

Regulating auditor independence

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ABSTRACT

The article considers, from the perspective of the European Commission, what is the role of the regulator in seeking to intervene in the provision of statutory audit services. The role of the auditor is considered both from the perspective of the capital market and in an agency context, and the article assesses how this interacts with the regulator. It then goes on to examine a number of theoretically possible options for regulating audit independence and audit quality. It ends by presenting current Commission activity in this area.

1. INTRODUCTION

Auditor independence is one of the most thorny and political issues for a regulator to deal with. The public, the profession, users, politicians, journalists and competitors of the audit profession are very sensitive and all have (different) opinions on auditor independence. The challenge for a regulator seems to be to 'keep cool' and to act rationally in a swamp of perceptions and interests where calls for strict independence regimes are frequently heard.

The objective of this article is to structure and analyse some ideas and considerations on statutory auditor independence from a regulator point of view. Because audit cannot be considered entirely separately from financial reporting, Section 2 will deal with some reflections on the relevance of financial reporting. The importance of financial reporting will be examined from two different (theoretic) perspectives: the capital market perspective and the contracts perspective. Some conclusion will be drawn for regulating financial reporting and statutory audit. The recent EU policy initiative on financial reporting will be briefly presented in Section 3. Section 4 deals with regulatory considerations as regards auditor independence.

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2. REGULATORY PERSPECTIVES ON FINANCIAL REPORTING

2.1. The capital market perspective

The overarching goal of a capital market orientation is to ensure the functionality of the capital market. From a regulator point of view one can break down the concept of an efficiently functioning capital market into three types of 'efficiency'. (1) The 'institutional efficiency' which should provide the basic conditions for a market mechanism such as: sufficient information for investors, unhindered access to the market, maintenance of public trust in the stability and integrity of the market; (2) 'allocational efficiency' which will allow an optimal allocation of capital to companies; and (3) 'operational efficiency' which has to ensure that the transaction costs, including those for monitoring and enforcement, are minimized. On the basis of these three types of market efficiency a portfolio of capital market regulatory measures and infrastructure could seem to be necessary. Examples of such regulatory measures are: initial listing requirements for issuers (IPOs), rules on insider trading, requirements on financial reporting on audit and on corporate governance.

Financial reporting is important for both the allocational and institutional efficiency of the capital market. Whereas relevant and comparable financial information will contribute to allocational efficiency, reliable and transparent financial reporting is important for institutional efficiency. However, the efficient market hypothesis (EMH) puts the relevance of financial reporting into question. The EMH starts from the premise that the capital market is efficiently processing information and therefore share prices reflect all relevant company information. The EMH concept has some far-reaching consequences for financial reporting. Investors cannot identify incorrectly priced shares by scrutinizing financial statements. Many accounting issues lose relevance because the market is able to deal with accounting differences. For example, when assessing the economic value of a company it does not matter whether goodwill is capitalized or directly set-off from equity. Empirical research on the EMH suggests that the role of financial statements is more that of an *ex-post* confirmation of the share price already known by the market than a useful source of information for pricing company's securities. Despite the popularity of the EMH, financial statements continue to play an important role in practice. For example, investment analysts still use financial statements and recent theories combine the book-value of equity with the discounted net cash flow.

2.2. The contract (cost) perspective

Another reason why companies and stakeholders still attach importance to financial reporting is that accounting information plays a crucial role in 'contracts' between different actors such as management and shareholders,

employees, creditors or even clients. Examples of such contracts are the net profit expectations of the shareholders, the solvability ratio as a guarantee for a bank loan (ratio covenants), etc. If (contr)actors, for example banks, have to deal with unreliable or flexible financial statements they should add a risk premium to their interest rate. Therefore, financial reporting systems that provide relevant and reliable information decrease the cost of uncertainty for contracts that are (partly) based on accounting information. This contract perspective on financial reporting seems a sound basis for the application of strict accounting rules and rigorous audit. It also broadens the horizon from a capital market view to a more societal view because contracts are concluded with many stakeholders and for all kinds of companies.

