The EU Audit Directive and Audit Regulation – Implications for Private Shareholders

Mohammed Amin

Mohammed Amin is a chartered accountant and chartered tax advisor, and before retirement was for over 19 years a tax partner in PricewaterhouseCoopers.

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It is easy to get lost in the minutiae of EU legislation or to allow it to become a substitute for sleeping pills! Accordingly, before addressing how private investors should think about this issue, it is, in my view, essential to step back and look at the bigger picture.

One's view of the world is inevitably coloured by one's experiences. Apart from one year of teaching, my entire working career was spent in professional accountancy, primarily at the top end (6 years at Arthur Andersen and 22 years at Price Waterhouse/PricewaterhouseCoopers.)

External shareholders of listed companies face a simple problem. The company's management which the shareholders appoint has many incentives to present its financial results in the manner which is most favourable to management's interests. From time to time this extends to outright falsification. Hence the need for external auditors independent of management to provide an opinion on the accounts prepared by management.

As with all regulators, this in turn creates the risk of "regulatory capture." Management have every incentive to be "nice" to the auditors in order to influence the way they opine upon the accounts. This risk is amplified because it is very easy for the auditor to end up regarding management, particularly the Chief Financial Officer (CFO) as the auditor's client. In practice it is the CFO who authorises payment of the auditor's invoices, and who hires the auditor to provide non-audit services. Furthermore, upsetting the CFO is likely to lead to the termination of the audit engagement.

All audit regulation and rule setting is an attempt to address the above problems. The situation today is undoubtedly less bad than in, say, the 1930s but is far from perfect.

Against this background, what does the EU legislation actually do?

The EU has been producing community-wide legislation on accounting and auditing matters for many years. Accordingly, Directive 2014/56/EU of The European Parliament and of The Council of 16 April 2014 proceeds by amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts. *"By 17 June 2016 Member States shall adopt and publish the measures necessary to comply with this Directive. They shall immediately inform the Commission thereof. Member States shall apply those measures from 17 June 2016."*

As Member States have certain flexibility in how they implement the Directive, it is more useful to look at the planned UK implementation than the text of the Directive itself.

In October 2015 the relevant department, the Department for Business Innovation and Skills (BIS) issued a document 2015 "Auditor Regulation: Consultation on the technical legislative implementation of the EU Audit Directive and Regulation."

Responding to such technical consultations is hard work and it is no surprise that all 25 responses which BIS has published came from either large audit firms, professional bodies, large investors etc. The key things (in my view) that shareholders in listed companies can expect to see are:

The maximum duration of an engagement, for which an auditor should be appointed and reappointed annually before a tender process is required will be ten successive accounting years. This will mean a significant increase in tender activity compared with past practice. I recommend reading the Cranfield University April 2015 PhD thesis "The Factors Affecting the Auditor Selection Decisions of FTSE 350 Companies in Competitive Tenders" by Philip Drew, a former PwC colleague which contains a goldmine of informative data. For example it shows how rare audit tenders have been.

By 20 years the company must change its auditor. This is the first introduction of mandatory rotation in the UK. Some countries such as Italy have had mandatory rotation for many years. Opinions are divided on the merits. If the mandatory rotation period is too short, the audit firm never has time to gain sufficient detailed knowledge of the client, which creates the risk of bad audits. However, with 20 years that is not a real risk!

Audit firms are prevented from offering services that are considered to give rise to too great a risk of compromising the auditor's independence. These services are described in a "blacklist" in the Regulation. The fee

income from remaining permitted non-audit services is capped at 70% of the average audit fee income from that client over the 3 preceding financial years. In practice this is likely to make little difference. For the last 15 years there has been great pressure on listed companies to not use their auditors for non-audit services and these have declined markedly as a proportion of the audit fee.

There are many technical changes which will be of interest only to auditors and to the companies which engage them which in practice matter little to private investors.

Apart from the increase in audit rotation which we are likely to see, these changes, in my view, do little to address the fundamental problem that company management have far too much influence on the appointment and termination of auditors. While the formal decision is now taken by the independent non-executive directors on the audit committee, my perception is that they still pay far too much attention to the views of management. My own attitude when I served on audit committees was that the better the relationship between the CFO and the auditors the worse I felt and vice versa!

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