New Auditor Legislation in Switzerland

As many options as a Swiss Army Knife?

In this article Jean-Philippe Heim considers the new auditor legislation in Switzerland, which will introduce a system that takes into consideration the most recent international developments and the various interests of all market participants.

International pressure

In an effort to provide additional protection to investors of public companies, in January 2002 the US Congress passed the Sarbanes-Oxley Act (SOX). Amongst other things, SOX established the Public Company Accounting Oversight Board (PCAOB) to oversee any audit firm that provides audit reports to issuers listed on US stock exchanges. Auditors of Swiss companies publicly traded in the US are no exception.

Because PCAOB oversight would include access to any reviewed corporate documents, sensitive information of Swiss companies such as Logitech, Nestlé and Novartis would be made available to a foreign government, a prospect that Switzerland found unpalatable.

Heeding the calls made by Switzerland and other countries, the Securities and Exchange Commission (SEC), through the PCAOB, suggested an international cooperative approach to this problem in order to grant an exemption to foreign audit firms that are regulated by an equivalent foreign authority approved by SEC.

Swiss reaction

Taking advantage of this opportunity, in December 2005 the Swiss Parliament passed an amendment to the *Obligations Code* and enacted the *Federal Law on Approval and Oversight of Auditors*. The general public could have vetoed this legislation by referendum. However, the deadline of 6 April 2006 expired without such a petition. So, the laws will now go into effect, most likely in the second half of 2007.

The European Union (EU), also reacting to SOX, recently proposed the Directive on Statutory Audit. Switzerland likewise took this into consideration in drafting its own legislation.

As part of this process, Switzerland recognised that audits serve different purposes depending on the type of company audited: for publicly traded companies, the main purpose of the audit is protecting investors; for large privately held companies, the purpose of the audit is to ensure a stable overall economy by preventing financial irregularities; and for small private companies, the main goal of the audit is to protect minority shareholders and certain creditors, in particular employees.

Accordingly, Switzerland proposed a system with various levels of audit standards, categories of auditors and definitions of independence.

Audit, review and options

The Swiss legislation requires all public companies, regardless of size, to annually submit their financial statements to an *audit*. The same requirement applies to large privately held companies, which are defined as maintaining for two financial years two of the following:

- total assets of CHF 10m (about EUR 6.5m);
- a turnover of CHF 20m (about EUR 13m); and
- 50 employees.

This level of audit requires an auditor to thoroughly examine financial statements and issue two reports: a detailed version for the board and a shorter version for shareholders.

All other companies, i.e. small private companies, are required to submit financial statements to a *review*. At this level, an auditor is permitted to perform a more limited evaluation of financial statements and issue a single report to the company.

The Swiss legislation, moreover, provides small private companies with certain options to balance the interests of minimising expenses with those of protecting minority shareholders, employees and other creditors.

By *opting up*, a minority of shareholders (at least 10%) may require any company to submit its financial statements to a more comprehensive evaluation ('super review'), which can be anything between a normal review up to and including a full audit.

By *opting out*, through the unanimous consent of its shareholders, a company with ten or fewer employees may decide not to have any form of audit or review.

By *opting down*, which is available upon the same conditions as opting out, small companies may submit their financial statements to a lesser form of evaluation ('light review'), thereby reducing the financial burden without eliminating entirely the benefits of a review.

Auditors and State oversight

The Swiss legislation, similar to that of the EU, requires audits of large private companies to be carried out by *expert auditors*. These are defined as being of good repute, having passed a professional competence examination and having a specified length of practical experience, which may be from zero to twelve years depending on the level of examination.

Reviews may be undertaken by (normal) *auditors*. To be registered as such,

a person must have the same qualifications as an expert auditor, except that only one year of practical experience is required.

It is important to note that a 'super review' may be carried out by a (normal) auditor and a 'light review' may be undertaken by any person, even those with little or no qualifications.

Audits of public companies must be performed by *government-regulated audit firms*. Aside from consisting of more than one person, such firms are required to maintain sufficient insurance coverage.

Under this new legislation, as in the US, foreign audit firms are subject to Swiss governmental oversight. In order to provide reciprocity, however, such firms may be exempted if they are overseen by a foreign authority approved by the Swiss Federal Council.

Independence

Switzerland has also adopted different levels of independence, which vary according to the type of evaluation undertaken.

For full *audits*, the applicable independence standard requires that the auditor make his opinion objectively. To this end, his independence must not be restricted either in fact or in appearance.

The law cautions that the auditor's independence may be limited where he has a direct relationship with the client, providing examples such as a managerial role or a financial interest in the audited company or a close relationship with any manager of such company.

The law also recognises that an auditor's independence is compromised by indirect relationships, which exist when other people close to the auditor have relationships with the client. It would therefore be forbidden for an auditor to audit a company, if, for instance, the auditor's brother were a member of its board.

For *audits of public companies*, the principle and the examples mentioned above are enhanced by specific rules to prevent a situation in which the auditor is financially dependent on any single client. Thus, the fees billed to any audited company may not exceed 10% of the total fees invoiced by the audit firm.

For *reviews*, the independence standards are the same as for a normal audit, but the law does not provide any examples of incompatible relationships. Moreover, it expressly allows the auditor to provide other services to the client, recognising that such companies often cannot afford the services of a separate accountant and an auditor.

For '*light reviews*', chosen by opting down, the applicable independence standards are even further relaxed and would permit, for example, close relatives of a company's directors to evaluate its financial records!

Not far enough?

In adopting new legislation that is compatible with US audit regulations, Switzerland has taken the first step towards qualifying for the exemption from PCAOB oversight provided by SOX.

Whilst fulfilling international expectations, the Swiss Parliament demonstrated innovation by expressly recognising the various interests of different types and sizes of companies.

However, there is one important measure that Switzerland deliberately omitted: the prohibition on dismissing the auditor without proper grounds. In fact, the guarantee of not losing its client at the first disagreement is arguably one of the best ways to ensure the auditor's freedom to express views that the client may not want to hear.

In any event, a Swiss commission rejected this measure many years ago, stating that the right to dismiss the auditor at any time 'is too much rooted in our country'...

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diary deadlines

15 July
Foreign companies listed on US exchanges now have to comply with *section 404* of the *Sarbanes-Oxley Act* and the US Securities and Exchange Commission's (SEC) internal controls for financial reporting (CSR Vol 28, p 188).

24 July
The *Occupational Pension Schemes (Winding up Procedure Requirement) Regulations 2006 (SI 2006/1733)* are due to come into force (CSR Vol 30, p 45).

27 July
Companies House WebFiling seminar takes place in London (CSR Vol 30, p 12).

31 July
Comments are due on the consultation on proposed amendments to the FRSSE (CSR Vol 30, p 4).

31 July
Comments are due on the ASB consultation on the future application of reporting requirements for UK companies (CSR Vol 30, p 20).

31 July
Companies House seminar aimed at helping companies to keep on the right side of the law takes place in Norwich (see www.companieshouse.gov.uk/about/seminars.shtml).