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GREEN PAPER

**THE ROLE, THE POSITION AND THE LIABILITY OF THE
STATUTORY AUDITOR WITHIN THE EUROPEAN UNION**

(presented by the Commission)

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1. INTRODUCTION

- 1.1 The requirement to have the annual and consolidated accounts of certain companies audited by a qualified professional, which was introduced for the Community as a whole by the Accounting Directives, is designed to protect the public interest. The assurance offered by audited accounts should enhance the confidence of all parties which are concerned with the affairs of companies. The increased transparency resulting from the harmonisation of the financial information published by companies together with the increased reliability of that information as a result of the audit by an independent and qualified professional were regarded as an important contribution to the completion of the Single Market.
- 1.2 The role of the statutory auditor has recently been the subject of much debate world-wide. As a result in particular of a number of important financial failures, questions have been raised concerning the function of the statutory audit and the independence of the auditor. At EU level, it has been difficult to respond to these questions because the regulatory framework which surrounds the statutory audit at EU level is incomplete. There is no common view at EU level on the role, the position and the liability of the statutory auditor. The absence of such a common view has a negative impact on audit quality and on the freedom of establishment and freedom to provide services in the audit field.
- 1.3 Against this background and in response to requests from the auditing profession, the Commission considers it desirable to organise a wide-ranging reflection on the scope and need for further EU level action in this area. Since the European Council of Birmingham, the Green Paper has become one of the privileged instruments for the consultation of Member States and interested parties. The present Green Paper is intended to raise the awareness of all interested parties in the issues at stake and to elicit their comments.
- 1.4 In drafting this document, the Commission took account of various studies which have been produced in this field at national and international level¹. The Commission itself launched a study on the role, the position and the liability of the statutory auditor, which was carried out by the Maastricht Accounting and Auditing Research Center (MARC), in order to establish a clear picture of the way in which the statutory audit is dealt with in the legislation of Member States. It is intended to discuss some of the issues raised in this document and the comments received at a Conference which the Commission is organising on 5 and 6 December 1996 concerning the role, the position and the liability of the statutory auditor.

¹ See bibliography annexed

1.5 After a short description of the existing regulation of the statutory audit at EU level and the reasons why renewed action at EU level may be justified, the document discusses the main issues relating to the role and the position of the statutory auditor, his liability, the audit in small companies, group audit arrangements and freedom of establishment and freedom to provide services in the audit field. Each chapter concludes with a short section suggesting possible priorities for action and ways and means to tackle the issues at EU level. It is particularly on those points that comments from interested parties would be welcome.

2. REGULATION OF STATUTORY AUDIT AT EU LEVEL AND NEED FOR EU ACTION

- 2.1 In accordance with the Fourth Council Directive (78/660/EEC) of 25 July 1978 on the annual accounts of certain types of companies, all companies covered by the Directive must have their annual accounts audited by a qualified professional. The statutory auditor must also see to it that the annual report is consistent with the annual accounts for the same financial year. Member States may exempt small companies as defined in the Directive from the obligation to have their accounts audited.
- 2.2 The Seventh Council Directive (83/349/EEC) of 13 June 1983 on consolidated accounts has extended the audit requirement to all entities which draw up consolidated accounts on the basis of the Directive. Similarly, the Council Directives 86/635/EEC of 18 December on the annual accounts and consolidated accounts of banks and other financial institutions and 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings have introduced a requirement for all entities covered by those Directives to have their annual accounts and consolidated accounts audited by a qualified professional.
- 2.3 Member States may only approve as auditors the persons who satisfy the conditions of the Eighth Council Directive (84/253/EEC) of 10 April 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents. The conditions of approval concern professional qualifications on the one hand and personal integrity and independence on the other.
- 2.4 While the Eighth Directive defines the minimum qualifications of the statutory auditor it does not contain any specific guidance concerning the independence requirement. At the time of adoption of the Directive, the Commission stated that this situation was not satisfactory and that they reserved the right to come back to this issue at a later stage. This has not yet been done. Similarly, the Proposed Fifth Directive concerning the structure of public limited companies and the powers and obligations of their organs, which contains provisions dealing with the appointment and dismissal of the statutory auditor, the audit fee, the audit report and the liability of the statutory auditor, remains on the Council table. Some of the issues concerned are regulated at national level or are the subject of self-regulation through the accountancy profession. There are however inevitable differences in the way they are dealt with and there is often no legislative backing.

- 2.5 The justification for EU interest and action in this area rests in the Single Market. The audited financial statements of a company established in a Member State are used by third parties in other Member States, such as investors, creditors and employees. These third parties not unreasonably assume a certain level of assurance and a certain coverage of the audit. Just as there have been pressures to standardise these aspects of audits at a national level, partly in response to market forces, there is also demand for some standardisation of these aspects of the audit at a European level. It would of course be necessary to ensure that any standards which are developed can be kept up to date in the face of changes emanating from the development of the Information Society
- 2.6 There are also arguments related to the free movement of services and freedom of establishment. Several studies launched by the Commission, notably on Competition in European Accounting completed in 1992 and on the Role, the Position and the Liability of the Statutory Auditor completed in 1996, have shown that there is not yet a European market in audit services and that important differences remain between the national laws and regulations of Member States which deal with the statutory audit.
- 2.7 The 1992 study concludes that the need for the service provider to be located in the same place as the client, coupled with various legal and professional obstacles, rules out true cross-border trade. Measures taken towards harmonisation and mutual recognition have some way to go in order to bring about significant changes in this situation. The 1996 study concludes that if there is to be a European market for audit services, initiatives are needed at EU level in two areas : freedom of establishment notably of audit firms and freedom to provide services in the audit field on the one hand and audit quality on the other hand. The report also concludes that differences between the liability regimes in the Member States are likely to have a negative impact on intra-Union trade in audit services.
- 2.8 Similar concerns were expressed in a position paper presented by the *Fédération des experts-comptables européens* (FEE) in February 1996. In this document the accountancy profession asks the Commission to look at a number of issues which are particularly relevant for them and on which they believe that action at EU level is necessary. These issues concern particularly the freedom of establishment of statutory auditors and the freedom to provide cross-border audit services, as well as professional liability.

- 2.9 Finally, the lack of a harmonised view at EU level concerning the role, the position and the liability of the statutory auditor risks becoming a serious handicap in the negotiations which are taking place at international level with a view of improving the access of the European companies to the international capital market. Last year, the Commission presented a Communication to the Council and to the European Parliament on "Accounting Harmonisation : a new strategy vis-à-vis international harmonisation" (COM(95)508). In this Communication, the Commission announced a new strategy which would allow global players in Europe to obtain capital on the international capital market without having to comply with different requirements on financial reporting. The Commission announced its support for the international harmonisation process led by the International Accounting Standards Committee (IASC) together with the International Organisation of Securities Commissions (IOSCO), aiming at the establishment of a core set of accounting standards which will be accepted in capital markets world-wide. Steps are being taken in order to increase the influence of the EU in this international accounting harmonisation process.
- 2.10 There is however a significant risk that the accounts and consolidated accounts prepared by European companies will not be accepted in international capital markets unless these accounts have been audited by an independent and qualified professional in accordance with auditing standards which are regarded as generally acceptable world-wide. The International Auditing Practices Committee of the International Federation of Accountants (IFAC) has developed a number of international auditing standards. The EU will have to decide whether it wants to support these standards and if so, how and on what basis the European influence in the development of international auditing standards can be increased.

