

Rue de la Loi 83 - 1040 Bruxelles
Tél 32(2)285 40 85 - Fax 32(2)231 11 12

DISCUSSION PAPER

**EUROPEAN CO-ORDINATION
OF
PUBLIC OVERSIGHT**

September 2003

CONTENTS

| | |
|---|-----------|
| EXECUTIVE SUMMARY | 3 |
| 1. INTRODUCTION | 5 |
| 2. OBJECTIVES AND STRUCTURES OF OVERSIGHT OF THE AUDIT PROFESSION | 6 |
| 2.1. Why is oversight of the auditing profession necessary | 6 |
| 2.1.1. The framework of legislation and/or standards | 7 |
| 2.1.2. Application and enforcement of standards | 8 |
| 2.2. Involvement of third parties in oversight of the profession | 10 |
| 2.2.1. Why is it important to involve third parties in oversight | 10 |
| 2.2.2. How can representatives of the public interest be involved | 11 |
| 2.2.3. Combining self-regulation and public oversight | 12 |
| 2.2.4. Who should represent the public interest? | 13 |
| 2.2.5. Why oversight bodies need significant auditing expertise | 15 |
| 2.2.6. Funding | 15 |
| 2.3 Scope of oversight mechanisms - an audit is an audit | 15 |
| 2.4 Public Oversight at EU or Member State Level | 16 |
| 3. GENERAL PRINCIPLES ON EU CO-ORDINATION OF OVERSIGHT OF THE AUDIT PROFESSION | 18 |
| 3.1. The need for a public oversight on a EU level | 18 |
| 3.2. Institutional aspects of the co-ordination of EU public oversight | 19 |
| 3.2.1. Objectives | 19 |
| 3.2.2. Responsibilities, tasks and duties | 19 |
| 3.2.3. Organisation and legal structure - principles | 20 |
| 3.2.4. Organisation - long-run proposal | 21 |
| 3.2.5. Organisation - interim solution | 23 |
| 3.2.6. Funding of the secretariat | 24 |
| 4. FEE'S VIEWS ON CONVERGENCE AND EQUIVALENCE OF REGULATION OF CAPITAL MARKETS, CORPORATE GOVERNANCE, STANDARDS AND PUBLIC OVERSIGHT OF AUDITING | 25 |

EXECUTIVE SUMMARY

The objective of public oversight mechanisms is to improve public confidence and the credibility of high quality financial reporting. Public oversight seeks to demonstrate that the profession is committed to working in the public interest at the required highest level of quality. FEE supports the organisation of a robust oversight of the auditing profession in the public interest.

There are a variety of ways of providing oversight. FEE expresses a preference for mechanisms combining the profession and independent non-practitioners. FEE advocates a significant involvement of non practitioners who should be in a majority, and that there should be diversity as to how the public interest is represented so that oversight is not dominated by any single stakeholder. In any event, oversight bodies need significant auditing expertise to provide a good insight into the profession and provide practical solutions to improve quality.

Differences in legislation in the European Member States indicate that the regulation of the profession and robust public oversight structures are best organised at national rather than at European level. The European Commission in its Communication of 21 May 2003 "Reinforcing Statutory Audit in the EU" considers that the practical implementation of oversight should be at national level. FEE supports this approach.

In accordance with the approach of the Eighth Directive, FEE agrees that all statutory auditors should be covered and expresses a preference for oversight of the audit profession as a whole.

FEE emphasizes the inexorable trend to global standards. Auditing standards should be set by IAASB (the auditing global standard setter) under global oversight or consultation. National standard setting and guidance should be limited to national and emerging issues and under oversight. The same applies to ethics and independence standards which should be set by the profession under global oversight or consultation.

The establishment of an EU Co-ordination of oversight mechanisms is in the interest of the Member States and the audit profession. This arrangement should have a well-defined co-ordinating role. The objective is not to have a further layer of oversight at EU level. FEE does not support registration of auditors at EU level.

In its Communication of 21 May 2003, the European Commission acknowledges the need for an EU co-ordination mechanism to bring together the national systems into a cohesive, efficient, pan-European network. FEE believes that this proposal should be implemented quickly. Such a co-ordination could develop guidance on EU oversight principles and suggest improvements to arrangements and procedures for oversight, especially of quality assurance, at Member State level. FEE believes that a European co-ordination of audit oversight mechanisms should be established as a legal entity to build confidence. It should be visibly structured in the public interest and involve all stakeholders appropriately. Such a proposal could take time. Considering the urgency of this issue, especially in the transatlantic regulatory dialogue, FEE suggests a temporary solution which could be based on a Committee structure organised by the European Commission.

Main conclusions of the discussion paper

1. FEE supports developing common principles (and essential features) for the organisation of robust national public oversight arrangements in European countries.
2. The requirements of the single capital market, including recognition of the equivalence and convergence of the US and EU capital market regimes indicate a need for robust co-ordination of national systems of oversight in Europe.
3. This co-ordination would also help in achieving an efficient response to the oversight systems to be developed in the USA and elsewhere, allowing the elimination of unnecessary and burdensome duplication of oversight arrangements and supporting appropriate convergence of good practices.

1. INTRODUCTION

Recent corporate collapses, particularly in the US, have seriously undermined confidence in the capital markets as well as the public's trust in corporations, investment analysts, bankers, lawyers and auditors. Interest in corporate governance has been growing in reaction to the role of accounting errors or fraud in the demise of a number of important companies. Many of the failures could be attributed to a lack of integrity on the part of management where individuals were involved in aggressive accounting, earnings management or fraudulent financial reporting to manipulate share prices, borrowings and bonus plans. There is now a clear need to restore confidence in capital markets and elsewhere by enhancing corporate governance in order to provide financial information of the highest quality.

Auditors lend credibility to financial statements only if those who rely upon the auditor's report are confident that the auditor has conducted the audit to the highest standards. Accidents may be part of life and some business failures are to be expected but users of accountants' services want to be sure that the risk of unexpected accidents is minimized and that, when such accidents do occur, involving apparent audit failure, they are treated with due diligence and transparency and without undue delay.

