

The 8th Directive, regulation and the European Union: a dialogue with Commissioner McCreevy

Introduction

The European Audit Committee Leadership Network is a group of audit committee chairs drawn from leading European companies committed to improving the performance of audit committees and enhancing trust in financial markets. The network is convened by Ernst & Young and orchestrated by Tapestry Networks to access emerging best practices and share insights into issues that dominate the new audit environment.

The European Audit Committee Leadership Network held its third meeting in Brussels on 22 June 2005. During the meeting members participated in a dialogue with the EU Commissioner for the Internal Market and Services, Mr Charlie McCreevy; his Deputy Head of Cabinet, Ms Claire Bury; and Mr Jürgen Tiedje, Head of Unit for Accounting and Auditing. During the discussion, members considered the following issues:

- **Whether a unified European capital market will emerge to compete with the US**
- **Why European companies require an additional layer of regulation when they already comply with national governance codes and possibly the Sarbanes-Oxley Act**
- **How the European Commission determines how much regulation is enough**
- **The 8th Directive on Statutory Audit's requirement for one member of the audit committee to be competent in auditing and/or accounting**

The members of the network participating in the dialogue with Mr McCreevy, Ms Bury and Mr Tiedje sit on the boards of 34 large, mid and small cap public companies. They were:

- Mr Per-Olof Eriksson, Audit Committee Chair, Volvo
- Sir Anthony Greener, Audit Committee Chair, BT
- Mr Jan Hommen, Audit Committee Chair, Royal Ahold
- Mr Daniel Lebègue, Audit Committee Chair, Alcatel
- Mr Tom McGrath, Global Managing Partner, Ernst & Young
- Mr Christian Mouillon, Global Vice Chair, Assurance and Advisory Business, Ernst & Young
- Mr Anders Nyrén, Audit Committee Chair, Skanska and Sandvik
- Sir Ian Prosser, Audit Committee Chair, BP
- Mr Pierre Rodocanachi, Audit Committee Member, Vivendi Universal
- Dr Klaus Schlede, Audit Committee Chair, Lufthansa and Deutsche Telekom
- Dr Ronaldo Schmitz, Audit Committee Chair, GlaxoSmithKline

ViewPoints reflects the network's use of a modified version of the Chatham House Rule whereby names of members and their company affiliations are a matter of public record, but comments made during meetings are not attributed to individuals. However, Mr McCreevy, Ms Bury and Mr Tiedje have given permission for their comments to be attributed.

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Opening remarks by Commissioner McCreevy

“Thank you for inviting me this morning to kick-off what promises to be a very interesting day of study and dialogue. In my comments I shall focus on the Commission proposal for the modernisation of the Directive on Statutory Audit, commonly referred to as the 8th Directive. This proposal, which we expect to be adopted in the next few months, is vital to the future functioning of audit committees. However, before saying a few words about audit committees, let me first briefly recap the objectives of this Directive.

Objectives of the 8th Directive

The role of auditors has become a major subject on the global political radar screen. And there should not be any doubt: it will certainly remain there. In many ways audit is the hub of the global financial system. It provides the essential control of probity, honesty, and accuracy of financial accounts. If it is weak – if there are errors or even misfeasance – then major economic and financial damage arises, not just in one jurisdiction, but everywhere. Because markets are global. And contagious. Audit therefore plays a key role in determining market confidence. Recent corporate scandals have cast a shadow on the role some auditors have played. This has led to a public perception that the audit profession lacks ethics and that auditing standards are not of sufficiently high quality. Confidence in the profession must be restored.

The Commission has put forward a proposal that will significantly change the legal framework for auditors in the EU. Negotiations with the European Parliament and the Council are progressing well, even if the *Financial Times* sometimes prefers to report the contrary. As I have said, we hope the negotiations on this vital piece of legislation can be finished in the coming months. It should provide a framework for audit for the EU which balances confidence for investors and ensures that the EU is a competitive place to raise capital.

