

**PROPOSAL ON INTERNATIONAL STANDARDS ON  
AUDITING IN THE EU  
NOVEMBER 2001**



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## 1. **THE PROPOSAL**

### **Summary**

- 1.1 The Council of the Fédération des Experts Comptables Européens (FEE) has approved this paper for presentation and discussion at the Paris meeting of the European Commission Committee on Auditing on 12 and 13 November 2001. FEE proposes that:

*By 2005 national auditing standards in the European Union should require auditors of financial statements to:*

- *perform audit procedures that comply with International Standards on Auditing (ISAs);*
- *report on financial statements in accordance with ISAs; and*
- *perform additional audit procedures and report on additional matters in response to specific legal, regulatory or other needs established at a national level.*

- 1.2 The proposal could be incorporated in an EU recommendation and implemented within the existing European legal framework using current national arrangements for delegation of auditing standard setting. It is envisaged that implementation will be supported by a forum of European national auditing standard setters. Such a forum will need to win the confidence of key stakeholders with an interest in audit quality including the European Commission and its Committee on Auditing, Member State governments, securities regulators, professional bodies of accountants, audit firms and the preparers and users of audited financial statements.
- 1.3 The membership of FEE comprises 38 professional bodies of accountants based in 26 countries including all 15 Member States of the EU. FEE strongly supports global harmonisation of auditing standards on the basis of ISAs. FEE is therefore keen to play a leading role in the harmonisation of auditing standards and auditors' reports in Europe. This role could involve further consultation with national standard setters, the European Commission, the Committee on Auditing and other stakeholders to develop this proposal and to explore options for establishing a forum of European national auditing standard setters.

### **Background**

- 1.4 There is broad agreement in Europe on the need to improve the quality and comparability of financial statement audits and auditors' reports on the basis of ISAs developed by the International Auditing Practices Committee (IAPC) of the International Federation of Accountants (IFAC). For example, the European Commission's Green Paper "The Role, the Position and the Liability of the Statutory Auditor within the European Union" underlined the importance of considering ISAs as a starting point for standards to be applied by statutory auditors within the EU.
- 1.5 Current EU interest in auditing standards and auditors' reports follows the successful work of the European Commission and the Committee on Auditing to develop recommendations on audit quality assurance and auditor independence. These initiatives to spread best practice and enhance and harmonise audit quality support the functioning of the EU internal market as a whole as well as the Lamfalussy Report's vision for the swift integration of European capital markets. At the June 2001 meeting of the Committee on Auditing in Oslo, the chairman identified auditing standards as the next major project on the Committee's agenda and it was noted that FEE had decided to develop a strategy for the use of ISAs in Europe.
- 1.6 Earlier drafts of this FEE proposal were debated at the FEE Executive meeting on 3 September 2001, at the FEE Auditing Working Party meeting attended by the Chairman of the IAPC on 20 September 2001 and at the FEE Council meeting on 23 October 2001. Comments on earlier drafts were also invited from European Commission staff at meetings on 28 August, 18 September and 23 October 2001 and from the European Contact Group of the major audit

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firms at its meeting on 28 September 2001. Frequently asked questions relating to the proposal are set out in Appendix II.

