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AUDIT COMMITTEE FORUM™

Alert 16

Audit Reform

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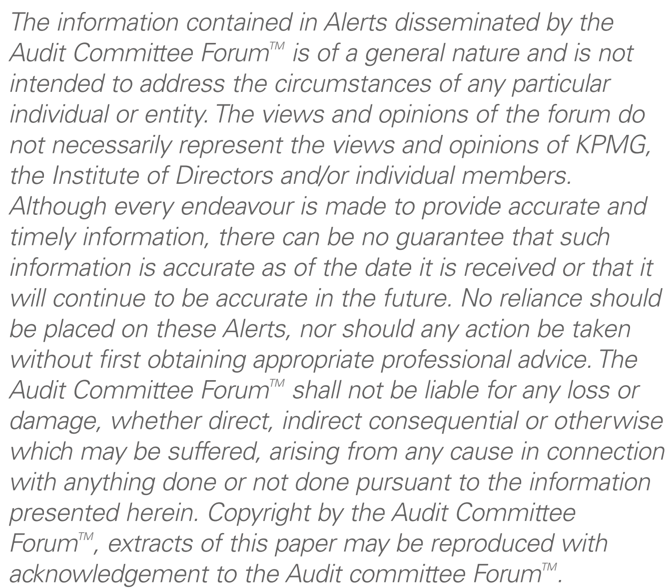

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Audit Reform

Purpose of the Alert

The purpose of this Alert is to provide information on how the key European Commission Audit Reform proposals pertain to the South African context and the current status of South African legislation and corporate governance principles relating to these proposals.

Source documentation can be obtained on the following link: (http://ec.europa.eu/internal_market/auditing/reform/index_en.htm).

European Commission Audit Reform Proposals

On 30 November 2011, the European Commission (EC) published Regulations to increase the quality of audits of financial statements of public interest entities (PIEs) and a Directive to enhance the single market for statutory audit proposals on "reshaping the audit market".

The EC notes that the general objective of the changes in audit is to:

> contribute to the efficient functioning of financial and non-financial markets by strengthening the market role of the audit profession to provide relevant economic agents and the market with more reliable, transparent and meaningful information, at an acceptable cost, about the veracity of financial statements of companies.

The proposals outline three main objectives with respect to PIEs[1]:

1. To clarify and define the role of auditors;
2. To reinforce the independence and professional scepticism of auditors; and
3. To improve market conditions for the audit with a view to increasing audit quality.

[1] The proposals introduce and expand the definition of a PIE, which – in addition to listed entities – encompasses a range of financial institutions and a new 'Large PIE' category (broadly listed companies with a market capitalisation, or relevant financial institutions with balance sheet/asset under management, in excess of €1 billion).

A Directive and Regulation

The Directive amends the current Statutory Audit Directive, which applies to all statutory audits. A final Directive would need to be implemented by EU member states into national law.

The Regulations, which contain many of the more controversial proposals, would in their entirety apply directly in all member states when they come into force.

Key proposals

The key proposals that we have focused on include:

- The creation of "audit only" firms;
- Mandatory rotation of audit firms;
- Mandatory tendering;
- Restrictions on audit firms providing non-audit services;
- Audit committee requirements;
- Audit report; and
- Private report to the audit committee.

Revised proposals

The Parliamentary Committees, JURI[2] and ECON[3], will be producing amendments to the original proposals. The ECON Committee voted on 11 March 2013 and the JURI Committee voted on 25 April 2013 to amend the original EC proposals.

This Alert focuses on these key proposals with respect to the South African market.

[2] The Committee on Legal Affairs (JURI) is responsible for the law governing the EU's administration and for parliamentary law, which includes the Statute for Members of the European Parliament, parliamentary immunity and the verification of members' credentials after their election.

[3] The Economic and Monetary Affairs Committee (ECON) plays a key role in the work of the European Parliament. It has responsibility for such matters as the economic and monetary policies of the EU.

This Alert focuses on these key proposals with respect to the South African market.

Audit-only firms

Original proposals	Revised proposals
This requirement would apply to any firm network: • Whose member firms have a combined annual audit revenue within the EU of over €1,500 million; and • Which has at least one member firm that generates more than one-third of its annual audit revenues from audits of Large PIEs. If these thresholds are exceeded, then all of the member firms of that network, which include those outside the EU, would be banned from providing non-audit services within the EU.	The ECON Committee voted against the audit-only firm concept on 11 March 2013. The JURI Committee voted on 25 April 2013 to remove all the provisions designed to create audit-only firms.

South African context

Section 94(7) of the Companies Act, 71 of 2008 sets out the statutory duties of the audit committee that relate to the provision of non-audit services by the external auditor –

d) to determine, subject to the provisions of this Chapter, the nature and extent of any non-audit services that the auditor may provide to the company, or that the auditor must not provide to the company, or a related company;

e) to pre-approve any proposed agreement with the auditor for the provision of non-audit services to the company.