The 8th Directive aims to help us meet three important challenges:

- **The first concerns audit oversight in Europe.** We need to ensure robust public oversight of the audit profession, while respecting the different cultures in the Member States of the European Union. There must be good co-operation between the oversight structure in the EU and third country oversight structures, such as the PCAOB in the US. We are all in the same boat – we must work together, and we can learn from each other. Early adoption of the Directive is critical as the US intends to start inspections in the EU at the end of this year.
- **The second relates to quality assurance, education and ethics.** High quality audits in all parts of an audit firm’s network can only be achieved if the audit firms have adequate internal quality controls to supplement external quality assurance. Top class education and training of employees is equally essential in an environment where standards change rapidly and transactions

become ever more complex. High ethical standards will raise investors' confidence in the audit profession.

- **The third concerns auditor independence.** This has been a controversial issue. In our negotiations with Member States in Council, the issue of non-audit services has been hotly debated. Some argued that all provision of non-audit services should be prohibited. The current draft text is balanced and allows in its application for some flexibility on the part of Member States. Auditor rotation is an important complement to these provisions.

Audit committee

Having mentioned auditor independence, this is an appropriate moment for me to turn to the audit committee. The Commission included in its proposal for the 8th Directive a provision stipulating that public interest companies should have an audit committee. I attach great importance to this principle. Moreover, there is nothing revolutionary about it. Most listed companies worth their salt in Europe already have audit committees.

I have to say I am perplexed by the amendments which were voted yesterday [21 June 2005] in the legal affairs committee of the European Parliament, giving companies the option of not having audit committees but "similar bodies" established under national law but with no indication of how such bodies should be composed.

Audit committees, provided that they have adequate know-how, can play an important role in buttressing and ring-fencing auditor independence. As chairs of audit committees, you know how important it is that auditors are able to resist undue pressure from company managers. Pressure on the figures can at times be intense. This is not just for the sake of the auditors who can often be caught between a rock and a hard place! Rather, it is for the sake of your company, its shareholders and investors.

The existence of an audit committee sends a positive signal to investors. And as chairs of audit committees, you almost certainly already play an important role, not just in monitoring auditor independence, but also in: the selection of the statutory auditors; monitoring of the financial reporting process and the audit; monitoring of the internal audit function (where one exists) and monitoring the effectiveness of the company's internal control system. In so doing you do not replace the board, you simply provide expert scrutiny in these areas and then report to the board on them.

Membership of the audit committee

The Commission has suggested that the audit committee of listed companies should have at least one independent member who is competent in accounting or auditing. Enron and Parmalat both had audit committees, but had no safeguard on independent membership. In fact, the Sarbanes-Oxley Act requires that all members of an audit committee be independent.

The draft directive does not set in stone a definition of independence. I can see the arguments in favour of leaving some flexibility to Member States on this and the details of how audit committees work should be dealt with in national corporate governance codes or national legislation, as Member States see fit. There is a Commission Recommendation on non-executive or supervisory directors which was issued in 2004. This Recommendation offers guidance on how to assess independence. As such, it usefully complements the modernised 8th Directive, but it is not mandatory.

Small listed companies have argued that audit committee requirements are costly. I would hope that most of these companies will strive to live up to the highest standards. Whether the company is small or large, we are always dealing with investors' money. Nonetheless, I can see the practical problems which smaller companies may face and I am open to dropping the independence requirement for [the audit committees of] small listed companies, provided at least that the chairman of the board is not also the chairman of the audit committee.

Financial expertise

The 8th Directive requires at least one member of the audit committee to be competent in accounting and/or auditing. You may argue this goes too far compared to Sarbanes-Oxley and the SEC rules, which do not insist on this, provided it is explained to investors. But what is the value of an audit committee without a minimum level of expertise on the part of at least one member? Moreover, the expertise requirements under EU law are far less demanding than the corresponding US requirements.

Clearly the adoption of the directive will not be the end of the story. We will monitor carefully how Member States implement and apply it and the Commission itself may need to adopt implementing measures. But rest assured I intend to make sure that the balance which I referred to earlier is respected. In reacting to scandals we need measured, reflective judgement. Europe must be competitive. Regulation must be commensurate to risks. It must not stifle business and entrepreneurial spirit. The jury is still very much out on whether the Sarbanes-Oxley Act has been successful: I am sure that as the overall cost benefit analysis is completed, we too will have much to learn.