This contractors' perspective also allows us to apply the concepts of agency theory, such as moral hazard and adverse selection, to the different contractual relations. Agency theory is one of the few theoretic clarifications for the audit function. The principal (investor) has to overcome his (asymmetric) information disadvantage compared to the agent (management) and will therefore need independent audit services to verify information provided by the agent. The selfish agent may push the auditor towards his interest and the auditor has to maintain a delicate balance between professional scepticism and fostering the client relationship with management.

2.3. Conclusion for financial reporting and audit regulation

Both the capital market perspective and the contracts perspective support the importance of financial reporting. Audit adds credibility to financial statements and therefore to the trust that investors (can) have in the functioning of the capital market. If the quality of the (or even a) statutory audit is low, investors' interests could be harmed and the confidence in the capital market would be undermined. Therefore capital market regulations defining a certain minimum quality of statutory audit are justified in order to maintain the institutional efficiency of the capital market.

From the contract perspective, credible and comparable financial information on the basis of strictly applied accounting rules is of crucial importance for all the contractual relationships that refer to financial statement figures. In the contract view, statutory audit adds value to all parties involved in contractual relationships with the company which makes it more of a company law than capital market law issue. Additional disclosure and audit requirements than those needed for retaining investors' confidence in the functioning of the capital market, could be justified.

The main consequences of using the contract perspective compared to the capital market perspective are to justify additional regulatory requirements for financial reporting and audit and a broader scope of application of these requirements than just for listed companies. Entities that are important to the economy as a whole and conclude 'contracts' with many actors (some of which

possibly could find it difficult to protect their rights on an individual basis) could be included in the scope of the financial reporting and audit regulation. I would like to refer to these as 'public interest entities' which would include banks, insurance companies, investment funds, pension funds, as well as listed companies.

3. RECENT EU INITIATIVE ON FINANCIAL REPORTING

At the heart of the recent European Commission Communication on financial reporting² is the idea of an efficiently functioning, fully integrated, EU capital market. A fully integrated EU capital market should ensure an optimal allocation of capital, be efficient and competitive. Relevant, comparable and credible financial reporting is considered as one of the key elements for enabling optimal allocation of capital to companies and optimal investment portfolio decisions. In legal terms the proposed financial reporting strategy is more a capital market law than a company law issue.³ However, the present EU legislation on accounting and the statutory audit are the Fourth, Seventh and Eighth Company Law Directives. The scope of these directives includes not only listed but also non-listed companies. About 3 million limited liability companies established in the EU are, through Member State legislation, subject to the EU Accounting Directives. The regulatory challenge is how to achieve an efficient capital market in regulatory terms without undermining the relevance of financial reporting for other entities.

A possible solution would be to differentiate regulatory measures in substance/scope and possibly in legal form. Provisions that are essential for the integrated EU capital market should be obligatory, whereas for other entities they could be optional. Furthermore, requirements for capital market players could be different (or higher) than those for non-capital market players which also would prevent a disproportionate burden for SMEs. Directly binding EU regulations would contribute significantly more to the actual realization of a single EU capital market than EU directives that have to be transposed into national law.

The recent EU financial reporting strategy is an example of regulatory differentiation in scope: a requirement to use IAS for consolidated accounts for companies whose securities are listed on EU regulated securities markets versus an option for other companies or individual accounts. It is important to take into account this issue of the scope of company law when comparing EU initiatives on financial reporting and statutory audit with pure capital market approaches such as the US. The SEC, for example, deals with 'only' about 7,500 listed companies and a similar number of registrants that offer securities to the public without being listed.