3. THE ROLE OF THE STATUTORY AUDITOR

A definition of the statutory audit

- 3.1 Although the Fourth and Seventh Directives require annual and consolidated accounts to be audited by a qualified professional, the Directives do not contain a definition of the statutory audit. Similarly, the Bank Accounts and Insurance Accounts Directives require a statutory audit without defining what this means.
- 3.2 According to the definition adopted by the International Federation of Accountants (IFAC), the objective of an audit is to enable the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an identified financial reporting framework.
- 3.3 Numerous studies have shown that there are considerable differences between what the public expects from an audit and what the auditing profession believes that the auditor should do. The expectation gap resulting from this is a major problem for auditors since the greater the gap in expectations, the lower is the credibility and prestige associated with their work. It is an issue for the public at large, because the proper functioning of a market economy depends heavily on confidence in audited financial statements.
- 3.4 Any definition of the statutory audit should consider the needs and the expectations of users to the extent that they are reasonable, as well as the ability of the statutory auditor to respond to those needs and expectations.
- 3.5 As far as the needs and expectations of users are concerned, they can be considered reasonable if :
 - the tasks have been prescribed by law ;
 - there are stakeholders who are willing to pay for the service (i.e. there is an effective demand) ;
 - there exists a statutory auditor who is willing to supply the service (for a price which reflects notably his level of qualification, the difficulty of the task, the number of hours and the risk involved) and is competent to do so.
- 3.6 What statutory auditors can supply will depend not only on what clients are willing to pay for, but also on the auditors' technical skills and attitude to risk. Some of the demands placed on auditors may be unreasonable in that auditors cannot be expected to possess the skills necessary to do the work.

3.7 The public expects the statutory auditor to have a role in protecting the interests of shareholders, creditors (e.g. suppliers, banks and credit institutions), pensioners, employees and the public generally by providing them with reassurances concerning :

- the accuracy of financial statements
- the going concern status / solvency of the company
- the existence of fraud
- the respect by the company of its legal obligations
- the responsible behaviour of the company with regard to environmental and societal matters.

It is useful to examine briefly the reasonableness of these expectations.

The accuracy of financial statements

3.8 There seems to be a widely held view among users of financial statements, that an unqualified audit report guarantees the material accuracy of the financial statements.

3.9 There are two misconceptions inherent in this expectation. The first is that it is possible to prepare financial statements that are "accurate" and the second is that the financial statements are the responsibility of the auditor.

3.10 As to the first misconception, it is generally agreed among those who are well informed about accounting that financial statements cannot be "accurate" in the sense that there is only one set of figures that correctly expresses the results of a company's operations and its financial status. The choices available for the accounting treatment of complex business operations and the uncertainties implicit in management decision-making defeat any attempt to develop a set of financial statements that all informed observers would regard as "accurate".

3.11 In the EU, legal recognition that no set of financial statements can be uniquely "right" is embodied in the requirement that the annual and consolidated accounts should give a true and fair view, which is incorporated in the Accounting Directives. The strength of the true and fair requirement, which is an overriding principle in the Accounting Directives, is that it allows for the inevitably judgmental nature of many accounting figures.

- 3.12 There has been considerable criticism of auditors for not taking a stronger line when dealing with financial statements that comply "creatively" with the rules. When, in the auditors' opinion, the financial statements are misleading as a result of the directors' accounting choices and disclosure practices, auditing guidelines require the auditor to issue a qualified opinion that states clearly all the factors giving rise to the disagreement, the implications for the financial statements and, whenever practicable, a quantification of the effect on the financial statements. Moreover, when the auditor considers that the effect of the disagreement is so material or pervasive that the financial statements as a whole are misleading, auditing guidelines require him to issue an adverse opinion.
- 3.13 The second misconception is that it is the statutory auditor who prepares the financial statements and is responsible for them. On this issue there is no doubt that it is the Board of Directors and not the statutory auditor which has the responsibility to adopt financial statements (prepared by management) showing a true and fair view. It is the directors and not the statutory auditor which determine the accounting treatment and disclosure practices adopted in the financial statements. Directors are in the best position to know the affairs of their company, to maintain its records and to prepare its accounts. Auditors should be independent of and separate from the management and supervisory boards of their clients. Their duties would therefore seem quite distinct. They should state whether, in his view, the financial statements have been prepared in accordance with the law and whether they show a true and fair view.

The going concern status / solvency of the company

- 3.14 Several surveys have shown that there is an expectation on the part of a significant proportion of the general public that the statutory auditor's report guarantees the financial soundness of a company.
- 3.15 Annual accounts are prepared on the basis that the company will continue as a going concern. Directors are entitled to adopt this basis only if they are satisfied that this is indeed the case. (If it is not, different accounting rules apply.) Some countries are considering a requirement for directors to comment explicitly on the ability of the company to continue as a going concern and to take the necessary steps to ensure that such comment is well founded.
- 3.16 Auditors have a duty to be alert to factors that may increase the company's financial strength or decrease its resources, thus allowing them to assess whether the going concern basis is appropriate. They should warn the directors or supervisory board as soon as they become aware of matters that may threaten the going concern basis. Acceptance of the going concern basis implies solvency, that is, that at the balance sheet date the company's position was such that it would have been able to meet its liabilities in full as they fell due. Users expect the audit report to contain the auditor's opinion on solvency where the going concern basis is accepted.

- 3.17 Requiring this of the auditor would not relieve directors of the responsibility placed on them by company law for determining whether or not a company is solvent, nor mitigate the seriousness of their offence were they to continue trading while it was insolvent². Directors' responsibilities are a continuing one, while the auditors' opinion is based on the position as seen at a particular date.
- 3.18 Auditors need to be cautious in the way they report publicly any concerns that they may have. Continuance of a company may depend upon the rest of the world not knowing that its status as a going concern is open to any doubt. If, for example, auditors report that a company will continue as a going concern only if the bank continues to roll over its loans and its suppliers continue to grant normal periods of credit, this may result in the bank insisting on immediate repayment and the suppliers insisting on cash on delivery.
- 3.19 On the other hand, some companies might still be in existence and shareholders' and creditors' money saved if problems had been identified earlier. Moreover, there are examples of companies that are able to continue trading despite its being public knowledge that they suffer from liquidity problems and are subject to discussions about financial reconstruction. Indeed, certain studies have found, comparing a set of companies having a going concern qualification with a matched set having no qualification that the survival rates were indistinguishable.
- 3.20 Some Member States have laid down specific procedures² to be followed by directors and auditors when the going concern assumption is called into doubt. Different reports on corporate governance focus on this issue and some propose that directors should provide auditors with a written statement confirming that, in their view, the company will remain a going concern for the twelve months from the date the directors approve the financial statements. The directors should provide the auditors with evidence to support that view. Auditors will have a responsibility to perform procedures specifically designed to test the directors' view that the company is a going concern. The Cadbury Report³ and the Vienot Report³ propose that directors should be required to satisfy themselves that the going concern assumption is reasonable and that they should report accordingly to shareholders. Auditors should have a responsibility to test the directors' view that the company is a going concern and to give their opinion on the matter.

² These procedures go beyond what is presently required by virtue of Article 17 § 1 of the 2nd Council Directive (77/91/EEC) of 13/12/1976 which states that in case of a serious loss of the subscribed capital, a general meeting of shareholders must be called to consider whether the company should be wound up or any other measures taken.

³ See Bibliography annexed.

3.21 Although neither the directors nor the statutory auditors can guarantee the continuing financial soundness of a company, it seems reasonable to expect the directors to state publicly whether in their judgement, given the trading environment in which the company is operating and expects to operate, adequate financial resources are available to enable it to remain a going concern for at least twelve months from the day the directors adopt the financial statements. It seems equally reasonable to expect the auditors to carry out procedures aimed at testing the directors' stated judgement and to report publicly on the result of such tests.

The existence of fraud

3.22 Audits have traditionally been associated with the detection of fraud. A survey carried out in the UK in 1989 found that 75% of the general public, including the majority of financially knowledgeable people, think that it is the statutory auditor's responsibility to detect fraud of all kinds. The same survey found that 61% of the general public think that it is the responsibility of the auditor actively to search for fraud.