In Europe, the subject of oversight of the audit profession has been under consideration for some time. The issue is mentioned in the European Commission's Recommendation on Quality Assurance of 2000. The Commission repeated in April 2002 that oversight would be a major item in its future strategy on statutory auditing.

In October 2002, the Technical Committee of the International Organization of Securities Commissions approved a statement on "Principles for Auditor Oversight". IOSCO considers that that: "*Within a jurisdiction, auditors should be subject to oversight by a body that acts and is seen to act in the public interest.*" While the nature of an auditor oversight body and the process through which it carries out its activities may differ among jurisdictions, IOSCO proposed principles to make oversight effective. One of these principles is that "*there is a growing consensus internationally as to the benefits of an auditor oversight system that is not based exclusively or predominantly on self-regulation.*"

In its Communication of May 2003, the European Commission states: "*Public oversight is a major element in the maintenance of confidence in the audit function. The present erosion of confidence is partly based on a public perception that any self-regulating profession runs a risk of conflicts of interests in dealing with its shortcomings.*" The following objective is identified: "*In the light of the emerging EU capital market there is a need for an EU co-ordination mechanism to bring together the national systems into a cohesive, efficient pan-European network.*"

The reactions to the lack of confidence in capital markets in the European Parliament, in the Member States and in the European media emphasise the urgency of initiatives aimed at demonstrating that the auditing profession in Europe is subject to a robust system of oversight. The approval of the Sarbanes-Oxley Act in the USA, including extra-territorial provisions on registration of audit firms and oversight of these firms, shows that there is a worldwide need, calling for co-ordination and recognition of equivalence in quality between the European and US oversight systems.

This paper intends to discuss in the first instance the objective and structures of oversight regimes at Member State level. It will then discuss the reasons for having a EU co-ordination mechanism of national oversight systems and make proposals for institutional arrangements.

2. OBJECTIVES AND STRUCTURES OF OVERSIGHT OF THE AUDIT PROFESSION

2.1. *Why is oversight of the auditing profession necessary*

Auditing provides assurance to many groups of users that the financial statements give a true and fair view in accordance with the relevant reporting framework and, where appropriate, whether these financial statements comply with statutory requirement. Recent events have demonstrated that business failures and inadequate or fraudulent financial reporting severely undermine the credibility of capital markets. The assurance offered by audited financial statements should enhance the confidence of users of financial information. Accordingly, the audit report contributes to the credibility of capital markets in the public interest.

The ultimate goal of the audit profession is delivering the best quality audits to users of financial information. This objective will only be reached if at the same time the credibility of the audit profession is supported by public confidence, which can be improved by establishing appropriate oversight mechanisms. Since statutory auditors work in the public interest, the public interest should be involved in the oversight mechanism.

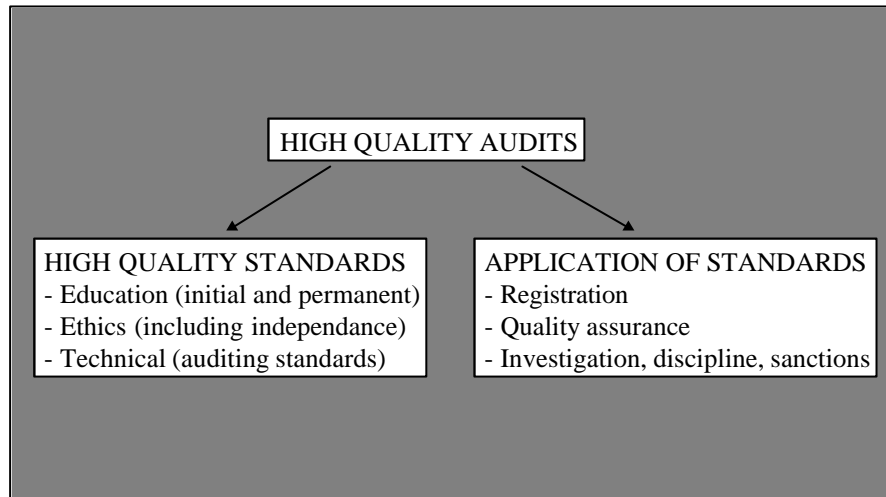
Transparency is an essential feature of any oversight mechanism which intends to secure public confidence. Appropriate information should be made available through action plans and activity reports concerning:

- Structure and membership of oversight mechanisms,
- Objectives, scope, powers and detailed procedures,
- Relationships with other oversight and enforcement bodies (including EU co-ordination).

The two main questions to be addressed by public oversight mechanisms are:

- Is the framework for setting auditing and related standards appropriate?
- What are the mechanisms to ensure that these rules and standards are applied and enforced in practice?

The following diagram illustrates the relationship between high quality audits and standards:



2.1.1. The framework of legislation and/or standards

By definition, statutory audit is required by law. In all Member States of the European Union, only qualified professionals approved (registered) by the competent authorities of the Member States may carry out statutory audits. A legal framework already exists, which defines the conditions to be approved. The Directive of 16 April 2003 amending the Accounting Directives also defines the minimum content of the audit report.

However, legislation is not the appropriate instrument to enter into the details of education requirements, auditing standards or ethical principles. These aspects will usually be developed further by professional bodies of accountants under oversight or by bodies to which auditors will provide the necessary technical expertise.

FEE believes that oversight arrangements should cover standards on education, auditing principles and procedures, and ethics.

At least, such oversight should address the due process used in developing standards, providing a mean for their acceptance by public authorities, preparers, users and other stakeholders.

Because of the inexorable trend to global standards, used by a large number of countries, FEE considers that:

- Auditing standards should be set by IAASB under global oversight or consultation;
- National standard setters have to ensure that global standards are applicable at national level;
- National standard setters may have additional responsibilities limited to guidance on the impact of national regulations and emerging issues and under oversight;
- Ethics and independence standards should be set by profession under global oversight or consultation.

In its position paper “Proposal on ISAs in the EU” dated November 2001, FEE proposed the application in Europe of International Standards on Auditing (ISA) and also the IFAC Code of Ethics. FEE strongly believes that the responsibility to set standards on auditing should remain with a professional body organised at a global level. It supports the work of the International Auditing and Assurance Standards Board (IAASB) which has this responsibility for more than 20 years and which combines the knowledge and experience of high level audit experts for the benefit of establishing high quality auditing standards.

