

27th February 2013

Mandatory audit firm rotation requirement under the European Statutory Audit Directive

The undersigned associations¹ support efforts by European legislators to improve the quality of statutory audits and to reinforce auditor independence.

However, we would like to express our concern that the proposed mandatory rotation of audit firms, under consideration in Council in the context of the Commission's proposals for a Regulation on specific requirements regarding statutory audit of public-interest entities, would not achieve the desired objectives. Moreover, it could prove counterproductive given its potential to disrupt audits significantly and to reduce their overall quality. These risks are particularly severe in the case of the largest global companies (whether financial or non-financial), and are even more acute when the mandatory rotation period is as short as the proposed six years (or nine in the case of joint auditors).

Newly appointed auditors require a considerable amount of time to familiarise themselves with their new client, particularly clients with the high degree of complexity that is common in the financial sector. As a result there is a significant risk that the initial audits give a lower than acceptable level of assurance. Furthermore this initial phase ties up the resources of the audit firms and those of the client. There is also the risk that during the latter part of a fixed audit term there is less incentive to focus on longer-term issues with a concomitant reduction in audit quality. If audit firms were to be changed at regular short intervals, the risk of lower quality audits would substantially increase. This risk is even more material when the audit is of a large complex multinational group.

Auditors are less able to provide robust challenge when they are unfamiliar with the business being audited, in particular in relation to complex judgmental areas such as the valuation of illiquid instruments and the level of impairment provisions. Large financial institutions, like many other

¹ 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 some 4,500 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 alone.

The Association for Financial Markets in Europe (AFME) represents a broad range of European and global participants in the wholesale financial markets. Its members comprise pan-EU and global banks as well as key regional banks and other financial institutions. AFME advocates stable, competitive and sustainable European financial markets, which support economic growth and benefit society.

multinational groups, are complex businesses. Understanding of the business is lost on a change in the audit firm. It is important to note that a quality audit goes well beyond the audit report. Informed comment on topics such as the robustness of group reporting and control systems, and adherence to corporate policies is of great value to the Audit Committee and management and consequently to shareholders.

Mandatory rotation might force companies to change their auditor as well as their non-audit services providers, should the proposal to prohibit provision of non-audit services to audit clients be adopted, with reduced choice for both cases. Complex multinational financial institutions often rely on a single world-wide auditor and this severely restricts the choice of alternatives to firms that are able to deliver quality services at global level. Some of these firms are likely to be excluded given that they are major suppliers of non-audit services. The combination of these factors means that the Audit Committee of a large multinational financial group may be unable to identify more than a few alternative auditors which they consider have the necessary skills to tender, with the risk that this number will be further reduced during the tendering process. It is therefore questionable whether the proposed measure would meet the objective of decreasing concentration in the audit market.

In this context, we would like to note that a number of countries have in the past abolished the mandatory rotation requirement as it failed to meet the desired objectives. Also, as stated in the position of one of the firms outside the four big firms, mandatory rotation may well have the effect of increasing market concentration.

We understand that one of the objectives of introducing mandatory audit firm rotation is to enhance independence. We believe there are better means in the area of corporate governance to achieve this objective such as change of the auditing team and its lead auditor or re-tendering.

Rotating the lead auditor, and other audit partners and team members on a phased basis is already either mandatory, or accepted best practice, in many countries; taken with the rigorous peer review processes already practiced by the large audit firms, and the reputational risks associated with any major failure of these processes, we believe this goes a very long way to ensure the independence of audits. We believe the requirements in the current European Statutory Audit Directive (2006/43/EC) successfully address independence concerns.

Re-tendering should be a matter for constant vigilance by strong and independent Audit Committees. We believe it is essential however that, at the very least, the Audit Committee of a major multinational group should have the option of reappointing the existing auditor in circumstances where they genuinely believe that a mandatory change would lead to lower quality audit and/or to a materially increased risk of audit failure. Any such decision

to maintain auditors following a tender process should of course be fully explained and justified to shareholders and to other stakeholders, and potentially also to regulators if questioned.

To conclude, we believe there is a significant risk that mandatory rotation would not contribute to reducing market concentration or improving audit quality. Moreover, we see no persuasive arguments for restricting the requirement to particular sectors. Specifically, for financial institutions we believe audit quality and market confidence could be particularly impaired given that their audit firms must have extensive knowledge of their clients and experience in the constantly evolving business environment in which they operate.

We trust our concerns can be taken into account in the course of inter-institutional discussions and we stand ready to discuss our position in more detail.

Yours sincerely,



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