3.23 Until recently the standard auditor response was to say that the auditors' prime role is not to prevent or detect fraud and that this is in any event impossible. It was not until the 1980s that in some Member States, legislation sought to make explicit reference to fraud reporting / detection as an audit objective. Since that period, governments have become particularly concerned with issues of law and order, white collar crime and investor protection following well-publicised affairs that made press headlines in several Member States.

3.24 Regulatory bodies in a number of Member States have issued auditing guidelines related to the statutory auditor's responsibility in relation to fraud, other irregularities and errors. The guidelines specify the respective responsibilities of management and of the auditor. Management has primary responsibility for the detection of fraud, other irregularities and errors. This responsibility is seen as part of management's stewardship role. The auditor's responsibility is to plan, perform and evaluate his audit work so as to have a reasonable expectation of detecting material misstatements in the accounts, whether they are caused by fraud, other irregularities or errors.

3.25 The guidelines recommend that if, during the course of the audit, the statutory auditor begins to suspect fraudulent activity, he has a responsibility to investigate until his suspicions are either allayed or confirmed. In some Member States it is recommended that the auditor promptly report to senior management all fraud detected during the audit, even if the effect of the fraud is not material in the context of the company's financial statements. The only circumstances in which auditors should not so report is when they suspect senior management is involved in the fraud. In these circumstances the auditor should report the matter to an appropriate authority. In some Member States, statutory auditors are required to report to the Ministry of Justice.

- 3.26 Auditing guidelines suggest that the auditor may need to take legal advice before making a decision on whether the matter should be reported to a proper authority in the public interest. The difficulty for auditors is that normally they will have to make a decision based on their suspicions of fraud rather than on proven facts. If they report their suspicions to a third party and are subsequently unable to establish firm evidence of fraud they may be liable to legal action.
- 3.27 In the financial sector, auditors' responsibilities in this regard have been clarified, in most Member States, by legislation which releases auditors from their obligations of confidentiality to their client organisations and give them the right but not the obligation to report to a regulatory body.

It is now specifically provided for in Article 5.1 of a Council Directive 95/26/EC adopted in June 1995 that the statutory auditor of a financial undertaking" shall have a duty to report promptly to the competent authorities any fact or decision concerning that undertaking of which he has become aware while carrying out that task which is liable to :

- constitute a material breach of the laws, regulations or administrative provisions which lay down the conditions governing authorisation or which specifically govern pursuit of the activities of financial undertakings, or
- affect the continuous functioning of the financial undertaking, or
- lead to refusal to certify the accounts or to the expression of reservations ; ..."

This Directive also provides in its Article 5.2 that : " The disclosure in good faith to the competent authorities, by persons authorised within the meaning of Directive 84/253/EEC (the statutory auditor), of any factor or decision referred to in paragraph 1 shall not constitute a breach of any restriction on disclosure of information imposed by contract or by any legislative, regulatory or administrative provision and shall not involve such persons in liability of any kind".

This Directive is to be implemented in all Member States by July 1996

- 3.28 If the fraud is material, statutory auditors need to ensure that the financial statements reflect the effect of the fraud and that all necessary details are disclosed. Provided the auditors are then convinced that the financial statements give a true and fair view, it is not necessary to qualify the audit report. If the fraud is not material in the context of the financial statements, it is the responsibility of the directors to decide whether disclosure is necessary. However, since undetected material fraud will result in financial statements which do not present a true and fair view of the company's affairs, it would seem that auditors have a duty to employ the means which they think are necessary to detect material fraud if their opinion is to be valid.

3.29 The public expects the opportunities for fraud to be minimised. It seems reasonable to expect the Board of Directors to take responsibility for setting up and maintaining systems of internal control that, inter alia, minimise the opportunities for fraud and maximise the likelihood that any such fraud will be quickly detected. It seems also reasonable to expect statutory auditors to confirm in the audit report that such systems of internal control exist and to say whether or not they appear well designed to serve their purpose. In the same way, it would appear reasonable to expect auditors to support the directors in their attempts to prevent and detect fraud by reporting to the directors any weaknesses they may have identified in these systems of internal control and any suspicions they may have in regard to fraud.

The respect by the company of its legal obligations

3.30 It appears to be the general view that it is the auditor's duty to detect contravention of company law or of statutory regulations which specifically relate to company law. The auditor cannot however be reasonably expected to report on matters beyond his competence or expertise, especially in today's complex legal environment.

3.31 The directors should take responsibility for setting up and maintaining systems of internal control that, inter alia, minimise the opportunities for committing illegal acts in the name of the company and that maximise the likelihood that any such illegal acts will be quickly detected. It would seem reasonable to expect the statutory auditor to confirm in his audit report that such systems of internal control exist and to say whether or not they appear well-designed to serve their purpose.

3.32 In addition, as part of their responsibility to prepare financial statements which show a true and fair view, directors must ensure that the statements reflect the financial implications of illegal acts detected, if these implications are judged to be material. The statutory auditor, as part of his responsibility to express an opinion on whether the financial statements give a true and fair view, must confirm that the statements reflect the financial implications of any such illegal acts.

Responsible behaviour by the company with regard to environmental and societal matters

3.33 There have been demands over recent years for companies to be subject to an audit of their social behaviour, most notably in respect of the physical environment but also in terms of employment practices, safety of operations, trade sanctions, product development policies and other issues of concern to the general public and to particular interest groups.

- 3.34 Without entering into the merits of such an audit or audits, it might be asked whether the statutory auditor has appropriate qualifications and experience to carry out this work, or whether it should be a separate exercise from the statutory audit and be carried out by qualified experts in the area(s).
- 3.35 Although it is unreasonable to expect the statutory auditor to make judgements on matters outside his competence and expertise, it can be argued that auditors should accept that their responsibilities will tend to increase in line with public expectations. The auditor can, given time and a sufficiently clear consensus on what is expected, avail himself of the necessary expertise in areas which go beyond strict financial audit.

Priorities for action and possible methods

- 3.36 The absence of a common definition of the statutory audit in the EU creates a damaging expectation gap. A common approach to the statutory audit, taking account of the latest developments at international level, seems desirable. If the audit is to add confidence to published financial statements, users need to know what the audit certificate means in terms of assurance. In this regard, particular attention should go to the role of the auditor in respect of the going concern status of the company and the action to be undertaken by the auditor in case of fraud and other illegal acts.
- 3.37 Consideration should be given to what extent existing International Standards on Auditing could be the starting point of a common definition of the statutory audit. Full account would also need to be taken, however of any particularities which distinguish the European from the international environment.
- 3.38 To be effective, the common definition would need to become part of the regulatory framework in all Member States. It is for consideration whether an EU Directive would be needed to achieve this result or whether a Recommendation would suffice. In either case, due attention would need to be paid to flexibility, so that any legal requirement can easily be adapted to the rapidly changing environment in which the auditor operates.

The audit report

Contents of the audit report

- 3.39 The audit report is the medium through which the statutory auditor communicates with shareholders, creditors, employees and with the public at large. It is the result of the audit process. Usually, a distinction is made between a "long form" audit report and a "short form" audit report. The "long form" report is addressed to management and is not normally made available to the public.
- 3.40 Although the content of the audit report is not prescribed under the Accounting Directives, company law in most Member States has specified the matters which have to be included in the published audit report. Professional bodies in all Member States have established standard forms of published audit reports. However, only three Member States have made it a binding rule that those standard forms be used.
- 3.41 In general, the audit report concerning the annual accounts in Member States would normally contain the following information :
- whether the auditor has obtained all the information and explanations which, to the best of his knowledge and belief, are necessary for the purposes of his audit ;
 - whether, in his opinion, proper books and records have been kept by the company ;
 - whether the annual report is consistent with the annual accounts ;
 - whether the annual accounts give a true and fair view of the company's assets, liabilities, financial position and profit or loss ;
 - whether the annual accounts comply with the requirements of company law ;
 - whether the audit was carried out in accordance with auditing standards.
- 3.42 Looking at the audit reports of the largest listed companies in Member States, one could say that, in their present form, users can derive comfort only from the absence of a qualification to the financial statements. They give users no help in understanding what the auditors, who are appointed by shareholders and report to them, actually do in return for the audit fee paid to them. Without this information, it is difficult to see how investors and other users can form a conclusion with any degree of confidence on the weight they can place on the auditors' opinion.