Against such a background, there are strong arguments that public oversight of the quality of the global standard setter should be organised at global level. An effective oversight or consultative mechanism should then be established at the level of IAASB and the Ethics Committee of IFAC to monitor the transparent and effective working of the global standard setter. Such global mechanisms should involve the main stakeholders including representatives from the EU.

Public oversight mechanisms should monitor the implementation of the global standards and, if necessary, provide advice on their incorporation in the national environment. They should also be involved in the definition of additional local needs, if necessary, to be combined with internationally developed standards. From a European perspective, providing input to the global standard setter is also relevant to the work of a national public oversight body.

2.1.2. Application and enforcement of standards

High quality standards must be accompanied by measures aimed at ensuring a full respect of these standards by qualified professionals. In this regard, it is generally accepted that three main aspects need to be considered:

- Statutory auditors must be registered to carry out such a regulated activity;
- A quality assurance system must be in place to enhance public confidence in the ability of the profession to comply with the standards;
- In the case of complaint, or when there is evidence that the standards might not have been complied with in a specific audit engagement, investigative and disciplinary proceedings following a due process must lead to appropriate sanctions.

As we will explain below, in most cases such systems are in place in Member States based on existing European legislation or the European Commission’s recommendations.

2.1.2.1. Registration of statutory auditors

The 8th Directive requires the approval of statutory auditors at national level by the competent authorities of the Member States. Article 28 of the Directive requires Member States to ensure that names and addresses of all natural persons and firms of auditors approved by them to carry out statutory audits are made available to the public. FEE considers that approval and registration of statutory auditors should remain a national responsibility in accordance with the 8th Directive. There is no reason to have a central European registration for all or some categories of statutory auditors.

Public oversight of registration aims at demonstrating that the conditions required by law are respected. National governments may decide to operate registration directly or through a government agency. The 8th Directive also allows Member States to delegate this responsibility to other competent authorities, including a professional body. Where Member States delegate registration to professional institutes or other bodies, public oversight should also aim to ensure that registration requirements are applied consistently and that a possibility of appeal is open when registration has been rejected.

The 8th Directive establishes minimum qualifications to be approved as a statutory auditor. If additional criteria need to be developed, for instance on permanent education, the Member States should avoid any such requirement from inhibiting free movement of auditors throughout the single market. This could be achieved by agreeing on common European benchmarks for such criteria.

2.1.2.2. *Quality control systems*

In 2000, the European Commission adopted a Recommendation on Quality Assurance. This recommendation includes principles on public oversight of the quality assurance activity of the audit profession which should be fully implemented in the context of an EU system of public oversight of the profession. Paragraph 6.1. of the Recommendation states “The public oversight requirement is meant to ensure that the quality assurance is in fact and appearance an exercise with sufficient public integrity.”

In its Recommendation on Quality Assurance, the European Commission fixed some benchmarks for quality assurance systems and explicitly stated that these systems and also disciplinary regimes need to be linked at national level. Monitoring the implementation of this recommendation is obviously part of the role of the oversight mechanism at national level. The Recommendation includes a provision on oversight:

“The actual organisation of public oversight for quality assurance will differ between Member States depending on existing structures of supervision on the statutory audit profession and the importance of sector specific regulatory monitoring of statutory audit quality.

Public oversight for quality assurance could be an “add-on” to existing supervision structures for the audit profession that already involve public participation, whilst in other situations it could require a separate committee including non-professionals such as representatives of business, representatives of securities regulators and representatives of shareholders.

The objectives of public oversight on quality assurance could include:

1. Supervision of the management (planning and control) of the quality assurance system,
2. Evaluation of the review results,
3. Approval of public reporting of results of quality assurance”¹

¹ The IOSCO Principles on Auditor Oversight include a similar requirement: “This oversight process may be performed in co-ordination with similar quality control mechanisms that are in place within the audit profession, provided the oversight body maintains control over key issues such as the scope of reviews, access to and retention of audit work papers and other information needed in reviews, and follow-up of the outcome of reviews.”

FEE believes that these objectives remain valid and should be incorporated in any new oversight arrangements.

The European Commission's Recommendation on Quality Assurance and the IOSCO Principles for Auditor Oversight, recommend a mechanism to require auditors to be subject to disciplinary sanctions in the case of negative outcomes of quality reviews, established according to a fair due process of investigation including rights of appeal.

2.1.2.3. Disciplinary schemes and sanctions

Enforcement measures are necessary to ensure that standards on auditing and ethics are effectively applied. Shortcomings must be subject to sanctions, including, in the worst cases, the removal from the register. For instance, Article 26 of the 8th Directive requires that Member States "ensure that approved persons are liable to appropriate sanctions when they do not carry out audits in accordance with Articles 23 (integrity), 24 (independence) and 25". The Recommendation on Quality Assurance also points out that the link between quality reviews and disciplinary sanctions adds to public credibility.

In addition to other safeguards built into the system of investigation and discipline, such as the involvement of judges or independent persons and appropriate transparency of the process, adequate public oversight arrangements are useful to demonstrate to the public that the profession take seriously the respect of rules and standards by all its members. These matters of investigation, discipline and sanctions over statutory auditors should also be part of the responsibility of national oversight mechanisms. A key element of their responsibilities is to uphold the principle of fairness in the definition and due process (including appeals) in the use of such powers.

