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EUROPEANISSUERS' POSITION ON THE REFORM OF STATUTORY AUDIT IN VIEW OF THE CURRENT COUNCIL NEGOTIATIONS AND THE ENSUING TRIALOGUE NEGOTIATIONS

29 July 2013

SUMMARY

In view of the current Council negotiations and in preparation for trialogue negotiations, we would like to share our views on the Parliament position and on the current Council position on the reform of Statutory Audit.

We are concerned that the audit market reform may add considerable costs to 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.

Our key concerns are:

Mandatory rotation of audit firms

- Mandatory rotation of audit firms would excessively constrain the selection of statutory auditors especially for large companies, deteriorate audit quality and result in lack of a regulatory level playing field;

Linkage and role of the audit committee

- Excluding that the audit committee may be a subcommittee of the administrative body would contradict well-established corporate law and corporate governance practices in Member States; we believe there is no legitimate reason to impose a specific model to all Member States;
- In a number of Members States, the audit committee has no decision-making power by itself and as such does not have the capacity to approve non-audit services (NAS) other than prohibited NAS or to validate a selection procedure. However, we acknowledge the custom of a pre-approval by the supervisory board which is in place in other Member-States. Such pre-approval processes, which are embedded in national company-law or corporate governance-structures, provide sufficient flexibility for practical usage.
- Transfer of responsibility for ensuring integrity of financial statements and for submitting recommendations regarding the financial reporting process would be counterproductive and in contradiction to the allocation of competences between the board and the management;
- Extending the current role of the audit committee to a comprehensive assessment of the audit engagement, to monitoring of the work of statutory auditor(s) or audit firm(s) and of the completeness and integrity of the draft audit reports, would interfere with the principle

of independence of the statutory auditor/audit firm. In addition, the audit committee does not have the capacity of becoming an "additional auditor".

Non-audit services

- A mandatory cap on non-audit services other than prohibited services deprives companies of flexibility to act according to circumstances; moreover a ceiling, if any, should not be determined by reference to the statutory audit of the parent company only, but also to the statutory audit of the consolidated financial statements, if any;
- Prohibition of certain non-audit services that do not compromise the statutory auditor's or audit firm's independence should be refrained from;

Some content elements of the audit reports

- Improvement of the quality of the audit reports without extending the scope of statutory audit and making it more complex and costly. In particular we are strongly opposed to audit work that would go beyond the current international auditing standards requirements as regards internal financial control system and consideration of laws and regulation;

Effects of the proposals on small and mid-cap companies

- Lack of amendment to the Regulation ensuring that the legislation follows "Think Small First" principle, whereby EU small and mid-cap quoted companies (which we define as those under €1 billion market capitalisation) should not be subject to the legislation in the first 2 years, until a review has been carried out of the effects of the proposals on the largest companies.

Legislative files	Procedure
Proposal for a regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities	2011/0359(COD)
Proposal for a Directive of the European Parliament and of the Council amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts	2011/0389(COD)

Latest texts referred to in this document:

- "the Parliament position on the Regulation": report of the Legal Affairs Committee, adopted on 25 April 2013 - A7-0177/2013
- "the Parliament position on the Directive": report of the Legal Affairs Committee, adopted on 25 April 2013 - A7-0171/2013
- "the Council position on the Regulation": Presidency compromise text of 2 July 2013 - 11908/13
- "the Council position on the Directive": Presidency compromise text of 2 July 2013 - 11833/13

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1. SELECTION, NOMINATION AND DURATION OF THE AUDIT ENGAGEMENT

Companies support the long-term development of a reliable alternative offer to that of the large audit firms, ultimately making it possible to remedy the current oligopoly on the audit market for large companies. However, the offer must not be developed in haste, to the detriment of the audit quality. It is also not the prime task of the regulator to provide for such environment but should rather be a development of the market. As the audit offer is very limited especially for large companies, the selection of statutory auditors would be excessively constrained by the introduction of mandatory rotation of firms, the excessive reduction of the maximum duration of the audit engagement and the introduction of a long cooling-off period.