### **Practical considerations**

- 1.7 Already today, auditors whose methodologies are aligned with ISAs identify and complete programmes of additional work to satisfy the requirements of national auditing standards. Nevertheless, users of financial statements across the EU do not have transparent, up-to-date and readily usable comparisons between national auditing standards and ISAs. The proposal will transform this situation by expecting all auditors to comply with ISAs and to report accordingly and by putting the spotlight on national standard setters to identify, justify and communicate additional requirements contained in national standards.
- 1.8 Appendix I illustrates an auditors' report prepared in accordance with ISAs that could become a common European auditors' report. It reflects the recent revision of ISA 700 effective for periods ending on or after 30 September 2002. Such a report would eliminate the current lack of clarity about whether audits performed in accordance with national standards also comply with ISAs. However, it does not deal with the fact that current national auditing standards also call for additional audit procedures in relation to:
- the audit of the financial statements; and
  - matters beyond the financial statement for which national laws and regulations place additional reporting responsibilities on auditors.
- 1.9 Some European standard setters already require a single audit report that separates the opinion on the financial statements from additional national reporting requirements. However, such reports do not identify additional audit procedures in respect of the financial statements that are required by national standards. Under the proposal, national auditing standard setters will need to identify all additional requirements in their current national standards and then consider whether they need to be retained, and if so, whether and how they should be communicated so as not to confuse users and obscure the core ISA report. The overall aim is that an international audience should:
- clearly understand that the auditors have performed an ISA audit on the financial statements and what the results are; and
  - be able to appreciate what additional value can be derived from the auditors' compliance with additional national requirements.
- 1.10 In the case of additional national reporting requirements, national standard setters will have to decide whether auditors should report on these within an expanded ISA report or a supplementary report. The case for supplementary reporting will be strongest where the additional reporting relates to matters that are distinct from the financial statements such as corporate governance disclosures. The case for reporting within an expanded ISA report will be stronger where a requirement is integral or closely linked to the financial statement audit, for example reporting on bookkeeping records and the consistency of other reports with the financial statements.
- 1.11 Additional national audit procedures to support the opinion on the financial statements currently relate to requiring specific types of evidence, specific quality control procedures and the communication of specific matters. In relation to such procedures, standard setters will have to decide:
- whether auditors should present an additional opinion on the financial statements in accordance with national standards in the same report as the ISA opinion or in a supplementary report; and

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- whether auditors should explicitly describe the principal additional procedures within an expanded ISA report or a supplementary report, or remain silent and leave interested users to identify the additional procedures from other sources.

## **2. BENEFITS OF THE PROPOSAL**

### **Internal market efficiency**

- 2.1 In June 1998, FEE published a major study "Setting the Standards: Statutory Audit in Europe" which checked whether national auditing standards reflected the requirements of ISAs. It concluded that national standards were substantially in line with ISAs. A study presented by the European Commission to the Committee on Auditing in November 2000 reached similar conclusions. However, a FEE Survey of June 2000 "The Auditor's Report in Europe" showed that there was considerable variation in the wordings of statutory auditors' reports between EU Member States. The variations were caused in part by differences in auditing standards and, more significantly, by differences in national laws and regulations governing the subject matter and form of auditors' reports.
- 2.2 Although Member States have developed national auditing standards that are substantially in agreement with ISAs, relatively minor differences in standards are neither transparent nor clearly identifiable and this creates obstacles to the development of a single internal market in audit services. The proposal would enable simplification of the process by which statutory auditors approved in one Member State obtain qualifications permitting them to practice in another. By specifying ISAs as the common content of auditing standards in all Member States, the proposal would make it easier to identify the specific local knowledge relevant to practising in a particular country.
- 2.3 However, the most substantial benefits of the proposal will be in markets which rely on audited financial statements. When audited financial statements are used across borders, the value of the assurance provided by auditors' reports is reduced by variations in auditing and reporting practice. Either users of auditors' reports do not understand the nature of the assurance provided or they have to invest extra resources in obtaining such an understanding. This contributes to the fragmentation of European markets and raises business costs.
- 2.4 By enhancing cross-border confidence in audited financial statements, the proposal will promote the internal market for goods and services across all sectors. It will also facilitate cross-border capital flows including fund-raising and merger and acquisition activity and the buying and selling of securities. Particularly in the context of public capital markets, the proposal is consistent with the Lamfalussy Report and complements the adoption of International Accounting Standards and International Financial Reporting Standards (IAS) developed by the International Accounting Standards Board (IASB) from 2005.

