

# Audit Update

Revisions in the Swiss Auditing Act (CO) and New Supervisory Auditing Law (SAL)

AUDIT

February 2006

**Revisions in the Swiss Auditing Act (CO)** and the new **Supervisory Auditing Law (SAL)** have significant consequences for audited companies/organizations and their auditors. The changes will be effective as of 2007/2008.

## Content

Comparison Statutory Audit and Limited Audit	2
Amendments Code of Obligations (CO)	3
Risk Assessment and Internal Control System (ICS)	6
Auditors Supervision	7

Inofficial KPMG translation

The new Auditing Act and the new Supervisory Auditing Law will not only affect corporations, but other legal entities, in particular large corporations with limited liability, co-operatives, foundations and clubs. Potentially, over 300,000 privately held legal forms will be affected by the new auditing law.

A statutory audit is required for publicly held companies, larger companies as well as larger clubs and foundations. The auditing companies of these organizations will have more encompassing requirements. For the numerous small and middle size corporations, which total about 170,000, considerable relief will be granted in the form of a limited or even no year-end audit (opting-out). Corresponding relief will be valid for other legal entities.

The bills were mostly unchallenged during sessions of Parliament and were almost unanimously passed on December 16, 2005 by the representatives of the Cantonal and National Councils. The Federal Council will determine when the laws will come into force after the referendum deadline of April 6, 2006. This is expected to be July 1, 2007. Audits of year ends that start after July 1, 2007 would be subject to the new requirements.

Following is a detailed presentation of the most important changes and effects on audited companies.

## Comparison of a Statutory Audit and a Limited Audit

Statutory Audit (Art. 727 CO)	Limited Audit (Art. 727a CO)
<p><b>A) Similar Expressions</b> Full Audit</p> <p><b>B) Application (most important criteria)</b></p> <ol style="list-style-type: none"> <li>1) Publicly traded companies, characteristics:               <ol style="list-style-type: none"> <li>a. Ownership papers quoted on the stock exchange</li> <li>b. Outstanding bonds</li> <li>c. Participation of at least 20 percent in the assets or the turnover of the group financial statements according to letter a or b</li> </ol> </li> <li>2) Companies (including clubs and foundations), which exceed two of the following sizes in two consecutive business years:               <ol style="list-style-type: none"> <li>a. Balance Sheet sum of CHF 10 Mio.</li> <li>b. Annual Turnover of CHF 20 Mio.</li> <li>c. Annual average of 50 full time positions</li> </ol> </li> <li>3) Companies which must issue financial statements</li> </ol> <p><b>C) Professional Requirements</b> Strict requirements Publicly traded companies: Government supervision</p> <p>Recognized auditors (Art. 727b CO)</p> <p><b>D) Independence</b> High Standards (Art. 728 CO)</p> <p>Rotation of the lead auditor after seven years (Art. 730a CO)</p> <p><b>E) Objective and Scope of Examination</b> Largely comprehensive (Art. 728a CO)</p> <p><b>F) Auditors Report</b> Comprehensive audit report to the Board of Directors (detailed report) and short opinion to the general meeting (Art. 728b CO)</p> <p>Positively formulated confirmation in the audit opinion: «The financial statements are in accordance with law and statutes...»</p> <p><b>G) Reporting Obligation</b> Notify the court if there is an obvious insolvency or the Board of Directors is incompetent (Art. 728c Paragraph 3 CO)</p> <p><b>H) Entry in the Commercial Registry (Ordinance planned)</b> Name and domicile of the auditors with reference to the statutory audit</p>	<p><b>A) Similar Expressions</b> Review, limited or summary year end audit (limited audit)</p> <p><b>B) Application</b> Smaller companies / legal forms which do not fulfil the size criteria according to Art. 727 CO</p> <p><b>C) Professional Requirements</b> Less stringent when applied to professional practice</p> <p>Recognized auditors (Art. 727c CO)</p> <p><b>D) Independence</b> Reduced requirements (Art. 729 Par. 2 CO): Permissible to help in bookkeeping No requirement to rotate</p> <p><b>E) Objective and Scope of Examination</b> Brief, limited to specific audit procedures such as interviews, analytical audit procedures and related detailed tests (Art. 729a Par. 2 CO)</p> <p><b>F) Auditors Report</b> Short opinion to the general meeting (Art. 729b CO)</p> <p>Negatively formulated confirmation in the audit opinion: «... we have not come across any facts which would lead us to believe that the financial statements are not in accordance with law and statutes ...»</p> <p><b>G) Reporting Obligation</b> Same as statutory audit</p> <p><b>H) Commercial Registry Entry</b> Name and domicile of the auditors with reference to the limited audit</p>

## Amendments to the Code of Obligations (CO)

A far-reaching change in the new Auditing Act relates to the difference between a **statutory audit** and a **limited audit**.

