Fédération des
Experts-comptables
Européens

Discussion Paper on the Free Movement of Firms

10 October 2000[1]

In its survey of March 1999, FEE presented its thinking on the liberalisation of the accountancy profession in Europe. In approving this report, the FEE Council was aware of the necessity to undertake further work on some matter which were not fully dealt with in the report. In fact, the report states (p.50) "At this stage in the debate, these proposals do not include specific provision for holding companies." In this area, some new initiatives are desirable in order to improve the free movement of natural persons and especially the free movement of legal entities across the European Union.

Further work is justified not only in the context of the free movement of professionals in Europe but also in that of the work of the World Trade Organization.

The present discussion paper is to be read in conjunction with the survey approved by the FEE Council in March 1999. It does not alter the principles addressed in this former report.

I. SUMMARY OF FEE'S PREVIOUS POSITIONS

A. General Principles

According to article 48 of the Treaty establishing the European Community (formerly 58), "Companies or firms formed in accordance with the law of a Member State and having their registered office, central administration or principal place of business within the Community shall, for the purposes of this chapter, be treated in the same way as natural persons who are nationals of Member States."

Where the application of this provision of the Treaty is concerned, FEE believes that the principles defined for natural persons should be applied to legal entities; the protection of the general interest is applicable in both cases. Consequently, in its report of March 1999, FEE proposed that all professional firms approved in a Member State can freely:

- Offer cross-border services in another Member State (freedom to provide services;
- Establish a branch in another Member State;

[1] Translation of the French original text

- Create a subsidiary in another Member State.

In the three cases, the individual professional responsible for providing the services and signing the reports on behalf of the firm must have acquired the host country title and be subject to all professional obligations in the host country.

The creation of a subsidiary would involve two additional requirements:

- The majority of the members of the administration or management body of the subsidiary must be professionals approved locally in the Member State of the subsidiary and;

- If there is a requirement relating to professional insurance in the host country, the professional providing services on behalf of the firm must comply with the requirement in force in that Member State unless the subsidiary that he represents can prove that it is covered for its activities in the host country.

In its paper of March 1999, FEE also concluded that a number of remaining barriers to the free movement of legal entities should be addressed, notably with regard to:

- National regulations prohibiting collective practice;
- Regulations restricting the choice of legal form permitted for collective practice;
- Rules restricting the choice of names of professional firms.

B. Principles applicable to the free movement of audit firms

Free movement where audit firms is concerned raises specific legal issues: the Eight Council Directive of 10 April 1984 on the approval of persons responsible for carrying out the statutory audit of accounting documents (84/253/EEC) must be taken into account. Article 2 of this directive defines conditions for the approval of firms of auditors which has a bearing on the free movement of these firms.

In other words, there exist sufficient grounds relating to the general interest which prevent the constitution of audit firms that do not meet the conditions of the Eighth Directive in a Member State of the European Union and the free circulation of such firms throughout the Union.

However, the implementation of the principles of the Eighth Directive does not mean that Member States are automatically obliged to permit the free movement on their territory of audit firms which may respect the requirements of the Eighth Directive but do not comply with the more restrictive requirements of the national legislation. In this case, it is necessary to examine if the requirements laid down by national legislation comply with the rules of the free movement of persons in Europe. They must be justified by imperative requirements in the general interest (justification test) and objectively necessary in relation to the protection of the general interest (proportionality test).

Remaining restrictions will find their origin in:

- Competence requirements (a) or,
- Requirements concerning integrity and independence (b)

(a) The Eighth Directive requires that natural persons who carry out statutory audit on behalf of firms as a minimum satisfy the conditions imposed on statutory auditors.