### **Capital market efficiency**

- 2.5 A regulation proposed by the European Commission will require all EU listed companies to prepare group financial statements in accordance with IAS from 2005. The regulation will have direct application across the EU. Member States may also introduce national legislation to require IAS to be applied to unlisted companies and individual company financial statements. Nonetheless, the benefits of the move towards IAS, in terms of companies' improved access to markets and lower costs of capital, will be reduced if audit reports on IAS financial statements only refer to the national auditing standards of the country where a company is incorporated. To put it bluntly, such reporting would be absurd and would damage the reputation of the auditing profession throughout Europe. Hence the proposal to require auditors to report under ISAs by 2005.

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- 2.6 This approach will be particularly useful as the IAPC makes improvements to its standards in coming years, for example to reflect developments in risk-based audit methodologies and to secure endorsement of ISAs by the International Organisation of Securities Commissions (IOSCO). It will become increasingly difficult for cross-border users of auditors' reports to have confidence that national standards are substantially in line with ISAs without making an investment in tracking the programmes of each country's standard setter for reflecting changes in ISAs in its standards. Users will be relieved of such costs and uncertainties if audit reports refer directly to ISAs.

### **Respect for the principle of subsidiarity**

- 2.7 The proposal avoids unnecessary political conflict by respecting national standards and laws. It preserves the rights of Member States to place responsibilities on auditors in relation to material outside the financial statements and also to require audit procedures beyond those envisaged within ISAs. In all EU member states a common framework exists for imposing a statutory audit obligation through the accounting directives and for governing the approval of statutory auditors through the Eighth Company Law Directive. It is left to national authorities and legal systems to determine additional responsibilities of statutory auditors, how the standards applied by approved statutory auditors should be set and how to monitor compliance with those standards. The relevant auditing standards are issued by national standard setters which are generally organised by professional bodies of accountants. The proposal relies on the current legal and regulatory mechanisms for establishing the authority of auditing standards in EU Member States and enforcing their application.
- 2.8 Although Member States and national bodies will still be able to impose additional auditing and reporting responsibilities, transparent identification of incremental requirements will encourage businesses, auditors and capital market participants to engage in dialogue about the costs and benefits of such requirements. Governments, regulators and standard setters will come under pressure to justify new requirements and to abolish unjustified and superfluous burdens. Conversely, the IAPC will come under pressure to adopt good ideas developed by national regulators and standard setters. This will be particularly relevant at the beginning of the process envisaged by the proposal. Over time, national bodies would be expected to work on new ideas on the basis of international co-operation.

### **Efficient use of technical resources**

- 2.9 The proposal will free resources of European national auditing standard setters for international standard setting and updating. It is indicative of the international scarcity of technical resources that only two EU standard setters have so far dealt with the implications for auditors of publishing audited financial statements on the internet. More efficient use of resources in auditing standard setting also potentially frees scarce technical experts to work on other elements of the European financial reporting infrastructure needed to support the internal market and the goals of the Lamfalussy Report. For example, there is much work to be done to strengthen regulatory systems for enforcing IAS, to establish audit quality assurance programmes to support compliance with auditing standards and auditor independence requirements, and to develop an agreed corporate governance framework in which high quality auditing can thrive.

## **3. IMPLEMENTATION ISSUES**

### **The role of the auditing profession**

- 3.1 The proposal is based on the idea that the bodies entrusted by Member State governments with the job of setting auditing standards should take responsibility, in the public interest, for transforming the transparency and comparability of auditing and audit reporting in the EU. By making such a commitment, standard setters and the professional bodies that support their activities will make it easier for the Commission, Member States and regulators to discharge

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their broader internal market responsibilities including realisation of the Lamfalussy Report's vision of an integrated European capital market.