2.2. Involvement of third parties in oversight of the profession

2.2.1. Why is it important to involve third parties in oversight

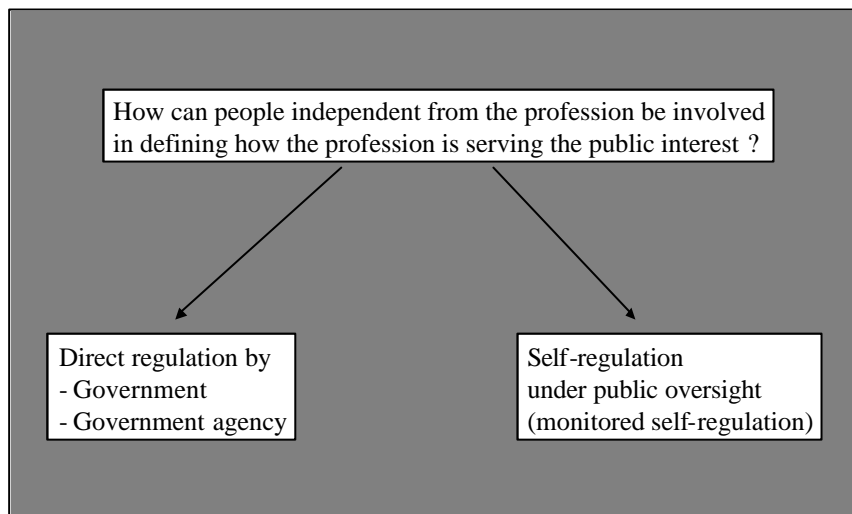
The audit profession's role is to act in the public interest. Therefore, the public should be able to obtain confirmation that professional bodies always have the public interest in mind when taking decisions.

Audited financial information is used by a wide range of stakeholders. Consequently, the public interest should be represented in oversight mechanisms by a range of stakeholders. Reliance on government alone is not appropriate because government is not best placed to articulate directly and in detail the sometime diverging interests of these stakeholders. Also, direct supervision by government authorities may be largely restricted to the form and may not sufficiently address the detail and substance of profession.

It is essential to develop other mechanisms where independent third parties will be actively involved. Their role can be twofold. Either, they can contribute directly to the development of standards or to the enforcement process, or they can monitor the process and give assurance to the public that the professional authorities are acting in the public interest (see 2.2.3).

2.2.2. *How can representatives of the public interest be involved*

As illustrated in the diagram below, one must broadly distinguish between two different systems: regulation by Government or under Government’s auspices and self-regulation by the profession with an external system of oversight endorsed by government. IOSCO’s “Principles for Auditors Oversight” expresses the same idea as follows: “A mechanism should exist to require auditors to be subject to the discipline of an auditor oversight body that is independent of the audit profession, or, if a professional body acts as the oversight body, is overseen by an independent body.”(VI)



- **Oversight only by regulators**

Even when the law enacted by Parliament establishes the basic principles, it is common practice in many countries to delegate to Government the responsibility to adopt detailed rules implementing the provisions of the law (secondary legislation). With regard to statutory audits, in some countries, this covers for instance institutional aspects of the audit profession and the disciplinary system. The Government itself can use expertise available in public bodies such as securities regulators or establish a new specialised body to deal with these issues, monitor compliance and look after enforcement.

In some countries, the public interest is served by attributing to public authorities the responsibility to set the rules to be applied by statutory auditors in carrying out their tasks. If secondary legislation or standards are necessary, Government is responsible for defining these additional regulations. It can be assisted by consulting bodies or delegate the responsibility to specialised institutions such as securities regulators.

In other countries regulation by Government or Government agency is not the selected method because often the necessary technical expertise in auditing and related matters is not available under these circumstances. Such countries have established an independent regulator which is separate from the State administration and from the profession itself. The responsibilities of this independent regulator may be identical to those that public authorities could carry out by themselves. The advantage of the method is its flexibility and the possibility to associate different stakeholders and experts to the process.

- **External oversight by independent stakeholders of the self-regulatory activities of the profession**

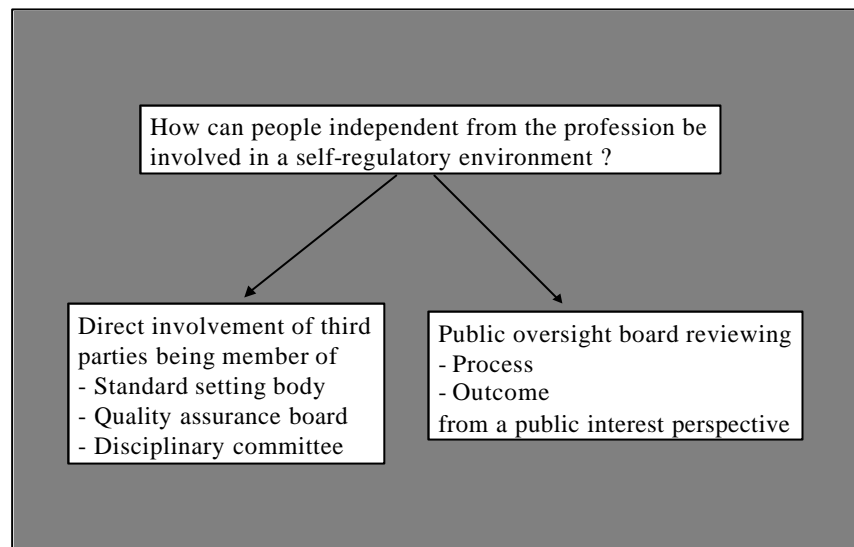
Self-regulation can be used to secure that the members of a profession observe updated legal and professional requirements and standards in performing their tasks. Therefore, with regard to the auditing profession, in addition to standard setting, areas such as licensing, registration, external quality assurance (oversight of the work of auditing firms by peers or professional bodies) or disciplinary regimes may lie in the responsibility of the audit profession. The objective of oversight of the self-regulatory activities of the profession is to ensure that the profession consistently achieves the goal of maintaining technical, educational and ethics standards at a high, up to date level which attracts public confidence in statutory auditing.

2.2.3. Combining self-regulation and public oversight

Diversity of oversight mechanisms needs to be recognised and accepted on the basis of the subsidiarity principle. However it is crucial that arrangements in the Member States have common features. FEE has a preference for a mechanism which combines the benefits of significant auditing expertise with the benefits in terms of public confidence of independent non-practitioners.

Monitored self-regulation is a preferable system because it provides technical expertise and professional knowledge. Other systems could also achieve the same results but they will often face the risk of developing an expensive bureaucracy.

Monitored self-regulation can be achieved by involving independent persons in activities of the professional body of auditors, including standard setting and enforcement of standards. As shown in the diagram on the next page, there are two main possibilities to involve third parties: direct involvement and external oversight:



Oversight arrangements can involve third parties and stakeholders co-operating in the process and ascertaining whether the self-regulated body is acting sufficiently in the public interest. This can apply for instance in education (involving academics), in quality assurance (involving regulators), and in disciplinary regimes (involving judges).