- 3.43 There seems to be a general consensus that more information should be given about the scope and nature of the work on which the audit report is based. Users very often consider the audit report as an assurance or a certificate for their decision making. It is necessary that the audit report clearly states the auditor's responsibilities for reporting on the financial statements.
- 3.44 The results of recent surveys have shown that harmonisation of the form and the wording of the audit report has increased in the EU over the last ten years. This is to a large extent the consequence of a more widespread and consistent adoption of the relevant International Standard on Auditing. Differences still exist however between Member States with regard to the wording and the coverage of the standard short form statutory audit report. These differences have a single market impact to the extent that they reduce the utility of reports issued in other Member States. In principle, where similar statutory audit work has been performed, this should be clearly communicated by way of similar wording in the audit report.

Priorities for action and possible methods

- 3.45 Once an agreement has been reached on the definition of the statutory audit, it should be easier to agree on the minimum content of the audit report. Because the audit report is the medium through which the statutory auditor communicates with shareholders, creditors, employees and with the public at large, it seems desirable that a similar wording in the audit report is used throughout the EU.
- 3.46 In several Member States the wording of the audit report has been adapted to that developed by the International Federation of Accountants. It is for consideration to what extent this could also be the starting basis for a common definition at EU level. Proper attention would however need to be given to any particularities which distinguish the European from the international environment. In order to reduce the expectation gap, it would be necessary for the audit report to provide more information on what the auditor has actually done, which professional standards he has applied in carrying out his task and whether the financial information prepared by the company conforms with legal and other regulatory requirements. It would also be necessary for any reservations which the auditor might have to be clearly spelled out in his report.

3.47 As for the definition of the statutory audit, it seems necessary for the common definition of the audit report to have legislative backing in the Member States. It is for consideration whether this points to binding legislation (i.e. a Directive) at the EU level, or whether a Commission Recommendation would be enough. Due attention must in any case be paid to flexibility, so that any legal requirement could be easily adapted to the rapidly changing environment in which the auditor operates, in particular developments related to the introduction of new information technologies.

4 THE POSITION OF THE STATUTORY AUDITOR

The competence of the statutory auditor

Competence in the Eighth Directive

- 4.1 There can be no doubt that the demands put on the statutory auditor require this auditor to be a highly qualified professional. This is the reason why the Eighth Directive of 10 April 1984 on the approval of persons responsible for carrying out the statutory audits of accounting documents has put the competence of the statutory auditor at a very high level indeed.
- 4.2 However, differences in the educational systems of the Member States cannot be ignored. These were a source of difficulties when attempts were made at the time of implementation of the Directive to compare national educational levels in the Member States. As a result, the accounting profession in Europe has stressed the need for professionals who want to offer cross-border services to acquire the host country professional title.
- 4.3 Although the Eighth Directive has led to some harmonisation in this field, there are still important differences. There is at present no common understanding about the contents of the different courses which are listed in Article 6 of the Eighth Directive and which are part of the test of theoretical knowledge. The lack of a common understanding became clearly apparent when new Member States joined the EU and when Central and Eastern European countries asked for technical assistance for the establishment of training programmes for auditors.
- 4.4 The development of information technology is likely to have important consequences for the audit function. It is sometimes seen as a threat to auditors, because of the diminishing importance of published financial statements to investors who may be able to obtain financial information on a permanent basis through different means. It can however also offer new opportunities, in terms of new attest functions associated with the new information flows, systems and types of information that reporting entities will provide to users as the information era moves forward. This is bound to have implications for the educational requirements which are presently included in the Eighth Directive and which were established taking account of the audit function in a different technological environment. For this and other reasons, it may be necessary to adapt or clarify Article 6 of the Eighth Directive.

Priorities for action and possible methods

- 4.5 It is regrettable that neither the accounting profession, nor the academic community have taken any concrete steps to clarify the competence requirements listed in the Eighth Directive. It would appear that the definition of a curriculum for the education of auditors should be primarily a task for those who are directly involved in the educational process. More harmonisation in this field would certainly facilitate the application of the Mutual Recognition Directives (see also section 8). In this context, it should be evident that the training process must prepare the auditors to operate in a Single Market. Such an initiative at European level could be undertaken for instance in the framework of the new Community programme SOCRATES and in particular Chapter I - ERASMUS, Action 1.D on University co-operation projects on subjects of mutual interest ("Thematic Networks"), which provide a reflection forum involving representatives of the socio-economic and professional world in specific subject study areas, including those of other countries participating in these programmes.
- 4.6 Updating the list of courses included in Article 6 of the Eighth Directive will require an amendment to the Directive. If and when that is considered opportune, consideration should be given to the introduction of a procedure which will allow it to be further amended in future without passing through the full legislative procedure.

The independence of the statutory auditor

Definition of independence

- 4.7 In accordance with the Eighth Directive, the statutory auditor must be independent. At the time of adoption of the Directive, it was impossible to agree on a common definition of independence. As a result, this subject has been dealt with differently by Member States.
- 4.8 As pointed out by FEE⁴, independence is the main means by which the statutory auditor demonstrates that he can perform his task in an objective manner. In dealing with independence, it is necessary to address both independence of mind, i.e. the state of mind which has regard to all considerations relevant to the task in hand and independence in appearance, i.e. the avoidance of facts and circumstances which are so significant that an informed third party would question the statutory auditor's objectivity.

⁴ See bibliography

- 4.9 In recent years, concern has been expressed about the threats which have developed to auditors' independence. Several surveys reported on the fact that companies were increasingly prepared to challenge auditors, to shop for opinions, to seek legal advice on auditors' views and to change auditors. Some reports concluded that, given the competitive pressures, it would be idealistic to assume that all auditors are at all times unmindful of the risk of losing business. Criticism has been voiced that the professionalism of the audit function has diminished in favour of a more "businesslike" attitude.
- 4.10 Moreover, it has become, more common for the audit to be put out to tender. The principal objective in seeking competitive tenders is to obtain the services of the auditors as cheaply as possible. It is sometimes suggested that management resort to tendering in order to put pressure on the incumbent auditors, particularly when disputes have arisen.
- 4.11 The growing intensity of competition for audit "business", and especially for the audit of large "prestige" companies, is also a cause of concern. There is no doubt that competition sometimes results in low-cost and perhaps even below-cost tenders. The procedure of calls for tenders which ensures transparency and competition, should not have as a consequence that auditors quote an audit fee which does not allow them to carry out their work in accordance with professional standards⁵. Some observers infer that the successful tenderers expect to recoup the balance of the full cost of the audit from non-audit consultancy services. This points to another concern which relates to the provision of non audit services.
- 4.12 The question whether the auditor should provide other services to his audit client has been the subject of much debate. It has been advocated that the provision of other services to an audit client is likely to increase the auditor's understanding of the client's business and operations and therefore results in a better audit. It has also been argued that there is no evidence that the volume of non-audit fees in relation to the level of audit fees is a threat to objectivity. Nevertheless, there is an equally strong belief that the provision of a broad range of non-audit services to an existing audit client can impair audit objectivity. Safeguards are necessary to respond to these concerns.

⁵ In the case of public procurement, the Council has adopted a set of rules assuring transparency in competition for the award of public entities contracts. These rules also apply to audit services. See Directives 92/50/EEC and 93/38/EEC - Annex 1A - Category 9.

