

EU-Commission's proposal for a regulation on specific requirements regarding statutory audit of public interest entities – Deutsches Aktieninstitut's proposed amendments

5 November 2012

In November 2011 the EU-Commission has published legislative proposals concerning the statutory audit of public interest entities. The Commission's proposals are presently being discussed in the European Parliament on the basis of a parliamentary draft report prepared by JURI rapporteur Mr Sajjad Karim.

Deutsches Aktieninstitut has followed the debate on the reform of the audit markets closely and expressed its concern that the very far-reaching proposal of the EU-Commission would drastically interfere with well established mechanisms of corporate governance, decrease the quality of audit services and threaten the shareholders' fundamental right to appoint the auditor upon the supervisory board's recommendation.

Please find in the annex of this paper our proposed amendments which adequately address our concerns regarding the following issues:

- External rotation: See our proposed amendment no. 8;
- Provisions governing audit committees: See our proposed amendments no. 1, 6 and 7;
- Prohibition of the provision of non-audit services: See our proposed amendments no. 2, 3 and 4.
- Provisions governing the duties of auditors: See our proposed amendment no. 5;
- Too far-reaching competencies of supervisory authorities: See our proposed amendments no. 9;
- Discrimination of international audit networks: See our proposed amendment no. 3.

Deutsches Aktieninstitut is the organisation of German stock-exchange-listed companies and other organisations interested in capital markets developments.

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Annex: Amendments to the EU-Commission's proposal for a regulation on specific requirements regarding statutory audit of public interest entities

Amendment 1

Proposal for a regulation

Recital 23

Text proposed by the Commission

(23) Audit committees, or bodies performing an equivalent function within the audited entity, have a decisive role in contributing to high-quality statutory audit. It is particularly important to reinforce the independence and technical competence of the audit committee by requiring that a majority of its members is independent and that at least one member of the committee has competence in auditing ***and another one in auditing and/or*** accounting. The Commission Recommendation of 15 February 2005 on the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board sets out how audit committees should be established and function. Considering, however, the dimension of boards in companies with reduced market capitalisation and in small and medium-sized public-interest entities, it would be appropriate that the functions assigned to the audit committee for those entities, or to a body performing equivalent functions within the audited entity, may be performed by the administrative or supervisory body as a whole. Public-interest entities which are UCITS or alternative investment funds should also be exempted from the obligation to have an audit committee. This exemption takes into account the fact that where those funds function merely for the purpose of pooling assets, the employment of an audit committee is not appropriate. UCITS and alternative investments funds, as well as their management companies, operate in a strictly defined regulatory environment and are subject to specific gov-

Amendment

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ernance mechanisms such as controls exercised by their depositary.

cised by their depositary. ***Member States may determine that the functions assigned to the audit committee or a body performing equivalent functions may be performed by the administrative or supervisory body as a whole.***

Justification: Amendment refers to Recital 24 of Directive 2006/43/EC which provides member states the option that the function of the audit committee could be assigned to the supervisory or administrative body as a whole. This rule takes into account particularities in different member states, e.g. the fact that German corporate act allows companies to install supervisory boards comprising three members. Therefore, many mid sized issuers with a market capitalisation above the thresholds described in Art. 31, which supervisory boards comprise three persons only, are not obliged to implement an audit committee so far. This possibility should be preserved in future as well.

Amendment 2
Proposal for a regulation
Article 9 – paragraph 2

Text proposed by the Commission

2. When the statutory auditor or audit firm provides to the audited entity related financial audit services, as referred to in Article 10(2), the fees for such services shall be limited to no more than 10 % of the fees paid by the audited entity for the statutory audit.

Amendment

2. When the statutory auditor or audit firm provides to the audited entity non-audit services other than prohibited non-audit services, as referred to in Article 10(2), the audit committee should prepare guiding principles on the question which and to which extent the statutory auditor should provide such services. These principles could e.g. limit the fees for such services to a pre-defined proportion of the fees paid by the audited entity for the statutory audit.

Justification: It should be left to the audit committee to decide against the background of the company's specifics which and to which extent the auditor should provide non-audit services. A general limitation of non-audit services as proposed by the EU-Commission is much too inflexible and does not adequately take into account specifics of the audited entity.

Amendment 3
Proposal for a regulation
Article 10

Text proposed by the Commission

Article 10
Prohibition of the provision of non-audit

Amendment

Article 10
Provision of non-audit services

services

1. A statutory auditor and an audit firm carrying out statutory audit of public-interest entities shall not directly or indirectly provide to the audited entity, to its parent undertaking and to its controlled undertakings services other than statutory audit services and related financial audit services.

