Center for Corporate Governance
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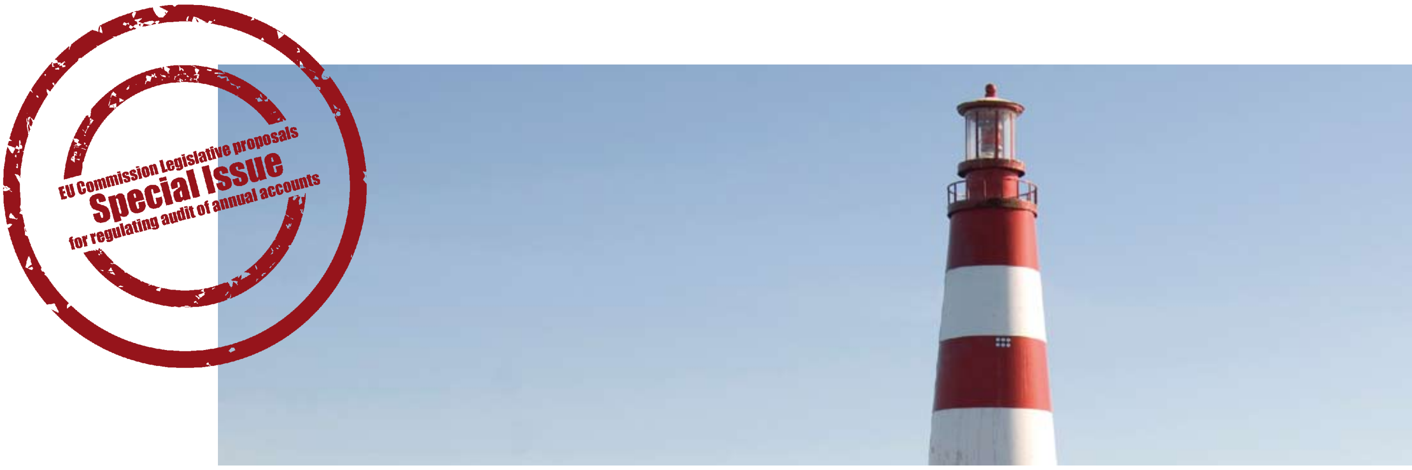
Corporate Governance Forum
Information for Supervisory Board and Audit Committee members



Dear Reader,

on 30 November 2011, the EU Commission published legislative proposals for the regulation of the audit of annual accounts. The proposals, for which EU internal market commissioner Michel Barnier is responsible, are to a large extent identical with the original discussion paper ("Green Paper") on the audit of annual accounts published in October 2010[1]

The draft now presented severely restricts the decision-making powers of supervisory boards and shareholders regarding the appointment of auditors and would, in our view, have far-reaching consequences not only for the auditors, but also for the companies to be audited, and for the German economy as a whole.

The Commission has missed the primary objective of improving the quality of the audit of annual accounts, in particular with regard to future financial crises and to the further development of the role of the (statutory) auditor. Instead, the proposals are of a predominantly interventionist nature. Their primary aim is intervention in the audit market, whereby the required external mandatory rotation of the auditor – in our view – encourages concentration, contrary to its objective.

An analysis of opinions on the Green Paper performed on behalf of the Deutsches Aktieninstitut (German Equities Institute – DAI) shows that the planned regulatory measures – with the exception of the introduction of international standards on auditing (ISAs) – found no support from stakeholders outside the profession either.[2] The legislative proposals, which largely follow the Green Paper, are all the more surprising. We summarise the most important regulatory proposals for you in this special issue of the Corporate Governance Forum.

[1] EU Commission dd. 13.10.2010, COM (2010) 561 final; on this, see the Special Issue of Deloitte Corporate Governance Forum dated November 2010.

[2] Böcking/Gros/Wallek/Worret (all Goethe University, Frankfurt am Main): Analysis of the EU Consultation on the Green Paper "Audit Policy: Lessons from the Crisis" – An analysis of opinions on the consultation process, studies by Deutsches Aktieninstitut, vol. 51, edited by Rosen, Frankfurt am Main, December 2011 (available for download at: http://www.dai.de.)