- 4.13 Such safeguards could consist in confining the provision of other services to those whose nature and quality are consistent with the auditor's professional image and which are unlikely to impair his objectivity, or in requiring the fee for both audit and non-audit services to be disclosed. A solution which would consist in preventing the auditor from providing any other service to his audit client would clearly solve the appearance problem. However, practice has shown that this solution is not a viable alternative, as it is too easy to circumvent by having the service provided by an affiliated or associated firm.
- 4.14 In all cases the auditor should ensure that he and his firm are not involved in the management or decision making of his client. The auditor should not be engaged in the preparation of the financial statements of his client, be involved in the valuation of assets or liabilities for purposes of recording them in the financial statements, act for the client in the resolution of litigation which may have a material impact on the financial statements, or perform services having a direct impact upon senior management such as their recruitment.
- 4.15 Some commentators find cause for concern where a company retains the same auditors for a long period. It is argued that this can lead to too close and cosy a relationship with management, with the auditors becoming too responsive to management's wishes. The question whether the statutory audit should be made subject to a system of mandatory rotation has been the subject of considerable debate. The arguments in favour of such a system are not conclusive. In this context, it is important to note that one of the two Member States which had a system of mandatory rotation has recently abolished it. A solution which could enhance the perception of the auditor's objectivity, without causing the efficiency and quality drawbacks of firm rotation, could consist in setting up a rotation of audit partners within the same firm.

Priorities for action and possible methods

- 4.16 Independence is an important issue. Based on different traditions and experiences, this issue is dealt with differently in Member States. It is unlikely that it will be possible in the short term to agree at EU level on a common definition covering the various issues raised in relation with auditor independence. The adoption of a set of rules which regulate independence does not by itself bring about independence in practice. However, agreement on a common core of essential principles in all Member States would constitute an important step towards the establishment of an internal market for audit services. These principles could be developed by the profession at EU level.
- 4.17 It is for consideration which instrument is most appropriate to ensure that an agreement reached at EU level is likely to be adhered to in practice.

The position of the statutory auditor within the company

The statutory audit and corporate governance

- 4.18 The statutory audit is an essential element of the system of corporate governance. In order to put the statutory audit in the right perspective, it is necessary to distinguish the role of the various organs of the company in the field of financial reporting. While the directors are responsible for the preparation of the financial statements, the role of the statutory auditor is to report to the shareholders on the financial statements presented to him by the directors. In doing so, the statutory auditor acts in the interests of the shareholders who have a financial stake in the company. In addition, his report lends credibility to the financial information used by third parties.
- 4.19 Because the shareholders have the most direct interest in the outcome of the statutory audit, all Member States have given the right to appoint and to dismiss the auditor to the shareholders in the general meeting. However, for the shareholders of most listed companies, as a result of their large numbers and transient nature, there is no effective mechanism for them to do so. It is usually the directors who effectively appoint and dismiss the statutory auditor, with the decision merely being ratified by the shareholders at the annual general meeting. A consequence of this is that statutory auditors are criticised for not being independent of the directors. It is argued that, in disputes between the directors and the statutory auditor on issues such as accounting policy choices, the statutory auditor has an incentive to concede to the wishes of the directors. The statutory auditor may be put in a particularly difficult position in such disputes if the directors have gathered opinions from competing firms of auditors.
- 4.20 It is argued that another result of the auditors being effectively appointed by the directors is that, due to cost pressures, both parties have reduced the role of the statutory audit to the minimum necessary to fulfil the legal requirements of company law as interpreted by the auditing firms themselves. It is argued that this has led to less attention being given by the statutory auditors to the assessment of the efficiency and effectiveness of companies' internal control systems, which could lead to an increased incidence of fraud and other illegal acts.
- 4.21 The agreement of the statutory auditors' remuneration with the directors creates a further problem. The audit fee is normally agreed in advance and is based on the usually valid assumption that the auditors will not find any evidence of malpractice. However if, in the course of their work, the auditors become suspicious that there has been fraudulent activity that they feel should be subject to further investigation, they will have to agree with the directors a fee for this additional work. If the directors are involved in the malpractice, the statutory auditor finds himself in a very difficult situation.

- 4.22 In order to preserve the independence and objectivity of the statutory auditor, procedures giving greater assurance that the shareholders are able to make a real choice, for instance through a greater use of audit committees and/or reforms of board procedures or through the association of other parties, such as the workers council in the appointment and dismissal of the auditor, have been developed or are currently been examined in certain Member States.
- 4.23 Both the Cadbury report in the United Kingdom and the Vienot report in France recommend that the board of directors in listed companies should establish an audit committee of at least three non-executive directors, chaired by one of their members. Since 1978, the New York Stock Exchange has required all listed companies to have audit committees composed solely of independent directors and the 1987 report of the American Treadway Commission⁶ concluded that audit committees had a critical role to play in ensuring the integrity of US companies financial reports. Experience in the United States has shown that, even where audit committees might have been set up mainly to meet listing requirements, they have proved their worth and developed into essential committees of the board of directors.
- 4.24 However, it is likely that companies without a strong internal audit function will be unable to provide an audit committee with sufficient information to fulfil its responsibilities. The scope of the work of the statutory auditor and the timing of the statutory audit are unlikely to be adequate and appropriate for this purpose. Furthermore, the statutory audit is essentially a snapshot at a particular point in time whereas assessment of the effectiveness of a company's management information systems and systems of internal control should be undertaken on a continuous basis. Consequently, recommendations have been made for the appointment in major companies of a chief internal auditor to lead a strong internal audit team that is capable of providing the audit committee with sufficient information to fulfil its responsibilities on behalf of the board. As stated by the European Confederation of Institutes of Internal Auditing in their position paper on Internal Auditing in Europe⁷, the furnishing of objective and timely appraisals of the quality of an organisation's internal control and systems for managing business risk, would contribute significantly to strengthening management's control of the operations, thus contributing to sound corporate governance. In their view, it is necessary for the EU to introduce binding legislation for significant enterprises and sectors requiring the establishment of a professional internal auditing function and regulating qualifications and experience required, as well as the duties of the Board and Chief Executive in relation to internal audit conclusions and recommendations.

⁶ See bibliography

⁷ See bibliography

- 4.25 In Member States, the length of the statutory audit appointment varies from a fixed period of 1 year to 6 years to an indefinite period. In the Amended Proposal for a Fifth Council Directive it is proposed that the statutory auditor should be appointed for a specified period of not less than three financial years, and not more than six financial years.
- 4.26 The 1996 study carried out for the Commission shows that the position of the statutory auditor within the company is not the same in all Member States. Differences range from an external adviser to an organ of the company. In some cases there even exists a dual audit requirement, which means that in addition to the statutory audit requirement following from the Accounting Directives, there is another audit imposed by the Stock Exchange Regulatory Authority. It is not clear that such a system offers any advantages in terms of improved control. On the other hand, it can lead to confusion concerning the relative status of the different auditors, especially if they come to different conclusions concerning the same company.

Priorities for action and possible methods

- 4.27 Recent debates about corporate governance have stressed the need to define more clearly the role of the board of directors in preparing the financial statements. The issue is however much more complicated and extends to defining the role of all parties involved in the financial reporting process (board of directors, supervisory board, general meeting of shareholders, auditor). In order to improve the system of checks and balances within the company, more attention should be paid to issues such as the creation of an audit committee and the establishment of a proper functioning system of internal control.
- 4.28 It is difficult to deal at EU level with matters of corporate governance : past efforts to harmonise law on the structure of the company have not succeeded. In order to contribute to the debate at national level, it might be useful to consider a Recommendation at EU level on possible ways to improve the present system of corporate governance, especially in as far as it relates to financial reporting. It would then be up to Member States to initiate any necessary legislative action at national level.

The role of governmental and professional bodies

Quality control

- 4.29 In accordance with the Eighth Directive, auditors must be approved by an authority designated by Member States. This authority must see to it that the persons approved as statutory auditors satisfy all the requirements imposed by the Directive and that they carry out audits in accordance with the principles of professional integrity and independence.