- 3.2 Before national standard setters can take responsibility for delivering ISA-based audits in the EU, they will need to develop a plan for co-ordinated action that will inspire confidence amongst stakeholders at national and European level that the results will be in the public interest. Key stakeholders include the European Commission and its Committee on Auditing, Member State governments, securities regulators, professional bodies of accountants, audit firms and preparers and users of audited financial statements. FEE is well placed to act as a catalyst for establishing a forum for co-ordination amongst standard setters since its member bodies in all Member States either have responsibility for setting auditing standards or make significant contributions to the standard setting process.
- 3.3 The European Commission and the Committee on Auditing could signal European political and regulatory support for the proposal by developing a recommendation on the subject of ISAs. However, national standard setters and FEE need not wait for the finalisation of such a recommendation before starting work. By taking the initiative, they will accelerate harmonisation, promote efficiency and inspire greater public confidence in their commitment to the public interest. It would be regrettable if an apparent lack of urgency from the auditing profession provoked consideration of an EU regulation on auditing standards or direct action by securities market regulators. By fundamentally altering the legal framework under which auditing standards are given authority in the EU, a regulation would consume significant administrative resources and political energy. Imposing ISAs through securities market regulations would simply add to existing statutory audit requirements and offer no way forward for unlisted companies.

#### **Co-ordination amongst national standard setters**

- 3.4 The purpose of the proposed forum of European national auditing standard setters is to provide a focus for dialogue at the EU level and encourage harmonisation and transparency. In the run-up to 2005 it will help ensure that implementation of the proposal stays on track and allow the Commission and other European bodies to communicate any concerns about the commitment of the standard setters and the auditing profession to delivering the proposal.
- 3.5 At a practical level, standard setters could use the forum to:
- a) develop a common approach to compiling an inventory by country of the additional requirements of national auditing standards and laws and regulations;
  - b) discuss national practices and identify those that the forum and other European bodies should present to the IAPC for incorporation into ISAs;
  - c) identify other areas of EU-wide concern where the IAPC should be invited to take a lead in improving ISAs;
  - d) learn from national standard setters who have already incorporated ISAs in their national standards;
  - e) share plans for modifying national standards in anticipation of the implementation of the proposal;
  - f) develop a common approach to prevent inconsistencies that might result from translating ISAs into all EU languages and applying them in different national legal and institutional environments;
  - g) identify for discussion with the IAPC areas of potential improvement in the ISA 700 auditors' report shown in Appendix I;
  - h) develop a consensus on whether additional national reporting requirements should be discharged in an expanded ISA report or through a supplementary report;
  - i) develop a consensus on whether additional audit procedures should be explicitly reported and, if so, how; and
  - j) involve standard setters from European countries outside the EU that wish to implement the proposal.

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- 3.6 To show real commitment to implement the proposal, national standard setters joining the forum would be expected to acknowledge the need to:
- a) identify and summarise all additional requirements imposed by national laws and regulations and national auditing standards;
  - b) consider withdrawing requirements for audit procedures that are additional to those required by ISAs and do not respond to specific national legal, regulatory or other needs where such requirements fail to win international support;
  - c) liaise with national governments and regulators to eliminate costly or superfluous responsibilities imposed on auditors;
  - d) require compliance with ISAs under their national standards by eliminating areas in which national standards are less demanding than ISAs; and ultimately
  - e) transpose ISAs into national standards, for example by wholesale incorporation with additional national requirements being set out in separate documents.

#### **The potential role of the IAPC**

- 3.7 Currently, professional bodies of accountants that are members of IFAC are obliged to use their best endeavours to work towards implementation of ISAs and to incorporate the principles on which they are based in national auditing pronouncements. To take the harmonisation of auditing standards in Europe to a higher level, the proposal calls for a major new commitment to the objectives and standards of the IAPC not only by professional bodies of accountants but also by European institutions and investors and national regulators and standard setters. It will be important for the IAPC to maintain the support and trust of these stakeholders by pledging itself to transparent and efficient processes and standards of the highest quality. For this reason, great importance will attach to actions taken in response to the recent consultation on the IAPC Review Task Force's recommendations on changes in the membership, organisation and processes of the IAPC.
- 3.8 It is hoped that IFAC and the IAPC would support measures to facilitate the proposal's implementation, for example by:
- a) acknowledging that securing the adoption of ISAs in the EU should rank as a major strategic objective of the IAPC alongside the endorsement of ISAs by IOSCO;
  - b) integrating any forum of European national auditing standard setters into the formal consultation structures of the IAPC;
  - c) working with national auditing standard setters to identify and address potential inconsistencies that might result from translating ISAs into all EU languages and applying them in different national legal and institutional environments;
  - d) establishing practical copyright, distribution and royalty arrangements for the reproduction of IAPC material by national standard setters;
  - e) actively seeking European input into the thorough review of ISA 700 that the IAPC is committed to undertaking;
  - f) liaising with the forum on planned developments in ISAs in the period to 2005 to ensure smooth implementation of the proposal; and
  - g) recognising the valuable role that national standard setters can play in providing resources and leadership for IAPC projects.

