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Perspectives in
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International standards on auditing and their adoption in the EU: legal aspects and unsettled questions

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I. Introduction

The Audit Directive of May 2006¹ enforces the use of ‘International Standards on Auditing’ (ISA) for all statutory audits to be performed in the EU. Aiming at a consistently high quality for all statutory audits required by Community law, the Audit Directive has given implementing powers to the European Commission to adopt the ISA in accordance with the so-called ‘comitology procedure’. Moreover, the Commission has recently commissioned a Study on ‘The Evaluation of the possible Adoption of International Standards on Auditing (ISA) in the EU’.² The object of that Study is to address the incremental direct and indirect costs for EU companies and audit firms, as well as the benefits resulting from the possible adoption by the European Commission of the ISA.

Improving audit quality through the adoption of ISA within the EU has a number of fundamental legal implications that need to be considered in order to comprehensively cover the subject. The following article outlines some of the most important of these issues after an introduction into the genesis of the harmonization process and a brief look at the competence of the EU to adopt ISA.

¹ The Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts, amending Council Directive 78/660/EEC and 83/349/EEC and repealing Council Directive 84/253/EEC [2006] OJ L 157/87, (hereafter, ‘the Audit Directive’).

² Tender Markt/2007/15/F – Study on International Standards on Auditing, Lot 1: Evaluation of the Possible Adoption of International Standards on Auditing (ISAs) in the EU.

II. History of internationalization of auditing standards

A. From IAG to ISA

Not surprisingly, the harmonization of standards of auditing is closely linked to the harmonization of accounting standards.³ The historical starting point of international harmonization of financial reporting was in October 1972, when during the tenth international congress of accountants in Sydney the International Coordination Committee for the Accountancy Profession (ICCAP) was founded.⁴ This congress laid the foundations for the genesis of the International Accounting Standards Committee (IASC), the predecessor of the International Accounting Standards Board (IASB). During the ninth international congress of accountants in 1967 an international working party had been created dealing with the convergence of international best practice in auditing.⁵ This decision followed the discussions back in 1962 during the eighth international congress of accountants on the necessity of creating a higher degree of uniformity in accounting and auditing standards.

In October 1977, ICCAP took the initiative, during the eleventh international congress to create the International Federation of Accountants (IFAC).⁶ IFAC is the organization that took over the tasks of ICCAP, thereby serving the accounting profession worldwide and having the public interest in mind. The decision to create the International Auditing Practices Committee (IAPC) was taken by the Board of IFAC in 1977.⁷ Being one of the most important committees of IFAC, the IAPC developed the International Auditing Guidelines (IAG), which were in fact the predecessors of the International Standards on Auditing (ISA). The IAG represented the best practice within the major audit firms at that time, within the field of auditing and review of historical financial

³ P. Wong, 'Challenges and Successes in Implementing International Standards: Achieving Convergence to IFRSs and ISAs', September 2004, www.ifac.org.

⁴ For the following, see D. Schockaert and N. Houyoux, 'International Standards on Auditing within the European Union', *Revue bancaire et financière/Bank- en Financiewezen*, 8 (2007), 515.

⁵ IFAC, *News* (February 2007), 12, www.ifac.org.

⁶ Sixty-three member bodies signed the official protocol, see Schockaert and Houyoux, 'International Standards on Auditing', (note 4, above), 515 footnote 4; for a critical analysis of IFAC's role in the Internationalization of Auditing Standards see C. Humphrey, A. Loft, S. Turley and K. Jeppesen, 'The International Federation of Accountants: Private Global Governance in the Public Interest' in G. F. Schuppert (ed.), *Global Governance and the Role of Non-State Actors*, (Baden-Baden: Nomos Verlag, 2006) 245–72.

⁷ Cf. IFAC, *The First Fifteen Years. 1977–1992*; IFAC, *News* (May 2007), 9, available on www.ifac.org.

information. The first IAG (IAG-1) dealt with the purpose and scope of an audit and was approved in October 1979; they replaced by ISA-1 Objective and General Principles Governing an Audit of Financial Statements in 1992 which in 1994 became renamed ISA 200.

After a period of increased internationalization of business activities and capital markets during the 1980s, the IFAC counted 106 member bodies within 78 countries by the end of 1991, compared to 78 bodies within 55 countries by the end of 1978. In the context of this evolution and the expectation that IAG would shortly be recognized by official securities organizations, IAPC reformed its framework of standards, following IFAC's Constitution created in November 1991. From then on, the 'International Auditing Guidelines' were renamed as 'International Standards on Auditing'. Doing so, the IAPC acknowledged that its standards had obtained a benchmark status⁸ for the audit and review engagements related to historical financial information. Therefore, IAPC, being one of the committees of IFAC, had become the auditing standard setter in the international marketplace. In October 1992 the International Organization of Securities Commissions (IOSCO) published a resolution whereby ISA was recognized on capital markets as an acceptable alternative for national auditing standards, in the context of cross-border offerings of continuous reporting by foreign issuers.⁹

