

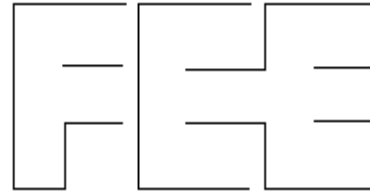
Date
14 October 2003

Le Président

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Dear Karel,

Re: Principles to be included in the Eighth Directive

Referring to our earlier letter dated of 31 July 2003 and subsequent discussions FEE is pleased to provide you with additional input on the modernisation of the Eighth Directive.

We strongly agree with the objective of the Commission to reinforce investor confidence in capital markets and to enhance public trust in the audit function in the EU by developing a new modernised and principles-based Eighth Directive. The principles-based Directive should provide a framework for statutory audits. It should not introduce too much detail into the Directive since this may lead to unintended and unforeseen consequences at Member State level. Consequently, our comments concentrate on the major aspects of the issues instead of commenting on every single detail.

In developing a new Eighth Directive, it needs to be borne in mind that, due to the enlargement of the European Union, the new Directive would also apply to the accession countries. Therefore, the legal environment and current regulation of those countries needs also to be taken into account when developing principles for an appropriate audit infrastructure.

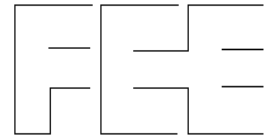
FEE notes that the cross-border provision of services and the need for local registration of statutory auditors based on an aptitude test will be dealt with in the Eighth Directive rather than in the Directive on Mutual Recognition of Professional Qualifications. FEE welcomes and strongly supports this approach which will result in the need to delete the second last recitals of the present Eighth Directive.

In the following, we would like to provide you with additional ideas on the following issues:

- Scope of the Eighth Directive (Article 1)
- Ownership and management of audit firms (Article 2)
- Corporate governance in relation to statutory audit (appointment, dismissal, remuneration,)
- Legal recognition of a European co-ordination of national public oversight
- Evaluation of possible endorsement systems for ISAs

Scope of the Eighth Directive (Article 1)

Pursuant to Article 1(1) of the Eighth Directive the directive applies to persons or firms performing statutory audits of annual or consolidated financial statements required under EU laws, regulations and administrative provisions. After having reconsidered whether there is any need for expanding the scope of the provisions of the Eighth Directive to other assurance services than statutory audits of annual or consolidated accounts FEE suggests not to change Article 1. If the European legislature



after careful consideration believes that other assurance services should be performed by approved persons, a reference to the Eighth Directive should be included in the respective directive or regulation instead of amending Article 1 of the Eighth Directive. This flexible approach would not require changes to the Eighth Directive every time new requirements are enacted for assurance services performed by approved persons.

According to Article 1 (2) of the Eighth Directive it is within the responsibility of the Member States to decide whether only natural persons or also legal persons or other types of company, firm or partnership can be approved to carry out statutory audits.

However, national rules prohibiting collective professional practice prevent de facto the free circulation of audit firms in those Member States which have such rules. According to the preliminary results of the survey on audit firms that currently is carried out by FEE, almost all of the Member States allow not only natural persons but also audit firms to be appointed as statutory auditor. Therefore, FEE recommends to amend Article 1 (2) of the Eighth Directive by deleting the Member State option which allows for restricting the approval to carry out statutory audits to natural persons only. The proposed amendment would not only contribute to the decrease of barriers to the free movement of audit firms but would also help in the discussions with other regulators and mutual recognition of each other systems.

In addition, restricting collective practice to certain national legal forms results in prohibiting the free provision of cross-border services and the establishment of branches, and even subsidiaries. FEE recommends that professional accountants should be able to carry on their professional activities in the legal form of their choice, that is to say, they should not be prevented from setting up a branch on the grounds that the legal form of the parent is not recognised in the host Member State. In the case of a subsidiary, it should, of course, adopt a legal form authorised in the host Member State, but it should not be possible to prevent its setting up on the grounds that the legal form of the parent company is not recognised in the host country. In countries where restrictions in choice of legal form exist, these national requirements should be disapplied for foreign practices wishing to open a branch or subsidiary, or to acquire an interest in a local practice.

