The new Audit Regulations

On January 1st, 2008 statutory changes with regard to the audit procedure will enter into force. Henceforth there will be two different audit procedures (ordinary/limited), depending on the economic significance of the enterprise. Among other things the regular audit will include a review whether the audited company has an internal control system.

The revision of the legal provisions governing the audit procedures has to be seen as part of a broader change of the rules on corporate governance. The new provisions are part of the law of corporations, however they are expressly applicable to public limited companies and cooperative societies as well. Similar provisions will be introduced in the law of associations and foundations. In addition to the changes in the Code of Obligations (and the Civil Code) a new act will be introduced dealing with the admission and supervision of auditors.

It depends on the economic significance of a company whether it is submitted to an audit and which kind of audit is applicable (and not only on its legal form as under previous law). The new provisions provide for two different **kinds of audits**:

The **ordinary audit** consists of a detailed revision of the annual balance sheet and/or the consolidated group accounts with regard to their conformity with the law, the articles of association and possibly a chosen set of rules (such as e.g. Swiss GAAP FER) as well as an examination of the appropriation of the profits. Furthermore the audit company will check whether an internal control system exists. Upon completion of the audit, the auditor will report in detail to the board of directors and submit a summary report to the annual general assembly of the shareholders. This ordinary audit is compulsory for public companies, especially public companies which are quoted at the stock exchange. All public companies will be audited by auditing companies which are under the control of a government body. This new government control will carry out inspections of such audit companies at least once every three years. Companies which are considered to be "economically important" are also subject to an ordinary audit. Companies qualify as such if they meet two out of three of the following thresholds within two subsequent years: A balance sheet total of CHF 10 mio., sales profits of CHF 20 mio., 50 fulltime jobs per annual average. Such companies will have to be audited by expert auditors with a special license i.e. auditors with a professional expertise based on several years of practice. Finally, the ordinary audit applies to all companies which must provide consolidated group accounts.

A so called **limited audit** (review) grants a certain relieve with regard to the scope and intensity of the audit and the reporting. This limited audit will be applied to smaller and medium sized companies which do not meet the thresholds mentioned above. Nevertheless, the audit applies to the annual balance sheet and the appropriation of the profits. The report will be primarily based on interviews with the directors and the employees of the company and the examination of relevant corporate documents. Confirmation of third parties (banks e.g.) will not be requested. Checks regarding the existence of an internal control system are not within the scope of a limited audit and the audit report will consist only of an audit summary addressed to the annual shareholders' meeting. The risk that the audit report is wrong or incomplete accordingly is considerably higher than in the case of an ordinary audit, also because the required standards with regard to the professional expertise and independence of auditors are lower. While these auditors also need a license from the government control body, the requirements regarding professional experience are lower. It follows that a limited audit will cause less expense and therefore favours small and medium sized companies. The specification of that type of audit as "limited" might be misleading as this limited audit does not discern itself materially from the type of audit applied to many small or medium sized companies today.

The new provisions leave room for companies to deviate from the system described above if they comply with certain specific requirements:

- A group of shareholders representing at least 10 % of the share capital may request that an ordinary audit is carried out *(opting up)*. This provision serves the protection of minorities.
- Companies which on average employ less than 10 fulltime employees may with the consent of all shareholders forgo an audit *(opting out)*. Under the same conditions the audit may be limited to certain specific aspects *(opting down)*.
- Finally, companies which are not under an obligation to carry out an audit may voluntarily submit themselves to a limited or even an ordinary audit *(opting in)*. Pressure for an opting in might e.g. be exercised by crediting banks.

An important change with regard to the scope of an **ordinary audit** is the duty, explicitly mentioned in the act to check whether an **internal control system** is in place. According to the Swiss Auditors Association's handbook the term "internal control system" refers to

all procedures, methods or measures which are designed to warrant an orderly running of the company's activities and are introduced or put in place by the board members and management. The scope of such check is limited to the existence of measures and procedures which are concerned with the accounting and the rendering of accounts and aim to secure a proper financial reporting within the frame of the law. Other areas such as operations processes and compliance will not have to be checked as long as they have no effect on the balance sheet.

It is the board of directors' **responsibility** to ensure that a functional and adequate internal control system is set up and maintained. This responsibility is based on the legal duty of the board of directors to establish and maintain sufficient accounting and financial control. The implementation of this control system may however be delegated to the management. There are no specific legal requirements regarding implementation. Measures taken will rather have to be customized to the individual characteristics of the company such as its size, complexity, business activity and financing.

The question whether the examination of the existence of an internal control system is a **new material element** of the auditors duties or not has triggered intensive discussions. The report of the Federal Council on the draft version of the new provisions does not mention this particular aspect of audit as a new duty of an auditor but rather as an aspect of an audit specifically mentioned in the law, and as such as an element of due diligence within the scope of the annual audit. If so, the novelty would not constitute a significant change of the status quo as auditors are using internal control systems as a basis for their examinations already today.

The Chamber of the Auditors and the big audit companies on the other hand take the view that the examination of an internal control system is a new task within the auditor's duty as defined by the law. It follows therefore that the internal control system ought to be scrutinised and tested in accordance with a defined audit strategy. In particular they consider it to be the auditor's duty to examine whether an internal control system is actually implied. The auditing companies therefore recommend the following procedure to small and medium sized companies with respect to the definition of their internal control system: The board of directors needs to define a certain amount of specific objectives with regard to processes containing elements of risks such as sale or purchase of products (e.g. how does the company ensure that deliveries are made only to solvent buyers). Having defined the respective processes, the methods by which such goals are attained in the daily business then have to be recorded. Such records provide the necessary basis for an auditor to confirm the existence of an internal control system.

Regardless of the question whether the law makers intended to introduce an additional task for the auditors or not, it might be unavoidable for companies to formalise and record their internal control systems with greater care in the future. Otherwise they run the risk that the auditor's report will contain reservations. Most companies with a state of the art organisation do have internal control systems already and will thus not be required to introduce new procedures. However, the duty to formalise and document the existing control system may cause considerable expenses in time and money. Practice will teach us to find individual and adequate solutions.

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