In July 1994, IAPC laid the foundations for the structure of an ISA,¹⁰ consisting of basic principles and essential procedures, which were indicated by bold-lettered paragraphs, and explanatory and informative guidance, which were indicated by grey-lettered paragraphs. Furthermore, the ISA were numbered per topic, thereby following the logical sequence of the performance of an audit of financial statements (series 200 on the responsibility of the auditor, until the series 700 and 800 on reporting). In November 2001, IPAC was reformed by the general assembly of IFAC in order to become the 'International Auditing and Assurance Standard Board' (IAASB).¹¹ Using its new name, this Board intended to spend more time on standards for 'assurance agreements', which from January 2004 on, were named 'International Standards

⁸ IFAC, *Annual Report* (1993), 1; and IFAC, *Annual Report* (1995), 2.

⁹ Following the reform of the ISA in July 994, IOSCO suspended the resolution. IOSCO never officially withdrew this resolution. Until today, IOSCO discusses within the Consultative Advisory Group (CAG) of IAASB on the evolution of auditing standards in the context of IAASB's Clarity Project.

¹⁰ IFAC, *Annual Report* (1994), 3.

¹¹ IAASB, *Annual Report* (2002), 8.

on Assurance Engagements' (ISAE). At the same time, a rigorous due process had been set up within IAASB regarding its standard-setting function. By the end of 2004, IFAC counted 163 member bodies within 119 countries, which represented twice the membership from 1978. In the years from 2004 to 2008, IAASB has taken care of its 'Clarity Project' (see *infra*).

B. From minimum guidelines to benchmark status

The creation of IFAC's constitution in November 1991 had impact on the obligation of member bodies. In the period before November 1991, IAG constituted the 'minimum guidelines' to be followed and promoted by bodies at the national level.¹² After November 1991, IAPC stated that, as far as there was consistency between the IAG and the domestic law and regulations, compliance with these national laws and regulations immediately resulted in compliance with IAG. At that time, IFAC accepted that there were differences between domestic legislation and international standards. When IAG conflicted with national law or regulation, the member bodies needed to comply with the obligations as set out in IFAC's constitution: each member body, in its quality of standard setter, should use its best endeavours to incorporate the international standards (renamed as 'ISA') within the national auditing standard.

In April 2004, the ISA received a benchmark status for the audit of financial statements, namely through the new member obligations¹³ imposed by the Statements of Membership Obligations (SMO). In particular, paragraph 4 of SMO 3 stated that member bodies should use their best endeavours to establish convergence with the international standards, thus contributing towards the elimination of the differences of content between national and international auditing standards. Following these obligations, the member bodies of IFAC have considered the ISA as a basis for the national auditing standards. In the European Union, e.g., Belgian, Dutch, Luxembourg, French, and German auditing standards have been subject to a process of transformation ('transposition') of the international 'guidelines' or 'standards'.

¹² IFAC, *Towards the 21st Century: Strategic Decisions for the Accountancy Profession*, 3, www.ifac.org.

¹³ IFAC, *Handbook of International Auditing, Assurance, and Ethics Pronouncements* (2005), 119–25.

C. *The Clarity Project*

The so-called 'Clarity Project' of the IAASB has been created following the comments in 2003 on the exposure draft (ED) 'Operations Policy n° 1 – Bold Type Lettering Exposure Draft'. In this ED, the need to use black and grey lettering within the ISA was debated. Significant comments were given by the IOSCO. This project was set up to deal with the comments on the setting of auditing standards that, back in 1994, regardless of IAPC's consideration of these comments, were not followed by a corresponding modification of the ISA.

In September 2004, IAASB issued a Policy Statement 'Clarifying Professional Requirements in International Standards Issued by the IAASB', followed by a Consultation Paper 'Improving the Clarity and Structure of IAASB Standards and Related Considerations for Practice Statements'.¹⁴ Already in October 2005, four EDs were issued, namely ED ISA 300 on planning an audit of financial statements, ED ISA 315 on the auditor's risk assessment, ED ISA 330 on the reduction of the audit risk to an acceptable low level by performing audit procedures further to the auditor's risk management,¹⁵ and ISA 240 on the auditor's responsibilities regarding fraud during an audit of financial statements. In mid 2006, the comment period expired and in December 2006 IAASB issued the final ISA 240, 300, 315 and 330, which, for the first time, were named 'Clarified ISA'. In July 2006, the IAASB approved ISA 600, 'Audit of Group Financial Statements'.

The other ISA will be subject to a 'clarification' process until the presumed final date of the project in 2009. The essence of the 'Clarity Project' can be summarized as follows:

1. The ISA and ISQC 1 are based on clear principles and objectives.
2. The objectives should be met on the basis of a number of requirements representing the essential procedures to be performed by the auditor in 'virtually all' circumstances of the audit engagement.
3. The necessary guidance (application guidance) is given to the auditor in order for him to apply these requirements in all circumstances of the audit engagement, i.e., small and less complex entities, public sector entities, larger entities, public interest entities, etc.