Quoted companies oppose a mandatory rotation of audit firms and excessive reduction of the maximum duration of the audit engagement for various reasons:

- negative **impact on audit quality**: audit quality would inevitably decline if a group auditor did not have sufficient knowledge and means at his disposal and if the maximum duration of his engagement was too short to fully understand the activities;
- lack of a reliable alternative audit offer for large companies: only a very small number of audit firms have characteristics which match those of large companies;
- lack of measures accompanying the European Commission's proposals;
- lack of a regulatory level playing field, potentially resulting in major difficulties to organise statutory audits within international groups.

We would like to underline that in the United States these reasons have been legally acknowledged: On 8 July the US House of Representatives (House Financial Services Committee – H.R. 1564) has approved a bill banning mandatory audit firm rotation. It was argued that the selection of an auditor was a decision to be made by a public company's board of directors and ratified by its shareholders and not a decision which should be left to the regulator. Furthermore, the absence of evidence for mandatory rotation enhancing audit quality was recognized. In addition, also the UK Competition Commission has just recently decided against bringing in mandatory switching of auditors (http://www.competition-commission.org.uk/media-centre/latest-news/2013/Jul/cc-outlines-measures-for-audit-market).

Therefore we oppose article 33 of the Council position on the Regulation that proposes a maximum duration of 10 years, with a possible extension of 3 to 6 years and a 4-year cooling-off period.

Furthermore, we consider that the engagement of the statutory auditor or the audit firm should be renewable by decision of the shareholders[1] without prior evaluation of the audit quality or of the audit engagement by the audited entity or its audit committee.

[1] on a proposal of the Board after receiving a recommendation of the Audit Committee.

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We plan to develop our position on mandatory rotation of audit firms further in response to the ongoing discussions at the Council level.

2. AUDIT COMMITTEE

The draft Directive and Regulation set out requirements, which run counter well-established corporate law and corporate governance practices. We take the view that inclusion of this issue in the scope of the review is inappropriate and that it should rather be covered by company law and corporate governance practices. In this context the alignment with long-established and well-tried national mechanisms must be ensured.

Linkage with the administrative or supervisory board

In some Member States[2], the committees of the Board, which are **non-permanent** — like the administrative or supervisory body —, are **sub-groups of the board of directors or supervisory board** and appointed by the board. They are tasked with preparing its work, but the board, as a collegial body, remains collectively accountable for the performance of its duties. In that case, **the audit committee should be recognised as a committee of the board and not treated as if it were a separate legal body**, **with an independent status from the board. This should not call into question the possibility to have an audit committee separate from the board, which currently exists in Italy** ("Collegio Syndicale")**.**

There is no reason to impose a specific model to all Member states. Indeed, Article 41 of the current Directive on statutory audits provides that the functions assigned to the audit committee may be either performed by a sub-committee of the administrative of supervisory body or by one of these bodies as a whole. We are committed to this principle, which is not compatible with the EP proposal.

Therefore:

- **we strongly support the approach of the Council (Article 38a(1) of the Directive), whereby the audit committee may also be a committee of the administrative body or supervisory body of the audited entity;**
- **we are opposed to the Parliament position (Article 38a(1) of the Directive), which does not foresee the possibility for the audit committee to be a committee of the administrative body of the audited entity.**

[2] These comments do not concern the case where the audited entity is exempted from the obligation to have an audit committee and can decide which body or organ shall perform its functions (art. 31(2) of the Council position; art. 38 a(4) of the Parliament position).

Lack of legal capacity

In a number of Member States, the audit committee has no decision-making rights on its own and cannot be given any power. In some other Member States, the audit committee may be delegated powers by the administrative or supervisory body. There is no reason to impose a specific model to all Member States. Indeed Article 41 of the current Directive on statutory audits provides that the functions assigned to the audit committee may be either performed by a sub-committee of the administrative or supervisory body or by one of these bodies as a whole. The European Position is not compatible with this widely accepted principle, from which there is no reason to depart. In the former Member States, the authorising power belongs to the senior management in a one-tier system and to the management body in a two-tier system and the audit committee does not have the capacity to **approve** non-audit services (NAS) other than prohibited NAS or the power to approve a selection procedure. It may instead recommend a selection procedure for approval and review NAS other than prohibited NAS (please see our comments below).

We therefore disapprove articles 10(2) (NAS approval) & 32(3) (selection procedure) of the Council position on the Regulation and would rather opt for the contents of these provisions to be transferred into a Directive in order to achieve alignment with well-tried mechanisms among member states.