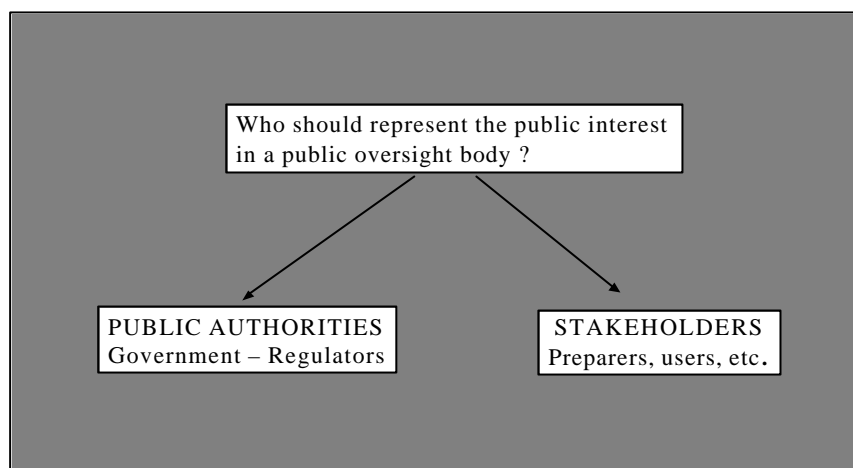
Another approach is the establishment of a separate independent body to review the process and performance of professional bodies in carrying out their task in the public interest. This is a public oversight board in the narrow sense of the expression.

In practice, several Member States have developed systems combining direct involvement of non-practitioners, for instances judges in disciplinary procedures, with the establishment of an external public oversight arrangement.

The role of a public oversight board is not integrated in the decision making process in individual cases, but it would be logical to extend its responsibilities further than just an independent regular reporting on achievements. For instance, delivering views on request or in a systematic way on draft standards or on implementation measures is a normal way of carrying out oversight. In certain cases, one could also go so far as using a veto right or providing an obligation to reconsider a decision.

2.2.4. *Who should represent the public interest?*

Oversight bodies must be independent from the profession. This is why FEE believes that significant involvement of non-practitioners is necessary. Independent non-practitioners should be in a majority in oversight mechanisms. This approach should enable oversight mechanisms to adopt a wide view of their responsibilities in order to balance the stakeholders' interests that comprise public interest. Essentially public authorities and users of auditor could claim to appoint representatives of the public interest.



Public oversight differs between Member States depending on existing structures for supervision of the audit profession and the importance of sector specific regulatory monitoring of audit quality. In its Communication of 21 May 2003, the European Commission acknowledges that securities regulators or sector specific regulators may be a proxy for representation of the public interest. It emphasises however that *“Any initiative concerning public oversight should take into account also the potential role of other stakeholders. No single supervisor or stakeholder has a sufficiently broad scope to adequately reflect these diverse interests in the oversight of auditors that perform more than one million statutory audits in the EU.”*

Many stakeholders can be interested in the outcome of the audit: preparers of financial statements, representatives of investors, employees, governments and their agencies, stock exchanges, financial analysts, and lenders. The oversight mechanisms should not be dominated by one single group of these stakeholders.

The European Commission also states in its Communication *“The actual organisation of public oversight for quality assurance differs between Member States depending on existing structures of supervision of the audit profession and the importance of sector specific regulatory monitoring of audit quality. Securities regulators or sector specific regulators may be a proxy for representation of the public interest. But any initiative concerning public oversight should take into account also the potential role of other stakeholders. No single supervisor or stakeholder has a sufficiently broad scope to adequately reflect these diverse interests in the oversight of auditors that perform more than one million statutory audits in the EU.”*

The selection of representatives of the public interest should be decided at Member State level and an independent and transparent nomination procedure is desirable because it builds public confidence. Involvement of public authorities can also assist in this regard. However, FEE considers that involvement of a range of stakeholders is by far the preferable method.

2.2.5. Why oversight bodies need significant auditing expertise

FEE believes that oversight bodies, to be effective, also need significant auditing expertise. This provides the oversight mechanism with a better insight into the working of the environment of the auditing profession. It is important that oversight mechanisms can be confident that proposals they make or decisions they implement will represent practical solutions to improve audit quality. This may include cost/benefit considerations.

2.2.6. Funding

The oversight mechanism should have appropriate resources to achieve its goal, which includes the authority to have its decisions acted upon over the whole profession and human and financial resources to carry out its task effectively.

A variety of possible sources of funding have been identified:

- Governments;
- Levy on all companies subject to statutory audit (through company public registers);
- Other stakeholders;
- A combination of the above.

Ideally, the oversight mechanisms at Member State level should be wholly independent. FEE believes that the funding should not only be from the profession.

2.3. Scope of oversight mechanisms – an audit is an audit

Statutory audit in Europe is applicable to a wide range of companies. The perspective of the Treaties is to build an internal market for business and people in Europe and this goes far beyond the establishment of a level playing field just for investors active in capital markets.

The role of statutory audit in listed companies and other entities which are of significant public interest because of their business, their size, their number of employees or their corporate status may be specific but the fundamental justification for a statutory requirement is not different. FEE has always considered that all statutory audits should be conducted to the same standard – “an audit is an audit”. Therefore, all measures aiming at improving the quality of the services provided should apply to all kinds of audit engagements. This approach allows for greater emphasis in quality assurance and oversight activities related to the audit of listed companies and other public interest entities.

FEE is aware that in some Member States, as in the United States, there are separate arrangements for quality assurance and oversight of the auditors of listed entities. Nevertheless, in the interest of the integrity of all statutory audits, FEE has a preference for integrated oversight arrangements over the statutory audit profession as a whole.

2.4. Public Oversight at EU or Member State Level

The objective is that robust oversight mechanisms should exist in all EU Member States to ascertain and continuously improve the quality of audit performed by statutory auditors. FEE believes that these arrangements should respect fundamental common principles and essential features necessary to gain public support in a single market.

Oversight systems are organised in various ways in the Member States.

