

Public Company Accounting Oversight Board

Public Meeting

on

Auditor's report

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Written Statement

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Disclaimer

This document presents my personal views and does not prejudice or represent any formal proposal or position of the European Commission.

I am honoured to be with you today to discuss such an important topic as the auditor's report. I would like to thank the PCAOB on behalf of the European Commission for the opportunity to participate in this public meeting and to express my views on this topic. It is indeed appropriate that the changes that are taking place in the world of audit reporting should be openly discussed. Therefore, I would like to praise the PCAOB for taking the initiative to promote an open debate on the auditor's report.

Before proceeding to a brief presentation about the main changes to auditor's reporting currently taking place in the European Union (EU), I would like to refer to the comprehensive preparatory work and vast consultation process that the Commission launched in October 2010 with a Green Paper entitled "Audit policy: Lessons from the crisis". On the basis of almost 700 responses received, the European Commission presented, in November 2011, two legislative proposals: one for a Directive, amending Directive 2006/43/EC, on the statutory audit of annual accounts and consolidated accounts (the Statutory Audit Directive) and the second for a Regulation on specific requirements regarding statutory audits of public-interest entities (PIEs) which are defined as listed companies, credit institutions and insurance undertakings. The reform rests on two pillars which encompass both horizontal and specific measures. The horizontal measures apply to every auditor – under EU terminology, every statutory auditor or audit firm – irrespective of the nature of the audited entity. Additionally, stricter requirements have been set for the audits of PIEs.

The audit reform aims to increase audit quality and to restore investor confidence in financial information, an essential ingredient for fostering investment and economic growth. After two years of negotiations, the European Parliament and the Member States reached a political agreement on the amended Directive and the Regulation on 17 December 2013; final approval is expected soon. The revised regulatory framework will not only enhance the independence of auditors, but will also ensure that investors are given better information on the audited entity through a strengthened audit report.

The most common audit opinion is a "template" clean opinion. The "pass or fail" model does not even mirror in a proper manner the work that is carried out by the auditor. Such a paradigm is not helpful to those who hold an interest in the audited companies.

There is a general consensus that the audit report needs to become more informative, especially when the auditor expresses an unmodified opinion. Specifically, the audit report needs to become more "tailor made", as it is an essential tool from the investors' perspective.

Since 2006, EU law has had some requirements concerning the audit report, set out under the Statutory Audit Directive. However, further requirements proved necessary, given the importance and usefulness of the information held by the auditor after having performed the audit. Following the audit reform, the EU will have increased the informational value of the audit report, which, for instance, will refer to the key areas of risk of material misstatement of the annual or consolidated financial statements, or explain to what extent the statutory audit was considered capable of detecting irregularities, including fraud.

During my brief presentation I will focus on the changes brought to auditor reporting by the audit reform that will impact on the PIEs, as the potential market and economic impact of the performance of any such entities is usually greater than that of other types of company.

I would also like to draw your attention to the fact that EU Member States are entitled to impose further requirements beyond those provided for under the EU law, in order to give some room to accommodate the specific needs of each concrete legal environment.

To conclude my introductory remarks, I would finally like to stress that the requirements imposed under the EU law do not contemplate any kind of template or reporting model. Consequently, it will be up to each Member State to impose such a model, if deemed necessary, at least as long as the Commission does not adopt the International Standards on Auditing.

One of the major objectives of the audit reform is to increase transparency. For this purpose, the auditor's report will now have to indicate aspects such as **the place where the statutory auditor or audit firm is established**, together with other **relevant information relating to the audit tenure**. For instance, the report will include a statement on the auditor's appointment, indicating the respective date and by whom or by which body the auditor was appointed. These elements will allow investors to better assess the type of relationship established between the auditor and the audited entity, in particular the duration of such a relationship.

The fact that numerous financial institutions revealed huge losses in the wake of the crisis – which in some cases led to bankruptcy – following the public presentation of clean audit reports, inevitably gave rise to the question of whether auditors are fulfilling their role. **The going concern assumption** is a crucial principle in the preparation of financial statements, shaping the content of the financial statements presented by the company management. The audit reform highlights the important role played by auditors in assessing the use of this principle by imposing on auditors the obligation to report on any material uncertainty related to events or conditions that may cast significant doubt about an entity's ability to continue as a going concern.

The auditor's tasks include identifying and assessing risks of material misstatements. The auditor's report is could be a valuable piece of information for investors, helping them in their decision-making process. Part of the results of the work carried out by the auditor will, of course, remain in the sphere of the audited company, but some other findings should be shared with the public. That is why the auditor's report will include a description of the **most significant assessed risks of material misstatements**, as well as a summary of the auditor's response to those risks and, finally and where relevant, key observations arising with respect to those risks. As noted previously, the audit reform does not impose any standardised language, so there is room for auditors to balance the need to provide useful information to the public with the need to keep the auditor's report clear and objective. In any case, the legal framework requires that the auditor's report should be written in clear and unambiguous language.

Many stakeholders may be unaware of the limitations of an audit, which leads to an undesirable “expectation gap”. This is particularly relevant in the context of audits of PIEs, given the wide potential impact that their performance means for investors and for the economy as a whole. That is why auditors in the EU will now have to explain **to what extent the statutory audit was considered capable of detecting irregularities, including fraud**. Once again, the new regulatory framework will not impose any standardised language for this requirement, leaving a margin of manoeuvre for the auditors to shape the contents of the relevant paragraphs. We hope that the audit market will quickly realise the usefulness of this tool to address any “expectation gap”.