The draft bill is now the subject of discussions in the European Parliament and the member states in the Council of the EU. In the further legislative process, it is crucial that all stakeholders affected by the regulatory proposals engage in the discussion. We at Deloitte continue to press all involved for a solid set of rules on corporate governance, as well as for sensible measures to improve audit quality.

At the same time we are counting on your support to prevent yourself, as a supervisory board member, director or entrepreneur, losing decision-making powers in the selection of your auditor or consultant as a result of over-regulation, without any improvement in audit quality being expected from this. Express your opinion – for example in the German Equities Institute (DAI), in the Federation of German Industries (BDI), in your own interest groups or directly with political representatives in the Federal Government and in the European Parliament.

I am happy to be at your disposal personally for a discussion of the Commission's proposals and their impact.

You can reach me at mplendl@deloitte.de
or by phone on +49 (0)89 29026 8332

Yours

Martin Plendl

Understanding the legislative proposals

At the heart of the Commission's regulatory proposals is a "Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities".[3] The effect of a Regulation as an instrument is that its provisions – as soon as they have been passed by the European Parliament and the Council and published in the EU's Official Journal – have direct legal effects on all auditors and entities affected by them. The Regulation is supplemented by a Directive amending the existing 2006 Statutory Audit Directive.[4] Directives have to be implemented in national law by the member states.

Scope of the Regulation

The EU Commission's proposed Regulation applies to public-interest entities (PIEs). Under the proposed Regulation, these include, as before, entities whose securities are admitted to trading on a regulated market, credit institutions and insurance undertakings. Furthermore, payment and electronic money institutions, investment firms, alternative and classic investment funds and possibly central counterparties in OTC derivatives trading are intended to be included in this term.

In addition, the draft Regulation defines large public-interest entities. These include the largest ten issuers of shares in each member state and in any case all issuers of shares that had an average market capitalisation of more than EUR 1.0 billion, financial and credit institutions with total assets of more than EUR 1.0 billion and investment funds with managed assets of more than EUR 1.0 billion. This definition is relevant to the mandatory inclusion of certain audit firms in the invitation to tender for the audit (Art. 32 (3a)) and the criteria for determining pure audit firms (Art. 10 (5)).

Comment

While the Regulation, according to the Commission, is intended to regulate (only) the statutory audit of public-interest entities, the audit of companies not in this – now broad – category should be based on the amended statutory audit directive. However, we dare to forecast that, with an eye on foreign investors and other stakeholders, small and medium-sized businesses too will, or will have to, align themselves in the medium to long term as far as possible with the rules laid down in the Regulation.

The major regulatory proposals at a glance

1. **External rotation:** mandatory rotation of the audit firm after a maximum of six years; in the case of joint audit, after a maximum of nine years
2. **Audit Committee:** concretisation of the tasks of the audit committee and tightening of the requirements for its members
3. **Mandatory call to tender:** procedure for the selection and appointment of the auditor with the responsibility of the audit committee
4. **International Standards on Auditing:** application of international standards on auditing
5. **Non-audit services:** prohibition of advisory services (including tax advisory) for audit clients
6. **Pure Audit Firms:** separation of audit and consulting services in the business model of large audit firms (> EUR 1.5 billion in the EU) that obtain more than 1/3 of their annual audit fees from the audit of large-scale public-interest enterprises.

[3] EU Commission dd. 30.11.2011, COM (2011) 779 final: proposal for a "Regulation of the European Parliament and of the Council on specific requirements regarding statutory audit of public-interest entities" (http://ec.europa.eu/internal_market/auditing/docs/reform/regulation_en.pdf).

[4] EU Commission dd. 30.11.2011, COM (2011) 778 final: 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" (http://ec.europa.eu/internal_market/auditing/docs/reform/directive_en.pdf).

1. External rotation

Mandatory rotation

Under the draft Regulation, the engagement of the statutory auditor has to be for a minimum of two years, whereby the engagement may be renewed only once. In total, the duration of the two engagements may basically not exceed six years. After this, a cooling-off period of four years applies before an audit firm or a member of its network may be appointed as auditor again (Art. 33 (1) and (2)).