- 4.30 Most Member States have delegated the authority to approve the statutory auditor to one or more professional associations. In such cases, it is important that these associations also supervise the way in which their members conduct the audit. Most of these associations have developed professional rules describing the way in which the audit has to be carried out. These auditing standards are often inspired by the standards developed by IFAC. This is not, however, the case in all Member States and these auditing standards, where they are applied, are in most cases only a recommendation and not a legal requirement. There is at this stage therefore no guarantee that the statutory audits carried out by professionals approved on the basis of the Eighth Directive are of equivalent quality.
- 4.31 Similarly, the way in which professional associations supervise their members is not the same. While some associations have organised peer review systems, whereby the work of an auditor is at regular intervals reviewed by another auditor, other associations have set up a special unit responsible for reviewing the way in which members carry out statutory audits. Here again, there is no guarantee that quality review systems in the various Member States are equivalent, or even adequate.
- 4.32 Some Member States have decided not to delegate the authority to approve auditors to a professional association but have this task carried out by a Ministry or by another body, such as a Chamber of Commerce. In this case too, appropriate arrangements need to be made to ensure that there is quality control and that actions are undertaken in cases where the auditors do not carry out their tasks in accordance with the principles of professional integrity and independence.
- 4.33 In most Member States, special audit requirements apply to companies in the financial sector which are subject to prudential control by a competent authority. These additional requirements have been set up to ensure the protection of investors and policyholders. In addition, Member States may authorise exchanges of information under strict conditions and between the competent authorities of the financial sector and the professional body of the statutory auditor, according to paragraphs 1 and 2 of Article 4 of Directive 95/26/EC.

Priorities for action and possible methods

- 4.34 The absence of a legal requirement at EU level that all statutory audits conducted on the basis of Community law must be carried out on the basis of an agreed set of auditing standards is a handicap for the Single Market and in the international context. It should be examined whether the standards on auditing developed by the International Auditing Practices Committee of the International Federation of Accountants and already applied to a certain extent in most Member States could provide a possible basis for agreed standards at EU level. As with international accounting standards, it would seem necessary to devise a mechanism to determine whether existing IFAC standards meet European requirements and to ensure increased European influence in the development of international auditing standards.

- 4.35 Such a mechanism at EU level could bring together all parties involved at national level in the definition of auditing standards and could discuss all relevant auditing matters. It would be important that an assurance be obtained that any auditing standards agreed upon at EU level were actually being followed in practice at national level. This might be difficult to achieve without giving those standards some kind of legal backing.
- 4.36 Even if a code of principles on auditor independence and a core set of auditing standards can be agreed upon, the system will only be effective if the standards are enforced and if there is appropriate quality control. If a mechanism were set up at EU level, as suggested above, one of its tasks could also consist in examining the way in which quality control in the audit field is assured in the various Member States. Within the context of the Single Market, it is also important that the regulatory authorities in Member States communicate with each other. The rules of professional secrecy should not present any obstacle to this.

5. AUDITOR'S CIVIL LIABILITY

Towards a limited liability ?

- 5.1 Professional liability is an important issue for auditors. In some Member States, audit firms have been made responsible in a number of cases for amounts which were disproportionate with the audit fee and with the auditor's direct responsibility for the financial failure. The auditor usually disposes of professional indemnity insurance and there is a tendency to sue by preference the party whose professional liability has been insured.
- 5.2 There are major differences as to the liability regime of the statutory auditor within the EU. In some Member States, there exists a legal civil liability cap, limiting the amount of damages that the statutory auditor might have to pay in the case of litigation. In other Member States, auditors can limit their liability by contract. Differences also exist regarding the possibility for the courts to limit the amount of damages in the case of litigation.
- 5.3 Various suggestions have been made in order to arrive at a regime which could be regarded as more equitable to the auditor. These suggestions include the generalisation of a legal liability cap, the possibility for the auditor to limit his liability by contract, the incorporation of the audit firm into a limited liability company, the introduction of proportional liability and the introduction of mandatory professional insurance for auditors and for directors.
- 5.4 The original proposal for a Fifth Company Law Directive provided for unlimited liability of the statutory auditor to third parties. The amended proposal contains no provision directly imposing upon the statutory auditor a liability to third parties, but provides for liability of the auditor only to the audited company, stating that these provisions do not in any way exclude an auditor's liability to shareholders and third parties under the general private law of the Member States. During the negotiation of this proposal in the Council of Ministers working group, the text was further clarified by stating that it is up to the Member States to regulate the civil liability of the persons responsible for the statutory audit so as to ensure that compensation is made for any damage sustained by the company, any shareholder or third party as a result of wrongful acts committed by the auditors in carrying out their duties. Member States could however allow the limitation by law or by contract of the civil liability to the audited company on the basis of negligence. Discussions on the Fifth Directive were however discontinued in 1991.

5.5 Meanwhile, it cannot be denied that the existence of different liability regimes in Member States has internal market consequences. As a result of an extensive liability regime, audit firms may avoid high-risk clients or even entire industries, calling into question the very rationale for a compulsory statutory audit. Costs of statutory audits to clients in highly litigious Member States may be higher than elsewhere. Insurance premiums throughout the EU might become more expensive as a result of litigation in some Member States. This might lead to a further concentration of the audit market in the hands of a limited number of audit firms. To the extent that there exists a legal or contractual liability cap only in some Member States, there might be a tendency to sue the auditor preferably in those Member States where there is no such liability cap.

Priorities for action and possible methods

- 5.6 There can be no doubt that the clarification of the role and the position of the statutory auditor would have a positive effect on the assessment of his liability in the case of an audit failure. Whilst there does not seem to be a reason to confine the liability of the auditor to the audited company - as the statutory audit has been required in the public interest - it would seem reasonable that the liability of the auditor should be limited to amounts which reflect his degree of negligence.
- 5.7 Action at EU level in this field is likely to be difficult. The audit profession is not the only profession which is struggling with problems of liability. Furthermore, the legal traditions in Member States in the area of civil liability are quite different. It is for consideration whether the negative effects of a continuation of differences in the regulation of audit liability are significant enough to justify EU action, considering the difficulties which such action is likely to face and the possible discrimination which action specific to the audit profession might entail as regards other professions.

6. THE STATUTORY AUDIT IN SMALL COMPANIES

The small company audit

- 6.1 In accordance with Article 51(2) of the Fourth Directive, Member States may relieve small companies, as defined in Article 11⁸, from the requirement to have their annual accounts audited by a qualified professional. Important reasons for this exemption were the wish not to create an additional burden for small companies but also the risks involved in a small company audit, where the auditor can rarely rely on appropriate internal control mechanisms. Where the exemption has been granted, Member States must introduce appropriate sanctions in order to ensure that the annual accounts and the annual report are prepared in conformity with the requirements of the Directive.
- 6.2 On the basis of Article 51 (2), most Member States have exempted small companies from the audit requirement, although the criteria for defining a small company do not necessarily correspond with the thresholds included in the Directive. In 1989, the Commission proposed to require all Member States to abolish the audit requirement for small companies. This proposal was strongly resisted by a number of Member States. It was argued that published accounts which had not been subject to an audit by a qualified professional could be misleading. It was also argued that the audit is in the interest of the company itself because it provides the company with the expertise of a qualified professional.
- 6.3 Considerations of independence play a lesser role in a small company where the auditor fulfils the role both of an adviser and of an external controller. It is not uncommon for the auditor in a small company to keep the books and records and to audit the financial statements. This certainly raises questions as to the independence of this professional and the usefulness of such an audit. This is the reason why some Member States forbid the auditor to be involved in the preparation of the financial statements of the company which he audits. In practical terms, this means that the company will have to pay for the services of two different experts, one expert who keeps the books and records and prepares the financial statements and another expert who carries out the statutory audit.

