Independence: Reflecting on the EU experience
The Swiss Federal Council has instructed the Department of Justice & Police (DOJP) to determine the legislative need for audit and audit oversight reform in view of regulatory developments in the EU. The DOJP’s report is expected to be available in fall 2017 as to establish a sound foundation for the Federal Council to determine the need, if any, for further action (e.g. re-design, liberalization or tightening of audit and/or audit oversight laws).

Changes to the current law in Switzerland have been made to stay relevant in an evolving global environment, for example, the classification of certain FINMA regulated entities as Swiss Public Interest Entities (Swiss PIEs) effective 1 January 2015. There are also amendments to the current audit legislation taking effect in mid-2017 which result in a moderate de-regulation of the extra-territorial reach of the Auditor Oversight Act (AOA). These are sensible amendments which consider the cost/benefit of the regulations in the context of attractiveness of the Swiss market and maintenance of investor protection. Continued reform in the financial services sector regulations will also impact the audit industry in the upcoming years.

As stated in their 2016 Activity Report, the Swiss Federal Audit Oversight Authority (FAOA) believes the current law has generally been successful, whereby pension scheme audits should in the future be performed only by state-regulated audit firms and a special license introduced if necessary.

So far, so good. The question now is to what extent the new EU rules on independence should influence future regulation in Switzerland. The Swiss rules applicable for financial statement audits tend to stay broadly in line with the Code of Ethics issued by the International Ethics Standards Board for Accountants (IESBA). Such international convergence facilitates an accurate understanding of the rules and consistent application, in particular with respect to multi-national companies.

One can only hope that upon reflecting on the DOJP report this fall, the Federal Council continues to take a sensible approach in rulemaking versus following the EU’s lead into a chaotic patchwork of regulations.

**Extra-territorial reach of EU audit legislation**

The EU audit legislation does not directly apply to entities outside of the EU – but certain EU Public Interest Entity (EU PIE) subsidiaries of non-EU parent companies as well as non-EU subsidiaries of EU PIE parent companies are in fact scoped into the requirements. The two key provisions that have impact are the mandatory audit firm rotation (MFR) and the restrictions around non-audit services (NAS), but there are other impacts as well, such as the requirements related to the Audit Committees at the level of the impacted EU PIEs.

As the EU rules only became effective from 17 June 2016, with specific transitional provisions, it is still early to comment on their impact. However, experience to date has shown that the regulatory developments in the EU have led to a patchwork of unnecessarily complex independence requirements, not only within the EU but also in comparison to the international IESBA standards. Multi-national groups operating in more than one EU Member State are faced with different sets of rules, increasing both cost and complexity. Lacking clarification on the implementation and interpretation of the EU rules by the European Commission (EC) and/or Committee of European Auditing Oversight Bodies (CEAOB) does not help the situation.

**Mandatory Firm Rotation – burdensome and limiting available choices**

If a non-EU (e.g., Swiss) parent company has subsidiaries in the EU that are considered to be EU PIEs as defined by the national law of the Member State where they are incorporated, then irrespective of size, such PIE subsidiaries’ auditors will need to rotate in accordance with the national law of the Member State where they are incorporated. As a number of Member States have adopted different EU PIE definition and rotation rules locally, it is entirely possible that the auditors of such EU PIEs within a multi-national group will need to rotate at different times and according to different rules. Currently it appears that there will be at least eight different maximum audit firm tenure periods in the EU, being 5, 7, 8, 9, 10, 14, 20 and 24 years applicable to either all PIEs or specific PIEs such as banks or insurance undertakings in certain Member States. These rotation periods additionally do not always align with the rotation requirements applicable to the individual audit partners involved in the audit engagement.

