

Insurance Europe Position Paper on the EU Audit legislative package

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Summary

Insurance Europe welcomes the package of proposals on EU audit presented by the European Commission on 30 November 2011.

Insurance Europe strongly supports high quality and independent audits, which are a vital basis for investor decisions. Ensuring transparency and conformity to local and international accounting principles are key elements towards achieving global financial stability.

We welcome harmonisation of auditing standards across Europe in particular, as that would not only enhance confidence in financial statements but would also facilitate cross border mobility of audit professionals.

However, other proposals go beyond audit reforms and may lead to unintended consequences for the already highly regulated insurance industry which is facing Solvency II Regulation that aims to protect policy holders and therefore investors. The Solvency II regime will cover all insurers and subject them to a stringent capital regime that includes substantial requirements for financial reporting and corporate governance. We consider that the development of these audit proposals has not taken sufficient account of Solvency II, and we highlight the need for the proportionality principle to be applied, especially for smaller and unlisted insurers.

Insurance Europe believes that the financial crisis should not be used to propose unnecessary and costly extensive legislation that will represent an additional burden for the insurance industry without an increase in audit quality. There is no evidence that audits of insurers have been inadequate, or that auditor independence has been violated during the last financial crisis.

We have serious concerns regarding proposals such as mandatory audit rotation and prohibiting non-audit services for audit clients. These would inevitably lead not just to higher costs but also to a reduction in audit quality because of the loss of expertise needed for auditing insurers, whose operations are inherently complex.

Insurance Europe would like to stress its support for the harmonisation of statutory audit requirements across EU jurisdictions. However, we are truly concerned about some aspects of the European Commission's approach and would like to advise on several unintended consequences that the proposed regulation could lead to. In this context, we suggest to develop a holistic approach to harmonise the audit market using a single Directive/Regulation as a framework that has proportionality as a main principle.

Finally, we would like to highlight that the roles of the various participants involved in the statutory audit process should remain clearly defined within a good corporate governance framework. The unconstrained right and responsibility of the audit committee to freely choose the most suitable statutory auditor is one of the important aspects in defining the boundaries of responsibility.

Furthermore, Insurance Europe has serious concerns regarding the following:

Key concerns

1. Impact on audit committee and boards

Insurance Europe considers that the role of the various participants involved in the statutory audit (auditors, audit committee, management, shareholders) should be clearly defined so as to ensure that each one is fulfilling their own responsibilities. Some of the proposed provisions reduce the free choice of the audit committee to choose the most suitable auditor for the statutory audit and the best provider of other services.

Furthermore, Insurance Europe is concerned by the extension of the responsibilities of the audit committee far beyond what is expected, such as the requirement to supervise the completeness and integrity of the draft audit reports or to submit recommendations or proposals to ensure the integrity of the financial reporting process.

We are also very concerned that the proposals make no distinction between different categories of public interest entities – by the nature, scale and complexity of their activities, or by whether they are already subject to other regulation that has similar objectives. A small local insurer, with no substantial external financing beyond that provided by its policyholders, who are in any case to be protected through Solvency II, would be treated in the same way as a large multinational listed retail group. We consider this to be disproportionate and that all these requirements, especially those relating to governance should be reconsidered for their impact on unlisted insurers. In this context, it cannot be too strongly emphasised that Solvency II already has substantial requirements for governance and reporting, and we consider that the Commission's proposals would add extra regulatory burden and cost.

2. Non-audit services

Insurance Europe strongly objects to the proposals that would extend current prohibitions on non-audit services and limitations on related financial audit services. There are already plenty of requirements and professional practices in place to ensure auditor independence and to prevent conflicts of interest when providing non-audit services, and current European law already provides safeguards.

It is the responsibility of the audit committee to prevent conflicts of interest before accepting additional services besides audit. From its side, the audit firm needs to consider its independence subject to legal repercussions in case of non-compliance with its professional Code of Ethics.

It may be necessary for audit firms to provide non-audit services in addition to audits themselves, in order to ensure that these are of a sufficiently high quality. This is particularly true for the insurance industry, as the supply of audit staff with the necessary expertise is already limited.

