



**Fédération des Experts  
Comptables Européens**

# Position Paper

*Date: May 7th, 2002*

## **THE ROLE OF ACCOUNTING AND AUDITING IN EUROPE**

*Position of FEE, the European Federation of Accountants*

Financial statements presenting a true and fair view of a company's financial position are a cornerstone of any capital market. The unexpected collapse of an important company listed on a stock exchange risks undermining the credibility of the information and the regulatory system which is put in place to protect investors. Even if business failures are unavoidable, this raises the question as to whether the financial statements concerned were sufficiently transparent in disclosing the risks run by investors. When the market considers that the information was not appropriate although a clean opinion was provided in the audit report, the position of auditors is usually questioned.

FEE, as the representative organisation of the accountancy profession in Europe, understands the seriousness of the questions raised by the Enron collapse. We recognise the fundamental importance of public trust in our profession and the need to work continuously to maintain that trust.

The ongoing debates in the US Congress, together with numerous opinions from governments, regulators, investors, corporations and the media show that the Enron case is very complex. Clearly, many aspects need to be considered. We need to take account of the current state of corporate governance and financial reporting in the EU and consider whether the systems in place would reduce the risks that the same kind of problems might occur in Europe. With this paper, FEE is highlighting the essential issues related to the accountancy profession which are at the centre of the current debate.

Other aspects should also come under scrutiny like the role of other professions and of regulators. FEE believes that there is a need to strengthen corporate governance arrangements so that they are equally effective across Europe in providing financial information of the highest quality to the capital markets. The principal elements of this framework are:

- Preparation of true and fair financial information by an effective and well resourced company accounting function
- Internal audit
- Informed review by directors, audit committees or supervisory boards
- Proper approval procedures for financial information by the body responsible within the company
- External audit and external review subject to quality assurance systems that inspire public confidence

- Effective enforcement bodies
- Stock Exchanges with supportive listing agreements
- Sponsors, advisers and investment bankers committed to high quality financial reporting particularly in respect of complex transactions
- Investors, analysts, rating agencies and the financial press, all of which should have clear ethical obligations to raise issues of dubious financial reporting

As illustrated below major steps have been taken recently in the European Union to improve the current financial reporting system. There is no reason to change the strategy but it should be given even higher priority. FEE will work with all partners in this debate to maintain momentum and, where necessary, suggest additional initiatives to preserve and enhance the effectiveness of the financial reporting system.

### **Financial Reporting Standards**

- *Capital Markets need high quality financial reporting. Europe will be the first major region in the world that requires application of International Financial Reporting Standards(IFRS) by 2005.*
- *A principle- based approach for standard setting requires both companies and their auditors to exercise professional judgement.*
- *EFRAG as a major contribution of the private sector was established to voice the European point of view in the development of IFRS.*

FEE has been actively involved in the debate on a financial reporting strategy within Europe, ultimately resulting in the proposal for a Regulation on the application of International Financial Reporting Standards to the consolidated accounts of listed companies from the financial year 2005. FEE argues that the approach taken by the European Union must be supported for two main reasons:

- *The approach of International Financial Reporting Standards is right since it is based on principles.*

FEE supports a principle-based approach to financial reporting and other standards. This means that clear principles designed to serve the public interest underpin rules that show how those principles should be applied in common situations. This approach promotes consistency and transparency and helps companies and their advisers to respond appropriately to complex situations and new developments in business practice. It also prevents regulatory overload and technical avoidance that can occur where detailed rules are developed in an attempt to cope with all the eventualities that may arise in practice.

A principle-based approach requires both companies and their auditors to exercise professional judgement. The objective of the financial statements is to present a true and fair view of the company's financial position, the results of its operations, and cash flows for the period. This approach emphasises the obligation to prepare financial statements that provide a faithful representation of all transactions rather than relying only on a narrow compliance with existing rules.

In our view, increased attention should also be given to developing new information, especially on business risks in financial statements and directors' reports. The financial reporting system needs to adapt on a continuous basis to developments in the business environment. The importance of reliability, as a characteristic of financial statements must also be emphasised; in that respect, transactions and other events that financial statements purport to represent need to be presented in accordance with their substance and economic reality and not merely their legal form. The principle-based approach is well-suited to such developments because it is more open to evolution and copes well with detail and complexity.

- *Global financial markets require financial information prepared in accordance with global standards (for competition, comparison and capital raising reasons).*

FEE supports IFRS because they offer a global solution to standard setting. The work program of IASB addresses most of the critical issues identified in the European financial reporting debate. IFRS represent a significant step forward requiring more disclosures and transparency. Conflicts between standards impair the credibility of financial information and therefore convergence is needed. Furthermore, national standard setters can be more easily put under pressure by local interest groups. It is important that Europe gives a proper contribution to the international standard setting process.