¹⁴ Available from the IAASB's website www.ifac.org/iaasb; 'Exposure drafts'.

¹⁵ These standards are the revised versions of the IAASB standards approved in October 2003.

4. In order to clearly distinguish between requirements and application material, IAASB decided in October 2005 to use the word 'shall' within the requirements section, and to use the present tense when dealing with explanatory material within the application guidance. IOSCO's comments, dating back from 1992, have proven to be significant. The difference between requirements and application material will replace the previous difference between bold and grey lettering.
5. Each 'clarified' ISA is set following a uniform structure consisting of a purpose, a requirements section and finally the application material. A short introduction and a set of definitions of key words will be provided at the beginning of each single ISA. Thus, the former 'bold lettering' paragraphs are regrouped at the beginning of each ISA.

All ISA will be subject to this new structure in a progressive way. The more recent standards will be dealt with in the first stage of the project, and the older standards will follow. IAASB will check which of the existing bold and grey lettering paragraphs correspond with the newly created requirements and application guidance sections. A paragraph in a 'to be clarified' ISA will be considered part of the requirement section if: 1) the requirement is necessary to achieve the objective stated in the standard; 2) the requirement is expected to be applicable in virtually all engagements to which the standard is relevant; 3) the objective stated in the standard is unlikely to have been met by the requirements of other standards; and finally 4) the requirement of an ISA as a whole is proportionate to the importance of the subject of the ISA, in order to realize the objective of an audit.

The ISA including ISQC-1 will be clarified following the planning provided by the Clarity Project: eleven standards are to be revised completely (clarified structure and full revision of the content, i.e. 'clarified and revised', namely ISA 260, 320 (and 450), 402, 450, 505, 540 (and 545), 550, 580, 600, 620, and 800. The other standards will only be clarified. Part of those standards have been recently rewritten and will thus only be subject to the clarification exercise (e.g. ISA 230, 240, 300, 315, 330, 500, 700 and 701). In the context of the presumed deadline of the Clarity Project in 2009, the remaining standards will only be clarified without the content of those standards being subject to a complete revision (e.g., ISA 210, 510, 520, 530, 710 and 720).

III. Harmonization of auditing standards within the European Union

After a number of financial reporting scandals like Enron and Worldcom in the US and Parmalat in Europe, investors' confidence in capital markets worldwide has weakened considerably and public credibility of the audit profession has been impaired, finally leading to what is widely known as an 'expectation gap'. In response to those scandals and in order to close that expectation gap, the US adopted the Sarbanes–Oxley Act in 2002. Already from 1996, the European Commission developed an approach regarding the statutory audit function, which has been accelerated after these scandals and ultimately led to the approval in the EU of the Audit Directive, ten years later.¹⁶ The initiative of a harmonized approach to statutory auditing in the EU was started by the EC's 1996 Green Paper titled 'The Role, Position and Liability of the Statutory Auditor in the EU'.¹⁷ The policy conclusions which the EU drew from these reflections were included in the 1998 Communication 'The Statutory Audit in the European Union: The Way Forward'.¹⁸ That Communication proposed the creation of an EU Committee on Auditing which would develop further action in close cooperation between the accounting profession and Member States. The objective of this Committee was to improve the quality of the statutory audit by promoting quality assurance, the use of international auditing standards and auditor independence. On the basis of the work of this Committee, the EC issued the 2000 Recommendations on 'Quality Assurance for the Statutory Auditor in the EU'¹⁹ and the 2002 Recommendation about 'Statutory Auditors' Independence in the EU'.²⁰ In its Communication in 2003 on 'Modernising Company Law and Enhancing Corporate Governance in the EU – A Plan to Move Forward',²¹ the Commission defined as its priorities

strengthening public oversight of auditors at Member State and EU level, requiring ISA for all EU statutory audits ... and the creation of an EU Regulatory Committee on Audit, to complement the revised legislation and allow the speedy adoption of more detailed binding measures ... The

¹⁶ D. Schockaert, 'ISA – Een antwoord op de vertrouwenscrisis', *Revue bancaire et financière/Bank- en Financiewezen*, (2004), 219.

¹⁷ Green Paper of 28 October 1996, [1996] OJ C 321/1.

¹⁸ Commission's Communication of May 1998, [1998] OJ C 143/12–16.

¹⁹ Recommendation of 31 March 2001, [2001] OJ L 091/91.

²⁰ Recommendation of 19 July 2002, [2002] OJ L 191/22.

²¹ Commission's Communication of 21 May 2003, COM (2003) 284 final, [2003] OJ C 236/2–13.