In addition, we strongly object to an artificial constraint (10%) on fees for related financial audit services, as audit firms are usually best placed to perform these services, e.g. on regulatory reporting. The Commission's proposal would affect insurers particularly badly because they would be forced to have separate auditors for financial statements and regulatory reports, creating a huge extra burden in terms of cost and management time. The effect would also be to reduce choice and may reduce audit quality, given how few firms have the necessary insurance expertise.

We support instead the transparent disclosure of fees to give appropriate information about auditor independence, together with audit committee approval to safeguard against conflicts of interest. We also believe that no prior approval should be required from a competent authority, as this would dilute the responsibility of the company's management and is an undue regulatory burden.

3. Pure audit firms

We strongly call in question the creation of pure audit firms as that will not necessarily lead to an increase in audit quality and may even reduce it. The proposed restrictions are counterproductive, more costly and will restrict the choice and access to specialised services. Pure audit firms will not be able to provide the same high quality personnel needed with expertise in audit and non-audit related services, especially in the insurance industry.

4. Mandatory rotation

We do not support mandatory rotation because the audit committee should retain the right to freely select the best auditor. Changing auditors is a time-consuming and costly procedure, without any guarantee that audit quality will be increased – indeed, audit quality may instead be reduced. Furthermore, these charges, at least part of them, could be passed on to the final consumers. We do not consider that sufficient evidence has been found to show that without mandatory rotation auditor independence has been violated nor that audit quality has been compromised, and we do not see any proof for changing the current requirements. Mandatory external rotation would create inflexibility and extra costs, preventing high quality audit reward through reappointment on merit. Furthermore, from the analysis of investors' responses to the Commission's Green paper on audit policy, we found little support for mandatory rotation.

In many jurisdictions there is already obligatory partner rotation within an audit firm for listed entities, without the mandatory need for rotation of the audit file between other audit competitors. We believe that obligatory partner rotation within the same audit firm protects against loss of knowledge of the audited company by the audit firm, thus assuring audit quality will be increased and audit costs may be reduced. Furthermore, obligatory partner rotation within the same audit firm reduces the potential risk that the audit partner becomes too familiar with the audited company.

Insurance Europe is concerned with the Commission's intention to open the market to smaller audit firms through mandatory rotation. We consider that these audit firms may lack the resources and expertise to audit insurers which are by nature complex, highly regulated and therefore difficult to audit. Moreover, large international groups will require a large group of experts working on insurance at global level. The effect may be to further concentrate the audit market for insurance companies within the largest firms.

Additional unnecessary complexity is created when cross border groups need to ensure that the time limits on the rotation are aligned in all European member states.

Insurance Europe would also like to highlight some of the articles and paragraphs of concern in the proposed Regulation on specific requirements regarding statutory audit of public-interest entities.

Specific articles in the proposed Regulation

1. Article 8 - Employment by public-interest entities of former statutory auditors or employees of statutory auditors or audit firms

We support the proposed requirement that a key audit partner performing a statutory audit of a Public Interest Entity does not take up any duties in the management, audit committee or board of that company within two years from the moment he or she resigned as a statutory auditor. However we do not agree that similar restrictions should apply to other audit staff members because this would restrict the availability of suitable quality staff for the insurer, and may also impair the individual's career development.

2. Article 9 – Audit fees

■ Para 2-3

Insurance Europe strongly opposes regulation, such as the 10% audit fee ceiling for related financial audit services. Any artificial restriction can lead to a risk of having to engage another audit firm, and to a reduction in choice and potentially quality if audit firms artificially constrain associated fees. Insurance Europe also opposes any legal restrictions that limit the free choice of the audit committee. We support instead the transparent disclosure of any fees charged to the client.

We believe that no prior approval should be required by a competent authority, as this would dilute the responsibility of the company's management and is an undue regulatory burden. We propose that this requirement should be deleted.