Where the statutory auditor belongs to a network, no member of such network shall provide to the audited entity, to its parent undertaking and to its controlled undertakings within the Union any *service other than statutory audit services or related financial* audit services.

2. *For the purposes of this Article, related financial* audit services shall mean:

(a) the audit or review of interim financial statements;

(b) providing assurance on corporate governance statements;

(c) providing assurance on corporate social responsibility matters;

(d) providing assurance on or attestation of regulatory reporting to regulators of financial institutions beyond the scope of the statutory audit and designed to assist regulators in fulfilling their role, such as on capital requirements or specific solvency ratios determining how likely an undertaking will be to continue meeting its debt obligations;

(e) providing certification on compliance with tax requirements where such attestation is required by national law;

(f) any other statutory duty related to audit work imposed by Union legislation to the statutory auditor or audit firm.

3. [...]

By derogation from the first and second subparagraphs, the services mentioned in point (b)(i) and (ii) may be provided by the statutory auditor or the audit firm, subject to prior approval by the audit committee as referred to in Article 31 of this Regulation.

1. A statutory auditor and an audit firm carrying out statutory audit of public-interest entities shall not directly or indirectly provide to the audited entity, to its parent undertaking and to its controlled undertakings ***prohibited non-audit*** services.

Where the statutory auditor belongs to a network, no member of such network shall provide to the audited entity, to its parent undertaking and to its controlled undertakings within the Union any ***prohibited non-audit*** services.

2. ***Non-audit*** services ***which would have material impacts on the financial statements to be audited and entail conflict of interest*** shall ***be prohibited***.

3. ***Non-audit services*** may be provided by the statutory auditor or the audit firm, subject to ***para. 2 and to a*** prior approval by the audit committee as referred to in Article 31 of this Regulation.

4. ***to 6. deleted***

[...]

4. [...]

5. [...]

6. [...]

Justification: The very detailed rules regarding non-audit services proposed by the EU-Commission ignore that a too strict legal ban of non-audit services is not appropriate as at present empirical evidence lacks that such a ban is capable of improving the overall audit quality.¹ The proposed rules will cause significant additional costs because companies would be required to find adequate substitutes to their incumbent suppliers. For these reasons the rule should be restricted to the core problem of non-audit services: “Self review” and conflict of interests. The amendment reflects that only non-audit services which are critical against the background of “self review” and conflict of interests should be prohibited. Concerning other non-audit services it should be left to the discretion of the audit committee to decide which and to which extend the auditor should provide these services (which is already well tried customs).

Furthermore, rules regarding international networks in Art. 10 para. 5 are not only questionable from a regulative and competition policy point of view but furthermore lead to a loss of expertise of the respective audit firms in the evaluation of complex business models. Against the background of the necessity to adequately reflect risks in financial reporting/accounting this could systematically interfere with the quality of audits. The interests of a shareholder who relies on the adequacy of the financial reports published would thus be challenged. Effective and internationally well represented audit companies that provide a wide range of services are of crucial importance for internationally operating enterprises.

Amendment 4

Proposal for a regulation

Article 11 – paragraph 4 – subparagraph 1 – point c

Text proposed by the Commission

(c) request permission from the audit committee to provide **the** non-audit services referred to in **Article 10(3)(b)(i) and (ii)** to the audited entity;

Amendment

(c) request permission from the audit committee to provide non-audit services **other than prohibited non-audit services as** referred to in **Article 10(2)** to the audited entity;

Justification: Amendment follows the amendment regarding Art. 10 proposed above.

Amendment 5

Proposal for a regulation

Article 22

¹ E.g. Francis, Jere R.: Are Auditors Comprised by Nonaudit Services? Assessing the Evidence. Contemporary Accounting Research, Vol. 23 (3), 2006, p. 747-760.

Text proposed by the Commission

1. The statutory auditor or the audit firm shall present the results of the statutory audit of the public-interest entity in an audit report.
 2. [...]
- (c) explain, where additional reports have been reviewed, the scope of such review;
- [...]
- (h) [...]**
- (i) [...]**
- (k) identify key areas of risk of material misstatement of the annual or consolidated financial statements, including critical accounting estimates or areas of measurement uncertainty;
- (l) *provide a statement on the the situation of the audited entity or, in case of the statutory audit of consolidated financial statements, of the parent undertaking and the group, especially an assessment of the entity's or the parent undertaking's and group's ability to meet its/their obligation in the foreseeable future and therefore continue as a going concern;***
- (m) [...]**
- (n) [...]**
- (o) [...]**
- [...]
- (s) [...]**
- [...]