Allocation of competences between the board (and thus, the audit committee) and the senior management

One of the important roles of the supervisory/administrative board and of its committees is to monitor the implementation by senior management of the main policy lines. In the field of statutory audit, based on the essential information received from the statutory auditor or the audit firm and from the senior management and without prejudice to their responsibilities, the board or the audit committee may "challenge" it if they do not obtain a clear understanding of the statutory audit findings on the annual and consolidated financial statements.

The **change in certain provisions relating to the audit committee would be contrary to the allocation of competences between the board and the senior management/management body**.

The supervisory/administrative board may challenge the integrity of the financial statements and thus the audit committee should be recognized the right of submitting proposals to improve the integrity of the financial statements. **However, it would be counter-productive to transfer from the management to the supervisory/administrative board the responsibility for ensuring the integrity of the financial statements and for submitting recommendations or proposals to ensure the integrity of the financial reporting process.** This responsibility would imply a significant presence in the company and frequent decisions and actions, which would not be compatible with the way supervisory/administrative boards operate.

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We propose to amend Article 38a(6)(a) of the Parliament position on the Directive and Article 38a(6)(a) of the Council position on the Directive as follows: the audit committee **"may"** only – and not "shall" — **submit such recommendations or proposals (or alternatively "monitor recommendations or proposals to ensure the integrity of the financial reporting process").**

Role of the audit committee vis-à-vis the statutory auditor(s) or audit firm(s)

The mission of the audit committee is to **monitor** the statutory audit: **extending this role to a comprehensive assessment of the audit engagement, to the monitoring of the work of the statutory auditor(s) or audit firm(s) and to the monitoring of the completeness and integrity of the draft audit reports would be incompatible with the principle of independence** of the statutory auditor. Furthermore, it should be acknowledged that the audit-committee is not capable of playing the part of an additional auditor/2nd auditor.

We therefore oppose Article 33(3)(b) of the Parliament position on the Regulation (comprehensive assessment), Article 24 of the Regulation in the Parliament and Council positions (auditor's work monitoring) and Article 38a(6)(b) of the Council position on the Directive (monitoring completeness and integrity of the draft reports).

3. INDEPENDENCE OF STATUTORY AUDITORS AND ROLE OF THE AUDIT COMMITTEE

Role of the audit committee

The independence rules applicable to certain services should take into account the role of the audit committee – as a non-permanent sub-group of the supervisory/administrative board – and the time constraints of corporate financial transactions:

- **The audit committee should not be primarily responsible for assessing threats and potential safeguards to independence**. The statutory auditor, the audit firm or any member of its network should confirm annually in writing to the audit committee his, her or its independence, allowing the audit committee to monitor the statutory auditor's or the audit firm's independence.

In Article 38a(6)(d) of the Council position on the Directive, the reference to Articles 22, 22c, 22d, 24a and 24b of the Directive and to Article 11 of the Regulation should be deleted, as their implementation comes under the sole responsibility of Member States, statutory auditors and audit firms.

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- ***Rather than being subject to prior approval by the audit committee, NAS other than prohibited services should be reviewed by the audit committee (in agreement with the board).***

> ***We therefore propose the following procedure: approval by a governance body[3] of the nature of the NAS that may be carried out by the statutory auditor (although a governance body may delegate it to the audit committee if appropriate); system of delegation of authority to senior management; ex-post information of the audit committee on the NAS carried out.***

Requiring prior approval by the audit committee would have serious drawbacks:

- *this would deprive European companies of timely and well-tailored NAS and lead to a deterioration in the quality and costs of these services;*
- *this would cause the audit committee to deviate from its strategic missions (see part "Audit committee");*
- *this would likely be differently assessed and applied across entities and countries.*

> ***Therefore, it should be clearly stated in Article 10(2) of the Council position on the Regulation that the provision of NAS is subject to approval by the audited entity, according to a policy that is approved by the audited entity's governance body and that specifies the delegation of authority.***

Non audit services (NAS) other than prohibited services

We oppose a mandatory cap on NAS which deprives companies of the flexibility to decide against the background of its specific situation on the appropriate volume of NAS. At the minimum a cap should adequately reflect companies' specifics. Therefore, the conditions under which a statutory auditor may carry out non-audit services (NAS) other than prohibited NAS should be amended in the Council's position, along the lines adopted by the European Parliament.

