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Confédération Européenne des Associations d'Administrateurs
European Confederation of Directors' Associations

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ecoDa's position paper

ON THE 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

In November 2011, the European Commission published its proposed reforms of the EU audit sector. The Commission is seeking – by means of a new EU Directive and Regulation - to increase the quality of statutory audits in the EU, improve confidence in audited financial statements and strengthen the role of audit committees.

According to the Commission, the reforms are intended to strengthen the independence of auditors and increase choice in the audit market. In addition, the Commission is proposing to create a Single Market for statutory audit services and a new approach to the supervision of auditors.

The key proposals are as follows:

- **Requirement for audit committee**. All public interest entities will be required to have an audit committee (or a body performing equivalent functions) comprised of non-executive directors (the majority of which must be independent).

- **Mandatory rotation of audit firms:** Audit firms will be required to rotate after a maximum engagement period of 6 years (with some exceptions). A cooling off period of 4 years will be applicable before the audit firm can be engaged again by the same client. Rotation can be extended to 9 years if joint audits (involving more than one audit firm) are performed.

- **Mandatory tendering:** Public-interest entities will be obliged to have an open and transparent tender procedure when selecting a new auditor.

- **Non-audit services:** Audit firms will be prohibited from providing non-audit services to their audit clients (although they may supply them to non-audit clients). In addition, large audit firms will be obliged to separate audit activities from non-audit activities in order to avoid conflicts of interest.

- **European supervision of the audit sector:** Oversight of auditor supervision activities within the EU will be undertaken by the European Markets and Securities Authority (ESMA).

- **Freedom of movement for auditors:** The Commission proposes the creation of a European passport for the audit profession.

<u>ecoDa's view on the proposals</u>

Overall perspective

As a representative of directors – one of the main consumers of audit services - ecoDa is concerned about the current structure of the audit market in Europe. ecoDa agrees with the European Commission that the market for audit firms in Europe is excessively concentrated, with negative implications for client choice. Furthermore, there is a high level of inertia in company-auditor relationships in many EU countries[1]. As a general principle of sound corporate governance, companies should seek to rotate their auditors within a reasonable timescale.

However, in contrast to the Commission's approach, ecoDa believes that many of the challenges facing the EU audit market could be more effectively addressed by amendments to national corporate governance codes or – for issues where regulatory intervention is unavoidable – national-level regulation.

Our concerns

ecoDa has two key concerns with the current proposals**. The first is that the Commission's proposals will reduce the ability of individual boards, audit committees and shareholders to make judgements concerning the appropriate relationship between the company and the external auditor**. Many more aspects of the auditor-board relationship will be defined by legislative requirements.

In the view of ecoDa, such a limitation in the discretion of company-level decision making will not contribute to improved corporate governance or company performance. In most cases, audit committees – or equivalent company-level bodies - are better placed than regulators to make judgements about auditor independence and possible conflicts of interest.

A second major concern is that the proposed EU legislation imposes a "one-size-fits-all" regulatory solution across the 27 EU member states. Such an attempt to harmonise the workings of the audit market – and specifically the functioning of audit committees - does not take into account the diverse functioning of corporate governance in a number of countries. In our opinion, the proposed measures would create an unjustifiable disruption of existing practices without commensurate governance benefits.

An important example of this diversity is provided by the distinctive functioning of boards and audit committees in the Nordic countries. In Sweden and Finland, the auditor is elected by the shareholders at the AGM with the express duty of reviewing the work of not only the CEO but also of the board.

The board or its audit committee may play a practical role in the process of recruiting the auditor by handling the tendering procedure and submitting a proposal to the AGM (in Sweden to the nomination committee). However, the final decision is legally required to be made by the AGM, and the auditor is generally seen as the shareholders' "watchdog" for the board and the CEO.

Therefore it strikes a strange note to Nordic ears when the Commission talks about the audit committee "overseeing" the audit and the appointment and dismissal of the auditor or

[1] For example, in the FTSE 100, the average tenure of an audit firm is 43 years.