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## APPENDIX I - AUDITORS' REPORT UNDER INTERNATIONAL STANDARDS

### **Independent auditors' report to the shareholders of XYZ**

We have audited the accompanying consolidated financial statements of XYZ for the year ended 31 December 200X which comprise the balance sheet, the income statement, the statement of changes in equity, the statement of cash flows and the related accounting policies and explanatory notes. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements give a true and fair view of the financial position of the group at 31 December 200X, and of the results of its operations and its cash flows for the year then ended in accordance with International Accounting Standards.

Auditors

Address

Date

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## APPENDIX II – FREQUENTLY ASKED QUESTIONS

### 1. Why is the comprehensive review and improvement of ISAs not specified as a precondition for implementing the proposal?

A precondition equivalent to the IOSCO endorsement is not proposed because:

- a) there is currently no European body with the authority, resources or expertise to conduct a review and specify required improvements;
- b) surveys show that auditing standards in Europe are substantially in accordance with ISAs and so it would send a confusing message to users of audited financial statements to imply that ISAs are not of an acceptable quality;
- c) where national standard setters believe that procedures additional to those set out in ISAs need to be performed in auditing financial statements, they will retain the authority to specify such procedures;
- d) the proposal offers a more effective means for identifying, prioritising and addressing perceived shortcomings in ISAs; and
- e) a review would delay progress towards transparent audit reporting in Europe.

### 2. How is the proposal affected by recent public consultation on recommendations made by the IAPC Review Task Force to improve the membership, organisation and processes of the IAPC?

Under the proposal, all audits of financial statements in the EU would be performed in accordance with ISAs set by the IAPC. The legitimacy of ISAs in the EU will be enhanced by implementation of the IAPC Review Task Force recommendations to: commit the IAPC to develop standards of unquestionable quality and to serve the public interest; provide public access to meetings, meeting materials and minutes, annual reports and strategic plans; work closely with national standard setters; and clarify the authority of ISAs.

Other recommendations include moving from a committee where all 14 members are nominated by IFAC member bodies to a 15 member committee by:

- reducing by seven the number of members drawn from member bodies whilst seeking to ensure that the majority of the remaining seven are from countries with strong national standard setting procedures;
- adding five representatives from international auditing firms; and
- including three non-auditor members drawn from academics, users of auditors' reports (including audit committee members) and the public sector.

It is only to be expected that consideration of the proposal by all those with an interest in audit quality in Europe will prompt further reflection on whether the recommendations of the Task Force will secure appropriate representation of European views and the public interest within the IAPC. However, support for the proposal will enhance the ability of European stakeholders to make their views count in the IAPC reform process.

### 3. Is there a danger that ISAs might develop in a way that is inconsistent with European perceptions of the public interest?

Yes. There is a particular danger that IOSCO will demand more detailed and prescriptive standards incorporating more minimum procedures as a price for endorsement of ISAs. Such developments would be contrary to a European emphasis on principles and professional judgement in auditing, accounting and ethical standard setting. It would also create economic difficulties in documenting compliance with ISAs on the many audits of smaller entities performed in the EU.