The EC proposal seems intended to apply to the 'Big 4' networks only. It could impair the ability of member firms of the affected networks to access the breadth and depth of expertise they currently bring to their audits.

The ACF agrees with the proposals from the JURI and ECON committees to have the provision deleted from the original proposals.

The ACF holds a mixed view with regard to mandatory firm rotation, with the majority of members being against it mainly because it takes away the rights from the audit committee and shareholders to decide who their auditors must be and when it is necessary to change auditors.

Mandatory audit firm rotation

Original proposals	Revised proposals
Under this Regulation, the initial audit appointment would have to be for at least two years. The appointment could be renewed only once and the maximum appointment term would be: • Six years (extendible to eight years on an exceptional basis by the audit regulator); • Nine years (extendible to 12 years on an exceptional basis by the audit regulator) if a joint audit. A cooling-off period of a minimum of four years applies before the same auditor can be reengaged.	The ECON Committee voted against mandatory firm rotation on 11 March 2013. The JURI Committee voted on 25 April 2013: • The proposal is to set the maximum duration of the combined audit engagements at 14 years and allow member states, by derogation, to extend this to a maximum of 25 years when at least one of three conditions has been met: (1) A public tender is conducted; or (2) The audit committee has performed a comprehensive assessment of the audit engagement, which includes consideration of professional competencies of the auditor and compliance with ethical and professional standards; or (3) Two or more statutory auditors are appointed.

South African context

Section 94(7) of the Companies Act, 71 of 2008 sets out the statutory duties of the audit committee that relate to the appointment of the external auditor –

a) To nominate, for appointment as auditor of the company under section 90, a registered auditor who, in the opinion of the audit committee, is independent of the company;

Section 90 provides for shareholders to appoint the auditor at the company's annual general meeting (AGM).

Section 91 of the Companies Act also requires the designated auditor (audit partner) to rotate every five years. This further promotes independence of the auditor.

In terms of King III (principle 3.9 paragraph 75): *the audit committee must recommend to shareholders the appointment, reappointment and removal of the external auditor. Where the audit committee recommends to shareholders that the incumbent auditing firm and designated auditor (a statutory responsibility for public companies and state-owned companies in terms of the Act) should be appointed as the external auditor, its recommendation should be based on an assessment of the auditing firm and the individuals' qualifications, expertise and resources, effectiveness and independence. The audit committee should ensure that the external auditor that is recommended for appointment is approved by the JSE (applicable only to listed companies).*

The EC proposal contains an implicit criticism of the audit committee's ability to determine whether and when to change auditors. It represents a major change with significant cost implications due to both the frequent rotation of audit firms and the tendering requirements noted below. It will constrain the audit committee's and shareholders' choice of audit firm, which could negatively affect audit quality.

The ACF holds a mixed view with regard to mandatory firm rotation, with the majority of members being against it mainly because it takes away the rights from the audit committee and shareholders to decide who their auditors must be and when it is necessary to change auditors.

Mandatory audit tendering

Original proposals	Revised proposals
• The audit committee would be required to identify at least two choices, unless it proposed the reappointment of the incumbent auditor (subject to the maximum six or nine years' tenure described above). • It would identify which firm it preferred and would have to provide a justification for its recommendations. • At least one of the firms invited to tender at the start of the process must be a smaller firm; i.e. one that has less than a 15% share of the audit fees of Large PIEs in that member state. • The Regulation contains specific requirements for the process that the audit committee must follow. • European regulators will produce guidance and appropriate auditor-selection criteria and a component authority will produce an annual list of eligible smaller audit firms.	The JURI Committee revised proposals: • Tendering should be required only when a change of auditor is to be proposed to the shareholders. The ECON Committee revised proposals: • Compulsory tendering of non-audit services; • Compulsory tendering of related financial audit services (if >50% of audit fees); • Non-audit services must be subject to transparent tender of fees >100 k; and • At least one auditor invited for tender should be outside of the 'Big 4'.

South African context

The Regulation would impose new statutory requirements on all PIEs (irrespective of size) in respect of the audit tender process and would most likely:

- Restrict the flexibility currently available;
- Increase cost;
- Make the process more time consuming;
- Be impractical (as the audit committee would have to negotiate two contracts with the two potential firms before presenting the choice to the AGM); and
- Create unnecessary bureaucracy as smaller firms are unlikely to be appointed if the audit committee wouldn't 'naturally' include them in the tender process.

Weighing up the cost versus benefits of mandatory audit tendering and understanding the statutory duties of the audit committee and shareholders under the Companies Act and King III (as discussed under mandatory firm rotation), independence of the auditor and audit quality can be achieved with current legislation and corporate governance principles.