Oversight mechanisms exist in all EU Member States and most other European countries. However the same conclusion can be drawn in this area as in other areas of financial regulation in Europe; Member States are organised in a variety of ways resulting from various traditions and cultural approaches to oversight.

There is a great diversity of national arrangements aiming at addressing these questions. These mechanisms range from direct regulation by public authorities or independent regulators to public oversight of a self-regulated profession.

In many countries, there is more than one oversight mechanism, addressing different aspects of the profession. The diversity is not an obstacle if the systems can be benchmarked against commonly agreed criteria and it can be demonstrated that the framework is robust and meets the needs of the users.

Oversight is best organised at Member State level.

Differences in legislation in the European Member States mean that the organisation of the public oversight structure for the audit profession should be at national rather than at European level. Other reasons may be found in the characteristics of the different national environments within the EU (such as scope of the oversight systems, legal regime of sanctions, and different languages). The existence of divergent mechanisms aimed at achieving the same goal of equally effective oversight which meets European benchmarks suggests that applying the subsidiarity principle would be appropriate in such circumstances.

When applied to some specific aspects such as registration or quality assurance, oversight needs to be operated in the local language and in consideration of the national environment in which the auditors operate. Since there must be investigation of any apparent audit failure and appropriate sanctions must be applied in case of professional misconduct, organisation and oversight of these processes is best conducted at Member State level.

By analogy, this principle was a fundamental consideration in the FEE discussion paper on enforcement of accounting standards in Europe. It has recently been reaffirmed by CESR in its standard n°1 on enforcement of accounting standards and it is also consistent with the Lamfalussy design. The same approach is suitable for oversight of statutory audit activities.

A co-ordination needs, however, to be organised at EU level.

Based on the subsidiarity principle, each Member State is free to organise the oversight mechanism of the audit profession in accordance with its laws and traditions for maximum effectiveness and for this purpose to establish public and/or private bodies. However, in order to ensure that oversight mechanisms are indeed equally effective throughout the single market, the essential principles and scope of oversight activities should be established by common European

principles and benchmarks. Oversight of statutory auditors needs to be of equivalent quality throughout Europe even if institutional arrangements may vary as between Member States.

FEE supports the statement by the European Commission in its communication of 21 May 2003 that *“It is important that those people who are in charge of public oversight at national level have the possibility to meet regularly to discuss their concerns, to exchange experiences and to develop best practices. Respecting the principle of subsidiarity, the Commission believes that the practical implementation of oversight should remain the responsibility of Member States.”*

Appropriate relationships with oversight and enforcement bodies must be developed.

In order to address oversight issues in a comprehensive and co-ordinated way, public oversight mechanisms for the auditing profession in the Member States should have appropriate relationships with other relevant bodies. This might include securities regulators, review panels and other bodies responsible for enforcement of financial reporting standards, financial regulators and auditors oversight bodies elsewhere (see co-ordination section 3). National oversight mechanisms should agree on the principles and the conditions for the exchange information in order to ensure an appropriate oversight of cross border audits within the single market.

Oversight activities must be transparent.

As mentioned above under paragraph 2.1, transparency is an essential feature of any oversight mechanism which intends to secure public confidence. Public oversight arrangements at Member State level should be organised in such a way that the fundamental principle of transparency is guaranteed.

3. GENERAL PRINCIPLES ON EU CO-ORDINATION OF OVERSIGHT OF THE AUDIT PROFESSION

EU Co-ordination of oversight mechanisms is in the interest of the member states and the audit profession

A. FEE SUPPORTS AN EU CO-ORDINATION PROVIDED IT

- Has a well defined co-ordinating role
- Is not a further layer of oversight at EU level
- Does not require registration of auditors at EU level

B. CO-ORDINATION TASKS

- On the basis of self assessment initially, establish and report on how EU principles of oversight have been implemented by member states and the profession
- If necessary, develop recommendations to the EU Commission on interpretation of oversight principles
- At regular intervals, review the effectiveness of quality assurance and oversight systems and recommend any necessary improvements
- Encourage convergence of best practice
- Provide a forum where member state oversight mechanisms, the EU Commission, CESR, the profession (and other stakeholders) can co-ordinate and develop their activities
- Provide a formal mechanism for exchange of information and co-ordination of oversight in cross border cases

3.1. The need for a public oversight on a EU level

Enhancing the credibility of auditing in Europe cannot be achieved exclusively through national mechanisms. The establishment and improvement of a single European market requires a co-ordinated European public oversight *system* offering a harmonised level of audit quality and the ability to address cross-border issues.

Provided it is not just a further layer of oversight at EU level, FEE supports co-ordination of EU public oversight mechanisms because it is in the interest of the Member States and also because it could help to:

- Build trust in the effectiveness of audit;
- Explain how EU principles of oversight are implemented by Member States and the profession;
- Support quality assurance at equivalent level for the single market;
- Co-ordinate Member States and EU Commission response to topical issues;
- Assist in review of cross-border audits requiring investigation;
- Explain EU arrangements in global regulatory dialogue.

3.2. Institutional aspects of the co-ordination of EU public oversight

3.2.1. Objectives

An agreement on principles for public oversight should be reached at EU level. To make the national systems effective and fully recognised in the internal market and internationally, these arrangements should be appropriately co-ordinated.

FEE considers that in the medium term, such co-ordination of EU public oversight co-ordination can only be fully effective if legally established; for example an organisation could be formed under law for this purpose. For convenience, in the remainder of this paper we will refer to it as the European Co-ordination Audit Oversight Board (ECAOB).

If public oversight is to be fully effective, it is necessary to think about the sanctions that should be taken against any Member State which does not implement in time the European principles and benchmarks. For example, the failure to implement a directive could result in an action before the European Court of Justice in the case of an apparent breach of Community law (art. 226 of the Treaty).