Exceptions

In the event that two auditors (so-called joint audit) are appointed for a continuous period of six years, the period after which an audit firm must rotate out of the appointment will be extended to nine years (Art. 33 (1)). The competent professional supervisory authority may consent to a further renewal of the appointment for two, in the case of a joint audit three, more years (Art. 33 (3)). However, in cases where the audit activity goes beyond seven years, the previously applicable mandatory rotation of the responsible audit partner (so-called internal rotation) after seven years applies in addition, with a newly applicable cooling-off period of three rather than two years as in the past. Moreover, the audit firm is expected to introduce a "gradual rotation mechanism" for the other auditors involved in the statutory audit (Art. 33 (4)).

On the obligatory rotation of the statutory auditor, the former auditor is required to prepare a handover file for the incoming auditor, the technical requirements on the contents of which are to be developed by ESMA[5] (Art. 33 (5) and (6)).

Comment

The proposals for mandatory rotation restrict the freedom of decision of the supervisory board and the audit committee to select the most suitable auditor. They do not lead to an improvement in the quality of the audit and the independence of the auditor or to more competition, and they increase the cost to the entity.

The research and business worlds see no benefits in external rotation

Mandatory external rotation was looked at in various countries in the past few years and mostly discarded again (or abolished subsequent to introduction). As recently as 2003, the concept was investigated in the United States in the context of Sarbanes-Oxley, but on the basis of a study by the U.S. General Accounting Office[6] it was ultimately not introduced.

We have examined all internationally available studies on the subject.[7] The results show no robust correlation between the duration of an audit appointment and the quality of the audit. Almost all countries' experience shows that, on introduction of external rotation, the costs exceed the benefits; 76% of the empirical studies speak out against the introduction of mandatory external rotation (see Figure 1).

The opinion of audit committees and enterprises also turns out to be in line with this result. Thus, according to the investigation by Böcking et. al., 100% of audit committees and 84% of companies preparing balance sheets rejected the Green Paper's proposal on the introduction of external rotation. We reach roughly the same conclusion on a preliminary analysis of responses to the "Concept Release on Auditor Independence and Audit Firm Rotation" from the PCAOB[8] dated 16 August 2011, in which the U.S.-American auditing profession supervisor again raised the question of external rotation.[9]

[5] European Securities and Markets Authority

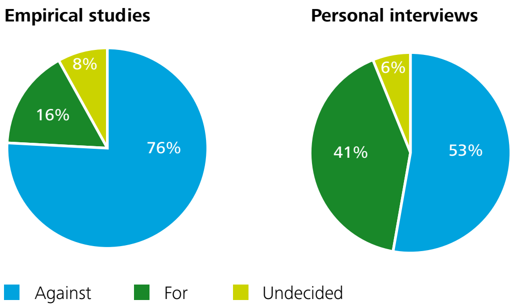
[6] U.S. General Accounting Office, Report to the Senate Committee on Banking, Housing, and Urban Affairs and the House Committee on Financial Services, Public Accounting Firms – Required Study on the Potential Effects of Mandatory Audit Firm Rotation (November 2003).

[7] The Deloitte analysis is based on 66 scientific studies on external rotation (49 empirical studies, 17 opinion studies); we are happy to provide the publication list on request.

[8] Public Company Accounting Oversight Board

[9] The Concept Release, including the Comment Letters received, is available for download from the PCAOB website at http://pcaobus.org/Rules/Rulemaking/Pages/Docket037.aspx.

Fig. 1 – Scientific studies on external rotation



2. Audit committee

In principle, each public-interest entity is required to set up an audit committee, whose tasks include monitoring the financial reporting process, as well as the effectiveness of the internal control, internal audit where applicable, and risk management systems, monitoring the statutory audit of the annual and consolidated financial statements, supervising the integrity of the auditor's reports (Art. 22) and the additional detailed reporting to the audit committee (Art. 23), as well as monitoring the independence of the auditor; furthermore it is responsible for the procedure on the selection of the statutory auditor (Art. 31).