⁸ According to article 53(2) of the Fourth Directive, the thresholds in Article 11 are reviewed every five years by the Council on a proposal of the Commission. The next revision of the thresholds is due to take place in 1999 and will take account of the Commission's Recommendation of 3 April 1996 concerning the definition of small and medium size enterprises 96/280/EC.

- 6.4 Some Member States have recognised the different reality of a small company audit and have created different professions, one profession which is primarily engaged in advising and auditing small companies and another profession which concentrates on large companies. Other Member States have made a distinction between micro-companies and small companies, whereby micro-companies are exempted from the audit requirement, while small companies are made subject to a so-called compilation report, which does not give the same assurance of a full audit but still gives some reassurance to users that the accounts have been properly kept.
- 6.5 Medium-sized companies fall somewhere in between the two categories. The general feeling seems to be that these companies should still be required to have their accounts audited by a qualified professional. In that case, the same criteria should apply as in the case of large companies in terms of independence and audit quality.
- 6.6 If one considers the question whether a statutory audit is useful in the case of small and medium-sized companies, it is important to keep in mind that there is a tendency to use the vehicle of limited liability companies which are not subject to an audit requirement as a means for money laundering. The question whether a company should be subject to an audit requirement can therefore not be seen exclusively in terms of deregulation. Arguments relating to public policy also need to be taken into account.

Priorities for action and possible methods

- 6.7 It is for consideration whether any change in the regulatory environment at EU level is desirable or necessary concerning the statutory audit in small and medium sized companies. At this stage, the Commission does not consider that convincing arguments have yet been advanced for changing the approach in the Fourth Directive whereby Member States can exempt small companies from the statutory audit. Moreover, it seems unlikely that Member States which require a statutory audit would be prepared to do away with it. Similarly the case has not been convincingly made for allowing or requiring the exemption of medium-sized companies from the audit requirement.

7. GROUP AUDIT ARRANGEMENTS

The statutory audit in groups of companies

- 7.1 Consolidated financial statements portray the financial position and results of a group as if it were a single entity. The statutory audit of consolidated financial statements should be carried out with no impediments and obstacles greater than those encountered in the statutory audit of the financial statements of a single legal entity. With the increasing complexity of international business and the ease with which funds can be transferred from country to country, it is of increasing importance that the statutory auditor of a group has a total picture of the significant activities within a group. This can be difficult in the case of groups having operations in more than one jurisdiction.
- 7.2 In practice, difficulties arise because there are no specific rules which offer guidance in the case of group audits. It is sometimes difficult for the group auditor to obtain information from the management and the auditors of the group companies which he does not audit. He may receive audited financial statements for the individual subsidiary undertakings, but he is not in a position to question the underlying rationale for the accounting treatment of transactions reflected in the financial statements. The group auditor may not have a total picture of the significant activities within the group. Difficulties may also arise due to the rules of professional secrecy.
- 7.3 Possible solutions to these problems have been advanced : joint audit appointments, the development of a comprehensive and integrated standard on group audits, the granting of full access to all information necessary for the group auditor to carry out his tasks and the appointment of a single statutory auditor to all group companies.

Priorities for action and possible methods

- 7.4 The conduct of a statutory audit of consolidated financial statements could be further examined to see to what extent the issues can be dealt with without legislative action. The mechanism which might be set up at EU level in order to examine the question of auditing standards (see paragraph 4.35 above) might usefully look at this subject. In the absence of clear guidance at international level, an attempt might be made to develop at EU level a set of principles which could guide the group auditor in this matter.

8. THE FREEDOM OF ESTABLISHMENT AND THE FREEDOM TO PROVIDE SERVICES

- 8.1 The Commission studies previously mentioned, have shown that there is at present no European market for audit services. National audit markets in the EU mainly function as separate markets, notwithstanding the fact that some forms of intra-Union trade in audit services exist. Although the different laws and regulations may not constitute an absolute barrier to intra-Union trade in audit services, they do make establishment or services offered across borders more costly and / or less effective and therefore less likely.
- 8.2 To the extent that an equivalent level of audit quality is established in all Member States and to the extent that proper arrangements can be found which ensure that the audit carried out in a particular Member State by a foreign individual or firm is surrounded with guarantees which are at least equivalent to those which surround an audit carried out by a local professional it should be possible to make progress in the direction of an internal market for audit services.

Freedom of establishment and freedom to provide services for individuals

- 8.3 The freedom of establishment of an individual statutory auditor in another Member State has been achieved, to a substantial extent, through Directive 89/48/EEC on the mutual recognition of professional qualifications. Auditors who wish to practice in another Member State, must acquire the qualification of this Member State but are exempted from following the complete educational programme. They can obtain this qualification, provided they pass an aptitude test. A possible alternative to establishment in most Member States is to delegate audit work in another Member State to an auditor established in that Member State. As this auditor would remain liable for the statutory audit, this solution is not in fact often practised. The Mutual Recognition Directive has only had a limited impact in the case of statutory auditors in that only a small number of auditors have been approved under this regime.
- 8.4 Impediments to freedom of establishment come from the regulatory bodies of some Member States which stipulate that their auditing laws and regulations also apply to their auditors working in another Member State, even though these persons have been approved to perform audit work under the law of the host country. In order to be able to work simultaneously in each of the two countries, such persons must respect, at the same time, the rules of the regulatory bodies of both countries, which can sometimes be impossible. A possible solution would be the adoption by the profession and the authorities, of a code of conduct proposing rules in cases of conflict between the home Member State and the host Member State.

8.5 As far as the freedom to provide cross-border audit services is concerned, most Member States require individual professionals to have a professional establishment on their territory. This requirement results from the need to maintain an active monitoring of the professionals concerned so as to guarantee the quality of the services they provide. It has been argued that where a professional auditor possesses the title of the host Member State and respects the regulations of that country when practising there, the obligation to have a professional establishment on the territory of the country is an unnecessary burden. In this respect, the jurisprudence of the European Court of Justice in the Ramrath case supports the argument that a Member State can require a mere infrastructure and a certain effective presence of the statutory auditor. As the study carried out for the Commission in 1996 points out, in those Member States where there is no restriction on the delegation of audit work, the foreign auditor can work under the responsibility of a national auditor in the host country.

Freedom of establishment and freedom to provide services for audit firms

8.6 Freedom of establishment can first of all be exercised through the creation of a subsidiary in another Member State. The creation of a subsidiary by a foreign audit firm or for that matter the creation of an audit firm by foreign professionals is made difficult by the fact that national laws and regulations directly restrict the opportunities for foreign auditors to establish an audit firm. As the study carried out for the Commission in 1996 points out, almost all Member States require that (more than) the majority ownership and/ or (more than) the majority of management needs to be in the hands of national statutory auditors. In addition, in some Member States, other legal forms than partnerships and sole proprietorships are not allowed. This limits the possibility of the separation of ownership and management of audit firms.

8.7 Compared to the provisions of the Eighth Directive, most Member States have established stricter laws and regulations on the ownership, management and control of audit firms. First, according to the Eighth Directive, audits may be carried out both by natural persons and firms of auditors which may be legal persons or other types of company, firms or partnership. Second, regarding ownership and management, the Eighth Directive only requires a majority to be in the hands of statutory auditors. In the case of management, the majority needs to be national auditors or auditors who have furnished proof of the legal knowledge required for purposes of the statutory auditing (Article 2(1)(b)(iii)). In the case of ownership, the majority may consist of statutory auditors from other Member States (Article 2(1)(b)(ii)). A number of Member States require that the capital of an audit firm should be held entirely by natural or legal persons (individuals or firms) having the local statutory auditor title. In the same way, many Member States have interpreted Article 2 (1)(b)(ii) of the Eighth Directive in such a way that a majority of the voting rights in an audit firm must be held by natural persons or firms of auditors who are approved under the law of the host country.