3. Article 10 –Prohibition of the provision of non-audit services

■ Para 3 -5

Insurance Europe strongly disagrees with the extension of the prohibition on non-audit services beyond that already provided for in European law. The proposal potentially leads to an increase in cost and reduced audit quality due to constraints on audit firm choice and competition, without sufficient compensating benefits. The requirement for audit committee approval would be a more appropriate approach to achieve the transparency needed. We also believe that no prior approval should be required by a competent authority, as this will dilute the responsibility of the company's management and is an undue regulatory burden.

4. Article 20 –Use of international standards on auditing

We see the introduction of the obligation to use the International Standards on Auditing (ISA) as an appropriate approach to harmonise audit procedures at the European level. Many countries already require the application of ISA. However, we believe that ISA should only be endorsed through a formal procedure at the European level.

ISA has no formal role in European law. We propose that the requirements of the endorsement procedure as stated in the Article 26 of directive 2006/43/EC of the 17 May 2006 should not be changed. Only the endorsed International Standards on Auditing on case-by-case basis can be treated as a mandatory obligation.

In addition, we consider that member states should be permitted to make further adjustments at member state level to allow for consideration of local requirements and improvements where needed.

5. Article 22 –Audit Report

Insurance Europe believes that the usefulness of the audit report will be compromised because of the requirement to report detailed information which is of no additional benefit to users, such as identification of the individual independence confirmations of the audit engagement team. We also do not understand the artificial limitation on the length of the audit report (paragraph four). In addition we do not agree with the requirement to include materiality levels, because such information is by its nature contextual and may be misleading if used in this way.

Furthermore we admit that some of the requirements go beyond the scope of what would be expected from audit reports, such as the indication of non-audit services and their authorisation, which are in principle responsibilities of the boards or audit committee.

We suggest verifying if all the required information ("at least ...") is really needed and expected by the shareholders or other stakeholders if such information can decrease the expectation gap. We would like to express our serious doubts about this.

Insurance Europe is also afraid that the requirements on auditors to indicate how much of the balance sheet has been directly verified or based on system and compliance testing (and to explain any variance), or the requirements to lay out the level of materiality or to indicate and explain any violation of accounting rules or law, [...], and other matters that are significant for the governance of the entity, may lead to the audit work being more and more a compliance exercise rather than an exercise of effective professional scepticism as required in Article 15.

We fully support the requirement to provide an assessment of the entity's ability to meet its obligations in the foreseeable future and therefore to continue as a going concern. The going concern assumption is the main principle of financial accounting and therefore of enormous importance for the shareholders and any other stakeholders.

6. Article 23 –Additional report to the audit committee

Insurance Europe believes that the costs of additional reporting requirements outweigh the benefits. Very many of the detailed reporting requirements ("at least ..."), for example comfort letters, description of the appointment procedure and explanations of consolidation principles, are not beneficial for the users of this report. In so far as the information is required by the audit committee, this should be met separately by the company's management. The responsibilities of management, the supervisory board and the audit committee should not be replaced by any form of increased reliance on external audit/supervision such as evidence to support the going concern principle. We do not agree with the option of making this document publicly available. Furthermore, the audit committee has the monitoring responsibility, which should be maintained.

7. Article 31 – Audit committee

Insurance Europe is concerned about the proposed introduction of additional responsibilities on audit committees such as the monitoring of external audits and the supervision of the completeness and integrity of draft external reports. We also believe that additional requirements for at least one audit committee member to have competence in auditing and another in accounting and/or auditing, is impracticable for many public interest entities; especially smaller ones.

We welcome the recognition in paragraph 3 that it is not appropriate to require all public interest entities to have an audit committee. We consider, however, that this list of exceptions to the general requirement should extend to all insurers, other than those that have listed securities/are capital market oriented. This is to avoid unnecessary extra regulatory burden and would achieve appropriate proportionality.

8. Article 32 - Appointment of the statutory auditors or audit firms

■ Para 3(a)

The requirement to invite at least one firm that has not received *'more than 15% of the total audit fees from large public-interest entities in the Member State concerned in the previous calendar year'* is artificial and unreasonable. It will most certainly result in market distortion as it will require the inclusion of firms in the auditor selection process not based on their suitability or professional knowledge, but on their size. Moreover the audit committee should have the right to freely choose the most adequate auditor without introducing unnecessary bureaucracy. The audit committee has the responsibility to make the optimal decision on behalf of shareholders/owners; any artificial constraint decreases their responsibility.