Expert members

At least one member of the audit committee must have competence in auditing. In addition, another member must have competence in accounting and/or auditing. Familiarity with the industrial sector of the company to be audited is required of all committee members, and the independence of the majority of the members and the chairman (Art. 31 (1)).

Appointment of the Auditor

The audit committee is required to submit a reasoned recommendation for the engagement of the auditor to the supervisory board of the audited entity. Insofar as the renewal of an existing mandate (regularly only allowed once) is not involved, the recommendation shall include at least two proposals, as well as the reasoned preference of the audit committee for a statutory auditor. In the case of the recommendation for a renewal of the existing appointment, it shall take into consideration the inspection results published by the auditor's professional supervision. Furthermore, the audit committee is required to state that its recommendation is free from undue third-party influence and that it was in particular not bound by contractual terms which limit the selection and are thus not permissible (Art. 32 (2)). Such clauses are null and void; any attempt by third parties to enforce such a clause is to be reported to the professional supervision by the entity (Art. 32 (7)). The audit committee's recommendation for the selection of the auditor is part of the supervisory board's recommendation to the annual general or shareholder's meeting; if the supervisory board is not in agreement with the audit committee, it has to justify this (Art. 32 (5)).

Comment

The proposals increase the demands on members of audit committees beyond the level we know in Germany under BilMoG[10], intervene in the audit committee's mode of operation and bureaucratise it.

3. Mandatory call to tender

Selection procedure for the statutory audit

Responsibility for the selection procedure lies with the audit committee. The entity to be audited is basically free in the selection of the audit firm that it requests to tender. However, it is not permitted to ask a former auditor excluded due to rotation obligations. On the other hand, it must invite at least one audit firm to tender that obtained no more than 15% of total audit fees from large public-interest enterprises in the member state concerned in the previous calendar year; the supervisory body responsible for the profession maintains a corresponding list. The tender documents must contain, apart from a description of the business activities, transparent and non-discriminatory selection criteria for the evaluation of the tenders, as well as any nationally required official quality standards. The tenders must be assessed according to the selection criteria laid down in the call for tender documents,

[10] German Modernisation of Accounting Law Act

whereby any inspection reports from the professional supervisor on the tenderers are to be taken into account. The entity prepares a report on the evaluation of the tenders, which is to be validated by the audit committee. Furthermore, the entity must be able to demonstrate to the supervisory body responsible for the profession that a fair selection procedure has taken place (Art. 32 (3)).

4. International Standards on Auditing (ISAs)

In performing the statutory audit, the international auditing standards recognised within the framework of the Statutory Audit Directive should be applied, insofar as they are in accordance with the requirements of the Regulation.

5. Non-audit services

Under non-audit services, the draft Regulation distinguishes between "related financial audit services" and "non-audit services". The following are "related financial audit services" (Art. 10 (2)):

- Audit or review of interim financial statements
- Audit services with regard to the Declaration on Corporate Governance
- Audit services with regard to questions of corporate social responsibility
- Audit services and certifications for supervisory or regulatory purposes which go beyond the scope of a statutory audit
- Certificates of compliance with the tax requirements where such attestation is required by national law
- Any other audit work prescribed by statute which is incumbent on the auditor under EU law

The fees for such audit activities should be limited to no more than 10% of the fees paid for the statutory audit (Art. 9 (2)).

Comment
Audit services of this kind are either to be attributed to statutory audit services, due to their close meshing with statutory audit in Germany, represent tasks reserved to auditors or, as other audit services under the applicable professional standards, already per se demand the independence of the auditor. Moreover, the extent of such activities should mostly follow from the applicable legal and regulatory requirements. A limitation on the fees for such services therefore neither serves to strengthen the independence of the auditors nor is it justified in the light of the lack of predictability of regulatory requirements and the corresponding amount of work.

