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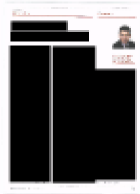

Audit White Paper

Following on from his article "The Future of Audit" in the June 2011 edition of Accountancy Plus, Michael Costello delivers an update and reviews the recent audit white paper.

Background & Introduction

When the European Commission published its proposals for audit reform in November 2011, it was clear from the decisive tone of this white paper that the appetite for change, as evidenced in the green paper issued almost exactly one year earlier, has remained undimmed. In what now represents its official position, the Commission has proposed to robustly legislate for greater competition and more obvious independence, with audit rotation and the prohibition of non-audit work for public-interest entities (PIEs) among its most eyebrow-raising objectives.

At its launch on November 30, internal markets commissioner Michel Barnier remained true to recent form when he said the proposals would address 'the current weaknesses in the EU audit market, by eliminating conflicts of interest, ensuring independence and robust supervision and by facilitating more diversity in what is an overly concentrated market.'

Auditors are, in effect, being presented with the most radical changes of their professional lifetime. However, it is clear from the response in many quarters that the lobbying process to dilute and minimise the impact of these proposals, which has, so far, largely proved unsuccessful, will now intensify as debate moves to European Parliament and Member State level.

Key Proposals

The white paper expresses the Commission's determination to bring about change at three levels:

- Address the expectation gap between what stakeholders expect and what audit actually delivers;
- Bolster the independence of audit to bring a more robust sense of scepticism to the role; and,
- Address market concentration so as to bring about greater choice.

The first area is likely be the least contentious, like Motherhood and apple pie, practically everyone is in favour of changes to expand the information in the audit report and develop a greater role for the audit committee. The Commission says audit committees should consist of non-executive directors, with at least one having experience and knowledge of auditing, and should play a key role in the appointment of auditors. Among technical changes proposed, the Commission wants the oversight of audit networks to take place at EU level with the European Securities and Markets Authority (ESMA) having a greater role in coordinating auditor supervision and in the publication of guidance.

The white paper also supports a European passport that will allow audit companies to compete across Member States and the harmonising of audit standards through International Standards on Auditing. Member States will be able to offer a simplified audit for SMEs, 'proportionate to the scale and complexity' of their business. One caveat to this otherwise laudable proposal is that, if Member States legislate on an individual basis, it is hard to see how a harmonised EU-wide passport system could work at SME level.

Joint Audit

One notable departure from the 2010 green paper and, arguably, a victory for the 'Anglo-Saxon model' is the issue of joint auditors for large companies. The French Commissioner had initially proposed to make this French practice mandatory but, in the white paper, it is simply 'encouraged'. However, companies who opt for joint audits would only be required to rotate auditors every nine years (rather than six for single firm audits). This may be incentive enough for consideration to be given to the double audit approach in some quarters and, with a greater role planned for audit committees, it is conceivable it would become best practice among some PIEs.

Market Concentration

The Commission's proposals to increase auditor independence and address market concentration, particularly with regard to PIEs, have, predictably, proved far more controversial. Changes proposed include, among others, the aforementioned

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mandatory rotation of six years; mandatory tendering for PIEs; the banning of certain non-audit services to audit clients; the prohibition of 'Big Four only' contract clauses; and, most radically, the separation of the large audit firms from their consulting arms. The conflict of interest problem is, effectively, to be solved by the creation of firms purely dedicated to audit and it is this which, predictably, has left the largest firms with their nose out of joint.

What is important to recognise, in all these proposals, is not simply the comprehensive way in which the Commission is seeking to reform the sector but the underlying conviction that drives it, i.e., that the status quo has failed. One objection put forward against this scale of reform is that it is not being demanded by the markets.

The fact that audit has not been vilified for the catastrophic failures in corporate governance evidenced over the last four years, is certainly to be welcomed. However, this hardly means that an objective and dispassionate review of its role is not warranted nor that the thrust of the Commission's thinking is not in the right direction.

Defensive

While stakeholders are perfectly entitled, indeed obliged, to parse these proposals carefully and debate their worthiness, some of the responses to date have seemed overly defensive and partisan, with the long-term public good that the audit role should be seen to serve sidelined. It is argued that the six-year audit rotation will negatively impact on audit quality as it can take auditors a few years to get up to speed on complex entities. Similarly, creating pure audit firms would mean auditors lack access to the expertise of their consulting divisions, while the proposals, overall, will result in greatly increasing the cost of audit.

What these objections point to – and the key difficulty the proposed changes face – is a challenge to a very successful business model. The reality is that audit services are frequently subsidised by non-audit services and artificially low pricing is used as a matter of routine. The reaction to the most radical proposal – that the largest firms split with their consulting arms – lacks credibility. Ten years ago most of the largest firms sold their consulting arms. Now, however, it is claimed they are integral to audit quality.

Consolidation

As the debate now moves to what is arguably its most important phase, European Parliament and Member State level, the wrangling and horse-trading will begin in earnest and local market issues will come to the fore. In Ireland, a key issue centres on the current levels of oversupply in the accountancy sector and the consolidation currently taking place. Given this consolidation has largely been responsible for creating the concentration issue in the first place, leaving the industry to 'right size' itself is unlikely to improve matters. The goal of widening the market and allowing a minimum of five or six firms to compete more equally will require Government and regulators here to play their part. Competition authorities may look at prohibitions on further consolidation at the very top and also the issue of below-cost selling.

As auditors, we must play our role in this debate by recognising the Commission's drive for change is grounded in genuine concern about the direction the industry has taken. If we allow naked self interest to colour this debate, we will miss a major opportunity to serve the public good and make audit fit for purpose in the years ahead. Governments, regulators and the public have all identified lack of independence in our sector as a major issue. Change that does not address this underlying problem may secure some short-term wins for some parties but will ultimately see the issue revisited in the future. On the next occasion, however, we are unlikely to find others so amenable to our point of view.

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Michael Costello, FCA, is Head of Audit at BDO.
Email mcostello@bdo.ie.