Providing that adequate safeguards are in place, the provision of non-audit services by the auditor can both enhance the quality and reduce the cost of the services (and potentially the audit) with no loss of independence.

Restrictions on non-audit services

Original proposals	Revised proposals
Under the Regulations, there would be very few non-audit services that could be provided by the audit firm or other firms within the audit firm's network to a PIE or its parent/subsidiaries within the EU. Permitted "related financial audit services" would be limited to: • Audits and reviews of interim financial statements; • Assurance on regulatory reporting by financial institutions; • Certification on compliance with tax requirements when such attestation is required by national law; and • Assurance on corporate governance and social responsibility. However, the fees for related financial audit services to an audit client would be limited to 10% of the audit fees paid by that entity. A limited number of non-audit services would be permitted. Within the EU, they would be subject to pre-approval on case-by-case bases by the audit committee (e.g. comfort letters for investors and human resources' services) or the relevant competent authority (e.g. acquisition of due diligence services and designing and implementing financial information technology systems). It would be possible for non-audit services to be provided by the auditor (or by a member of the audit firm's network) to a non-EU entity that was controlled by the EU entity. However, before such services are provided the auditor would have to assess whether its independence would be compromised by such services, using a threats and safeguards approach.	The ECON Committee voted on 11 March 2013: • Against caps on non-audit services' fees; • In support of a black list of prohibited non-audit services (broadly International Federation of Accountants (IFAC) based); • In support of non-audit services being subject to an open and transparent tendering procedure designed by the audit committee and approved by the competent authority. The JURI Committee voted on 25 April 2013: • To modify substantially the highly prescriptive and restrictive auditor independence rules proposed by the Commission relating to the prohibition and provision of non-audit services to align more closely with the 'threats and safeguards' approach which underpins the International Ethics Standards Board(IESBA) Independence Code; • To remove the 10% cap on non-audit services; • To include a requirement for the audit committee to prepare a policy governing the provision of non-audit services that is to be approved by the board and shareholders and communicated to the competent authorities; and • To include in the policy considerations with regard to the "nature of non-audit services and the extent to which they are to be subject to an open and transparent tendering procedure designed by the audit committee".

South African context

Under current legislation, corporate governance principles and the Independent Regulatory Board for Auditors (IRBA) and IFAC Code of Ethics for Professional Accountants, various safeguards are in place to ensure that the auditor's independence is not compromised by providing non-audit services.

Providing that adequate safeguards are in place, the provision of non-audit services by the auditor can both enhance the quality and reduce the cost of the services (and potentially the audit) with no loss of independence.

The ACF has recently re-issued Position Paper 4 – *Guidelines for audit committees on auditor independence relating to non-audit services by the external auditor.*

Audit committee requirements

Original proposals	Revised proposals
This Regulation requires all PIEs, with certain concessions for subsidiaries and certain types of financial institution, to have an audit committee (or a body that performs equivalent functions), which comprises non-executive directors – the majority of whom must be independent. At least one member must have competence in auditing and another must have competence in accounting and/or auditing. The committee members as a whole must have competence relevant to the sector in which the audited entity operates. The audit committee's responsibility with respect to the oversight of the audit and the appointment and dismissal of the auditor is made more explicit; in particular, the audit committee is to: • Supervise the completeness and integrity of the draft audit reports; • Be responsible for the procedure on the selection of the statutory auditor(s); and • Authorise on a case-by-case basis the provision by the statutory auditor (of those non-audit services that are still permitted).	The original proposals will remain.

South African context

Each year at the AGM public companies, state-owned companies or any other company that is required only by its Memorandum of Incorporation to have an audit committee must elect an audit committee that comprises at least three members.

South Africa already has strict requirements in terms of the composition of the audit committee and qualifications of audit committee members.

Regulation 42 requires that at least one-third of the members of a company's audit committee at any particular time must have academic qualifications, or experience, in economics, law, corporate governance, finance, accounting, commerce, industry, public affairs or human resource management.

In terms of King III (principle 3.1), *the board should ensure that the company has an effective and independent audit committee*

- *3.1.1 An independent audit committee fulfils a vital role in corporate governance. The audit committee is vital to, among other things, ensure the integrity of integrated reporting and internal financial controls and identify and manage financial risks.*

The audit committee is constituted as a statutory committee in respect of its statutory duties in terms of section 94(7) of the Companies Act, 71 of 2008.

The audit committee already fulfils the function as proposed by the EC and therefore the EC proposals should not have any major implications for the South African market.

