of Enron. The informal meeting of EU Finance Ministers in Oviedo, Spain on April 12-14 2002 called upon the Commission to quickly adopt the Recommendation on auditor independence.

What is the main thrust of the Recommendation?

The statutory auditor should be able to demonstrate his objectivity and integrity so that trust can be placed in his audit opinion. The best way to demonstrate this is by acting independently and being seen to do so. The starting point of the Recommendation is therefore that a statutory auditor should not carry out a statutory audit if there are any financial, business, employment or other relationships between him and his client (including the provision of non audit services) that a reasonable and informed third party would conclude compromising the statutory auditor's independence. This is a powerful, all encompassing statement, applicable to all audit situations.

What level of harmonisation would be achieved?

The Recommendation is an example of minimum harmonisation. Member States have the possibility to go beyond the proposed approach. Nevertheless, the Recommendation will bring about consistency in interpreting and addressing facts and circumstances which threaten statutory auditors' independence throughout the EU. The existence of such principles should also help to provide a level playing field for the provision of statutory audit services within the Internal Market. The principles are comprehensive, rigorous, robust, enforceable and reasonable. They should be consistently interpreted and applied by professional bodies, supervisors and regulators, as well as by statutory auditors, their clients and other interested parties.

In relation to the creation of a single EU capital market, the Recommendation could be used as a starting point to achieve a common approach in the future.

The present Recommendation should be considered as the maximum level of harmonisation which could be supported by Member States at the moment.

Why is this a Recommendation and not binding EU legislation?

Because the Commission considers that this would be the quickest and most effective means to bring about improvements in Member States' current rules concerning auditors' independence. Indeed, several Member States have already started implementing measures in line with the Recommendation. The 1998 Communication "The statutory audit in the European Union; the way forward" introduced the approach of "monitored self-regulation", whereby the audit profession would be challenged to live up to its commitment to deal with auditing matters on the basis of self regulation. All members of the EU Committee on Auditing agreed that this approach should also apply in the field of auditor independence.

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.

What are the detailed provisions of the Recommendation?

The Recommendation introduces an innovative, principles-based approach to auditor independence. It requires the statutory auditor to consider for each audit engagement independence threats and risks as well as the safeguards for mitigating those risks. Auditors should constantly apply safeguards against threats to auditor independence such as self-review or self-interest in order to be seen as independent. The ultimate safeguard (“prohibition”) is not to enter into certain relationships or not to provide certain services additional to the statutory audit.

First, the Recommendation deals with safeguards of a horizontal nature applicable to all audit engagements such as involvement of the audit client’s governance structure, external quality assurance, ownership and control over audit firms, audit firms’ internal safeguarding systems and the public disclosure of audit and non-audit fees.

The Recommendation also defines the scope of application of the independence requirements to the statutory auditor and those who can influence the outcome of the statutory audit. Those in a position to influence the outcome are persons directly involved in the statutory audit such as audit partners, the audit team, staff from other disciplines (e.g. lawyers, IT and taxation specialists) or persons in the “chain of command”. The Recommendation also addresses complex structures such as audit firms with local offices and which are a member of an international network of audit firms.

Secondly, the Recommendation addresses “specific circumstances”, providing examples of application of the principles-based approach for the most frequently occurring situations and relationships where auditor independence may be compromised. In other words, the Recommendation describes what specific safeguards the auditor should consider to mitigate any threat to his independence.

The following specific situations and relationships are mentioned:

- financial interests
- business relationships
- employment with the audit client and the audit firm
- managerial or supervisory role in the audit client and
- family and personal relationships.

Some examples given in the Recommendation where the auditor cannot be seen to be independent include:

- having a direct financial interest
- having significant indirect financial interests
- having business relationships outside the normal course of business and
- having family members with a senior management position at the audit client.

As regards the provision of additional non-audit services to the audit client or one of its affiliates, the Recommendation does not prohibit this if more general conditions are met such as not participating in decision making on behalf of the audit client and in the case of public interest entities, disclosure in writing to the governance body of the fees for additional services and details of relationships.

From this general deontology on additional services, the Recommendation provides examples of specific services such as the preparation of accounts and financial statements, design and implementation of financial Information Technology systems, valuation services, internal audit services, resolution of litigation for the audit client and recruiting senior management. For several additional services, the statutory auditor should apply the ultimate safeguard of prohibition which implies that the auditor is not allowed to provide those services.