According to Art. 727 Par. 1 und 2 CO, a **statutory audit** for **corporations** is required in the following cases (the same is valid for **companies with limited liability and cooperatives**):

1. Public companies; characteristics are:
  - a) Quoted ownership papers (stocks, certificates of participation, dividends)
  - b) Outstanding bonds
  - c) Subsidiaries with a participation of at least 20 percent in the assets or turnover in the combined group financial statements according to a or b
2. Companies which exceed two of the following sizes in two consecutive business years («economically significant companies», 5,000 to 10,000 in Switzerland):
  - a) Balance Sheet sum of CHF 10 Mio.
  - b) Annual Turnover of CHF 20 Mio.
  - c) Annual average of 50 full time positions
3. Companies which must issue financial statements (Art. 663e CO).
4. Stockholders representing 10% of the stock request an audit (Opting-up) (Art. 727 Par. 2 CO).
5. When the statutes provide for this (Art. 727 Par. 3 CO).
6. When the general meeting has decided upon it (Art. 727 Par. 3 CO).

Other circumstances can lead to a statutory audit (stake holder's request, for example upon the bank's request as a part of the loan contract, opting-in).

### **Independence requirements for auditors of a statutory audit**

According to Art. 728 CO, the following are not permissible with auditing clients:

- Membership on the Board of Directors, another management function in the company or a contractual employment agreement with the company.
- A direct or significant indirect participation in the stock of the company, or a significant claim or debt with the company.
- A close relationship of the lead auditor to a member of the Board of Directors, another person in management or to a significant stockholder.
- Participation in the bookkeeping as well as providing other services for which there is a risk in the position of auditor to have to audit some of their own work.
- Accepting work which would lead to economic dependence.
- Entering into a contract which is not consistent with market conditions or a contract where the results of the audit are linked to the interests of the auditors (for fees contingent upon success).
- Acceptance of valuable gifts or special advantages.

The statutory audit of a public corporation is performed by an auditing company which is supervised by the government and at other companies by recognized auditors.

**Clubs and foundations** are subject to a statutory audit based on the size criteria in line 2 (see page 3). Furthermore, the requirements for the auditors of corporations are fundamentally valid.

Statutory audits of all legal entities are subject to more **stringent independence requirements** according to the extended Art. 728 CO (see left).

The law prescribes the following **new audit area** for **statutory audits** (Art. 728 a Par. 1 line 3 CO):

The auditors examine whether ...

«An **internal control system exists** ...»

With this change, lawmakers have attributed much more significance to the ICS as an inherent part of the company's organization.

A **limited audit** is required according to Art. 727a CO when none of the criteria mentioned in line 1 to 6 are fulfilled. If all the stockholders agree, a company that has less than an annual average of ten full time jobs does not need to have an audit (Art. 727a Par. 2 CO, Opting-out).

The limited audit is performed by **recognized auditors**. The auditors are still obligated **to report bankruptcy** in the case of insolvency or if the Board of Directors take no action (Art. 725 Par. 2 CO).

A limited audit also requires the auditors to be independent. They can, however, participate in the bookkeeping and provide other services for the audited company. As far as there is a risk of auditing their own work, suitable organizational and personnel measures must be taken to ensure a reliable audit (Art. 729 Par. 2 CO).

The audit procedures are limited to interviews, analytical audit procedures, and related detailed test work (Art. 729a Par. 2 CO). The audit report to the general meeting contains a **negatively formulated confirmation** in the following manner:

*«We did not come across any facts during our limited audit, which would lead us to believe that the financial statements are not in accordance with law and statutes».*

## Risk assessment and internal control system (ICS)

### ICS Fitness Test

The following questions can help understand the **ICS** concept:

- Is there a documented assessment of the operative risks, as well as the risks in the area of internal and external financial reporting?
- Are the significant processes, the associated risks and the related controls documented and easy to follow? If not on what basis is the above mentioned risk assessment in particular, when related to processes of financial reporting, made?
- Where are the differences between today's, possibly historically evolved ICS in the company, and the generally accepted framework (for example COSO), i.e. which components of a suitable ICS are not, or are not adequately implemented at this time?
- Which companies/subsidiaries/branches in the country and out of the country need to be subject to these evaluations? How much time and which resources would be required for an ICS that is adapted to the company's size and complexity, including documentation?

**Risk assessment** and **internal control system** (ICS) are important components of effective corporate governance and have therefore received increasing attention from investors, creditors and other stakeholders. This is evident in the regulatory developments at an international level, (e.g. Sarbanes-Oxley Act, 8th EU-guideline) and now also in the Swiss legislation.

The new **Art. 663b CO** requires that the board of directors comment about **having done a risk assessment** in the notes to financial statements, which makes this area subject to audit (for statutory and limited audits).

As before, the Board of Directors (CO Art. 716a) are responsible for setting up and implementing a suitable ICS.

Today's auditing standards require that the auditors base their work on existing controls and include these in their audit. This ensures that auditing objectives such as the identification of risky areas, defining audit procedures are carried out using an audit approach which is as efficient as possible. What is new is that the auditor performing a **statutory audit** has to form an opinion about the existence of an **ICS** and possibly uncovered deficiencies.