Under marginal no. 11 of the Preamble to the draft Regulation "Auditors, audit firms and the members of their network [...] should be prohibited from providing non-audit services to entities audited by them". Although the draft itself contains no explicitly formulated prohibition of all non-audit services, it can be assumed that this is nevertheless de facto the case for almost all non-audit services. Thus the services that are "in any case" prohibited include:

- Expert services
- Tax consultancy
- General management or other advisory services
- Valuation services
- Fairness opinions or contribution-in-kind reports
- Actuarial and legal services (Art.10 (3a))

The draft only allows exceptions

- for the performance of human resource services (including the recruitment of senior management) and the preparation of comfort letters (if the Audit Committee approves this) and
- for due diligence services, and also the design and implementation of financial information technology systems at non-financial institutions, if the professional regulatory body has agreed to this (Art.10 (3b)).

These rules also apply to auditors of group companies in the network of the group auditor.

Comment

In Germany, there are already extensive provisions in the professional standards for the independence of the statutory auditor with regard to the admissibility of non-audit services in audit mandates. A tightening of the restrictions and the accompanying limitations on the choice of the service provider are unnecessary from a German perspective. In order to strengthen the independence of the auditor we support the introduction of international standards of independence and approval of the non-audit services to be rendered by the auditor by the audit committee, as requested by the European Parliament in its resolution on the Green Paper dated 13 October 2010.

6. Pure Audit Firms

Large audit firms which generate more than one-third of their audit revenue from large public-interest entities and belong to a network whose members have combined annual audit revenues which exceed EUR 1.5 billion within the EU are, according to the will of the European Commission, expected to withdraw completely from non-audit services business by not offering, either themselves or through network companies within the EU, such services to public-interest enterprises (Art.10 (5)).

Comment

We believe it is very doubtful that the quality of the audit will be improved if audit firms are no longer permitted to provide services to non-audit clients. In these cases, the quality of the statutory audit or auditor independence is not affected and is not improved by the creation of pure audit firms either. Rather, the introduction of pure audit firms will weaken the quality of the audit because it will then not be possible, even taking into account the tightened independence rules, to involve specialists from the fields of tax advisory, risk management or IT consulting who have not advised the entity to be audited, for the purposes of the statutory audit. Furthermore, the recruitment of qualified professional talent or the retention of qualified staff is rendered more difficult, as it is no longer possible to offer them varying fields of activity in statutory audit and in non-auditing.

If pure audit firms are actually introduced despite these concerns, existing audit firms and their networks are faced with various possibilities, each with grave repercussions: they could completely separate themselves from their consulting business and form pure audit networks, whereby they would lose attractiveness as an employer and would have to accept a loss of know-how and thus a deterioration in the quality of the audit. Alternatively, the audit firms affected could discontinue the necessary part of their audit business to the benefit of the competition, in order to ensure remaining in a multidiscipline-orientated network. However, only a limited range of possible auditors would then still be available to entities subject to statutory audit.

Recruitment of former employees of the statutory auditor

As in the currently applicable regulations, a cooling-off period of two years is required when one of the signatories of the [audit] report or the otherwise responsible audit partner transfers from the audit firm to an important management position, the management, the supervisory board or the audit committee in the (former) audit client. Now, a cooling-off period of one year is required also for other auditors who have been involved in the statutory audit, insofar as they want to transfer to a corresponding position with the client (Art. 8).

Comment

As a result, the transfer of qualified employees from audit firms to management positions in companies is impaired; the attractiveness of the auditing profession is reduced and the recruiting of qualified executives by companies is rendered more difficult.

Note

The regular 1/2012 issue of the Corporate Governance Forum will appear in March 2012.

Your contacts

Prof. Dr. Martin Plendl
WP/StB, Partner
CEO
Tel: +49 (0)89 29036 8332
mplendl@deloitte.de

Heiner Kompenhans
WP/StB, Partner
Head of Auditing
Tel: +49 (0)69 75695 6705
hkompenhans@deloitte.de

Dr. Claus Buhleier
WP/StB/CPA, Partner
Head of Corporate Governance Services
Tel: +49 (0)69 75695 6523
cbuhleier@deloitte.de

For more information, please visit our website www.corpgov.deloitte.com/site/uk or www.corpgov.deloitte.com/site/us

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