Audit report

Original proposals	Revised proposals
The proposals identify over 20 items that would have to be addressed in the auditor's report, which include: • The auditors' assessment of the entity's ability to meet its obligations in the foreseeable future and therefore continue as a going concern; • How much of the balance sheet has been tested substantively and how much has been audited based on system and compliance testing; • The variation in the weighting of substantive and compliance testing compared to the previous year; • The levels of materiality applied to perform the audit; • The key areas of risk of material misstatements of the financial statements; • An assessment of the internal control system, which includes significant internal control deficiencies identified during the statutory audit, as well as the bookkeeping and accounting system (note that this appears to cover only the parent entity in the case of a group); • Violation of accounting rules, laws, articles of incorporation, and accounting policy decisions and other matters significant to the governance of the entity; • Whether the statutory audit was designed to detect irregularities, including fraud; • The identity of each audit team member and a confirmation of the audit team's independence; • In the event of a qualified or adverse opinion or a disclaimer of opinion, the reason for such a decision; • Any non-audit services provided; and • Consistency of the audit opinion with the additional report to the audit committee. The length of the audit report would be limited to four pages or 10 000 characters.	The JURI Committee revised proposals: • The JURI voted to modify the Commission's proposals with regard to the auditor's report to shareholders and auditor communications to the audit committee to align these, in many respects, with the requirements of International Standards on Auditing (ISAs). • Expanded auditor communications are proposed and these are based largely upon the latest proposals of the International Auditing and Assurance Standards Board (IAASB). The ECON Committee revised proposals: • No major changes proposed.

South African context

Auditors will be required to report on more matters and in greater detail than is currently the case. As a result, issues previously covered by client confidentiality and reported privately to the audit committee or board will potentially be made public in the audit report.

The IAASB is currently busy with a project on revising the auditor's report; the objectives of this project are to:

- Appropriately enhance the communicative value and relevance of the auditor's report through proposed revisions to ISA requirements that address its structure and content; and
- Determine whether and how the IAASB's reporting ISAs, in their design, can be modified to accommodate evolving national financial reporting regimes, while at the same time ensuring that common and essential content is being communicated.

The ACF supports the IAASB project on revising the auditor's report.

Private report to the audit committee

Original proposals	Revised proposals
In addition to the audit report, the auditor would be required to provide a more detailed report to the audit committee, which explains in detail the results of the audit, presenting and justifying, inter alia: • The scope of the audit; • The auditors' risk assessment; • Audit work carried out; • Judgements about material uncertainties that raise questions about the entity's ability to continue as a going concern; • Whether the bookkeeping, accounting, financial statements and additional reports covered by the audit 'show appropriateness'; • All instances of non-compliance, including non-material instances if they are considered important to the audit committee; • An assessment of the valuation methodologies used to prepare the financial statements; • Full details of all guarantees, letters of support or public undertakings relied upon to support a going concern conclusion; and • How audit work was distributed between different audit firms, including the involvement of any third-country (i.e. non–EU) auditors and identifying what work they performed. The report to the audit committee would not generally be public; however, it could be disclosed to shareholders in a general meeting if the board so decided. Furthermore, upon request, the auditor should make the report available to regulators without delay.	No major changes proposed.

South African context

In terms of International Standards on Auditing (ISA) 260, *Communication with those charged with governance, auditors are required to communicate mandatory information to the audit committee.* Mandatory matters include:

- The auditor's responsibilities in relation to the financial statement audit;
- Planned scope and timing of the audit;
- How the auditor proposes to address the significant risks of material misstatement, whether due to fraud or error;
- The auditor's approach to internal control relevant to the audit;
- The application of the concept of materiality in the context of an audit;
- Significant qualitative aspects of accounting practices;
- Significant findings from the audit;
- Auditor independence;
- Significant matters discussed, or subject to correspondence with management, including business conditions affecting the entity, and business plans and strategies that may affect the risks of material misstatement.

The above matters are not a complete list but demonstrate that in South Africa auditors already report to the audit committee on specific matters and that this proposal will not have any major implications for the South African market. (It is important to note that the ISAs are not consistently adopted throughout Europe and the auditors would therefore not necessarily be obliged to communicate the above to the audit committee, depending on the auditing framework followed. EC also proposed the consistent adoption of the ISAs.)

Next steps

The next stage in the legislative process involves the European Council of Ministers. Council will now aim to reach a consensus position on the reforms among the 27 member states based on a 'trilogue' process designed to reach agreement on a final position between Council, Parliament and the Commission to enable a plenary vote of the Parliament and approval by the Council. This could take place before the end of this calendar year.

Whether or not the legislation is completed before the end of the current Parliament (European elections take place in May 2014) will depend largely upon the member states and their appetite for change and compromise.

At this stage the final outcome of the proposed reforms remains uncertain and we continue to monitor developments closely.

Member states through the European Council's Expert Working Group (CEWG) chaired by the Irish Presidency (Lithuania takes over on 1 July) are currently in the process of determining their own position on the Commission's proposals. The outcome of the JURI vote will undoubtedly have some impact upon the discussions that are taking place in the CEWG.

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