Risk assessment and ICS can only then be subject to an independent audit if they are **documented**. In order for the auditors to be able to make a positive comment about the existence of an ICS, a company must have an ICS that is established and in use.

The amendments to the code of obligations are subject to the facultative referendum with a deadline of April 6 2006. It is expected that the Federal Council will put this into force on July 1, 2007. The requirements are valid for all business years, which start at the same time or after. It is expected that this will affect the majority of companies for the **business year 2008**.

Management should start thinking today about the effects that these changes in the law have for their organizations and should start implementing changes early enough.

## Auditing Supervision- Regulatory Changes

The new Supervisory Auditing Law (SAL) is a consequence of regulatory changes abroad, which have been implemented after companies collapsed and balance sheet fraud was uncovered.

Following such events, the **Sarbanes-Oxley Act 2002 (SOX)** was passed in the USA. Among other things, this regulates the government supervision of the auditors through the existence of the Public Company Accounting Oversight Board (PCAOB), which has been active since the end of 2003. The "big four" US auditing companies were registered with the PCAOB in October, 2003. Subsequently, the big Swiss auditing companies were required to register with the US PCAOB in June 2004.

This means that internationally, large auditing companies are more intensely supervised and regulated. This is evident in the stricter independent requirements and the additional inspections of auditors.

In March 2004, the EU commission reviewed a new, stricter 8th EU guideline about the supervision of the auditors through the European PCAOB. This guideline was accepted by the European Parliament at the end of 2005.

The extraterritorial interference of the US and other PCAOBs, should be minimized with a **Swiss PCAOB** (under the supervision of Federal Government). With this Switzerland wants to create an autonomous regulation and at the same time do something about the risk that foreign authorities would find out about confidential business of domestic companies. Whether the US PCAOB will grant the "Swiss PCAOB" the same recognition, is open at this point.

The SAA is subject to a facultative referendum with a deadline of April 6, 2006. It is not expected that a referendum will be taken. The Federal Council should put this into effect on July 1, 2007.

## Contact us

### Main Office

#### Günter Haag

Partner, Head of Audit  
KPMG Schweiz  
Tel. +41 44 249 2046  
Fax +41 44 249 2029  
ghaag@kpmg.com

#### For Questions about ICS / Risk Assessment:

#### Hans-Ulrich Pfyffer

Partner, Head of Internal Audit Services  
KPMG Schweiz  
Tel. +41 44 249 2777  
Fax +41 44 249 4963  
hpfyffer@kpmg.com

#### German Speaking Part of Switzerland

#### Reto Stalder

Head of Audit  
KPMG Aarau  
Tel. +41 62 834 4860  
Fax +41 62 834 4880  
rstalder@kpmg.com

#### Stefan Inderbinen

Head of Audit  
KPMG Basel  
Tel. +41 61 286 9318  
Fax +41 61 286 9401  
stefaninderbinen@kpmg.com

#### Christoph Andenmatten

Partner, Head of Audit  
KPMG Bern  
Tel. +41 31 384 7723  
Fax +41 31 384 7647  
candenmatten@kpmg.com

#### Markus Forrer

Partner Head of Audit  
KPMG Luzern  
Tel. +41 41 368 3759  
Fax +41 41 368 3888  
mforrer@kpmg.com

#### Kurt Stocker

Partner, Head of Audit  
KPMG St. Gallen  
Tel. +41 71 272 0056  
Fax +41 71 272 0051  
kstocker1@kpmg.com

#### Martin Schaad

Partner, Head of Audit  
KPMG Zürich  
Tel. +41 44 249 2026  
Fax +41 44 249 3311  
martinschaad@kpmg.com

#### Ingrid Marbacher

Partner, Head of Audit  
KPMG Zug  
Tel. +41 41 727 7439  
Fax +41 41 727 7400  
imarbacher@kpmg.com

#### French Speaking Part of Switzerland

#### Adrian Duerig

Head of Audit  
KPMG Fribourg  
Tel. +41 26 347 4931  
Fax +41 26 347 4901  
aduerig@kpmg.com

#### William Laneville

Partner, Head of Audit  
KPMG Genf  
Tel. +41 22 704 1624  
Fax +41 22 347 7313  
williamlaneville@kpmg.com

#### Stéphane Gard

Partner, Head of Audit  
KPMG Lausanne  
Tel. +41 21 345 0335  
Fax +41 21 345 3888  
sgard@kpmg.com

#### Stefano Ponta

Head of Audit  
KPMG Neuenburg  
Tel. +41 32 727 6137  
Fax +41 32 727 6158  
sponta@kpmg.com

#### Italian Speaking Part of Switzerland

#### Lorenzo Job

Partner, Head of Audit  
KPMG Lugano  
Tel. +41 91 912 1220  
Fax +41 91 912 1213  
ljob@kpmg.com

#### Liechtenstein

#### Hans Vils

Partner, Head of Audit  
KPMG Liechtenstein  
Tel. +423 237 7055  
Fax +423 237 7050  
hvils@kpmg.com