The Recommendation also deals with various aspects of audit fees such as the provision of contingency fees for non-audit engagements, the relationship between the total fee from one audit client and the total turnover of the audit firm, as well as the adequacy of audit fees. Finally, the Recommendation states that there should be an internal rotation of key audit partners within seven years.

Would the Recommendation prohibit the provision of any additional service to the audit client?

No. A complete prohibition would undermine the principles-based approach of the Recommendation. However, as a starting point, the Recommendation does not allow the provision of any non-audit service to the audit client that compromises auditor independence. This means that provision of additional services to the audit client is only possible if the auditor documents the related risks and the application of adequate safeguards. According to the Recommendation, auditors cannot be independent if the provision of additional services would include participation in audit client decision-making on behalf of the audit client. Moreover, the Recommendation contains a number of horizontal safeguards on his independence such as a declaration in writing to the governance body of the audit client that none of the services provided compromised auditor independence as well as a detailed public disclosure of audit and non-audit fees.

The Recommendation contains descriptions of circumstances where “prohibition” is the only adequate safeguard. For example, the auditor should not provide valuation services (with a significant degree of subjectivity) where the amount has a material impact on the financial statements, participate in the preparation of accounting records and financial statements for listed companies or provide a short list of candidates for key financial and administrative posts in the case of public interest entities.

Where Member States believe there is a need to go beyond the approach set out in the Recommendation, both the nature of the instrument and the form of (minimum) harmonisation would allow this.

Finally, it is important to emphasise that present corporate governance systems in virtually all Member States allow individual companies, their governance bodies or their shareholders to act in a manner that would satisfy any (remaining) concerns they may have on auditor independence. For example, an individual company could decide to stop buying additional services from their auditors or to rotate the auditor.

Would the Recommendation require mandatory rotation of the audit firm?

No, not the audit firm. However, in the case of public interest entities, the key audit partners should at minimum be replaced within seven years after appointment to the audit team and should not be allowed to re-join the audit team before two years have elapsed.

In the light of the collapse of Enron, a clear majority of Member States considered that mandatory external rotation would, at this stage, not be a wise decision, because there is no evidence that this improves short, medium or long term audit quality.

Again, it is important to emphasise that present corporate governance systems in most Member States would allow individual companies or their governance bodies or their shareholders to rotate the audit firm if they deemed this necessary.

Has this Recommendation been issued as a response to Enron?

No, the Recommendation has been under preparation for more than two years to achieve harmonisation on auditor independence within the EU. Nevertheless, it deals with the two main auditor independence issues raised by the Enron case so far: the “provision of additional services” and “employment with the audit client”. Media attention on Enron’s collapse has also raised some further issues on auditor independence such as mandatory rotation.

Against this background, the Recommendation has been modified after discussion with the EU Committee on Auditing in order to reinforce the text on the following issues:

Provision of non-audit services to the audit client.

There is at present little support for an outright prohibition of all non-audit services to audit clients. However, the preamble to the Recommendation was modified in order to stress the responsibility of the profession to uphold auditor independence. If the Recommendation does not bring about the desired harmonisation, the Commission will review the situation three years after the adoption of this Recommendation, taking into account international developments, in particular on the issue of non-audit services.

Employment of auditors with an audit client.

A cooling-off period of two years should be introduced for key audit partners who take key positions at the audit client.

In addition, it was suggested to enhance the **disclosure of audit and non-audit fees** in general by presenting them in more than two categories thus improving the transparency for investors.

Mandatory external rotation.

A clear majority of the EU Committee on Auditing was not in favour.

What other international regulation on auditor independence exists?

There exist two other codes on auditor independence with international relevance: the IFAC (International Federation of Accountants) code of ethics and the revised US Securities and Exchange Commission (SEC) rule. Both have recently been modified in parallel with the drafting of the Commission Recommendation.

As to the US SEC independence rule, intensive discussions took place between the Commission services and SEC staff in order to achieve as much convergence as possible between the EU and US SEC approach. Total convergence with the US has proven to be difficult for a number of reasons. Different jurisdictions and regulatory frameworks create differences in terminology with an immediate effect on the scope of auditors, audit clients and their relationships.

Of a more fundamental nature is the difference in approach. Whereas the EU follows what is basically a principles based approach, the US-SEC favours a more rule based approach. It should be noted that also the US Independence Standards Board (ISB) has applauded the EU for its conceptual approach.