Commission envisaged the use of ISA as a requirement for all EU statutory audits ... However, a successful implementation of a binding requirement to apply ISAs in the EU ... requires the completion of a number of preliminary actions: the update and completion of the analysis of differences between ISAs and national audit requirements; the development of a set of principles ('framework') for the assessment of ISAs; the availability of high quality translation into all Community languages. As for audit reporting, the Commission plans to use the forthcoming revision of ISA 700 (audit reporting) as a starting-point for analyzing differences between national audit reports by EU professional bodies, facilitated by the European Federation of Accountants (FEE).

Despite those non-binding measures, the Commission required further initiatives in order to reinforce investor confidence in capital markets and to enhance public trust in the statutory audit function in the EU taking into account that auditing is an important part of good corporate governance practice. In May 2006, the European Parliament and the Council adopted the new Directive on statutory audits of annual accounts and consolidated accounts, the 'Audit Directive',²² which replaces the Eighth Council Directive of 1984. The Audit Directive of 2006 reflects a principles-based approach on auditing matters and aims at reinforcing and harmonizing the statutory audit function throughout the EU. The purpose of the Directive is to reinforce the confidence in the functioning of the European Capital Markets by: 1) clarifying the duties of statutory auditors, the independence and other ethical requirements; 2) by introducing a requirement for external quality assurance; 3) by ensuring public oversight over the audit profession by improving cooperation between competent authorities in the EU; and 4) by enforcing the use of ISA for all statutory audits to be conducted in the EU, through a process of adoption of the ISA, named 'endorsement'.

IV. Competence of the EU to adopt ISA

A core issue in the discussion of adoption of the ISA is the competence of the EU to implement ISA as binding upon Member States. Pursuant to the Audit Directive of 2006, statutory audits of annual and consolidated accounts (financial accounts) should be carried out on the basis

²² Directive 2006/43/EC (note 1, above).

of international auditing standards. This, in fact, does imply the adoption of those standards in accordance with Council Decision 1999/468/EC (Comitology Decision).²³ The Audit Directive of 2006 is important in order to ensure a high quality for all statutory audits required by Community law and provides that all statutory audits be carried out on the basis of 'all'²⁴ international auditing standards.²⁵ The Directive has given implementing powers to the Commission in order to adopt 'en bloc'²⁶ the ISA²⁷ in accordance with the Comitology Decision of the Council dated 28 June 1999. Within this context, the EC will need to be satisfied: 1) that the ISA have been developed with proper due process, public oversight and transparency, and are generally accepted internationally; 2) that they contribute to a high level of credibility and quality in relation to the true and fair view of the annual or consolidated accounts; 3) that they are conducive to the European public good.

In the context of ISA, the basic act is the Audit Directive of 2006, which confers on the Commission implementing powers to adopt ISA (article 26) in accordance with the comitology procedure. Furthermore, the Commission can dispose of the assistance of a committee. According to article 48 (1), the 'Audit Regulatory Committee' (AuRC), composed of the representatives of the Member States and chaired by the Commission, has been set up. Under the comitology procedure it is mandatory for the Commission to consult with the AuRC in relation to the adoption of ISA. The AuRC is then expected to form an opinion on the measures proposed by the Commission. The Audit Directive also introduces a requirement for Member States to organize an effective system of public oversight for statutory auditors and audit firms and to establish coordination of public oversight systems at the community level.²⁸

²³ See Schockaert and Houyoux, 'International Standards on Auditing', (note 4, above), 521.

²⁴ It also refers to related standards such as ISQC-1, Legislative Resolution from the European Parliament regarding the proposal for a directive on statutory audit of annual accounts and consolidated accounts and amending Council Directive 78/660/EEC and 83/349/EEC [2005], 5.

²⁵ Recital 13 of the Audit Directive (note 1, above).

²⁶ ISQC-1, Legislative Resolution from the European Parliament regarding the proposal for a directive on statutory audit of annual accounts and consolidated accounts and amending Council Directive 78/660/EEC and 83/349/EEC [2005], 5.

²⁷ Art. 26 (2) of the Audit Directive (note 1, above).

²⁸ Art. 33 of the Audit Directive (note 1, above); Recital 1 of the Commission Decision of 14 December 2005 setting up a group of experts to advise the Commission and to facilitate cooperation between public oversight systems for statutory auditors and audit firms [2005] OJ L 329/38.

In order to reach the goals outlined in the Audit Directive, the Commission needed to call an expert group, which would contribute to the coordination and the development of public oversight systems within the EU as well as to the technical preparation of the implementing measures.²⁹ Following the Decision of 14 December 2005, the Commission set up an ‘Expert Group of Auditors Oversight Bodies’ (EGAOB). The EGAOB is composed of high-level representatives from the entities responsible for public oversight of statutory auditors and audit firms in Member States or, in their absence, of representatives from the competent national ministries.³⁰ Only non-practitioners are allowed to become members of the EGAOB. The Commission may consult with this group on any question relating to the preparation of implementing measures provided for by the Audit Directive.³¹ Furthermore, the task of this group is to contribute to the technical examination of international auditing standards, including the processes for their elaboration, with a view to their adoption at the community level.³² The EGAOB also created a subgroup dealing with ISA (‘ISA subgroup’).³³ The objective of this subgroup is to provide technical expertise to the EGAOB and the Commission on items and issues encompassing the need to consider the drafting, the adoption and the use of ISA, and to allow the EC to provide a proactive input into the standard-setting process set up within the IAASB. A small delegation of practitioners is regularly invited to the meetings of EGAOB’s ISA subgroup, e.g., representatives from the European Federation of Accountants (FEE).

