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Launched in 1960, the European Banking Federation is the voice of the European banking sector from the European Union and European Free Trade Association countries. The EBF represents the interests of almost 5000 banks, large and small, wholesale and retail, local and cross-border financial institutions. Together, these banks account for over 80% of the total assets and deposits and some 80% of all bank loans in the EU only.

The EBF is committed to supporting EU policies to promote the single market in financial services in general and in banking activities in particular. It advocates free and fair competition in the EU and world markets and supports the banks' efforts to increase their efficiency and competitiveness.

European Banking Federation Comments on the Audit Legislative Proposals

Key Points

- Reservations about splitting the future European audit regime into a Directive and a Regulation.
- Rotation of auditors should not be mandatory.
- Auditors should not be prohibited to offer non-audit services. This could compromise the quality of the audits.
- The requirements in the 8th Directive sufficiently address the independence concern
- Joint audits or shared audits must remain optional
- Any change that would lead to reduced responsibility and the significance of audit committees should not be adopted.
- Banking regulators should not have the right to veto the bank's choice of auditor
- The strengthen banking supervision and regulatory requirements should be taken into account to avoid any overlaps.
- Agreement with the abolishment of restrictive clauses in lending contract that would require that customers' financial statements are audited by a particular auditor
- The content of audit reports should not cut cross directors' responsibilities for explaining going concern, accounting policies and judgments, etc.

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The European Banking Federation supports the efforts of the European legislators to improve the external audit. We believe the efforts should aim at enhancing the future role of audit and the surrounding regulatory framework that would ensure provision of high quality, relevant and effective external audit. To this extent we believe consistent legal framework in the EU would enhance the legal certainty that is of great importance. The application of International Standards on Auditing (ISA) to all EU statutory audits would in our view improve audit consistency across the EU.

We have fundamental reservations about splitting the future European audit regime into a directive and a regulation. This will give the impression that some audits are of higher quality than others, which should be avoided at all costs. We would therefore prefer dispensing the regulation and including more detailed requirements into the directive.

The recently strengthen banking supervision and regulatory requirements should be taken into account to avoid that additional audit and financial reporting requirements are introduced that would duplicate these prudential requirements.

The EBF does not believe that the audit market has failed to the extent that would merit such an extreme level of regulatory interventions. In particular, the proposed mandatory rotation of auditors after a maximum of six years runs the risk of reducing quality and thus achieving the exact opposite of the initiative's objective. There is a risk of new auditor having to get up to speed and become knowledgeable about the audited entity, its environment and processes at the beginning of the rotation period and also tail off towards the end. Therefore auditors would be less able to provide robust challenge if they were less familiar with the business being audited, particularly in relation to complex judgmental areas for financial institutions such as valuation of illiquid instruments and the level of impairment provisions. Financial institutions are complex businesses and any change in the audit firm therefore reduces the understanding of the business and could incur significant additional costs if audit quality is not to be compromised.

Furthermore, the impact of mandatory rotation would potentially cause companies to change their non-audit services provider as well as their auditor – with reduced choice in both cases. It is questioned whether the proposed measure would meet the objective of the regulators, notably to decrease concentration in the audit market.

The potential risk of an overly familiar, "cosy" relationship developing between auditor and audited can be minimised by regularly changing the auditing team and its lead auditor (internal rotation). Rotating lead auditors is already common practice in many countries and is sufficient to ensure the independence of audits. We believe the requirements in the 8th Directive sufficiently address the independence concern. Re-tendering should be a matter for constant vigilance by strong and independent Audit Committees. The decision to maintain auditors should be explained and justified to regulators if questioned. The proposed requirement for a mandatory rotation of audit firms should be dropped, in our view, since it would neither improve the quality of audits nor strengthen the independence of the auditor.

We also believe that the requirements that prohibit provision of particular non-audit services set in the 8th Directive adequately address the independence requirements. Financial institutions need access to diversified audit firms that can offer the necessary skills. Prohibition on the provision of non-audit services (and in some cases audit-only firms) would

restrict financial institutions from the freedom to choose the provider of services that best meets their needs. In our view, a ban on providing consultancy services is only justified if there is a risk of "self-auditing", i.e. if an auditor is substantially involved in putting in place an accounting system he or she will be subsequently required to audit. We would generally consider it a more useful approach to require the Supervisory Board or Audit Committee to approve all commissioning of non-audit services. It could then be decided on a case-by-case basis whether acquiring non-audit services from the firm's auditor would be inappropriate, acceptable or desirable. It should be borne in mind, moreover, that insight obtained in the course of auditing a company may improve the quality of consultancy advice (e.g. on tax matters). Conversely, the provision of consultancy services will, over time, give the auditor a more complete picture of the audited entity, which may improve the quality of the audit.

We have serious reservations about the additional restriction, proposed in Article 10(5) of the regulation, on big firms which generate more than one third of their annual audit revenue from large public-interest entities. In the interests of competitive equality, the same rules should apply to these firms as to any other firm of auditors and the provision of consultancy services should be banned only in the event of existing or potential conflicts of interest. We would also like to point out that large entities are especially reliant on the type of expertise offered by audit firms covered by the proposed provision. They will not, in our view, be able to find alternative suppliers without experiencing difficulties and a loss in quality. Article 10(5) should therefore be deleted.

Considering the duty of information of external auditors towards the board of directors and supervisory authorities, we believe that the auditor should first inform the company's management and its board of directors that should be committed to rectify any shortcomings identified by the auditors. If further action towards the supervisory authorities is considered appropriate and necessary, confidentiality must be ensured.

It is the responsibility of the company's management to provide the market with quality corporate reporting. While audit reports can be made more informative, they should bear in mind auditors and directors different responsibilities. The content should not cut cross directors' responsibilities for explaining going concern, accounting policies and judgments, etc.

Finally, we would oppose the adoption of any standards and practices that would limit the responsibility of auditors.

Any change that would lead to reduced responsibility and the significance of audit committees should not be adopted. Audit committees as representatives of shareholders in the entities governance should remain responsible for the appointment of the auditor. We do not believe the right of banking regulators to veto the choice of the audit committee is justified. Current strict independence rules and codes of ethics segregate the Audit Committees' selection process from functional and executive responsibilities. While there might be room to discuss the independence of auditors with regulators (e.g. list of audit firms considered eligible to carry out audits of financial institutions), the ultimate right to choose an auditor should remain with the entity. In this respect we also agree with consideration of the contractual clauses that restricts the auditor's choice as null and void. Moreover, we support the view that it should be the responsibility of the company to determine if it wishes to appoint a single auditor or prefers joint or shared audits.