"supervising" the audit report.

In the Nordic context, the imposition of such requirements by EU legislation would be seen as encouraging a mutual dependence between the board and the auditor that would seriously compromise the integrity of both. Such reforms would be regarded as a backward step in the overall functioning of corporate governance.

The financial crisis revealed failings in the functioning of company audits and raised questions about the integrity of financial reporting. However, overall, ecoDa is not convinced that the Commission's proposals are the optimal means of addressing these issues.

<u>ecoDa perspectives on individual issues</u>

1) Audit committees

The Commission's proposed Regulation will require all public interest entities, with certain concessions for subsidiaries and certain types of financial institution, to have an audit committee (or a body performing equivalent functions) comprised of non-executive directors – the majority of which must be independent.

According to the new Regulation, at least one audit committee 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 is operating.

The audit committee's responsibility with respect to the oversight of the audit and the appointment and dismissal of the auditor will be formalised in legislation. In particular, the audit committee will be explicitly required to:

- supervise the completeness and integrity of the draft audit reports;
- be responsible for the procedure on the selection of the statutory auditor(s);
- authorise on a case by case basis, the provision by the statutory auditor of those non-audit services that are still permitted.

ecoDa recognises that audit committees (and other equivalent bodies) fulfil a vital function in many EU companies (although, as noted above, it must be recognised that audit committees have differing roles and compositions in different EU member states).

ecoDa is supportive of the existing requirements– as defined in the 8th Directive on Statutory Audit - to include one individual with competence in accounting and/or auditing on the audit committee. However, the proposed new requirement for a second individual with an accounting/auditing background is unnecessary and overly prescriptive.

Although specialist financial skills are a desirable attribute for at least some audit committee members, the audit committee should not be formulated as an excessively narrow and technically-focused body. Like the rest of the board and other committees, it should contain members with a balance of skills and professional experience.

As has been discussed at length since the financial crisis, boards and their committees are likely to benefit from participants with a diverse range of backgrounds. In contrast, the proposed regulatory change may create an imbalance in the range of skills represented on both the audit committee and the board as a whole. This will work against the broader objective of increasing boardroom diversity, particularly along the dimension of professional background.

It should also be recognised that a more prescriptive approach to audit committee composition makes it increasingly difficult in small markets to recruit well-designed boards due to the highly prescriptive competence requirements that would be placed on individual directors.

The Commissions' proposals for the statutory responsibilities of audit committees are also likely to continue the process of shifting governance recommendations away from national corporate governance codes and into binding EU-level regulation. ecoDa does not believe that this is a desirable development.

In many EU countries, audit committees work extremely well in the context of governance codes and the "comply or explain" principle. This permits boards and audit committees a degree of flexibility in terms of how they fulfil their role.

The danger is that the legislative approach proposed by the Commission will reduce audit committees to organs of technical compliance rather than a sub-committee of the board with real judgemental responsibilities.

Furthermore, the legal definition by the Commission of a highly prescriptive statutory role for audit committee is likely to lead to a situation in which the audit committee is regarded as a body that is distinct (and distant) from the board as a whole. This would be a negative development. All board committees – including the audit committee – exist to support the work of the full board in the fulfilment of its responsibilities.

If audit committee were to become a specialised and stand-alone component of financial compliance, it would be detrimental to the overall standard of corporate governance within the EU. Good governance is best served if the skills and experience of the entire board – supported but not replaced by the audit committee - are brought to bear on issues of financial oversight and audit.

Finally, it is worth observing that 8th Company Law Directive on Statutory Audit (2006) – which defined an EU-wide requirement for an audit committee in public interest entities – has only been transposed into national law for a relatively short period of time (less than three years in a number of EU member states). Before introducing new EU-level legislation on audit committees, it would make sense to provide an opportunity for the current regulatory requirements to make an impact.

2) Audit market concentration

The European Commission is proposing to reduce concentration in the market for the largest audits by forcing the largest audit firms to either shrink or turn into "pure audit" firms.