A. Article 26 of the Audit Directive

According to article 26 (1) of the Audit Directive, Member States may apply a national auditing standard as long as the EC has not adopted an international auditing standard covering the same subject matter. When the EC will adopt the ISA, all standards related to the same subject matter dealt with by the ISA are no longer applicable. However,

²⁹ Recital 2 of the Commission Decision of 14 December 2005 setting up a group of experts to advise the Commission and to facilitate cooperation between public oversight systems for statutory auditors and audit firms [2005] OJ L 329/38.

³⁰ Art. 3 of the Commission Decision of 14 December 2005 (note 29, above).

³¹ Art. 2 of the Commission Decision of 14 December 2005 (note 29, above).

³² *Ibid.*

³³ Art. 4 (3) of the Commission Decision of 14 December 2005 (note 29, above).

Member States always dispose of the possibility to adopt a standard on a subject matter that is not related to an ISA adopted by the Commission.

According to article 26 (3)–(4) of the Audit Directive, Member States may impose audit procedures or requirements in addition to – or in exceptional cases, by carving out parts of – the ISA, but only: 1) if the procedures or requirements have not been covered by adopted ISA;³⁴ 2) if these stem from specific national legal requirements relating to the scope of statutory audits, meaning that those (i) comply with a high level of credibility and quality to the annual or consolidated accounts in conformity with the principles of true and fair view and with the European public good and (ii) shall be communicated to the Commission and the Member States before their adoption.³⁵ The Directive also provides for a time-limit on 29 June 2010 for the Member States to impose these additional requirements (but not for the carve-outs).³⁶ If the adopted international auditing standards contain audit procedures that would create a specific legal conflict with national law, stemming from specific national requirements related to the scope of the statutory audit, Member States may carve out the conflicting part of the international auditing standard as long as these conflicts exist,³⁷ provided that: 1) they communicate the specific national legal requirements, as well as the ground for maintaining them, to the EC and the other Member States at least six months before their national adoption, or in the case of requirements already existing at the time of adoption of an international auditing standard, at the latest within three months of the adoption of the relevant ISA;³⁸ 2) the carve-outs comply with a high level of credibility and with the European public good.³⁹ In general, however, carve-outs provide for a dangerous tool in the context of the harmonization of auditing standards within the EU.⁴⁰ Carve-outs will impair the credibility of auditing standards as well as the harmonization of auditing standards on a European level. The objective of the Commission is to analyse the content of the ISA in order to determine whether the conditions specified by the Audit Directive

³⁴ Recital 13 of the Audit Directive (note 1, above).

³⁵ Art. 26 (3) of the Audit Directive (note 1, above).

³⁶ Art. 26 (4) of the Audit Directive (note 1, above).

³⁷ Recital 13 of the Audit Directive (note 1, above).

³⁸ Art. 26 (3) of the Audit Directive (note 1, above).

³⁹ Recital 13 of the Audit Directive (note 1, above).

⁴⁰ *Ibid.*

have been met, e.g. the fact whether these standards 'are conducive to the European public good'. In late 2007, the Commission commissioned a study regarding a cost-benefit analysis related to a possible implementation of ISA as well as a study on the differences between the 'clarified ISA' and the PCAOB Auditing Standard.

B. Article 28 (2) of the Audit Directive

As long as the Commission does not adopt ISA 700 and 701 relating to the auditor's report, the Directive confers the powers on the Commission to adopt a common standard for audit reports for (annual or consolidated) accounts which have been prepared in accordance with IFRS as adopted by the Commission.⁴¹ This option for the Commission could provide for the creation of an auditor's report for financial statements prepared in accordance with IFRS that could be different from the auditor's report on other financial reporting framework, other than IFRS as adopted by the EU. This conclusion leads to the question whether an audit will still be an audit after the adoption of ISA. Moreover, the ISA are to be considered as a set of standards, as ISA build on each other, starting with the ISA on the auditor's responsibilities (ISA-series 200-260) and ending with the ISA on reporting by the auditor (ISA-series 700-805). Finally, ISA 700 clearly states that in order to report on the true and fair view of the financial statements in accordance with ISA, all ISA should be applied during the audit.

Therefore, not adopting even one ISA within the European context would necessarily lead to the non-adoption of ISA 700. One might question such a 'non-adoption' by the Commission, in the context of the objective of the Audit Directive to quest for a high level of quality of all statutory audits within the EU, including the audit of financial statements of small entities.