FEE supports the European Commission and Parliament's choice to support the work of IASB. The European Financial Reporting Advisory Group (EFRAG) by FEE together with UNICE (Union des Confédérations de l'Industrie et des Employeurs d'Europe), EBF (European Banking Federation), ESG (European Savings Banks Group), GEBC (European Association of Cooperative Banks), CEA (Comité Européen des Assurances), EFFAS (European Federation of Financial Analysts Societies), FESE (Federation of European Securities Exchanges), UEAPME (European Association of Craft, Small and Medium-sized Enterprises) and EFAA (European Federation of Accountants and Auditors for SMEs) has been established to support the use of IFRS and to advise on the decisions of the EU Accounting Regulatory Committee; this is a major private sector contribution to creating more transparent financial reporting in the European Union. The main part of EFRAG's work will be to contribute to the global standard setting process.

### **Enforcement of Standards and Corporate Governance**

- *FEE has recently published a discussion paper on enforcement of IFRS in Europe urging Member States to review their arrangements for enforcing accounting standards and to establish a mechanism for coordinating the activities of national enforcement bodies.*
- *Good corporate governance is a key element of enforcement; The responsibility of management and directors to deliver proper information to shareholders and the role of non-executive directors, audit committees or supervisory boards needs to be emphasised.*

The accountancy profession has taken steps to introduce International Financial Reporting Standards into practice. Companies as well as professional firms are facing an enormous challenge on training and education. The profession is working hard already to face the challenge within the very short period remaining before the mandatory application of IFRS.

The debate on enforcement has accelerated at different levels in Europe long before the Enron case. In 2001 FEE published a factual study on enforcement mechanisms in Europe. This study concluded that there are important differences in institutional oversight systems in Europe. In relation to enforcement of financial reporting standards, it concluded that for nearly half of the countries surveyed, there was at that time no institutional oversight system in place. The Committee of European Securities Regulators (CESR) established a subcommittee on enforcement showing that this issue will be a priority in the coming years.

FEE has recently published a discussion paper recommending that EU Member States urgently review their arrangements for the enforcement of accounting standards. There is a clear need for a European coordination on enforcement in order to ensure consistency of enforcement decisions within Europe. Enforcement should be built on effective national enforcement bodies. In countries where such an enforcement body for accounting standards does not exist, it is recommended to establish an enforcement body based on a review panel model. Such a model should be sufficiently flexible to extend enforcement to all companies which use IFRS in their financial information.

This is a clear example of FEE's proactive commitment to ensure that financial reporting systems support the efficient functioning of European capital markets.

Another key element of enforcement is corporate governance. As pointed out in a recent comparative study of corporate governance codes, published by the European Commission, the most important differences in corporate governance practices among companies incorporated in Member States result from differences in company laws and securities regulations rather than differences in code recommendations. The consultant concluded: "for the most part, the code recommendations are remarkable in their similarity and serve as converging force" (p.6). This convergence could however lead to some confusion if the corporate practices are interpreted against the background of diverging company law systems.

Investors very often lack information on the corporate governance structures and practices. In particular, the respective roles of directors, audit committees or supervisory boards and independent auditors for financial reporting are not always clear to the reader of the financial statements, when used in an international environment.

FEE considers as a vital improvement the achievement of EU-wide consistency on such elements as: the responsibility of directors for financial reporting; reporting to shareholders; and guidance on how audit committees should assess the quality of financial reporting, based on the results of the audit and taking into account the quality and effectiveness of the audit. Whether such an objective could be achieved only by non-binding legislation needs further consideration.

### **Auditing and quality assurance**

- *FEE supports the application of auditing standards which comply with International Standards on Auditing to reduce variations in auditing and audit reporting practice*
- *Quality assurance programs aim to reduce the risk of audit failure. FEE supports the European Commission's recommendation of 15 November 2000 that Member States establish robust quality assurance systems for auditors which inspire public confidence*

- *The recommendation envisages a systematic link between negative outcomes of quality reviews and sanctions*

When a company suddenly or unexpectedly faces severe financial problems, questions arise about the responsibilities of those who manage the company and more broadly all those having a role in the preparation, audit and analysis of the financial information. If the work of auditors is questioned, there needs to be a system in place for initial investigation of whether some aspects need to be more closely examined. When this examination shows that applicable standards have not been followed, an appropriate system of sanctions must be in place.

In such a case, the first reaction should not be to question the quality of the standards. These should only be changed after careful consideration and proper debate.