In principle, ecoDa is not opposed to reforms or improvements of audit firm structures and business models. We are not necessarily supporters of the status quo in the audit market.

However, we are not convinced that this specific reform will deliver significant benefits to companies or shareholders.

A particular concern for ecoDa is that it will substantially reduce the power of boards and board committees (particularly the audit committee) to exercise their judgement in the engagement of professional advisers. This would be a negative development for European boards of directors and supervisory boards.

ecoDa's view is that issues of market concentration are more appropriately addressed by national competition authorities, who are better placed to propose a market solution that is properly tailored to the needs of each Member State[2].

In addition, there are a number of other measures that could be considered at national level – by national regulatory authorities and within corporate governance codes – which could be supportive of increased competition in the audit market. These include the following:

- The outlawing of "Big 4 only" clauses in banking covenants;
- Allowing Member States to remove ownership restrictions on audit firms;
- Encouraging greater transparency in the audit appointment process;
- Recommending re-tendering and audit firm rotation within corporate governance codes - on a 'comply or explain' basis - every 10 years or so.

3) Mandatory rotation

There is already a legal requirement for the auditors of listed companies in the EU to rotate the lead audit partner every seven years. This was introduced as part of the 8th Company Law Directive (2006), and some EU countries have enacted the directive at national level with a partner rotation cycle of only 5 or 6 years (e.g. the UK and France respectively).

However, the Commission is now proposing mandatory audit firm rotation every six years for all Public Interest Entities (PIEs), or every nine years if the company is jointly audited by two auditors.

As currently drafted, this proposal contains an implicit criticism of the audit committee's (or other relevant board committee's) ability to determine whether and when to change auditor. It constrains the audit committee's (and/or shareholders') choice of audit firm which could be detrimental to audit quality.

A six year rotation period will be expensive for companies. This is particularly true for major multinational corporations, many of whom consider it efficient to use the same auditing network across their often very complex structure of business units all over the world. The Commission's Impact Assessment significantly underestimates the most important cost from a company's perspective: the opportunity cost in terms of management and board committee time of such a regular reappointment process

In particular, when a new audit firm takes over an assignment, even with the preparation of a

[2] In the UK, the national competition authority, the Competition Commission, is currently investigating the audit market. Its final report will be published by October 2013, although its provisional findings and possible remedies will be published in November 2012.

handover file, there is bound to be a loss of historical knowledge of the company which could have an impact on audit quality. It will almost certainly result in the company having to devote substantial management time to the induction of the new auditor, in order to ensure that they have a sufficient appreciation of the company's activities and business environment.

Such a regular loss of auditor knowledge has other implications. A recent report by the UK's Financial Reporting Council concluded that the application of an appropriate degree of professional scepticism by auditors depended on their being able to develop "a high degree of knowledge of the audited entity's business and the environment in which it operates, sufficient to enable it to make its risk assessment through its own fresh and independent eyes rather than through the eyes of management"[3]. Attaining a sufficient degree of professional auditor scepticism is fundamental to the quality of an audit process.

In some instances, companies could find themselves in circumstances where they are forced to appoint a firm that is less competent than the existing auditor, which would run counter to the objective of improving audit quality. Companies might also be forced to change auditors at a time of corporate crisis, when their attention should be on other issues rather than the time-consuming process of auditor selection.

Changes to national corporate governance codes - encouraging re-tendering and auditor rotation every ten years or so on a 'comply or explain' basis - would be a better solution from a cost-benefit perspective than mandatory rotation after only six years.

Just as corporate governance codes suggest that a director can no longer be defined as 'independent' after a certain period of time, it would also be reasonable for codes to assign a similar time period to the 'independence' of the external auditor.

Following the expiry of that period, companies would need to explain to shareholders their reasons for retaining an auditor that no longer qualifies as independent. Unless the company could make a compelling case for their retention, there would be a strong moral pressure on companies to begin planning for a rotation of their auditor.