V. Unsettled regulatory issues

Improving audit quality through adoption of International Standards on Auditing within the EU has a number of fundamental legal implications that need to be considered in order to comprehensively cover the

⁴¹ Art. 28 (5) of the Audit Directive (note 1, above).

subject. The following text outlines some of the most important of these issues.

A. *General legitimacy of harmonizing regulation*

First, the discussion of harmonizing auditing standards forms part of the general debate on harmonization of regulation.⁴² Accordingly, harmonization of auditing standards, like any regulatory harmonization, requires a careful analysis of arguments in favour and against. Harmonization in general may save costs on one side but, at the same time, may cause new costs because it terminates competition among regulators as an inventive process to steadily improve regulation. Hence, mutual recognition of audits may serve as a viable alternative to full harmonization of auditing regulation.⁴³ Moreover, it is said that harmonization in general bears the risk of ending up with standards that are not optimal. Harmonized standards, like harmonized regulations in general, tend to petrify and become resistant against reform. Experience shows that it usually turns out to be very hard and complex to change harmonized regulation. Having gone through cumbersome and lengthy negotiations in order to reach harmonization the parties are not really willing to reopen the negotiation process. Also, the role of interest groups in the process of harmonization, like lawyers, the judiciary, members of involved professions and politicians, has to be taken into consideration. All of these groups have individual interests that might be influential in the process of keeping traditional standards or adopting harmonized ones. Accordingly, it is necessary to analyse the specific relevance of the regulatory debate for harmonizing auditing standards.

⁴² For a comprehensive overview over the subject see the contributions in G. F. Schuppert (ed.), *Global Governance and the Role of Non-State Actors*, (Baden-Baden: Nomos Verlag, 2006); G. Hertig and J. McCahery, 'Optional rather than Mandatory EU Company Law: Framework and Specific Proposals', *European Company and Financial Law review*, 3 (2006), 341; W. Mattli and T. Büthe, 'Global Private Governance': Lessons from a National Model of Setting Standards in Accounting', *Law & Contemporary Problems*, 68 (2005), 225; R. Michaels and N. Jansen, 'Private Law Beyond the State? Europeanization, Globalization, Privatization', *American Journal of Comparative Law*, 54 (2006), 843; K. Bamberger, 'Regulation as Delegation: Private Firms, Decisionmaking, and Accountability in the Administrative State', *Duke Law Journal*, 56 (2007), 377.

⁴³ See M. Trombetta, 'International regulation of audit quality: full harmonization or mutual recognition? An economic approach', *European Accounting Review*, 12 (2003), 3.

In addition to these general considerations on harmonization of regulation, there are specific arguments regarding harmonization of auditing regulation that deserve closer investigation.

B. The particular problem of legitimacy of non-governmental regulation

The most important change regarding the adoption by the Commission of ISA is the fact that these standards will become part of a legal system which provides for auditing duties under domestic or harmonized European law. In other words, by adoption through endorsement, ISA will change from voluntary standards to mandatory regulations. However, ISA aren't drafted from a legislative point of view. They represent a benchmark status but not a comprehensive set of rules covering the wide range of possible issues to be regulated in the context of mandatory auditing. The situation is comparable to the adoption of IFRS by the Commission.⁴⁴ Accordingly, elevating ISA in their status from benchmark to law requires careful standard-by-standard analysis. At the same time, it is of course of paramount importance for the Commission to communicate its comments as early as possible to the IAASB. It is essential for the success of the harmonization process that ISA do not interfere with corporate law applicable in the individual jurisdictions, such as harmonized European or domestic company law.⁴⁵

While in a more technical sense, endorsement of promulgated international standards by the EU may serve as a suitable mechanism in order to implement those standards into national law, the fundamental question of democratic legitimation of those standards in the process of their development and creation is still open and deserves further research. Specific questions have to be tackled:

- First, who is standing behind the International Standards on Auditing? Who is responsible for selecting and appointing the individuals that

⁴⁴ See Humphrey, Loft, Turley and Jeppesen, 'The International Federation of Accountants', (note 6, above); R. Delonis, 'International Financial Standards and Codes: Mandatory Regulation without Representation', *New York University Journal of International Law and Politics*, 36 (2004), 563.

⁴⁵ European Commission, *Comment on Exposure Drafts Improving the Clarity of IAASB Standards*' (October 2005).

actually formulate the standards? To what extent is independence of standard setters guaranteed?

- Second, do the procedural rules for developing and setting the standards on auditing in fact satisfy basic legal due process requirements with regard to transparency, options for the public to comment, minority protection, and quality assurance?⁴⁶

C. *One-size-fits-all versus segmented approach*

At the moment, ISA follow a one-size-fits-all approach: all entities, whether listed or not, are audited under the same set of auditing standards. To the extent ISA have not already been adopted in EU Member States or transposed into national auditing standards in those States, adopting ISA in the EU may have significant effects on small and medium-size accounting firms that are mostly involved in rendering accounting services for non-listed entities. Like in the case of International Financial Reporting Standards, the question is whether the audit of small and medium-size entities, i.e., non-listed entities, requires specific ISA for SMEs.⁴⁷ In order to answer that question, it is necessary to substantially draw upon the corresponding discussion on IFRS. In the US, the Sarbanes–Oxley Act effectively introduced different standards on auditing for listed entities (PCAOB Auditing Standards) and non-listed entities (US-GAAS).