(b) Articles 25 and 27 of the directive apply the professional requirements of integrity and independence in relation to the statutory auditors of audit firms. These requirements are applicable to the approved individuals acting on behalf of the audit firm but it is important that they are not circumvented by a company's operations. For this reason, the directive lays down conditions on the majority of voting rights and the composition of the administration or management body in a firm of auditors. On these two issues, FEE adopted the following position in its report of March 1999:

1) Majority of capital and/or voting rights in firms of auditors

The Eight Directive requires that individuals or firms of auditors who satisfy at least the conditions imposed on statutory auditors hold the majority of voting rights. Two questions may be asked in that respect:

- Is it possible to adopt a more restrictive requirement beyond that of a simple majority? FEE believes that harmonisation should require that only a simple majority of capital/voting rights in firms of auditors must be in the hands of statutory auditors.

- Is it necessary to require that the majority of capital/voting rights in firms is held by locally approved auditors? FEE maintains that such rules are disproportionate to their objective and that it would be appropriate to clarify the clauses of the Eighth Directive in order to permit majority holdings in firms of auditors in one Member State by statutory auditors approved in other Member States.

2) Control of the administration or management body

According to the Eight Directive, the majority of members of the administrative or management body of a firm of auditors must be natural persons or firms of auditors who as a minimum satisfy the conditions imposed on statutory auditors. FEE believes that this requirement must be analysed separately from the majority of capital issue. It considers that the majority of the members of the administration or management bodies should be statutory auditors, natural persons or firms of auditors, who have been approved locally in the host Member State.

This requirement is proportionate because, for some clients, technical decisions concerning the audit opinion are taken within the administration or management bodies of the audit firm. The public interest requires that the professionals who take these decisions be in possession of the qualification of the host country.

II. WHY IS THIS ADDITIONAL STUDY NECESSARY?

After the publication of its report of March 1999, the FEE Council received some comments concerning the requirement that the majority of capital/voting rights in firms of auditors must be in hands of approved statutory auditors. In particular, the question was raised as to whether some limitations can be imposed on the composition of the minority holding of an audit firm.

A survey of the situation in the Member States demonstrates that:

- On the one hand, many of them still require majorities that are more restrictive than the simple majority and;

- On the other hand, many of them impose additional requirements on persons who may be associated in an audit firm. For instance, some expressly prohibit the participation of banks or financial institutions in the capital of audit firms. Others lay down specific rules in favour of individuals who are working in the audit firm without having acquired the qualification of an accountant. (or in favour of non-accountants employed in the audit firm).

Restrictions on the possession of shares in an audit firm may be justified by the general interest and appropriate to this objective. If this is the case, they can be invoked in a national context as well as in the context of free movement of persons in the European Union.

In this framework, it is useful to analyse the nature of problems raised by the participation of third parties in the capital of audit firms. Two main arguments are put forward:

- Given the specific responsibilities of a statutory auditor, it is important **to ensure** that no person or interest external to the profession can influence the decisions to be taken by the professional. The protection of the independence and objectivity of the statutory auditor must be guaranteed within the structure of a firm.

- A further argument is that a firm of accountants must be controlled and managed by professionals of this discipline in order to ensure that the clients who engage it are fully aware of the ethical and technical principles according to which the professional partners carry out their work. This argument relates to the protection of the independence but it also goes further to concerns the activity of the firm as a whole. It raises the question of how to deal with multi-professional firms? The answer is not always clear at national level. This complicates the discussion on the respect of the principles of justification and proportionality.

III. TYPOLOGY OF SHAREHOLDING

The characteristics/profiles of those individuals who could assume a shareholding, even when only a minority one, in an audit firm is of considerable importance. Among those who could become shareholders, it is possible to identify the following groups of persons:

1. Statutory auditors who are approved in the Member State where they have their domicile and head office;

2. Statutory auditors who are approved in a Member State of the European Union other than the one in which the firm has its head office and main activities;

3. Statutory auditors who have acquired an equivalent professional qualification but who are not approved in a Member State of the European Union;

4. A qualified accountant, who is a member of a professional Institute recognised by the competent authorities in a Member State of the European Union (or outside the EU with reciprocity) but who is not approved in accordance with article 2 of the Eighth Directive to carry out statutory auditing of the annual accounts or of the consolidated accounts.