The information gathered by the auditor in the course of the audit is as relevant as it is sensitive. This is why, following the audit reform, the auditor will have to prepare not just one but **two reports**: the so-called **auditor’s report**, to which I have been referring, and a **more detailed additional report** to be made **available to the audit committee** of the audited entity. This additional report will enhance the flow of information between the auditor and the audit committee. For example, the audit committee will be provided with: information about the methodology used in the course of the audit; a summary of the main elements taken into account when making the going concern assessment or a report on any significant deficiencies encountered during the audit; information that is of the utmost relevance to ensure a proper fulfilment of its role. This report will not be for the public – Member States may, nevertheless, allow the audit committee to disclose this additional report to some third parties.

Turning our attention to the PCAOB’s Release, we share the conviction that having the auditor report include **critical audit matters** recognises that investors are entitled to be given information beyond the “black or white” model that we have been used to and will grant them some access to the most challenging aspects of the audit. The EU approach focused on risks of material misstatements, whereas the PCAOB is shaping a new concept, that of “critical audit matters”. These two concepts may not be perfectly interchangeable, but they surely reflect a strong convergence of views.

We also welcome the PCAOB’s intention to introduce new elements in the auditor’s report, as **the year the auditor began serving as the company’s auditor**. Including a reference to the duration of the audit tenure will be a means to draw the attention of stakeholders to an element that in the EU is already perceived as a major risk: the long-lasting relationship between auditors and the audited company. To address such a risk, the EU is introducing a requirement for auditors to rotate after the audit engagement has reached a maximum duration of 10 years. Member States, on the one hand, have the possibility to provide for stricter requirements; on the other hand, they may provide for the maximum duration to be exceeded in cases where a tender is conducted (up 10 more years) or a joint audit is carried out (up to 14 more years).

The European Commission therefore welcomes the PCAOB Release and the proposals contained therein. There is **consistency** between these proposals and the EU audit reform with regard not only to the **general principle** of making the auditor’s report more informative, but also with regard to the **concrete approach** established to reach that goal. Both jurisdictions are looking in the same direction and aiming to improve audit quality.

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In conclusion, the European Commission welcomes the concrete signs of convergence in the area of providing the public with more and better information. We have been following with great interest the PCAOB initiatives and are aware of the fact that the winds of change inevitably give rise not only to understandable concerns but also to conservative voices of resistance. We have no doubts that the audit profession will be able to rapidly adapt to the new regulatory environment, ensuring investors, regulators and the public in general that they are committed to fulfil their crucial societal role. That is what is already taking place in the EU, where, in many instances, adaptation to the audit reform is already taking place, even before its formal application. We therefore encourage the PCAOB to proceed in this effort to pave the way for more and better audit reports in the US. Both the US and the EU can only benefit from increased quality of audit on both sides of the Atlantic. All these efforts are fostering regulatory consistency and enhancing the necessary convergence, thus paving the way for an even more effective cooperation between regulators.



THE AUDIT REPORT– RECENT DEVELOPMENTS IN THE EUROPEAN UNION

**PCAOB Meeting
Washington, 2 and 3 April 2014**

**Sven Gentner
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The Audit Reform

- **Objective:** increase the quality of statutory audit in the EU.

- **Structure:** two pillars, encompassing both horizontal and specific measures.
 - Directive: horizontal measures, applicable to every audit.
 - Regulation: stricter requirements for the audits of public-interest entities (PIEs), i.e. credit institutions, listed companies, insurance undertakings, or other entities designated as such by Member States (because of the nature of their business, their size or the number of their employees).

The Auditor's Report

- **EU Member States may impose further requirements**
→ Tool to accommodate the specific needs of each concrete legal environment.
- **No template or reporting model requirement**
→ Member States to define a model/template.

What's new? (1/4)

- Indication of the **place where the statutory auditor or audit firm is established.**
- A statement indicating **by whom or by which body the auditor was appointed.**
- A statement indicating **the date of the appointment and the period of total uninterrupted engagement**, including previous renewals and reappointments of the auditor.
 - Inclusion of more information aiming at increase transparency.

What's new? (2/4)

- **Obligation to report on any material uncertainty related to events or conditions that may cast significant doubt about the entity's ability to continue as a going concern.**

What's new? (3/4)

- Obligation to describe the most significant assessed **risks of material misstatements**, as well as a summary of the auditor's response to those risks and, finally and where relevant, key observations arising with respect to those risks.

What's new? (4/4)

- Explain **to what extent the statutory audit was considered capable of detecting irregularities, including fraud.**

Auditor's report + Additional report

- The auditor will have to prepare **two reports**:
 - the so-called **auditor's report** and
 - a **more detailed additional report** to be made available to the audit committee of the audited entity.
 - This additional report will enhance the flow of information between the auditor and the audit committee.
 - This report is not public.

The PCAOB Proposals

- Convergence between the PCAOB proposals and the EU audit reform:
 - In the general principle of making the auditor's report more informative;
 - In the concrete approach established to reach that goal.
- Critical audit matters
 - gives investors access to relevant information.
- Reference to the year the auditor began serving as the company's auditor
 - draws investors' attention to the risk of long-lasting relationships between audited entity and auditors.



**Thank you for
your attention!**