D. *Principles versus rules-based approach*

The fundamental ‘cultural’ difference between the traditional European auditing approach based on principles and objectives and the more rule- and checklist-based auditing approach of ISA mirrors the general divergence between Continental law and Anglo-American statutory law.⁴⁸

⁴⁶ FEE Issues Paper, *Principles of Assurance: Fundamental Theoretical Issues with Respect to Assurance in Assurance Agreements* (April 2003).

⁴⁷ For Denmark see, e.g., Erhvervs- og Selskabsstyrelsen, *Report on the Auditing Requirement for B Enterprises* (March 2005).

⁴⁸ For a general reference to the topic see D. Alexander, ‘A True and Fair View of the Principles / Rules Debate’, *Abacus*, 42 (2006), 132; B. Bennett, ‘Rules, Principles and Judgments in Accounting Standards’, *Abacus*, 42 (2006), 189; G. Benston, ‘Principles-versus Rules-Based Accounting Standards: The FASB’s Standard Setting Strategy’, *Abacus*, 42 (2006), 165; J. Braithwaite, ‘Rules and Principles: A theory of Legal Certainty’, *Australian Journal of Legal Philosophy*, 27 (2002), 47; W. Bratton, ‘Enron, Sarbanes–oxley and Accounting: Rules versus Principles versus Rents’, *Villanova Law Review*, 48 (2003), 1023; L. Cunningham, ‘A Prescription to Retire the Rhetoric of ‘Principles-Based System’

This difference can cause problems in the process of adopting ISA within the EU. If, as proposed, each ISA has an objective that the auditor must demonstrably achieve, there is a very real risk that the objectives will inevitably become input-orientated, detailed and procedural. Only then would auditors be able to defend their actions when judged in hindsight. Therefore, the tendency would be for objectives to focus on procedures and process rather than the aims of the ISA and overall objective of the audit. That risks leading auditors into a tick-the-box mindset – with the risk of negative consequences for audit quality and for the quality of the auditing profession.

E. Single standard objective versus overall objective

The IAASB's Clarity Project started with the modest goal of agreeing on writing conventions that would make auditors' professional requirements abundantly clear – identifying what it is that auditors 'must' or 'shall' do and rewriting 'present tense' sentences so that it is clear whether they are requirements or illustrative guidance only. Very quickly, however, the discussion extended to the structure of the ISA too. In future, ISA are likely to have separate sections for requirements and application guidance. The IAASB's October 2005 exposure draft (ED) on Clarity proposed that each ISA should have a stated objective. The auditor would be expected to achieve the objective of each ISA relevant to the engagement. To do so, the auditor would comply with the requirements set out in the ISA, but would also be expected to perform any other procedures that, in the auditor's professional judgement, were necessary in the circumstances. The IAASB's intention was to focus the auditor's attention on the aims of the engagement, rather than on procedures alone, and to reinforce the need for professional judgement in determining what procedures are necessary in the circumstances. The requirement for the auditor to judge whether all procedures that are 'necessary in the circumstances' to achieve a particular objective, is intended to embrace professional judgement and avoid a tendency for the ISA to try to comprehensively cover all circumstances. However, as drafted, the requirement places strong emphasis on the procedures to be performed rather than the evidence obtained. From a European perspective, the question

should be ‘Have I obtained sufficient appropriate evidence and, if not, what can I do to obtain the necessary evidence?’ rather than ‘Have I performed enough steps?’

Since the beginning of the Clarity Project, regulators, investors, auditors and other stakeholders have been debating the style and structure of the ISA. At stake is not only how the ISA are drafted, but also what is expected to comply with them, including the documentation required. Hence, it is necessary to address the issue of how the objectives of the different ISA fit together to meet the overall objectives of an audit. It might appear helpful for users in understanding how the objectives of the ISA relate to the objective of the audit. It also would be helpful to ensure that the body of the ISA is complete and not duplicative.

F. Sole responsibility versus division of responsibility

Liability for auditing services is another important issue in the context of internationalization of auditing standards. In the *Parmalat* case, division of responsibility among those auditing firms that participated in the audit of the entire corporate group was permissible. As a contrast, German law prohibits division of responsibility and provides for sole responsibility of the auditor even if he or she explicitly relies on the work of other auditors. Unsurprisingly, the reform of ISA 600 ‘Using the Work of Another Auditor’ has triggered a flood of comment letters. Exposure Draft ISA 600 now provides for sole responsibility, whereas under US law division of responsibility is permitted. Note that as a sort of counterbalance, US law prohibits limitation of auditor liability. From a European perspective, it is important to see whether the US will give in on that point and accept sole responsibility.