The objective of an audit is to express an opinion whether the financial statements are prepared in all material respects in accordance with an identified financial reporting framework. Placing the auditor's role in context, it is important to remind the shareholders that "although the auditor's opinion enhances the credibility of the financial statements, the user cannot assume that the opinion is an assurance as to the future viability of the entity nor the efficiency or effectiveness with which management has conducted the affairs of the entity" (ISA200/3)

FEE supports the mandatory application of the International Standards on Auditing developed by the International Auditing and Assurance Standards Board (IAASB) of the International Federation of Accountants (IFAC). FEE made a proposal in November 2001, that by 2005, EU national auditing standard setters should require auditors to perform audit procedures that comply with ISAs and report on financial statements in accordance with the same international standards. The aim is to reduce variations in auditing and audit reporting practice. This approach will be particularly useful as the international standard setter makes improvements to its standards in coming years, for example to reflect developments in risk-based audit methodologies. Public oversight of the standard setting process is also being improved and this should further enhance the credibility of the IAASB's standards.

The establishment of a Forum of European Standard Setters, as recommended by FEE, would help to identify areas of European concern. IAASB, the global standard setter, would then be invited to take the lead in improving International Standards on Auditing.

FEE recommended in April 1998, the establishment of high-level quality assurance schemes in all its Member Bodies. It strongly supported the European Commission's recommendation of 15 November 2000 on this subject. The Commission Recommendation on Quality Assurance is a high quality document and is in course of being implemented. FEE suggests that the planned review of its practical effect could be brought forward.

### **Ethical Standards and independence**

- *FEE supports the draft recommendation on statutory auditors' independence proposed by the European Commission; this recommendation is a major step forward and uses the principles-based approach which is the best solution to protect independence effectively.*

- *FEE believes that auditors are prohibited from providing services which compromise their independence. The draft EC recommendation on auditors' independence develops rigorous application of this principle.*

FEE has contributed to the debate on the independence of the Statutory Auditor by publishing, in July 1998, a comprehensive paper on "Statutory Audit- Independence and Objectivity". The paper adopts a principle-based approach. Fundamental principles are set out which must always be observed by the professional accountant. The accountant must conscientiously consider whether the engagement involves threats which would, either in fact or in appearance, impede the observance of the fundamental principles. Where such threats exist, the professional should put safeguards in place that eliminate the threats or reduce them to clearly insignificant levels. As an example, the review by a concurring partner provides an important safeguard. The paper states that if the accountant is unable to fully implement adequate safeguards, he should refrain from acting.

This approach prohibits relationships and situations, including the provision of non-audit services, which compromise auditors' objectivity. It combines rigour and flexibility and is the most satisfactory way of ensuring that ethical requirements are fully observed. In the rapidly evolving modern global economy it is impractical to comprehensively list all threats possible to independence. In fact such an approach is open to the dangers of ignoring threats not specifically mentioned or detailed in the rules. Therefore the auditor needs to document his/her judgment about independence, discuss the situation with those charged with governance in the audited company but also accept responsibility for the final decision he will take.

The European Commission published a recommendation on Statutory Auditors' Independence, which applied this conceptual approach. FEE supports this recommendation.

The document recommends important safeguards to auditors' independence and objectivity which would contribute to the continuous improvement of the system in the EU Member States, including for example a full disclosure of audit and non-audit fees, and documentation for each audit client to show whether or not circumstances might have threatened the auditor's objectivity. FEE acknowledges that different approaches to independence rules may exist but regulators should carefully consider the risk that these proposals may have a negative influence on the quality of audit services. FEE could also accept a mandatory provision preventing key audit partners joining their audit client in sensitive roles, as long as the responsibility is put on the company and the individual concerned.

On the other hand, in line with the draft EC recommendation, FEE does not favour mandatory requirements for rotation of audit firms to avoid a perceived familiarity risk. Whilst such measures can be seen as addressing public concerns about the appearance of independence, there is a danger that they have more negative consequences than benefits. Rotation leads to a loss of cumulative audit knowledge and increases the risk of audit failure in the first years after rotation. The EC recommendation suggests introducing, internal rotation of key audit partners (within firms) in public interest entities, which can be accepted by FEE.

The EC recommendation would also suggest additional requirements in most Member States, which could result in significant evolutions in areas such as disclosure of fees, involvement of audit committees, and documentation of the auditor's judgment on independence issues.

Commitment to professional ethics is crucial to the accountancy profession and to the credibility of the auditors. FEE reaffirms that the profession is committed to respecting the fundamental principles established by the Code of Ethics of the International Federation of Accountants amended in November 2001. The Code outlines appropriate measures concerning integrity, objectivity and professional behaviour. The decision by some accountancy firms to reconsider the scope of their activities in consulting areas is evidence of the dynamic approach followed by the global profession facing new demands from society. Those who are responsible for appointing the auditor or for contracting on non-audit services with Accountancy firms also have a role to play in putting in place some of the essential safeguards protecting statutory auditor's independence.