The financial reporting strategy underlines the importance of a sufficient enforcement infrastructure to ensure the correct application of accounting standards in practice. Only correctly applied accounting standards will truly increase the allocational and institutional efficiency of the EU capital markets. At

present the role of national securities market regulators varies significantly as regards the enforcement of accounting standards. Mainly because securities market regulators have different competencies according to their national jurisdictions. At this moment a committee of wise men⁴ (the Lamfalussy group) on the regulation of securities markets is examining the regulation of securities markets in the EU and the role of the securities markets regulators. The most common characteristic of enforcement is that all Member States rely heavily on external audit. In the EU regulatory framework statutory audit was developed from a company law background and as a matter of fact the EU capital market directives do not include the obligation for the audit of annual financial statements of listed companies. It is this context of heavy reliance on statutory audit for the enforcement of accounting standards that demonstrates the importance of the present EU work on statutory audit (see Section 4.4).

4. AUDITOR INDEPENDENCE AND AUDIT QUALITY

4.1. Background

It will be obvious that statutory audit has to be viewed in relation to financial reporting and its importance for the functioning of the capital market. From a substance point of view the ultimate question is not auditor independence but audit quality in terms of the level of assurance and aspects covered by the statutory audit. The recent turmoil on auditor independence started off with some SEC case evidence on the breach of SEC independence rules and was followed by audit firms' self-assessment of their compliance with these rules. The turbulent and partly aggressive reaction to the SEC's tough stance on auditor independence by the large audit firms should mainly be considered as a reaction to publicly discrediting the audit profession, rather than SEC regulatory pressure to split-off lucrative non-audit services. The main thrust of recently proposed SEC independence rules remains largely unchanged since they are, for the most part, simply a better structured re-editing of existing SEC independence rules.

The SEC fulfils the typical role of a capital market regulator in maintaining trust in the US capital market, until now with much success. One of the SEC's tasks is to oversee the audit firms that are authorized to audit SEC registrants. This task is quite different from common practice in most EU Member States where oversight is carried out on the statutory audit profession as a whole, and not segmented to auditors of listed companies. Several Member States are in the process of reinforcing the public element of statutory auditor oversight. It is efficient to include securities market supervisors and prudential supervisors in the public oversight of statutory auditors.

Auditor independence is not only on the SEC's agenda but also on the EU and international agenda. The EU Committee on Auditing established in May 1998⁵ is currently developing an EU approach to auditor independence. Auditor independence is also being discussed at Member State level, for example in

the Netherlands and Ireland (DIRT report). At an international level IFAC's ethics committee recently published an exposure draft on auditor independence rules.

From the recent discussions on auditor independence it seems that two positions have emerged: (1) perceived independence impairment is bad enough and therefore there is a need to strictly regulate the appearance of independence impairment; (2) there is no proof that the quality of the statutory audit is undermined, even if there are independence problems.⁶

One should note in relation to the second point that it is very difficult for an outside user to judge the quality of a statutory audit except when an audit failure occurs. Therefore systems of quality assurance to ensure compliance with auditing standards and respect of ethical rules are of crucial importance and are in fact the only way to publicly safeguard audit quality.

4.2. Is there a substantial independence problem?

From a regulatory point of view it is important to assess whether there really is a substantial independence problem. This avoids efforts being spent on solving 'virtual reality' problems. In my opinion, auditor independence, together with impartiality and integrity, are prerequisites for an auditor to be objective. Auditor objectivity should be understood as the quality that the auditor expresses the truth as he sees it, free from any bias. In essence, auditor independence deals with the question: do you (public, users of audited financial information) believe that an auditor in such and such circumstances would *not* be objective? The wording 'do you believe' implies that personnel perceptions and values are at the core of auditor independence. Perception is important enough if it leads to a lack of (investor) confidence in the functioning of the capital market. However, perceptions are difficult to capture and the regulator has the task of finding a balanced view of different actors (e.g., investors, creditors and other stakeholders) sometimes described with the metaphor of the (non-existing) 'reasonable stakeholder'.