- 8.8 Similar problems arise when an audit firm wants to create a branch in a host Member State. An additional problem in this context results from the fact that some Member States have limited the number of legal forms which an audit firm can take. This may have as a consequence that a foreign audit firm which has a legal form which is not allowed by the law of the host country cannot create a branch in that country.
- 8.9 As far as the freedom to provide cross-border audit services is concerned, the same problems described above may arise when a foreign audit firm wishes to carry out a statutory audit in a host country where it does not possess an establishment.

Priorities for action and possible methods

- 8.10 Despite the public interest considerations involved in the statutory audit, there is no convincing reason why the Treaty provisions on freedom of establishment and freedom to provide services should not fully apply to the trade in audit services.
- 8.11 Freedom of establishment (and to provide services) of individual statutory auditors is already dealt with through Directive 89/48/EEC. Some problems remain. For example, retaining the home country title after having obtained the host country title, and possible differences in the scope of activity between the Member State of origin and the host Member State. These problems could be further examined within the co-ordinators group set up by Directive 89/48/EEC, possibly in combination with the Contact Committee on the Accounting Directives, which is responsible for the Eighth Directive and in close co-operation with national professional associations of auditors.
- 8.12 Freedom of establishment for professional firms through the creation of a subsidiary remains problematic because many Member States have established laws and regulations which are more restrictive than those in the Eighth Directive. Member States should be asked to remove those national requirements exceeding those of the Eighth Directive. In this context, there is a need to clarify the meaning of Article 2 of the Eighth Directive in order to prevent it from being interpreted too narrowly. Such clarification should take place after consultation of the Contact Committee on the Accounting Directives. To the extent that Member States have adopted national dispositions which contain a discrimination on the grounds of nationality or non-justified restrictions to the right of establishment, action will be promptly undertaken in order to ensure respect for the provisions of the Treaty.
- 8.13 Without prejudice to the direct application of the relevant provisions of the Treaty, for the freedom of establishment for professional firms through the creation of a branch as well as for the freedom to provide cross-border audit services further initiatives may be needed. These could take the form of a specific Directive which complements Directive 89/48/EEC, as in discussion between the Commission and the profession.

9. CONCLUSION

- 9.1 This paper cannot deal exhaustively with the many sometimes very complicated issues which surround the audit function. The matters dealt with are those which are considered particularly relevant in the context of the Single Market.
- 9.2 In suggesting possible priorities for future action, particular attention has been given to the principles of subsidiarity and proportionality, as enshrined in the Maastricht Treaty. In conformity with the Communication on "Accounting Harmonisation : A new strategy vis-à-vis international harmonisation", preference is given to an approach which will allow a more coherent European view to be effectively expressed in the international debate.
- 9.3 The underlying goal of this initiative is to contribute to a general raising of the level of auditing in the EU, which will ultimately benefit to all parties concerned with the life of companies.
- 9.4 Please send comments to European Commission - DG XV - D/3 - Financial Information and Accounting Standards - 200, rue de la Loi - 1049 Brussels - Belgium - (Internet address d3@dg15.cec.be) - before 20 December 1996.
- 9.5 Comments received before 18 October 1996 will be taken into account in the preparation of the Conference to be held on 5/6 December 1996 in Brussels on this subject.

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FINANCIAL STATEMENT

1 TITLE OF OPERATION

Green Paper on the Role, the Position and the Liability of the Statutory Auditor in the European Union.

2 BUDGET HEADING INVOLVED

B5- 3000 : Actions relatives au fonctionnement du Marché Intérieur

3 LEGAL BASIS

4 DESCRIPTION OF OPERATION

4.1 General objective

The general objective of the Green Paper and the proposed conference on the Role, the Position, the Liability of the Statutory Auditor in the EU is to contribute to a wide-ranging debate with all interested parties on the issues surrounding the role, the position and the liability of the statutory auditor, which is sought by the Member States and bodies representing the profession.

4.2 Period covered and arrangements for renewal

The Green Paper is scheduled for adoption in July. The Conference is planned for 5 and 6 December 1996. The preparation work has already started and the follow-up to the Conference will continue into the first quarter of 1997.

5 CLASSIFICATION OF EXPENDITURE OR REVENUE

5.1 Non-compulsory expenditure

5.2 Non-differentiated appropriations

5.3 Type of revenue involved

6 TYPE OF EXPENDITURE OR REVENUE

The expenditures involved concern the costs relating to the organisation of the Conference namely small utilities for the conference, printing costs for the programme of the conference and the report that will be issued after the Conference.

-	100% subsidy	NO
-	Subsidy for joint financing with other sources in the public and/or private sector	NO
-	Interest subsidy	NO
-	Other	NO
-	Should the operation prove an economic success, is there provision for all or part of the Community contribution to be reimbursed?	NO
-	Will the proposed operation cause any change in the level of revenue? If so, what sort of change and what type of revenue is involved?	NO

7 FINANCIAL IMPACT

7.1 Method of calculating total cost of operation (relation between individual and total costs)

7.2 Itemised breakdown of cost

Commitment appropriations
ECU million
(at current prices)

Breakdown	year n	n + 1	n + 2	n + 3	n + 4	n + 5 and subs. yrs	Total
	1	0,024					0,024
Total		0,024					0,024

7.3 Schedule of commitment and payment appropriations

ECU million

	year n	n + 1	n + 2	n + 3	n + 4	n + 5 and subs. yrs	Total
Commitment appropriations	0,024						0,024
Payment appropriations							
year n	0,024						0,024
n + 1							
n + 2							
n + 3							
n + 4							
n + 5 and subs. yrs							
Total	0,024						0,024

8 FRAUD PREVENTION MEASURES

- Given the nature of the action, no specific fraud prevention measures are necessary.

9 ELEMENTS OF COST-EFFECTIVENESS ANALYSIS

9.1 Specific and quantified objectives; target population

- The objective is in particular to help the Commission to identify any areas or subjects where action at EU level may be needed, especially with a view to bringing about a single market for audit services and to continuing the improvement in the quality of financial reporting in the EU.

- The groups targetted are government departments in the Member States responsible for the regulation of companies, bodies representing the accounting profession and more specifically statutory auditors, organisations representing the preparers and users of accounts and those involved in standard-setting in this field.

9.2 Grounds for the operation

- The statutory audit and the liability of the statutory auditor are already the subject of considerable debate in a number of Member States. The Commission has been pressed to participate.
- In 1995, DG XV launched an important study contract relating to the role, the position, the liability of the statutory auditor in the European Union. This study provides, for the first time, an overview of the different ways in which the profession of the statutory auditor is organised in the Member States.

As a follow-up to this study, DG XV has prepared a draft Green Paper on the role, the position, the liability of the statutory auditor. This Green Paper raises a number of questions arising from the conclusions of the study. It is intended that the Green Paper will be adopted by the Commission in July 1996.

- The proposed Conference will mark the end of the consultation period on the Green Paper and will bring together an invited audience drawn from the groups referred to in the second paragraph of 9.1. above.

9.3 Monitoring and evaluation of the operation

- An evaluation of the action will be made in 1997, based on a report prepared by the Commission on the Conference.

10 ADMINISTRATIVE EXPENDITURE (SECTION III, PART A OF THE BUDGET)

10.1 Effect on the number of posts

Type of post		Staff to be assigned to managing the operation		Source		Duration
		Permanent posts	Temporary posts	Existing resources in the DG or department concerned	Additional resources	
Officials or temporary staff	A					
	B	1		1		March 97
	C	1		1		March 97
Other resources			1 (END)	1		March 97
Total		2	1	3		

10.2 Overall financial impact of additional human resources

ECU

	Amounts	Method of calculation
Officials		
Temporary staff		
Other resources (indicate budget heading)		
Total		

10.3 Increase in other administrative expenditure as a result of the operation

ECU

Budget heading	Amounts	Method of calculation
Total		

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