Amendment

1. The statutory auditor or the audit firm shall present the results of the statutory audit of the public-interest entity in an audit report ***prepared in accordance with the international auditing standards referred to in Article 26 of Directive 2006/43/EC.***
 2. [...]
- (c) explain, where additional reports have been reviewed ***as part of the statutory audit***, the scope of such review;
- [...]
- (h) and (i) deleted***
- [...]
- (k) identify key areas of risk of material misstatement of the annual or consolidated financial statements, including critical accounting estimates or areas of ***material*** measurement uncertainty ***and the related audit assessment;***
- (l) *state that the use of the going concern assumption is appropriate or disclose or highlight the existence of any material uncertainty that may cast significant doubt on the audited entity's ability to meet its/their obligation in the foreseeable future and therefore continue as a going concern;***
- (m), (n) and (o) deleted***
- [...]
- (s) deleted***
- [...]

Justification: The obligations of the auditor should be limited to financial reporting/accounting exclusively. E.g. to assess the appropriateness of the internal control system should be left to the audited company. The auditor should only evaluate if the monitoring system of the company is capable of fulfilling its tasks. Similar aspects concern the reporting on the state of the company. The auditor should not audit the latter but just certify the statements of the company's legal representatives concerning the state of the company.

Amendment 6
Proposal for a regulation
Article 31

Text proposed by the Commission

Each public-interest entity shall have an audit committee. The audit committee shall be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity or, for entities without shareholders, by an equivalent body.

At least one member of the audit committee shall have competence ***in auditing and another member*** in accounting and/or auditing. The committee members as a whole shall have competence relevant to the sector in which the audited entity is operating.

A majority of the members of the audit committee shall be independent. The chairman of the audit committee shall be appointed by its members ***and shall be independent.***

[...]

5. [...]

(c) monitor the statutory audit of the annual and consolidated financial statements ***and supervise the completeness and integrity of the draft audit reports in accordance with Articles 22 to 23;***

[...]

(f) authorise, on a case by case basis, the provision by the statutory auditor or audit firm of the services referred to in Article 10(3)(b)(i) and (ii) of this Regulation to the audited entity.

Amendment

Unless otherwise determined by the Member States each public-interest entity shall have an audit committee. The audit committee shall be composed of non-executive members of the administrative body and/or members of the supervisory body of the audited entity and/or members appointed by the general meeting of shareholders of the audited entity or, for entities without shareholders, by an equivalent body.

At least one member of the audit committee shall have competence in accounting and/or auditing. The committee members as a whole shall have competence relevant to the sector in which the audited entity is operating.

At least one member of the audit committee shall be independent. The chairman of the audit committee shall be appointed by its members.

[...]

5. [...]

(c) monitor the statutory audit of the annual and consolidated financial statements;

[...]

(f) approve the provision by the statutory auditor or audit firm of ***non-audit services as referred to in Article 10*** to the audited entity.

Justification: The proposed rules regarding audit committees contradict in part national corporate law governing the interplay between the audit committee / supervisory board and the auditor. Without doubt it is an important advantage of national corporate law to define the tasks of the audit committee by taking adequately into account the particularities of the respective corporate governance system.

As a “one-size-fits-all-approach” the proposed rules do not provide such flexibility for the following reasons:

- 1) The proposal of the EU-Commission regarding the composition of the audit committee does not adequately reflect corporate world in many member states. To require that at least one member of the audit committee should have competences in auditing and another member in accounting and/or auditing would mean that a supervisory board comprising three members, which could be found e.g. in several German mid sized companies, would consist of experts in accounting and auditing almost exclusively. This would contradict the political aim to diversify capacities of board members.
- 2) The proposed obligation that the majority of the audit committee should consist of independent members does not match the German corporate-governance-system which already separates management (executive board) and control (supervisory board) efficiently in order to minimise conflict of interests. To substitute current members with – by definition - independent members would be very costly and would not improve the supervisory function of the audit committee.
- 3) To oblige audit committees to supervise the completeness and integrity of the draft audit reports is inappropriate. Obviously, it would overstretch the capabilities of the audit committees’ members to perform this task and to become – more or less – a co-auditor.
- 4) The amendment concerning non-audit services mirror the amendment in Art. 10.

Amendment 7
Proposal for a regulation
Article 32

Text proposed by the Commission

[...]

2. The audit committee shall submit a recommendation to the administrative or supervisory board of the audited entity for the appointment of statutory auditors or audit firms. The audit committee shall justify the recommendation made.

Unless it concerns the renewal of an audit engagement in accordance with the second subparagraph of Article 33(1), the recommendation shall contain at least two choices for the audit engagement and the audit committee shall express a duly justified preference for one of them.