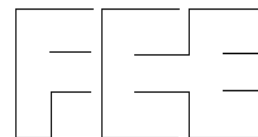
If the European legislator decides to prevent any restriction on the legal form of audit firms, it should however consider whether some principles should be introduced to safeguard in the public interest the substance of the obligations and responsibilities to the stakeholders.

Ownership of audit firms (Article 2)

With regard to our position on the conditions for approval of audit firms we would like to refer you to our Survey on the Liberalisation of the Accountancy Profession in Europe of March 1999 and to our Discussion Paper on the Free Movements of Firms of October 2000. In addition, we would like to draw your attention to the following issue:

As already mentioned in our Discussion Paper of October 2000 the conditions laid down in Article 2 (1) (b) (ii) of the Eighth Directive lead to the question whether it is necessary to require that the majority of capital and voting rights in audit firms is held by locally approved auditors or whether it could also be held by statutory auditors approved in other Member States. FEE maintains that it would be disproportionate to the objective of Article 2 to require that the majority of capital and voting rights in audit firms is only held by locally approved auditors. Instead, the wording of Art. 2 (1) (b) (ii) should be clarified in order to permit majority holdings in audit firms in one Member State by statutory auditors approved in other Member States. Therefore we suggest to add the following sentence between the first and second sentence of Art. 2 (1) (b) (ii):

“If such an approval is required it may be obtained in any Member State.”



Corporate governance in relation to statutory audit

a) Appointment of the statutory auditor

Our earlier letter contained proposals for a high level article on the election of the statutory auditor. In our discussions since then, you raised some concerns about the use of the term “election” instead of “appointment” and expressed some sympathy for addressing not only the appointment, but also the dismissal of the statutory auditor.

We can understand your preference for the term “appointment” as it is common in international context. However, it should be recognised that the appointment of the statutory auditor in most Member States covers not only the election of the statutory auditor by the general shareholders meeting, but comprises also actions to be taken by the body charged with governance of the audited company, e.g. by the (supervisory) board or by the audit committee (hereinto referred as “governance body”): The board or the audit committee usually prepares a recommendation for the proposed selection and appointment of the statutory auditor and agrees and approves – usually in consultation with the Executive Management – the terms of engagement of the statutory auditors. Such a procedure is either common practice or, in some jurisdictions, even required by Corporate Governance Codes or law. In some countries it is required by national legislation that the workers council is consulted before the auditor is appointed.

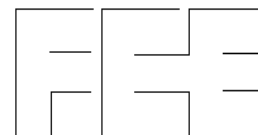
The participation of the governance body in the appointment and process contributes to the overall aim of strengthening and ensuring auditors’ independence. Therefore, when using the term “appointment” instead of “election” in the Eighth Directive, it should at least be made clear that the current practice can be maintained. Beyond this, FEE suggests to include a principle in the Eighth Directive requiring that the governance body of the audited company shall both prepare the recommendation for the proposed selection and appointment of the statutory auditor and shall approve the detailed contractual terms of the audit (as laid down in the audit engagement letter).

b) Dismissal and resignation of the statutory auditor

European provisions on dismissal and resignation of the statutory auditor need take into account the significant differences in the current national regimes on dismissal and resignation resulting from differences in the legal environment and corporate governance arrangements. For this reason, it seems hardly possible to go into detail. Detailed European requirements risk resulting in solutions being appropriate for some Member States, but leading to inappropriate results in other Member States. In some countries dismissal of the auditor and resignation by the auditor is not possible without a court decision, whereas in others it requires approval of the shareholders’ meeting. A further survey of what systems for dismissal and resignation currently exists would be necessary in order to assess if European legislation could be sufficiently flexible to allow for all such possibilities or if a certain degree of harmonisation of national systems should be desirable. Any proposals should not only cover dismissal but also resignation. At present and in conformity with a principles based Directive the requirements of the Eighth Directive on dismissal and resignation should therefore not deal with details on the conditions and procedure for dismissal and resignation, but should explain the overall purpose and objective of such procedures, which should than be enacted at Member State level.