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However, European input is likely to have greater influence on the future development of ISAs if the EU makes an early commitment to the IAPC's work and if there is a forum of European national auditing standard setters which plays a proactive role in the IAPC's formal consultation structures. Ultimately, if ISAs incorporated minimum procedures that were considered excessive, members of the forum could exercise the ultimate threat of withdrawing their support for ISAs.

**4. In what areas might the forum seek to influence the IAPC review of ISA 700 to improve the auditors' report set out in Appendix I?**

Areas for particular attention might include:

- a) providing more explanation of what it means to be an *independent* auditor;
- b) making reference to requirements relating to competence and systems of quality assurance;
- c) providing expanded information about the respective responsibilities of directors and auditors;
- d) identifying the financial reporting framework, such as IAS, in the introductory paragraph;
- e) considering whether auditors should always report positively on the results of their work rather than on the exception only basis specified in some national legislation; and
- f) addressing the increasing expectations of users of financial statements regarding accompanying information relating, for example, to corporate governance and commentary on financial performance.

**5. Is it expected that there will continue to be national requirements to perform additional audit procedures and to report on additional matters outside the financial statements?**

Yes. However, a target date of 2005 for implementation of the proposal will allow national standard setters and Member State governments time to identify all additional requirements and then to reduce their number either by dropping them or by persuading the IAPC of the merits of incorporating them in ISAs. Where additional national requirements are retained, standard setters should be concerned to ensure that auditors effectively communicate the value of these requirements to users of auditors' reports.

**6. Is the proposed European forum of national auditing standard setters an embryonic European Auditing Standards Board?**

No. The proposal does not envisage EU-wide opt-outs from ISAs or additional EU, as opposed to national, requirements. Consequently, there would be no European auditing standards and no need or role for a European Auditing Standards Board.

**7. How might public interest oversight be exercised over the proposed forum of European national auditing standard setters?**

The proposal does not provide a blueprint for the European oversight arrangements required for its implementation. Consultation to date suggests that stakeholders within and outside the auditing profession want to avoid creating complex new oversight structures to add to recent and proposed oversight bodies such as the IFAC Public Oversight Board and Compliance Committee, the International Forum on Accountancy Development (IFAD) and the Supervisory Board of the European Financial Reporting Advisory Group (EFRAG).

The key point is that the forum should be seen to acknowledge its public interest responsibility by acting transparently and responding in a positive and open manner to contributions from all stakeholders. The aim is to ensure that all those with an interest in audit quality across the EU support the forum's work. FEE is willing to develop specific proposals based on further consultation with national standard setters, the European Commission, the Committee on

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Auditing, Member State governments, securities regulators, professional bodies of accountants, audit firms and preparers and users of audited financial statements.

**8. Does the proposal see the modernisation of the accounting directives as a useful means to enhance and harmonise auditing standards across the EU?**

No. Although the accounting directives contain only a basic requirement for an audit, there is already a high degree of harmonisation of auditing standards across the EU. The usefulness of the directives in furthering harmonisation is questionable given the time involved for implementation in national law. More importantly, any meaningful requirement, for example in relation to the content of the audit report, would in effect establish European auditing standards and create potential inconsistencies with current and future national standards and ISAs.

**9. Is the proposal only relevant to the audit of financial statements prepared in accordance with IAS?**

No. The impetus to report in accordance with ISAs is strongest in the case of financial statements prepared in accordance with IAS and it is proposed that by 2005 all listed companies in the EU will be required to prepare consolidated financial statements on this basis. However, it is expected that national auditing standard setters will want to develop the proposal in the context of all audits for the following reasons:

- the audit of IAS financial statements will become the major part of European audit markets as listed companies prepare their consolidated accounts under IAS and as individual countries require the application of IAS to unlisted companies and individual company financial statements;
- it will become uneconomic to maintain different auditing standards for IAS and non-IAS financial statements; and
- the existence of dual auditing standards within a single jurisdiction would damage public confidence in audits.