When it concerns the renewal of an audit engagement in accordance with the second subparagraph of Article 33(1), the audit committee shall, for the preparation of its recommendation, take into consideration any findings and conclusions on the commended statutory auditor or audit firm referred to in Article 40(6) and published by the competent authority pur-

Amendment

[...]

2. The audit committee shall submit a recommendation to the administrative or supervisory board of the audited entity for the appointment of statutory auditors or audit firms. The audit committee shall justify the recommendation made.

The audit committee shall state that its recommendation is free from influence by a third party and that no contractual clause as referred to in paragraph 7 has been imposed upon it.

3. [...]

(a) the audited entity shall be free to invite any statutory auditors or audit firms to submit proposals for the provision of the statutory audit service on the condition that Article 33(2) is respected;

[...]

The audit committee shall ***prepare guiding principles regarding*** the selection procedure referred to in the first subparagraph ***on***

suant to Article 44(d).

In its recommendation, the audit committee shall state that its recommendation is free from influence by a third party and that no contractual clause as referred to in paragraph 7 has been imposed upon it.

3. [...]

(a) the audited entity shall be free to invite any statutory auditors or audit firms to submit proposals for the provision of the statutory audit service on the condition that Article 33(2) is respected **and that at least one of the invited auditors or firms is not one who received more than 15% of the total audit fees from large public-interest entities in the Member State concerned in the previous calendar year**;

[...]

The audit committee shall **be responsible for** the selection procedure referred to in the first subparagraph.

[...]

9. [...]

10 [...]

behalf of the administrative or supervisory board.

[...]

9. and 10 deleted

Justification: The procedure to select the auditor should be flexible enough to reflect the specifics of the audited entities. Therefore, it would inappropriately increase the administrative burden to oblige audit committees to consider a mid-seized audit firm in the selection process. If the audit committee comes to the conclusion that an audit firm is capable to provide audit services in due quality, it will propose the respective firm irrespective of seize. To include smaller audit firms in the selection process would produce additional costs only, even though it is foreseeable that they do not meet the requirements needed for a sound audit. Furthermore, guidelines of ESMA concerning the selection procedure are likely to be much too formalised and bear the risk to raise costs for the audited entities without adding further benefits.

Amendment 8

Proposal for a regulation

Article 33

Text proposed by the Commission

1. The public-interest entity shall appoint a statutory auditor or audit firm for an initial engagement **that shall not be shorter than two years**.

Amendment

1. The public-interest entity shall appoint a statutory auditor or audit firm for an initial engagement **of one year**.

The public-interest entity may renew this

The public-interest entity may renew this engagement *only once*.

The maximum duration of the combined two engagements shall not exceed 6 years.

Where throughout a continuous engagement of 6 years two statutory auditors or audit firms have been appointed, the maximum duration of the engagement of each statutory auditor or audit firm shall not exceed 9 years.

2. [...]

3. [...]

[...]

engagement on an annual basis provided that, prior to the reappointment, the audit committee has reported to the administrative or supervisory body that it has carried out an assessment of the threats to the independence of the statutory auditor or audit firm, as required by Article 31, and is satisfied that the statutory audit or audit firm has been able to and is likely to be able to continue to mitigate any threats to its independence.

Otherwise, the audit committee shall not recommend the statutory auditor or audit firm for reappointment.

2. and 3. deleted

[...]

Justification: The concept of external rotation is an unjustified interference with the corporate governance of listed companies. A mandatory change of the audit firm deprives the general meeting of shareholders of the right to independently appoint an auditor who is considered suitable for company purposes. Furthermore, academic evidence shows that a mandatory rotation rule in tendency leads to a loss of “tacit” knowledge regarding company specifics the audit firms acquired over the years of their appointment.¹ Consequently, the number of mistakes is likely to rise after the mandatory change of the audit firm. This is to the detriment of shareholders which rely on sound financial statements. Furthermore, the minimum duration of the auditor engagement contradict provisions in many member states.

Amendment 9

Proposal for a regulation

Article 46 – paragraph 3 – subparagraph 1 – point c

Text proposed by the Commission

Amendment

(c) common standards on the oversight activity of the audit committee referred to in Article 24

deleted

Justification: Too far-reaching competences of supervisory authorities will deprive companies of the necessary flexibility needed to adjust the auditor engagement and monitoring according to the company’s individual situation.

¹ See e.g. Cameran, Mara: The Audit Firm Rotation Rule. A Review of the Literature, SDA Bocconi 2005; as regards the Italian Rotation Rule: Cameran, Mara: Auditor Tenure and Auditor Change? Does Mandatory Auditor Rotation really improve Audit Quality?, Working Paper, 2009.