Any European principle on the dismissal and resignation of the statutory auditor should aim at ensuring high quality audits and especially at protecting and strengthening auditor independence. In developing such principles, among others, the following situations and issues need to be considered:

- Controversial discussions between the executive management or board of the audited company and the auditor with regard to the correctness of the accounts being audited. In order to avoid replacement of a “strong” auditor and to safeguard auditor independence, it is extremely important, that the auditor in such situations is protected from being dismissed by the executive management of the audited company.



- Concerns of the auditor with regard to the trustworthiness and integrity of the management of the audited company. In such situations the auditor should be able to resign from the audit engagement and to present his concerns to the bodies in charge of his appointment.
- Change of ownership of the audited company due to which the management of the audited company intends to replace the appointed auditor by the group auditor. Having appropriate rules for possible changes of the auditor is especially important for jurisdictions where the terms of appointment cover more than one financial year. However, such rules should not only take into account the concerns of the audited company, but also the overall aim of protecting auditor independence and the legitimate interest of the auditor not to be replaced when having already started the audit work.

In addition, it needs to be borne in mind, that in some regulated industries (for example banks and insurance companies) the national competent authority for supervision of the regulated enterprises plays an important role in the appointment and dismissal of the statutory auditor. For example, the administrative authority is entitled to give an advice or to reject the appointed auditor.

In order to prevent that the auditor is put under pressure by the audited company, the auditor should be entitled to address the issues resulting in his dismissal or in his own decision to resign from the audit engagement either to the governance body or, if appropriate, to the shareholders of the audited company.

c) Remuneration of the statutory auditor

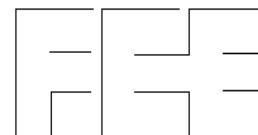
In its communication of 21 May, the Commission indicated its intention to include the remuneration of statutory auditors in the revised 8th Directive. If the European legislature believes that it is important to have such a provision, FEE would consider a discussion on the adequacy of audit fees and would recommend to promote a principle on disclosure. Both issues are also mentioned in the recommendation on independence.

The proposed amended 5th Directive (article 57) provides that, “the remuneration or its methods of calculation, of the persons responsible for auditing the accounts shall be fixed for the whole of their period of office before it commences, taking account of the nature and importance of the duties to be carried out”. This proposal predates the recommendation on independence, but could possibly be used for further discussions. However, there are some missing elements which need to be addressed, for example unexpected events, which should give rise to the possibility of rediscussing audit fees fixed in advance.

Fees received from an audit client by the statutory auditor, natural person or audit firms, for services provided during the client’s reporting period, must be publicly and appropriately disclosed in accordance with the national law of the Member States. The recommendation on independence suggests a further breakdown of fees for non audit services, distinguishing between categories of non audit fees. In our views, such regulation is too detailed to be included in a Directive. As we understand you intend to make proposals in the Eighth Directive for fee disclosure in the annual accounts of companies, we suggest that this be done by categorising the fees into three elements:

- fees for the statutory audit
- fees for audit related work (meaning work required to be done by the auditors by virtue of their position as auditor of the company or group, other than statutory audit work)
- fees for non-audit work

We consider that such an analysis would correctly distinguish three types of work, with companies providing further analysis of the last category in line with the EC Recommendation on Independence if such fees are particularly significant. This would strike an appropriate balance in legislation, allowing users of financial statements to assess this aspect of auditor independence without the need for excessively detailed legislation.



The recommendation on independence includes other proposals related to the independence of auditors (overdue fees, relationship between total fees and total revenue, etc). Without questioning these aspects FEE believes that these protections of auditor independence should not be part of a Directive as they involve the careful exercise of professional judgement. In addition, addressing these issues in the Eighth Directive would contradict the objective of developing a principles-based directive.

Legal recognition of a European coordination of national public oversight

FEE agrees with the Commission that the requirements of a single capital market, including recognition of the equivalence and convergence of the US and EU capital market regimes, demands a robust co-ordination of national systems of oversight in Europe. This requires that the co-ordination is not organised in a purely voluntary and relatively informal way. Co-ordination of EU public oversight can be effective only if it is visibly structured in the public interest and if it is legally established.