### **Oversight of the profession**

- *Quality assurance systems should have adequate public oversight.*
- *FEE agrees with the European Commission that harmonised conditions could be defined at EU level for organising the public oversight of the auditing profession in EU Member States.*

Client and market confidence is highly valued by the accountancy profession. Confidence is jeopardised by audit failures, and the credibility of the system suffers as a result. In addition, the profession has developed quality assurance programs with the aim of substantially reducing the risk of audit failure. . The implementation of the minimum requirements as proposed in the EC recommendation on the quality assurance for the statutory audit in the European Union should be surveyed in the near future and FEE would be ready to cooperate in this work.

Quality assurance systems should have adequate public oversight consisting of a sufficient number of non-practitioners on the overview-board of the quality assurance system. FEE would also support the development of common EU principles as to the appropriate composition, structure and duties of public oversight arrangements for quality assurance. No common model of oversight exists in Europe. FEE believes that oversight should be on the basis that the profession continues to be subject to monitored self-regulation.

FEE also agreed with the Commission's recommendation to establish a systematic link between negative outcomes of quality reviews and the disciplinary system. The disciplinary system should include the possibility of removal of the statutory auditor from the audit register. The disciplinary system should also be subject to public oversight.

### **Auditors' Liability and Risk of Catastrophic Loss Claims**

The more harmonised accounting and auditing standards become, the more discrepancies in other essential areas will detract from the functioning of the single market. This is particularly true for inconsistencies concerning auditors' liability. Wherever possible, such inconsistencies should be reduced to the minimum, perhaps by agreeing on some acceptable methods of reducing the risks of catastrophic loss claims. A survey recently published by the European Commission stated: "The progressive achievement of the internal market for statutory auditors through the improvement of relevant European legislation should trigger more cases likely to give rise to situations where differences in liability regimes become more crucial."

It is legitimate that auditors are financially liable for the consequences of their performance failure but it is essential that audit liability be set according to standards that reasonably relate to the consequences of unsatisfactory audit performance. FEE considers that the European Commission should address the liability issue.

The risk of catastrophic losses arising from huge claims in relation to audit is a most serious threat to the viability of the auditing profession. Few firms can afford the risk of taking to trial these claims, since an adverse finding might be financially unsustainable. The growth of such claims is also a definite reason why the profession is already less attractive as a career than in the past and the burden of litigation and related matters is also a serious disadvantage of auditing compared to other professions.

Such considerations also have implications for the capital markets. Reliable financial reporting is a cornerstone of effective capital markets and in turn requires a vibrant auditing profession of the highest calibre people. This is why some measures to mitigate the risk of catastrophic loss claims against auditors should form part of the EU capital markets programme.

## **Conclusion**

FEE strongly believes that the European initiatives described above have strengthened the credibility of the financial reporting system. It would be regrettable if on the basis of Enron, hasty measures were taken which, although well intentioned, had a negative effect on audit quality.

Logic dictates that no regulatory regime can eliminate risk. The accountancy profession has made substantial efforts over many years to provide businesses and capital markets with high quality accounting and auditing standards. As demonstrated by its action in recent years, FEE has been proactive in its contribution. FEE will continue to work on behalf of the European profession to raise standards and to highlight areas of concern.

In light of the doubts that have been raised as a result of the failures in the US and elsewhere, FEE will do its utmost to strengthen public confidence. This will be done by measures to:

- Support improvement of good corporate governance practices because these issues are gaining more importance in the European and global development of markets.
- Promote global solutions designed to meet the needs of the European Union
- Demonstrate how the principle-based approach, which is robust and flexible enough to be applied in a multi-jurisdictional environment will effectively offer the requested safeguards to protect the auditor's independence;
- Speed up implementation of improved quality assurance systems and broad public oversight based on monitored self-regulation.

FEE believes that action is needed in:

- Ensuring that EFRAG makes a significant impact in providing a European contribution to the international standard setting process (IFRS and IFRIC);
- Coordinating initiatives in the Member States on the enforcement of financial reporting standards, in order to ensure consistency in application decisions within Europe;
- Agreeing on the FEE proposal to require the application of International Standards on Auditing by 2005;



- Increasing efforts to support and influence the global standard setting process in auditing;
- Speeding up national programs of quality assurance in conformity with the EC's recommendation;
- Taking a final decision, as a matter of urgency, on the proposed European Commission recommendation on statutory auditor's independence;
- Improving the current situation in the area of auditors' liability; and
- Defining at EU level harmonised conditions for organising the public oversight of the auditing profession in the EU Member States.