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EuropeanIssuers' Position on the Audit Regulation proposal

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Our concern is that the audit proposals could adversely affect some 12,000 publicly quoted companies in Europe on whom the European economy relies for future growth. EuropeanIssuers maintains that there is an undue spill-over of regulation aimed at the financial industry and the banking sector to the end users of capital markets, which are listed companies that produce goods and services for the real economy.

1. **Internal control and lessons learned from Sarbanes-Oxley**

We have concerns with respect to the proposed requirements for the external auditor to assess the company's internal control system. The focus of the external auditor in the audit should be on the integrity of the financial reporting and its opinion should be based on this.

The assessment of the internal control system is the responsibility of the company, including the internal audit function operating within the company. An additional role for the external auditor in this respect would merely be duplicating the work already undertaken by the internal auditor, at significant expense to the company[1], without creating a corresponding increase in protection for investors or other stakeholders.

Furthermore, we believe these proposals would result in blurring the company's and the external auditor's responsibilities and significantly increases the risk that too much reliance is placed on an audit opinion for the wrong reasons. Despite incurring significant additional costs, the review of an external auditor can only be of a limited nature, but may create a false impression of the soundness of internal control systems[2]. Experience in the United States demonstrates that detailed regulations, such as under the Sarbanes-Oxley Act, did not prevent failings in internal control systems and may have created a false impression of internal control systems in some instances. We fear that valuable lessons from the United States experience have not been taken into account in the EU proposals.

We do see the benefits of an open dialogue between the auditor and the undertaking's management about the integrity of the internal control system, based on the auditors' findings during its audit of the financial reporting of an undertaking. This dialogue should take place between the management and the auditor only. An important premise for such an open dialogue is that the auditors' findings should not be disclosed beyond the company's management and beyond the audit committee or supervisory board. Therefore, we believe that even the option granted to the management of the undertaking to disclose the additional report to the general meeting of shareholders (art. 23 (1), last paragraph) is not a good idea.

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[1] Research by the US Chamber of Commerce shows that the costs to US listed companies of the audit provisions in the Sarbanes-Oxley Act may have doubled.

[2] As stated by the UK Financial Reporting Council's Turnbull Guidance: *"A sound system of internal control reduces, but cannot eliminate, the possibility of poor judgement in decision-making; human error; control processes being deliberately circumvented by employees and others; management overriding controls; and the occurrence of unforeseeable circumstances."*

2. **Mandatory audit committees**

We believe that the position of the audit committee within listed companies is adequately covered in national company laws and corporate governance codes. As far as we are aware, the application of these codes has not brought to light significant issues with respect to the composition, the role and the functioning of audit committees. If there had been such issues, these would have been noted by monitoring committees, such as the existing Monitoring Committees on Corporate Governance (in the Netherlands, France, etc), and resulted in recommendations to the national legislator. We do not therefore see the need for such issues to be dealt with at EU level.

Also we are particularly concerned that the proposal in Article 31.1 of the proposed Regulation calls into question the fundamental principles underlying the Board's operations: any specialised committee is set up by the Board and acts under the sole and collective responsibility of the Board. To appoint audit committee members by the general meeting would contradict such principles.

3. **Common Standards on Audit Committees**

Article 46 3 c) of the proposed Audit Regulation gives ESMA the power to issue common standards on the oversight of audit committees. We oppose such common standards for the following reasons:

a. Audit committees in different countries have different structures as recognised in the Audit Directive. Therefore, restraint with respect to common standards is appropriate;
b. Best practices and or common standards would typically emerge through the work of national monitoring bodies on corporate governance, as this is their area of expertise. We see no need for ESMA or national securities regulators to duplicate experience that already exists elsewhere;
c. The US experience has shown that rigid rules on governance do not help companies to have better internal controls and audit systems in place (e.g. Lehman Brothers was subject to the Sarbanes Oxley Act), as this could easily lead to (very costly) tick-the-box behaviour.
d. We doubt the benefits of the detailed appointment procedure and fear that this process will lead to additional costs and tie up scarce resources of audit committees.

4. **Mandatory rotation of audit firms**

A system of mandatory rotation of audit firms will reduce the number of audit firms available and lead to a more concentrated market, which is what the Commission intended to avoid by proposing new measures. We also believe that a rotation system for audit firms would reduce sound performance by auditors in the long-term.

There are several studies that indicate that the mandatory rotation principle leads to a loss of technical expertise, as it takes the newly mandated audit firm time to get used to company specifics.[3] These studies conclude that the detrimental effects of mandatory rotation far outweigh any positive effects.

5. **Pure Audit Firms / Non-Audit Services**

An introduction of regulation leading to pure Audit Firms (i.e. excluding consultancy) may lead to loss of quality, as the expertise necessary to audit large entities (especially listed) not only requires typical audit skills and knowledge, but also consultancy skills and knowledge. In addition, it is important to

[3] See the following studies: "*The audit firm rotation rule: a review of the literature*", SDA Bocconi, 2005; "*Mandatory rotation of audit firms"*, FEE, 2004; "*Required study on the potential effects of mandatory audit firm rotation*", GAO, 2003.

acknowledge that the choice of auditor is already extremely limited for certain companies, due to the specific businesses in which they are active. The proposal could also make the audit profession less appealing to graduates and thus lead to a loss of talent.

We are of the opinion that the provision of non-audit services should continue to be permitted, subject to appropriate safeguards such as management of potential conflict of interests.

6. **Joint Audits**

Although the European Commission did not include mandatory joint audits in its proposals and mentioned joint audits only in relation to rotation periods, we remain concerned that such proposals are not fully off the table for the future.

We do not believe that this would act as a catalyst for competition but we do believe that, for the vast majority of companies, the potential disadvantage of a joint audit would outweigh any potential benefits. In particular, extra costs would be passed on to companies. Not only would companies be confronted with the costs of joint audit itself, but also communication between these firms and the learning process for new firms would increase costs as well. Moreover, to ensure a sustainable quality of statutory audits, it is highly desirable to ensure stability of the audit teams, and especially of the key audit partners to maintain knowledge of the company/group, in respect of its main characteristics and better monitor its evolution. This is especially true for groups that are large, highly internationalised and/or have complex/specific activities.

7. **Supervisory veto right to the appointment of the auditor**

Article 32 (6) of the proposal for the Audit Regulation provides for a veto right for the supervisory authority of (listed or unlisted) credit institutions and insurance undertakings on the recommendation of the external auditor by the audit committee. We do not support proposals for supervisory authorities to become involved in the appointment of the statutory auditor. A veto right of the supervisory authorities should not be necessary, assuming that the framework of supervision on the external auditor and on audit firms operates well. We fail to see what kind of remaining justification there could be to oppose the recommendation of an auditor.

8. **Principle of subsidiarity**

In general, we have doubts as regards the compliance of the regulation with the principle of subsidiarity. The European Commission mentions article 114 of the Treaty of the Functioning of the European Union (TFEU) as the legal basis for its proposal. Especially the rules on external rotation, prohibition of non-audit-services and limitation of network-access for large audit firms, however, seem to be competition issues, rather than internal market ones.

EuropeanIssuers was set up to represent the interests of quoted companies across Europe. Our members include both national associations and companies from all sectors in 14 European countries.

We aim to ensure that EU policy creates an environment in which companies can raise capital through the public markets and deliver growth over the longer-term. We seek capital markets that serve the interests of their end users, including issuers.

For more information, please contact Susannah Haan, Secretary General, on +32 2289 2570 / email info@europeanissuers.eu or visit our website at www.europeanissuers.eu

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