The EU approach has the merit that it deals with all possible situations (also those which are unforeseen), and puts responsibility on the auditor to consider all possible threats to his independence and to apply adequate safeguards. Under the US rule-based approach, departures from the rules need ex-ante approval by the SEC. However, it would be wrong to overestimate the differences between the SEC and the EU approach – in most cases the solutions are the same - and it is fair to say that there is overall a high degree of convergence.

The International Federation of Accountants (IFAC) has recently adopted a revision of the independence chapter of the IFAC code of ethics. The IFAC overall approach is very similar to that of the EU (some members of the IFAC ethics committee are also members of the EU Committee on Auditing). IFAC covers also assurance services other than statutory audit.

Would SME audit firms be able to comply with the Recommendation?

Yes. Representatives of the auditors for small and medium sized enterprises (EFAA) were actively involved in developing the requirements and they also fully subscribed to the text of this Recommendation.

The Recommendation starts from the premise that an audit is an audit and that there is no justification to differentiate between small and large audit firms in terms of being seen as independent. However, the Recommendation recognises that the size of the audit firm can influence the availability and proportionality of some safeguards. For example, internal rotation in a small firm is not realistic and alternative safeguards are suggested. Furthermore, the Recommendation differentiates in the significance of threats to independence via the concept of public interest entities where a higher level of safeguards in relation to the larger public interest is considered proportional. In practice, though not necessarily, small audit firms often audit non-public interest entities. In this case, the Recommendation suggests proportionate safeguards. For example, the Recommendation allows, with the necessary safeguards, the preparation of accounts and financial statements of audit clients other than public interest entities.

What is the Commission's strategy on statutory auditing?

The lack of a harmonised approach to statutory auditing in the EU is the reason why the Commission organised in 1996 a wide ranging reflection on the scope and need for further action at EU level on statutory audit. This reflection was initiated by a Green Paper on the Role, the Position and the Liability of the statutory auditor within the EU (see [IP/96/1134](#)). From the comments received in response to the Green Paper, it appeared that there was a need for action at EU level. The policy conclusions which the Commission drew from these discussions were included in a Communication "The statutory audit in the European Union; the way forward" (see [IP/98/399](#)).

The Communication proposed the creation of a Committee on Auditing which would develop further action in close co-operation between the accounting profession and Member States. The overarching objective of the EU Committee on Auditing is to continuously harmonise and further improve the quality of the statutory audit. Main subjects on the agenda have been external quality assurance, auditing standards and auditor independence. The Commission has already issued a Recommendation on quality assurance in November 2000 (see [IP/00/1327](#)) and the use of international standards on auditing is the next policy priority.

What is the EU Committee on Auditing?

The EU Committee on Auditing was established by the Commission Communication "The statutory audit in the European Union; the way forward" of May 1998 (see [IP/98/399](#)). It meets two to three times a year. The Committee on Auditing is a platform where statutory audit regulators from the 15 Member States and the 3 countries of the European Economic Area, together with representatives of the audit profession, the internal auditors and the European representatives of the large audit firms deal with statutory audit matters. The overall objective is to develop a common view on statutory audit at EU level, in particular for matters that are not covered by existing EU legislation. In the context of a single EU capital market, audited financial information should have the same level of credibility throughout the European Union facilitating and stimulating cross border investments.

The EU Committee on auditing reports to the Contact Committee on the Accounting Directives in which Member States and EEA countries are represented.

Following Enron's collapse, what are the policy priorities on the statutory audit?

The informal meeting of EU Finance Ministers in Oviedo, Spain on April 12-14 2002 agreed on the conclusions of the Commission's paper entitled "first EU response to Enron-related policy issues", which identified policy actions in five key areas including the statutory audit (see [IP/02/584](#)). The Recommendation on auditor independence should be seen in the wider context of additional policy actions which will be included in a Commission Communication to be issued later this year. Such policy actions include:

- the use of International Standards on Auditing (ISA) for all EU audits by 2005
- minimum requirements for proper public oversight of the auditing profession at national and possibly at European level

- corporate governance in relation to the statutory audit, in particular the future role of audit committees in European listed companies
- the possible adoption of a Code of Ethics to underpin professional integrity within the Union
- the provision of a proper legal underpinning for the EU initiatives on statutory audit, notably by a modernisation of the 8th Company Law Directive on statutory audit and
- a review in 2003 of how the Recommendation on minimum requirements for systems of external quality assurance for statutory audit in the EU (adopted in November 2000 – see [IP/00/1327](#)) has been implemented in Member States.