If an EU PIE subsidiary within a multinational group is required to rotate its auditors, there is no requirement for the whole multi-national group to tender or exchange its group auditor. EU headquartered groups have tended to rotate auditors of the entire group, including non-EU subsidiaries, as it has often been the parent companies or key entities that are defined as EU PIEs. For non-EU parent companies, depending on the significance of the EU PIE, it may not make sense to rotate the auditors of the entire group, but rather only statutory auditors of the impacted legal entity (for example, when debt vehicles are defined as EU PIEs).

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The varying rotation periods can prevent a group operating in multiple jurisdictions from being audited by one audit network. The involvement of secondary audit firms from another audit network can increase complexity and risk as well as the cost of the audit. Furthermore, the combination of different independence rules in several jurisdictions and the varying audit firm rotation requirements can result in a EU PIE requiring two audits of a same entity by different firms (a local statutory audit and an audit for group reporting purposes) thereby increasing the cost and effort for the EU PIE.

What appears to be emerging as an important impact of the EU rulemaking is reduced choice for companies, given the limited availability of auditors that can meet the independence requirements while at the same time having the necessary expertise and geographic coverage. In certain EU countries companies have been observed tendering sooner than required (sometimes three years in advance of actual rotation), to reserve a team and/or specific lead audit partner at their preferred audit firm.

In fact, the U.K. Financial Reporting Council FRC\(^2\) has stated that “Companies that use several firms for different advice, should develop a long-term strategy for the procurement of professional services which ensures that at least two firms are able to participate in the audit tender process, and satisfy auditor independence requirements by the time of appointment, without unforeseen impacts on other services received by the company.”

While this is certainly true, it is odd advice considering the original intention of the EU audit reform to enhance competition in the audit market. In fact, in the UK, where audit tendering rules became effective in October 2012, there has been no sign of the audit firms outside the Big-4 gaining market share and effectively competing in the market for FTSE 100 audits. A similar trend has been noted in Italy, which has had mandatory auditor rotation for many years.

Furthermore, in group situations where multiple subsidiaries individually qualify as EU PIEs (for example in large insurance groups), the legal requirements for the actual conduct of audit tenders for each EU PIE has resulted in time intensive and costly processes for both the company and audit firms with no added benefit.

Thus, at first impression, the EU audit firm rotation requirement is costly, unnecessarily burdensome and not...

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achieving the underlying objectives of the rulemaking. In practice it appears to be limiting choice and importantly reducing the decision making ability of those charged with governance of the relevant companies.

The patchwork of Non-Audit Services (NAS)
The EU audit regulation contains a list of prohibited NAS that cannot be provided by the statutory auditor or its network, to a company that is an EU PIE, to the PIE’s EU parent company or to the PIE’s EU subsidiaries. As each EU Member State was given the option to allow certain tax and valuation services or add to the list of prohibited services, there is a significant lack of consistency between the Member States. When considering whether NAS are permissible, it is not only the restrictions applicable in the jurisdiction of the EU PIE that must be considered, but depending on the legal entities involved in the NAS, also the restrictions in the jurisdiction of its EU parent company and/ or EU subsidiaries.

There is also a lack of consistency between the Member States in the terminology and interpretation of NAS. The high degree of judgement needed in determining what is prohibited and what is not has created confusion and complexity for the EU PIEs.

Agreement between the Member States as to the scope and meaning of prohibited NAS, and finding an increased degree of alignment with the IESBA Code of Ethics, would certainly be a step forward but meaningful change is unlikely in the near term.

Conclusion

The independence regulations currently applicable in Switzerland provide a meaningful and appropriate frame for the scope of additional services that an auditor can reasonably provide to an audit client, in the best interest of the client and its stakeholders. Hopefully the Federal Council will hold back and continue to observe the developments of the EU Audit Reform over a longer period before proposing on this basis any new or amended regulation. The current approach of focusing on areas of specific importance to the Swiss market, keeping an eye on the attractiveness of the location Switzerland and acknowledging the important role and responsibilities of the Audit Committee in terms of the oversight of auditor independence is serving Switzerland well.

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