5. Individuals working in the audit firm whose professional qualifications are not those required for the audit of annual accounts (for instance lawyers, computer specialists etc.) and are recognized in the Member State where the domicile and head office of the firm is established;

6. Individuals working in the firm of auditors whose professional qualifications in another discipline than statutory auditing (for instance lawyers, computer specialists etc.), are recognised in another EU Member State than the Member State where they work;

7. Persons working in the firm of auditors whose professional qualifications in another discipline than statutory auditing (for instance lawyers, computer specialists etc.), are recognised in another country outside the European Union;

8. Any other persons employed by the firm of auditors who are not included in the above mentioned categories;

9. Any other persons, whether in possession or not of a professional qualification other than statutory auditing, who is not employed by the firm of auditors.

These eight situations can easily be classified.

First of all, one can distinguish the statutory auditor whose professional qualification has been recognized and is indisputable because it has been obtained in a Member State of the European Union.

Following this, one can identify individual holding a recognized professional qualification from a Member State of the European Union in a discipline other than that of statutory auditing which prevents them from obtaining an approval as statutory auditor. In this category, a distinction can be made for accountants who have not applied to become an approved statutory auditor (Group 4). Such a situation can occur mainly in those countries

where the functional title of statutory auditor is dependent upon being a member of an Institute which bestows the professional title of accountant.

Finally, a third category encompasses individuals who are not professionally qualified and who do not have a direct link with the audit firm. The interest of persons who are not working in the firm will be obviously different to that held by those who are actually employed in the audit firm. In the first case, the interest will be mainly, if not exclusively, capitalistic whereas, in the second case, it will normally be professional before anything else.

IV. FEE PROPOSALS

A. Definition of approved persons

In its survey of March 1999, FEE noted that the provisions of the Eighth Directive are not entirely clear and are interpreted differently among the Member States. In particular, the question is raised whether the professionals who form the simple majority of the capital or the voting rights in audit firms must be approved locally or whether it is sufficient that they have been approved in one of the Member States of the European Union.

Even though most Member States impose local approval, FEE believes/maintains that such rules are not in proportion to their objective and that it would be appropriate to clarify the clauses of the Eighth Directive in order to permit majority holdings of the capital and/or voting rights in firms of auditors by persons approved in a Member State the European Union, without any proviso that this Member State is the country in which the audit firm has its head office or its main activities.

The objective is clearly to allow the constitution of a subsidiary in which the parent company has a controlling interest. Legal barriers preventing such a possibility do not appear to comply with the objectives of the European single market. Accordingly, they cannot be justified by reference to Community law. However, in accordance with what is stated above, the professional responsible for the work and who signs the reports, and who is fully authorised to act on the company's behalf, must hold the qualification of the host country and adhere to its professional rules.

Consequently, FEE is of the view that the simple majority of the capital and/or of the voting rights in audit firms must be held by statutory auditors approved in a Member State of the European Union (persons of the first two groups mentioned in section III above).

B. Shares held by persons who are not approved in conformity with the Eighth Directive

With regard to the other categories, sufficient grounds can be put forward to justify the imposition of some restrictions to the free movement of statutory auditors in order to guarantee the specific duties of the audit firm. These restrictions could relate to the

characteristics of the persons holding shares in the audit firm and the percentage of shares they are allowed to hold.

The free movement of audit firms imposes to define a common position concerning the possibility for some Member States of the European Union to oppose the free movement of the firm of statutory auditors when it does not meet the shareholding criteria.

1. Quality of persons involved

The risk of impingements on the autonomy of decision of the statutory auditor approved in the European Union (who is holding at least a majority of the capital and/or the voting rights of the firm) will be reduced when the shareholding is held either by persons who are practicing the same profession outside of the European Union without being approved in the EU, or by persons who have a professional qualification different to that of the statutory auditor and are employed by the audit firm.