In its Discussion Paper "European Co-ordination of Public Oversight" FEE expressed a preference for the establishment of a co-ordinating body which should be organised separately from government or the Commission and which should be vested with delegated powers to perform well-defined co-ordination functions on oversight activities.

The European coordination should have appropriate resources to achieve its goal and financial resources to carry out its task effectively. It should be independent and should be seen to be independent. Therefore, FEE believes that the funding should not only be from the profession.

Possible wording of the Eighth Directive regarding the establishment of such a European coordination of national public oversight:

"(1) The Commission shall ensure that an independent body on co-ordination of public oversight in the field of auditing, called the European Co-ordination Audit Oversight Board" (hereinafter referred to as the "Board"), is established, which shall

- (a) establish and report to the Commission on how Articles ... [number of Articles dealing with public oversight to be added] have been implemented in the Member States;
- (b) review, at regular intervals, the effectiveness of quality assurance and oversight systems implemented in the Member States and recommend any necessary improvements;
- (c) develop, either at the Commission's request or on the Body's own initiative, recommendations to the Commission on interpretation of oversight principles;
- (d) provide a formal mechanism for exchange of information and co-ordination of oversight in cross border cases; and
- (e) encourage convergence of best practice of public oversight within the Member States.

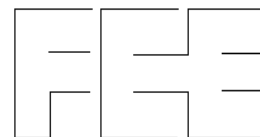
(2) The Board shall adopt its own rules of procedure and organise its own operational arrangements, which shall ensure that the Board acts independently and in the public interest.

(3) The Board shall present an annual report on its activities to the Commission, the European Parliament and the Council.

(4) Member States shall ensure that national oversight arrangements are empowered to work together with the Board and to participate in European coordination."

Obviously, the internal structure and constitution of the co-ordination of national public oversight needs further discussion. Following the ideas presented in our Discussion Paper the Eighth Directive could address the structure and constitution of the proposed ECAOB possibly along the following lines:

"(5) The Board shall be composed of high-level representatives from the national public oversight organisation competent in the field of auditing. Each national public oversight organisation shall be entitled to be represented in the Board. The Board may invite experts and observers to attend its meetings.



- (6) The Board shall elect a chairperson from among its members.
- (7) The Board shall set up
 - (a) a Consultative Forum where representatives of the public oversight arrangements of the Member States, the Commission, the profession and other market participants can coordinate and develop their activities, and
 - (b) an Executive Board consisting of five members which shall be responsible for ensuring that tasks referred to in paragraph 1 are properly carried out. The Members of the Executive Board shall be nominated by the Board with approval by an independent appointment panel of high public standing.”

Evaluation of possible endorsement systems for ISAs

FEE continues to support application of ISAs without any endorsement mechanism of individual ISAs in order to ensure a uniform and complete application of global auditing standards in the EU. As already expressed in our earlier letter, we suggest an endorsement system that requires recognition of the process of setting ISAs. Application of ISAs should be required in the EU on condition that IFAC and IAASB provide for a proper due process, oversight and transparency of the standard setting process in the public interest. The requirement should be set up by the Commission in secondary legislation under comitology procedures.

We deliberately do not recommend introducing criteria comparable to the criteria used in the IFRS-Regulation for endorsement of IFRS/IAS. First, recent developments have shown that the criterion of “European public good” has proved difficult to apply as there is no clear definition of what it means in terms of accounting. In addition, the criteria of understandability, relevance, reliability and comparability referred to in the IFRS-Regulation derive from the IASB’s Framework. However, as the IAASB does not provide such a framework, there are no comparable criteria for endorsement of auditing standards.

Therefore, we favour introducing the criteria of proper due process, oversight and transparency of the standard setting process in the public interest. The process in the international standard setter should provide for sufficient European influence and a commitment to a principles-based approach to result in standards suitable for application in Europe. In addition, the Commission should be required to reassess its endorsement decision at regular intervals. Together, the proposed criteria and the regular reassessment of the endorsement decision by the Commission would increase the pressure for IAASB to carefully take into account European input in the setting of auditing standards and to work in the public interest towards the highest quality standards on auditing.

We would be pleased to discuss any aspects of this letter you may wish to raise with us.

Yours sincerely,

David Devlin
President