3.2.2. Responsibilities, tasks and duties

The following tasks should be designated for the European co-ordination of public oversight:

- On the basis of self-assessment initially, ECAOB should establish and report on how EU principles for public oversight have been implemented by Member States and the profession. Appropriate solutions should be put in place in order to help the Member States to implement fully the principles laid down at EU level.
- If necessary, ECAOB should receive the right to develop recommendations to the European Commission and Member States on interpretation of EU oversight principles or benchmarks for the public oversight system at national level and on possible improvements to arrangements and procedures for oversight, especially of quality assurance, at Member State level. The status of these recommendations may need to be developed further. If so, the introduction of binding instruments at EU level should be seriously considered in order to make the system effective and credible to the public and others. The revised 8th Directive should provide for this possibility.
- At regular intervals, the ECAOB should review the effectiveness of Member States quality assurance and oversight systems. The results of the review should be reported to the European Commission and published at regular intervals. Recommendations for any necessary improvement should be made on this occasion.
- Rather than imposing a single system in each Member State, the objective is to encourage convergence of best practice in quality assurance and oversight through review, discussion and experience. This will facilitate the further development of common procedures to support the EU principles for public oversight.
- The ECAOB should provide a forum where Member State oversight mechanisms, the EU Commission, CESR, the profession (and other stakeholders) can co-ordinate and develop their activities.

- The ECAOB could also provide a formal mechanism for exchange of information and co-ordination of oversight in cross border cases. However ECAOB should recognise that there are confidentiality and legal issues. These difficulties should be addressed and resolved in order to develop a workable system in the single market.
- The ECAOB should also be involved in the discussions with other oversight bodies in the world, such as the US-PCAOB in order to explain the quality of oversight arrangements in Europe.

The ECAOB should meet criteria such as:

- Be visibly structured in the public interest
- Involve all stakeholders appropriately
- Be able to exercise the limited agreed co-ordination functions effectively
- Be credible to other oversight bodies

It should also:

- Be established as a legal entity to build confidence
- Be recognised in national laws in due course
- Be quickly established – if necessary on an interim basis
- Have a small secretariat

3.2.3. Organisation and legal structure – principles

The organisational form should meet the following criteria:

- The responsibilities of the ECAOB should be clearly defined and the body should be enabled to exercise the limited agreed co-ordination functions effectively. This includes the assessment of the work of national systems but also the co-ordination of investigations on cross-border audits.
- The ECAOB must be more than just a forum giving the opportunity to people involved in oversight activities to discuss their practical and administrative problems at Community level. FEE believes that the ECAOB will be fully effective only if it is visibly structured in the public interest. FEE recommends that stakeholders be appropriately involved in the work of oversight mechanisms at Member State level; we also believe that the ECAOB should offer representatives of the stakeholders the possibility to express views because many policy issues will be developed at European level.
- The ECAOB should be credible to other oversight bodies in the world and be able to explain the quality of oversight arrangements in Europe.
- The ECAOB should be established as a legal entity. Several reasons justify this proposal. The objective is that such a body would be structured in such a way that it could effectively work on a number of issues that require resources. This would not be possible if the body is organised in a purely voluntary and relatively informal way. Another reason is that it

should be visible to contribute to building confidence. In that respect, it is also crucial that such a European body be credible to other oversight bodies in the Member States and abroad.

- It will be difficult for the ECAOB to carry out its duties effectively if it is not recognised in national laws; however this condition should not delay its establishment which could be if necessary on an interim basis. Further legal recognition can be realised in due course.
- The ECAOB should have a small secretariat. The objective is not to duplicate the work carried out at Member State level. Therefore, the secretariat should not become a body carrying out direct oversight activities on auditors and audit firms. However, the ECAOB will not be able to operate effectively and to guarantee the equivalence of oversight systems in the Member States if it does not have a minimum of human and financial resources.

3.2.4. Organisation – long-run proposal

The structure of the European Co-ordination

A possible Solution... ECAOB

- A privately organised body with delegated powers to perform well-defined co-ordination functions
- All stakeholders (national oversight mechanisms, CESR, profession, others but not EU Commission) as shareholders – general assembly
- A supervisory board to monitor its funding, administration and discharge of its functions
- A relatively small board to exercise the co-ordination functions
- Board members nominated by stakeholders with selection by independent appointment panel of persons of high public standing
- Board membership – a part time role

With a possible interim solution...

- EU Committee with appropriate stakeholder involvement
- Careful definition of interim co-ordination functions
- Preparation of long-run solution with necessary legislation and benefit of experience and relationships with other bodies

- ❑ *A privately organised body with delegated powers to perform well-defined co-ordination functions*

Keeping in mind the principles discussed in the previous paragraphs, several possibilities have been considered including:

- a) A simple consultative body chaired by the European Commission;
- b) A Committee established by an EU directive or regulation, comparable to the Contact Committee in the 4th EC Directive;
- c) The implementation of a full structure similar to the “Lamfalussy” approach including bodies at level 2 and 3;
- d) A privately organised body with delegated powers to perform well-defined co-ordination functions.

As explained below, solution a) or b) could be used as an interim solution to establish quickly a European Co-ordination contributing to the harmonisation and the improvement of oversight systems in the Member States and to the necessary dialogue with foreign bodies having similar oversight responsibilities in other countries including the US PCAOB.

It is assumed that the common principles and benchmarks will be developed at EU level and this can only be by means of a directive or a Commission decision in accordance with the comitology procedure. The main principles and benchmarks on public oversight could be included in the proposed revision of the 8th Directive.

In the medium term, once the 8th Directive is revised, more integrated solutions appear to be preferable for the reason explained above (see Section 2). FEE recommends the establishment of a privately organised body with delegated powers to perform well-defined co-ordination functions on oversight activities.

- ❑ *Governance of ECAOB*

FEE believes that the European Co-ordination Audit Oversight Board could be structured with three elements:

- The general assembly should involve all stakeholders (national oversight mechanisms, CESR, profession, others) as shareholders;
- The supervisory board is the meeting of representatives of all national public oversight arrangements;
- A relatively small board, nominated by the stakeholders, would have the responsibility to manage the secretariat.

- ❑ *The general assembly*

The general assembly would be the meeting of representatives of all national public oversight arrangements. Representatives of other stakeholders including CESR, the profession and others should be involved at this level. The European Commission in its capacity of legislator and regulator should be an observer, but not a member having a voting right, in the general assembly. The administrative organisation has not been discussed at this stage but it would probably be useful to establish an autonomous body capable of achieving its objective with a sufficient level of flexibility.