G. Understandability

Following the Clarity Project of the IAASB, ISA are restructured in order to incorporate an Objective, a Requirements Section and an Application Material section. The authority of the Application Material is described in paragraph 22 of the redrafted preface of ISA: ‘While the professional accountant has a responsibility to consider the whole text of a standard, such guidance is not intended to impose a requirement for the professional accountant to perform the suggested procedures or actions.’ The adoption of ISA in the EU should not change the

authority of the Application Material. Furthermore, the text of an ISA should be read as a whole, including the Application Material, in order to create a consistent application of ISA within the EU. On the other hand, it is obvious that from the perspective of continental law jurisdictions the inclusion of Application Material in the text of ISA might pose questions with respect to the binding force of the ISA as well as the hierarchy between the various parts of ISA. The Clarity Project in that regard is but one first step in order to improve the understandability of ISA.

Another issue in that context is the variable use of words within the auditing standards. For example, in some cases the equivalent requirements in PCAOB-Auditing Standards and ISA use different words: the impact of this different usage needs to be examined. Furthermore, even when the same words are used, the words may have a different meaning due to different definitions or because the words used in the PCAOB-Auditing Standards have a meaning that is commonly understood in US jurisprudence, but for which no such a common understanding exists in ISA. It should also be recognized that the PCAOB-Auditing Standards and US GAAS are written within a certain legal and cultural environment, which means that these factors will be taken into account when evaluating the meaning of the differences between the standards and their impact on auditing practice.

H. Objectives of harmonization of auditing standards

1. Legal security and public trust in auditing

First and foremost, it is said that harmonization of auditing standards would contribute considerably to reduce the current standard overload (PCAOB Auditing Standards / US GAAS, ISA, German IDW-PS and other domestic standards) and, thereby, generally improve legal security and public trust in auditing. At present, the multitude of auditing standards applicable throughout Europe and the world makes it difficult for the auditing profession as well as for professional and non-professional investors alike to apply and understand auditing standards. As in the case of International Financial Reporting Standards (IFRS), International Standards on Auditing would tremendously simplify rendering and understanding the relevant services. This, in turn, would finally reduce capital costs for auditing clients.

2. Improving quality of auditing

Harmonized auditing standards would reduce the complexity of auditing and, thereby, reduce the likelihood of incorrect or incomplete auditing. Differing auditing standards are a most prominent source of problems and mistakes in the course of auditing across borders. This is particularly true in the case of large corporate clients with affiliations and branches in many different countries.

3. Reduction of civil liability risk

Harmonization of auditing standards would reduce the risk of civil as well as criminal liability for auditors. Hence, it would render auditing as a profession more attractive. Accordingly, it would become easier for auditing firms to recruit the personnel required to render in particular large-scale or cross-border complex auditing services.

I. Adaptability of ISA to common European auditing standards

As a precondition for any adoption of International Standards on Auditing, it is necessary to ask for the underlying principles of these Standards. What are the core regulatory subjects, what is the regulatory approach (in terms of regulatory method)? Do these Standards mandate or merely recommend specific action? Do they spell out the regulation in all detail? Do they operate on the basis of sanctions like civil liability? Moreover, the question has to be answered whether and to what extent these principles correspond to traditional Auditing Standards in force within the EU.

J. Problems of transition

On the downside, like in the case of any harmonization, adopting newly introduced uniform auditing standards inherently causes problems of transition. It will definitely take some time until the harmonized standards are applied in a uniform as well as correct manner. Hence, for a transitory period the advantages of harmonized standards have to be counterbalanced against the disadvantages of untested standards.

VI. Conclusion

The European Commission pointed out the need for high quality in all statutory audits required by Community law in order to contribute to the

prevention of corporate and financial malpractice. For that purpose, the Audit Directive approved by the European Parliament and the Council in 2006 states clearly that statutory audits be carried out based on ISA.

The Audit Directive reflects a principles-based approach on auditing matters and aims at reinforcing and harmonizing the statutory audit function throughout the EU, thereby building up confidence in the functioning of the European capital markets. To that extent, the Directive provides for the application of ISA for all statutory audits to be conducted in the European Union. For ISA to become part of a legal system, the Commission has to apply the comitology procedure. This procedure sets out the authority of the Commission, the European Parliament and the Council for taking the necessary steps in order to adopt ISA for all statutory audits to be performed within the EU.

ISA are subject to a clarification project of the IAASB, which is one of the most important committees of the International Federation of Accountants, as well as a private body setting international standards. The Clarity Project is an ambitious undertaking designed by the IAASB in order to clarify what exactly is required under the ISA, which purposes are being envisaged within the ISA and how the required audit procedures could be applied in different circumstances of the audit engagement. This article identified a number of issue and questions that deserve closer analysis in order to make sure that harmonizing statutory auditing throughout the EU by adopting ISA will become a success.