We also question how this requirement will operate in practice. It would require an official point of reference where financial data is listed by auditor for each member state. This in turn will require each Member State to conduct a data collection exercise, and to publish the results in a form that is accessible by the entity and usable by audited firms, a complex exercise which will inevitably generate expenses and bureaucracy. There will invariably be a delay in publication of such information for the previous calendar year. We seriously doubt that this requirement will achieve the European Commission's objective, i.e. an increase in the choice of auditors and/or quality of the audit.

For these reasons we suggest the deletion of paragraph 3 (a)-(c) and (e)- (g).

■ Para 6

Provision to give the competent authority 'the right to veto the choice [of the auditor] proposed' by credit institutions and insurance undertakings is unreasonable and unjustified, particularly as it entails a system of prior approval with unspecified requirements and an undefined timetable. Insurance Europe registers its strong opposition to this proposal.

We refer to the responsibility of the audit committee to freely choose the best suitable statutory auditor. The quality of the audit, assured by the international standards on auditing and audit inspection regimes, is a responsibility of the statutory auditor. We doubt that the competent authority can better assess than the audit committee itself if the auditor is a suitable one.

9. Article 33 - Duration of the audit engagement

■ Para 1, para 2

Firstly, Insurance Europe would like to refer to its main arguments as already stated under "key concerns". Secondly, we think that artificial limitations on the length of engagement of audit firms are not reasonable. Thirdly, there is no empirical evidence that mandatory rotation leads to an improvement of the audit quality.

Changing auditors is a time-consuming exercise with financial implications that will at least partly be passed on to policyholders and shareholders/owners. Moreover, we are seriously concerned that the mandatory change of the statutory auditor would lead to a decrease in audit quality. New auditors may be less able to challenge management because they are not familiar enough with the business. This matters a great for insurers, which are complex and difficult to audit. An insurer has liabilities to policyholders that may be decades in duration, and their valuation requires the use of sophisticated actuarial techniques. An insurer also uses financial instruments to match its liabilities and manage its risks, and considerable judgment is required here also on the part of the auditor. Furthermore most of the requirements in article 33 lead to a diminishing of shareholder rights which, Insurance Europe believes are unfavourable developments.

■ Para 4

We understand the European Commission's motivation for the internal rotation (like obligatory partner rotation and senior staff). Nevertheless, Insurance Europe believes that senior staff rotation requirements are best addressed through professional audit requirements or other codes of conduct, as opposed to legislative measures. Furthermore, some member states already have rules in place that deal with rotation of key audit staff which is a sufficient approach. We consider that obligatory partner rotation might be an appropriate alternative to audit firm rotation.

10. Article 34 – Dismissal and resignation of the statutory auditors or audit firms

■ Para 2

We understand the necessity to ensure the independence of the statutory auditor in fulfilling his responsibilities to the company as a whole. Therefore we do not agree that the audit committee or individual shareholders should have specific rights to apply to the courts to dismiss auditors. This should be the responsibility of the company as a whole, for example as represented by its shareholders in a general meeting, to appoint and dismiss its auditors. We further consider that the role of the competent authority in relation to the dismissal of auditors should be constrained, so as to leave the primary responsibility with the company.

11. Article 46 – ESMA

We are aware that there is a need for coordination but we are not convinced that this role should be given to the European Securities Market Authority (ESMA), as it may be inconsistent with ESMA's mandate, which focuses entirely on the functioning of the securities markets. We advise thorough reconsideration of the proposed extension of ESMA responsibilities.

About Insurance Europe

Insurance Europe is the European insurance and reinsurance federation. Through its 34 member bodies — the national insurance associations — Insurance Europe represents all types of insurance and reinsurance undertakings, e.g. pan-European companies, monoliners, mutuals and SMEs. Insurance Europe, which is based in Brussels, represents undertakings that account for around 95% of total European premium income. Insurance makes a major contribution to Europe's economic growth and development. European insurers generate premium income of over €1 100bn, employ nearly one million people and invest almost €7 500bn in the economy.