Since one of the objectives is to ensure that national quality assurance systems comply with the principles and benchmarks developed at EU level and to assess possible difficulties in national environments, an EU oversight mechanism would be fully effective only if all national oversight bodies were involved.

❑ *The supervisory board*

The supervisory board would be composed of representatives of national oversight mechanisms. Its responsibilities would be to monitor the funding of ECAOB, its administration and discharge of its functions.

❑ *The Board (ECAOB)*

Considering the proposal made above that representatives of all oversight mechanisms in the Member States be part of the supervisory board of the European Co-ordination, the establishment of a relatively small board structure and most likely specialised committees will be necessary to carry out properly the specific co-ordination tasks allocated to this body.

The members of the Board would not have a full time role. They should however ensure that their availability is sufficient to carry out their duties.

The general assembly would nominate the Executive members with approval or endorsement by an independent appointment panel of persons of high public standing.

3.2.5. Organisation – interim solution

The establishment of a European Co-ordination of the oversight systems which already exist in the Member States should be a priority because it is required to restore confidence in the auditing profession and in the capital markets in Europe and internationally. The proposed permanent structure developed above would take some time to be established quickly so that an interim solution would be advisable.

An temporary solution could consist of a committee chaired by the European Commission aimed at proposing common principles for oversight systems in the Member States. Such a solution could be implemented quickly by decision of the European Commission. FEE considers that it should however be a temporary mechanism in order to prepare a more integrated solution as developed above. The reason for having an interim and urgent solution is that this committee should support the European Commission in the necessary dialogue with foreign bodies having similar oversight responsibilities in other countries including the US PCAOB. These discussions cannot be delayed until a more formal and integrated solution can be developed at EU level.

Such a very flexible co-ordination would also be useful in an interim phase to help oversight bodies in the Member States in developing common views before moving forward towards more permanent solutions.

As far as possible some of the characteristics of the final proposal should be developed in the temporary solution. This includes notably:

- Involvement of representatives of national oversight bodies, stakeholders and representatives of the profession having significant auditing expertise;
- Transparency in the composition of the Committee and its decision processes;
- Sufficient resources and authority to be effective in its co-ordination responsibilities.

3.2.6. *Funding of the secretariat*

The need for funding of ECAOB should be modest and rely mainly on the resources of national oversight bodies existing in the Member States (people and money).

ECAOB would not have a large staff since its objective is mainly to co-ordinate the action of national bodies. However, it cannot operate effectively without a small secretariat. Establishing such a secretariat is a necessity to demonstrate to the outside world that the co-ordination exists and operates effectively.

The opportunity to have an alternative system based on funding by the private sector was considered but *rejected* for two main reasons. Firstly, in several Member States, oversight is operated by Government or a Government Agency that might be reluctant to participate in such a body. Secondly, the experience in the US and other countries shows that a wholly privately funded oversight mechanism is open to criticism by those who are supposed to benefit from this mechanism. For the same reasons, the profession cannot run the secretariat.

4. FEE'S VIEWS ON CONVERGENCE AND EQUIVALENCE OF REGULATION OF CAPITAL MARKETS, CORPORATE GOVERNANCE, STANDARDS AND PUBLIC OVERSIGHT OF AUDITING

In increasingly global financial markets, regulators are rightly considering the existence of equivalent measures to protect investors in a company from abroad seeking to raise funds in a domestic market. This is particularly relevant in the context of the European single market and merits a common approach to public oversight of the audit profession within the EU. It is also appropriate that the issue is raised globally.

The underlying complexities became more visible since European accounting firms providing services for SEC registered foreign companies or significant affiliated of SEC parent companies are subject to the Sarbanes-Oxley Act. Therefore, they will be subject to the extensive rules on oversight of the Public Company Accounting Oversight Board (PCAOB). The affected European accounting firms therefore risk being subject to a twofold professional oversight.

It should be considered how an intervention of foreign legal systems in the national legal system and twofold financial and administrative burdens arising from the necessity to observe the requirements of two different systems could be avoided. The objective should not be to achieve exceptional exemptions on the basis of Sec. 106 of the Sarbanes-Oxley Act which might give the impression that European accounting firms do not want to or are not able to comply with the stringent US regulations and thereby imply that audits performed by European accounting firms are of inferior quality. Instead, it should be made clear that the European public oversight systems – which already exist and in some cases are being established or improved – are equivalent in quality to the US system, which is itself in transition.

The European Commission's Communication of 21 May "Reinforcing Statutory Auditing in the EU" states: "Whilst the Commission shares the objectives of the SOA and supports many of its measures, differences in the EU's cultural and legal environments require mutual acceptance by the US of equally effective European solutions. A transatlantic (and global) capital market cannot be achieved unless the EU and the US mutually recognise the equivalence of high quality regulatory systems."

At this stage the SEC and the PCAOB have not recognised the concept of equivalence as a basis for general EU wide exemptions in their rulemaking. If its efforts to deal satisfactorily with the requirement for EU audit firms to register in the US remains unsuccessful, the European Commission envisages in its Communication "the application of the principles that will be included in EU legislation to also non-EU audit firms performing audit work in relation to the EU capital market".

In its rule on the registration system for public accounting firms (2003-007 of 6 May 2003), the US PCAOB states "Where possible, the Board will seek to build compliance with its requirements on compliance with foreign regulatory regimes". It also indicates that it "has already commenced dialogue with other oversight bodies outside the United States in order to achieve its objectives generally, as well as to try to reduce administrative burdens and to provide for coordination in areas where there is a common programmatic interest, such as reporting, inspection and discipline." This can be understood to mean that the US authorities are aiming for appropriate regulatory convergence at the highest standard.

FEE supports the policy of the European Commission which is to continue its own programme of reforms and to demonstrate full equivalence throughout Europe as soon as possible. To do otherwise would risk undermining the very concept of a single capital market. FEE agrees with the Commission's position that: "A co-ordinating mechanism of national systems of public oversight at EU level could also be an important platform for a regulatory dialogue on audit policy issues with regulators from third countries including with the PCAOB and/or SEC."

In the same manner any public oversight system within the EU should consider the effect of cross-border listings and include provisions on the recognition or quality assurance mechanisms existing in the USA and in other part of the world.