4) Joint audit

Joint audits are encouraged by the Commission's proposals. In our view, joint audits should be a possible option for a company (for example, they are widely utilised in France). But they should not be favoured by EU legislation. Regulators should adopt a neutral stance on their utilisation.

Ultimately, the decision as to whether to appoint joint auditors or not should be a matter for the individual company. ecoDa would not support European legislative proposals that overrode or second-guessed this company-level judgement.

5) Alternative ownership structures

[3] Auditing Practices Board. "Professional Scepticism: Establishing a common understanding and reaffirming its central role in delivering audit quality". Financial Reporting Council, March 2012, Page 12.

ecoDa is favourably disposed towards a relaxation of the ownership rules on audit firms to allow audit firms to raise capital from external sources. This would allow firms to recapitalise in the event of audit firm collapse. It could also allow smaller firms to grow their practices, thereby facilitating an entry into the audit market for the largest companies. However, a decision on this issue should be a matter for national regulatory authorities.

6) Restrictions of the sale of non-audit services

ecoDa recognises that the sale of non-audit services by audit firms has the potential to create conflicts of interest that might bring the independence of the auditor into question. However, it should also be recognised that auditors are sometimes better placed than other external consultants to offer useful financial advice to the company, e.g. in relation to its internal control framework.

Finding a balance between these considerations – within broad parameters - is a matter that is best left to the judgement of individual companies.

We are also not convinced that pure audit companies are an effective solution to the problem of auditor independence. If an audit firm provides non-audit services to its non-audit clients, this is not necessarily a source of concern for auditor independence.

A "pure audit" firm might find it difficult to recruit and retain the appropriate quality of audit staff and have less ability to involve "in-house" specialists in their audit work, e.g. in areas as tax, pensions and property valuation. It might also have difficulty in achieving the scale required to audit global multinational companies, which would not be conducive to increasing choice in the audit market.

Our preferred approach is to ensure that considerations of auditor independence – and the key role of the board or relevant committee in monitoring auditor independence – are strongly emphasized in national corporate governance codes and related guidance.

It may be appropriate for codes to be more prescriptive on this issue than in the past, e.g. recommending that the non-audit fees should never exceed, say, 50% of the total audit fees. However, such a recommendation is best embedded within the soft law framework of national governance codes – which gives some scope for flexible implementation by boards and shareholders - not European-level regulation.

Within the broad parameters outlined by national corporate governance codes, decisions about the purchase of non-audit services – and the preferred business model of the auditor – should be left to the judgement of individual companies.

7) Effective contingency plans

Despite the potential disruption that would be caused by the collapse of one of the 'Big Four', no audit firm should be too big to fail. ecoDa welcomes the Commission's proposed requirement for audit firms to have contingency plans in order to mitigate the systemic risk of an audit firm failure.

8) European Passports for auditors

ecoDa welcomes the possible creation of a single European passport for auditors. However, this needs to be accompanied by a registration regime that ensures the necessary level of capability to undertake statutory audits in the differing legal environment of other EU member

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About ecoDa - The European Confederation of Directors' Associations

www.ecoDa.org

The European Confederation of Directors' Associations. ecoDa is a not-for-profit association based in Brussels, acting since March 2005 as the "European voice of directors". Through its national institutes of directors (the main national institutes existing in Europe), ecoDa represents around fifty-five thousand board directors from across the EU member states.

ecoDa's mission is to promote good corporate governance and improve the effectiveness of boards of directors and/or supervisory boards, particularly by means of appropriate director training, professional development and boardroom best practice

ecoDa's members: IoD, GUBERNA, IFA, ILA, IC-A, Hallitusammattilaiset ry, the Slovenian association of supervisory board members, the Croatian Association of certified supervisory board members, the Polski Instytut Dyrektorow, the Norwegian institute of directors (Styreinstitutt), the Norwegian StyreAkademiet, the Baltic institute of directors, the Swedish StyrelseAkademien and the Macedonian FYR Institute of Directors.

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