By contrast the risk of influence may be considered to be greater when the shareholding is held by persons whose only interest in the firm of statutory auditors would be capitalistic and, in particular, when the shares are held by financial companies. Indeed, these persons are not necessarily as sensitive to the ethical and professional constraints as those who are professionally engaged in the firm of statutory auditors.

It appears to be difficult to distinguish between persons who have a capitalistic interest in the audit firm on the basis of whether or not they have a recognized professional qualification. The essential distinguishing factor is whether these persons are effectively working in the audit firm and consequently are directly interested by the quality of the professional service delivered by the firm. If the persons who are not statutory auditors are not active in the firm (as employees or in an equivalent capacity), it can be taken that they do not exercise any influence on the working of the firm.

2. Percentage of participation

With regard to the percentage of shares that can be held by the two groups of people who are not statutory auditors FEE expresses the view that:

a) The percentage that can be held by accountants (as defined above) must be brought up to the maximum compatible with the Eight Directive;
b) at the present time, bearing in mind the restrictions which exist in the Member States and the influence that any reform could have on the users of a statutory auditor's services, one can appreciate that limitations may be considered as proportionate when they do not exceed 25%;
c) With regard to the participation in the audit firm of persons exterior to the firm (outsiders), or even employees of the firm who do not hold a specific professional qualification, it is understandable that some Member States consider it necessary to impose more restrictive requirements, or even in the present situation, exclude completely the participation of such individuals. However, this situation can have meaningful

consequences on the free movement of firms; it will be necessary to return to this issue and to consider new measures of harmonization.

3. Indirect participation

An additional question must be raised concerning the professional status of a foreign firm of statutory auditors that wishes to participate in the capital of a firm in the host Member State but does not fulfil all conditions required in this Member State. This situation will be illustrated by an example:

- In Member State A, the participation of persons who are not approved this State and who are not working in the audit firm is allowed whereas it is forbidden in Member State B.

- A partner of an audit firm established in Member State A is not approved in this State for the audit of the annual accounts. This partner holds a small minority participation of 5%.

- The firm of statutory auditors established in Member State A could not open a branch in the Member State B. Would this firm be permitted to assume a shareholding in a firm established in Member State B?

Given that the audit firm is approved in the Member State of origin, it will be acceptable to allow it to assume a shareholding in a firm in the host Member State in its capacity as an approved professional firm. However, it is quite apparent that this conclusion will allow the constitution of subsidiaries where they could not be established directly.

CONCLUSION

It is important to define the conditions under which firms of statutory auditors are allowed to establish in the Member States of the European Union. The Eighth Directive (84/253 EEC) requires that the majority of the voting rights be held by persons approved for the statutory audit of the accounts in the Community. The existence in the Member States of additional requirements over and above this limit and the imposition of certain conditions where a minority is concerned can be a barrier to the free movement of firms.

In the context of liberalisation, FEE recommends a compromise between the theses in presence. This compromise must guarantee in all circumstances respect for the principle of independence of the statutory auditors which is justified by the general interest.

First of all, in relation to accountants who are members of a professional Institute recognised by the competent authorities in a Member State of the European Union (or outside the EU with reciprocity) but who are not approved in accordance with article 2 of the Eight Directive to carry out statutory auditing of the annual accounts or of the consolidated accounts, no restriction exceeding what is required by this Directive is acceptable for their participation in a firm of statutory auditors.

Then, in all European countries, the possibility for persons who have not been approved as statutory auditors, to participate in professional firm should not be submitted to restrictions exceeding 25% on the condition that the shares are held by:

- Professionals permitted in a State Member of the European Union to practice their profession together with statutory auditors;

- Non-professional individuals working within the firm;

- Legal entities established in another Member State of the European Union of which the regulations concerning shareholding meet the same professional requirements as those in the host Member State;

- Subject to reciprocity, statutory auditors and other professionals allowed to exercise together with them, established outside of the European Union.

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Current position of FEE on ownership and management/control of an audit firm