Concluding remarks

Rapid adoption and implementation of the 8th Directive is essential. Combined with proper enforcement, it should help restore confidence in the audit process. While some aspects may still be debated, the 8th Directive will establish a clear and modern legislative framework conducive to the prosperity of properly run companies. Our investors and capital markets deserve no less".

Dialogue with Commissioner McCreevy

***Network member:* How likely is it that a unified European capital market will emerge to compete with the US?**

Mr McCreevy: An integrated European market is a goal for Europe to be a player on the world stage. The Financial Services Action Plan set out measures in May 1999 to achieve this goal but they need to be implemented properly in Member States. Then we can evaluate to see if [the plan] is doing what it is supposed to do. We want to make a level playing field so that financial markets can be more unified.

***Network member:* Why do European companies require an additional layer of regulation when they have to comply with national governance codes and SEC registrants also have to comply with Sarbanes-Oxley? Is there a 'regulatory race' between Europe and the US?**

Mr McCreevy: We are not in a race to out-do each other, although in any great bureaucracy there will always be people who will legislate on anything.

I am not interested in having another layer of regulation. PCAOB [the US Public Company Accounting Oversight Board] audit inspections will start in Europe at the end of this year. We can

either do our own inspections here or we can roll over. It is not possible to have a universal standard of corporate governance throughout the EU. On audit, we are trying to get convergence on some of the basics in the EU. The 8th Directive on Statutory Audit is not revolutionary.

On accounting, if Europe and the US can get their house in order on accounting standards, there is a chance the rest of the world will follow. It is a goal worth pursuing to have a set of agreed international standards between the US and Europe but you won't get them in the next five years. However, you can get recognition of equivalence on both sides and that would be a good thing for everyone.

Ms Bury: We endorse a principles-based approach, not the tick-the-box approach as in the US. The 8th Directive has a light touch compared to Sarbanes-Oxley. It has some key principles to bring national practices together. The UK and Ireland use the governance principle of “comply or explain”, but other Member States have different cultures. The European Corporate Governance Forum¹ is working to promote convergence, not a European Code. We want to make Europe an attractive place to do business.

Mr McCreevy: If we had got things right in the first place we would not have had various disasters occur, such as Enron, WorldCom or Parmalat. It happened in the US and it happened here. A directive in all areas of corporate governance would be a Herculean task, which would take years to achieve. An EU of 25 countries has to respect different cultures. We need an approach which, over time, seeks to get everyone moving in the same direction. We may be able to put it all together in the end. We don't want to end up being purer than pure and there's nobody left to do any business. I am a buffer between the zealots behind me and to the side of me. I used to tell my civil servants in Ireland: it is in our interests to keep business alive. They pay the taxes and without taxes we don't get paid.

***Network member:* How does the European Commission determine how much regulation is enough, particularly given the Commissioner's publicly stated view that new regulation must provide benefit?**

Ms Bury: We are moving towards a better culture for when regulation is necessary in the EU. The “Better Regulation Initiative”² has been taken to heart in the Commission. We now have impact assessments upstream and downstream [of new regulation]. We are more careful with legislation. The 8th Directive won't have detailed rules like Sarbanes-Oxley. We don't want to over-regulate in this area. However, “gold plating”³ by Member States could still lead to fragmentation.

Mr McCreevy: The results of the recent French and Dutch referenda [rejecting the draft EU Constitution] show people are concerned about interference. We are not going down the road of

¹ The European Commission set up the European Corporate Governance Forum in October 2004 to examine best practices in Member States with a view to enhancing the convergence of national corporate governance codes and providing advice to the Commission. The Forum comprises fifteen senior experts from various professional backgrounds (issuers, investors, academics, regulators, auditors, etc.) whose experience and knowledge of corporate governance are widely recognised at European level. For further information see the press release at <http://europa.eu.int/rapid/pressReleasesAction.do?reference=IP/04/1241&format=HTML&aged=0&language=en&guiLanguage=en>

² The Commission's Better Regulation initiative of June 2002 set out to ensure an improved standard of regulation in the EU's daily legislative work. It also proposed that work should be done on the stock of existing legislation, some dating back several decades. In its Communication to the Laeken Summit (December 2001), the Commission called for a simplification of EU law and a reduction in the volume of legal texts by 25% by the end of 2004. The Commission adopted a further Communication in March 2005, Com (2005) 97 announcing an approach of impact assessment and a new phase of simplification. The objective is to seek out and eliminate regulatory excess to the benefit of European competitiveness.