The ceiling proposed by the Council (70 % of the statutory audit fees paid in any three year period by the audited entity for the statutory audit) would be problematic, as a company that publishes consolidated financial statements incurs expenses **for the entire group** concerning not only the statutory audit but such NAS.

In our view, **when a company publishes consolidated accounts, a ceiling** applicable to these NAS, **if any, should be determined by reference to the group, and not to the parent company alone.**

[3] The audit committee, or any specialised committee of the board, is not a governance body.

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We therefore propose that explicit reference is made in article 9(2) of the Council position on the Regulation to "fees paid in any three year period by the audited entity for the statutory audit *of its* (the audited entity's) *financial statements and, where applicable, of the consolidated financial statements that the audited entity publishes*".

Also, it is not clear – and should be specified - whether the fees for the NAS are calculated on a yearly basis or not.

If a ceiling were applied, we support the Council position that clearly excludes from its calculation those services related to audit work imposed by national and Union legislation (art. 9(2)). We also observe that in case of multinational groups operating through subsidiaries in third-countries, NAS might be required not only by their legislations, but also by established practices in foreign markets or customary contractual clauses.

Therefore, we propose to extend the exemption provided in article 9(2) of the Council position on the Regulation to cover at least any services related to audit, audit related and non-audit work provided by national, third-country and Union legislation.

Prohibited non-audit services

- **Periods of prohibition**: a statutory auditor or an audit firm, **without compromising** his/her/its **independence**, may provide prohibited **non audit services to a non-audit client** in the financial **year** immediately **preceding** a financial year in which he/she or it becomes the statutory auditor or audit firm of this client, or in the period of **twelve months** immediately **following** the issuing of the audit report. Moreover, a cooling-off period would not enhance competition in the audit-market but rather restrict it as it further limits the choice of the auditor especially in conjunction with the proposed rotation-mechanism discussed.

Therefore, instead of prohibiting the provision of certain non-audit services in the financial year immediately preceding the financial year to which the audit relates (Article 10(1)(ii) of the Council position on the Regulation), or in the period of twelve months immediately following the issuing of the audit report (Article 10(1)(iv) of the Council position on the Regulation), **the Regulation should allow the provision of such services, subject to the statutory auditor or audit firm assessing the associated threats and safeguards, under the supervision of the competent authority.** Accordingly Article 10(1)(ii) and (iv) of the Council position on the Regulation should be deleted.

- **Some corporate finance services do not compromise** the statutory auditor's or audit firm's **independence, and thus should not be prohibited**. This is the case in particular for the following services, which were mentioned in the European Commission's proposal for

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a Regulation[4]: providing comfort letters for investors in the context of the issuance of an undertaking's securities; due diligences services to the vendor or the buy side on potential mergers and acquisitions and providing assurance on the audited entity to other parties at a corporate transaction.

The scope of Article 10(1)(k) of the Council position should be revised to exclude from any prohibition at least the services that were mentioned in the European Commission's proposal for a Regulation (please see above: providing comfort letters and assurance and due diligences services in the context of corporate financial transactions).

4. AUDIT REPORTS AND SCOPE OF THE STATUTORY AUDIT

The legal audit reform aims at improving the quality of the controls performed by the statutory auditor, NOT at extending their scope. Audit reports can be more detailed than they currently are. However, statutory audit must remain focused on avoiding material misstatements in the financial statements.

The proposed content of the long form audit report (Art. 22 of Commission proposal for a Regulation) and the additional report to the audit committee (Art. 23) may imply some detailed disclosure or compliance checks, which would go well beyond the control of financial statements, and increase the work and costs of the statutory audit. Furthermore, it would inevitably increase the barriers to entry to the statutory audit market, which is contrary to the objectives of the reform. We therefore **support proposals that reinforce the audit report without extending the scope of the statutory audit and making the reports more complex**.