³ “Gold-plating” EU directives is when implementation by Member States goes beyond the minimum necessary to comply with a directive.

regulation at all in some of these areas. We subscribe to the principle of subsidiarity⁴ in Europe but it is not often carried through in practice. The US has a rapid fire response to things, hence Sarbanes-Oxley. Some people now say it's gone too far. In Europe, we have a long [legislative] process and by the time you get something through it is very difficult to reverse. Having such a complex system for putting through legislation does mean that the legislation is usually the result of extensive discussion.

***Network member:* The foundation for good corporate governance practices is the national code. These national codes have common recommendations and principles on 80-90% of the topics. How can we build on this foundation and favour pragmatic convergence?**

Mr McCreevy: I am a believer that most people copy others. People who are successful in business are not always the people who had the Big Idea. The person with the Big Idea is usually bankrupt. On two areas of corporate governance – non-executive directors and disclosure of remuneration – our recommendations were not mandatory. We should work through bodies such as the Corporate Governance Forum to promote convergence. In my system [in Ireland], the shareholders are king or queen. In some Member States that is not the situation. Maybe in 10 years' time everyone will converge in the middle, we can't push it any further. In the business world, if one part of Europe allows capital to think that's the best place to be, that's where they'll go. The Commission has to make sure we don't make things so unattractive that capital goes elsewhere outside of Europe.

***Network member:* The 8th Directive has a requirement for one member of the audit committee to be competent in auditing and/or accounting. Is this a stricter requirement than Sarbanes-Oxley, which only requires that one member be a “financial expert”? That definition would include a CEO, for instance; the 8th Directive's definition would not.**

Mr McCreevy: We simply want the balance of one independent member who is financially literate, but the wording may be too tight and creating misunderstanding, so we will look at that.

Mr Tiedje: We are trying to ensure there is some financial literacy in the audit committee.

Appendix: biography of Commissioner McCreevy

Born in 1949, Mr McCreevy worked as a chartered accountant until 1977, when he was first elected to Dáil Eireann (the Irish Parliament) for the constituency where he was born – County Kildare. From 1992 until 2004, he held various cabinet posts in Fianna Fail-led governments including: Minister for Social Welfare, Minister for Tourism and Trade and Minister for Finance.

Having presided over Ireland's entry into the European Monetary Union and later the changeover to the euro, Mr McGreevy was selected as Ireland's European Commissioner in 2004. He was asked to take on the Internal Market and Services portfolio by Commission President, Mr Jose Manuel Barroso.

Mr McCreevy was educated at a Franciscan college before gaining a degree in commerce at University College, Dublin. He is a member of the Institute of Chartered Accountants.

⁴ The principle of subsidiarity, based on Catholic social teaching that, “A community of a higher order should not interfere with the life of a community of a lower order, taking over its functions”, regulates the exercise of powers between institutions of the EU. It is intended to determine whether, in an area where there is joint competence, the EU can take action or should leave the matter to the Member States.

About this document

ViewPoints is produced by Tapestry Networks to stimulate timely, substantive board discussions about the choices confronting audit committee members, management, their advisers and auditors, as they endeavour to fulfil their respective responsibilities to the investing public. *ViewPoints* is a synthesis of key issues arising from discussions among members of the European Audit Committee Leadership Network. The ultimate value of *ViewPoints* lies in its power to help all constituencies develop their own informed points of view on these important issues. Anyone who receives *ViewPoints* may share it with those in their own network. The more board members, management, advisers and auditors who become systematically engaged in this dialogue, the more value will be created for all.

The views expressed in this document represent those of the European Audit Committee Leadership Network, a group of audit committee chairs drawn from Europe's leading companies committed to improving the performance of audit committees and enhancing trust in financial markets. They do not reflect the views nor constitute the advice of network members, their companies, Ernst & Young or Tapestry Networks. Please consult your advisers for specific advice. Ernst & Young refers to all members of the global Ernst & Young organisation.

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