Companies have **three concerns** with regard to the scope of the reports, as defined in the **Council's position**:

1) they are strongly opposed to the statutory auditor reporting on the entity's or parent company's **internal financial control system** (IFC). Internal Control (IC) is supervised by the company's IC functions more frequently, comprehensively and effectively than a statutory auditor would ever be able to do. It is essential to avoid the excess witnessed in the US, where experience demonstrates that detailed regulations, such as under the Sarbanes-Oxley Act, did not prevent failings in IFC systems. This would lead to excessive costs for companies, without increasing protection for investors and stakeholders. Companies' experience in the US was that their audit costs in some cases doubled. The work of the statutory auditor or audit firm on a company's IFC system should be limited to those defined by Article 41(4) of the current Directive on statutory audits ("report to the audit committee on key matters arising from the statutory audit, and in particular on material weaknesses in internal control in relation to the financial reporting process") and the international auditing standards (ISAs)

[4] Article 10(3)b.

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to be adopted by the European Commission (in particular ISA 260 Communication with those Charged with Governance and ISA 315 *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement*) and thus, there is no need to foresee such additional requirement;

Therefore, we are strongly opposed to article 23(2)(ga) of the Council position on the Regulation.

2) the role of the auditor should not be extended to **functions** which are **under the competence of the company and/or other third parties**. Due to the lack of appropriate skills, the auditor should not identify, indicate and / or explain "*material breaches and misstatements of legal requirements including articles of association, identified in the course of the audit"* **(Article 28(1a)(f) of the Council position on the Directive)** or "*all instances or threats of non-compliance with laws, regulations or articles of association which were identified during the course of the audit* **(Article 23(2)(h) of the Council position on the Regulation**). Such extensions would be a source of confusion for investors and/or would potentially lead to increased risks for auditors and costs for companies;

Therefore, these sentences should be deleted.

3) the Regulation should not require statutory auditors or audit firms to disclose in their audit report "any key **areas of risk of material misstatement** of the annual or consolidated financial statements" **(Article 22(2)(k)) of the Council position on the Regulation)**. This would **unnecessarily cast doubt** about the information provided by the audited company and would be a source of confusion for users of financial statements and audit reports.

Therefore, point (k) should be deleted.

5. PROTECTION OF COMMERCIAL INTERESTS AND CONFIDENTIALITY

According to Article 23 of the Commission proposal for a Directive, the working arrangements with third-country authorities should ensure the protection of the commercial interests of the audited entity, including its industrial and intellectual property. This objective of protection, which is imperative for companies, needs however to be strengthened upstream by the non-transfer to such authorities of information that could affect companies' legitimate interests or business secrecy. The cooperation of ESMA or ECAOB (ECAOB is referred to in the Council's position) with third-country authorities should lead to mutual recognition and mutual trust, while respecting the confidentiality of information concerning companies or provided by companies. Moreover, the obligation of

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professional secrecy should apply to persons employed or formerly employed by competent authorities.

6. ESMA VS. ECAOB

The Commission proposal grants powers to ESMA in the field of audit supervision. Companies believe that it would be more appropriate to confer them to ECAOB (European Committee of Auditing Oversight Bodies), considering the broad scope of statutory audits (beyond listed companies and other public interest entities) and the coordination role in this field already played by EGAOB (European Group of Auditing Oversight Bodies). ESMA or ECAOB should not be given powers to describe corporate responsibilities in this field.

7. PUBLIC OVERSIGHT

Companies believe that the involvement of practitioners in the governance of the public oversight system is a necessity and provides added value. It should therefore not be excluded.

8. SMALLER ISSUERS

We believe there should be amendment to the Regulation ensuring that the legislation follows "Think Small First" principle, whereby **EU small and mid-cap quoted companies** (which we define as those under €1 billion market capitalisation) **should not be subject to the legislation in the first 2 years, until a review has been carried out of the effects of the proposals on the largest companies**.

We note that small and mid-cap quoted companies are still exempt from some requirements of the US Sarbanes-Oxley Act and that the EESC opinion on the Audit Directive and Regulation proposals recommends a total exemption for smaller companies, which would be our preferred option.

Most importantly, small and mid-cap quoted companies do not pose a systemic risk and additional compliance burdens with regard to audit could be a brake on growth and European economic recovery.

***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 can deliver growth over the longer-term. We seek capital markets that serve the interests of their end users, including issuers.

More information can be found at www.europeanissuers.eu.