There are some pitfalls in this 'heuristic' exercise of developing proportional regulations on auditor independence. Or to use some audit terminology: there are some 'inherent limitations' in regulating auditor independence. Some actors might not be free of opportunistic bias. For example, competing management, IT consultants and lawyers will argue (and lobby) that if the auditor additionally provides their type of services, the auditor cannot be objective. Other actors may plead for auditors to be 'more catholic than the pope' to implicitly demonstrate their own immaculate ethical attitude. Also personal perceptions within the same group of actors can differ. Whereas one investor could judge that in a situation where a UK audit team member with a German sister-in-law who works as a cleaning lady in the German subsidiary of the audited UK group auditor objectivity would be impaired; another investor would not see this as a problem.

Furthermore, general cultural differences can play a role. Whereas in some cultures it is perfectly acceptable to receive small gifts, in other cultures with a different public morality this could be unacceptable. The main difficulty with

nearly every example is that one can easily argue one way or the other on the possible impact on auditor independence without being able to prove the correctness of one or the other. Ultimately one can only get to certain gradations of the extent to which objectivity could be impaired in certain situations. Whatever typology of situations will be used, they will vary greatly in practice due to additional facts that influence the likelihood of impairing auditor objectivity. Also new developments will create new situations that are not covered by an established typology of situations.

Another pitfall is an unclear definition of the 'the auditor'. The one who signs the audit report? The audit team? The engagement partner? The audit firm? Partners in a position to influence the outcome of an audit? Does it include affiliated firms? And so on. An undifferentiated definition of auditor leads easily to unrealistic and disproportional effects, some of which even could be challenged on the basis of constitutional rights of personal freedom.

One of the biggest pitfalls for the regulator is that the public/users of audited financial statements lack a comprehensive view on what other factors contribute to ensuring the auditor's objectivity. These factors should be taken into account when assessing possible impairment of auditor objectivity in specific circumstances. The auditor himself will always consider these other factors or 'quality drivers' when issuing his audit opinion and trading off intentional wrongdoing. The following quality drivers are relevant for ensuring auditor objectivity, some are to be regulated and others self-regulatory or inherent to a market economy with competition:

- 1 *The auditor liability exposure.* Audit firms have paid some out-of-court settlements that were significant in relation to their turnover from audit. Auditor liability is a very effective quality driver for the audit profession. The regulator should make decisions on a number of issues such as: the need for a specific auditor liability regime, the circle of who can bring the plaintiff (also third parties), and possible liability caps.
- 2 *Quality assurance system.* If the auditor is subject to a quality assurance system there is an increased risk of detection of intentional wrongdoing. Public oversight and publication of quality review results will ensure publication of poor audit quality.
- 3 *System of professional disciplinary sanctions.* The profession as a whole has an interest in keeping a positive public image of the audit profession. Intentional audit failures should normally lead to a withdrawal of licence of the auditor or the audit firm.
- 4 *Damage to the brand name of the audit firm.* Audit failures will result in a loss of market share and profitability which will seriously affect the economic value of the audit firm.

When regulating auditor independence the whole architecture for ensuring audit quality should be considered. Only then will the regulator achieve an efficient and proportional set of rules and requirements. This would satisfy, in an optimal way,

investors' trust in the efficient functioning of the capital market and would be fair to the audit profession. Singling out independence from the other quality drivers will almost certainly result in disproportionate independence rules.

It occurs to me that some of the breaches of the SEC independence rules which have come to light recently cannot be considered as serious independence problems, in particular in cases where the scope of independence rules appeared to be unrealistically large (probably because they were established at a time where the global audit firms were less global) and therefore disproportionate to the (real) risk of impairing auditor objectivity. It seems therefore logical that the recently proposed SEC independence rules have narrowed the scope of application.

The arguments mentioned above would suggest that there is not a real auditor independence problem. But I believe that there is a real problem because investors and other users of financial statements continue to express their concern on auditor independence which could undermine the functionality of the capital market.⁷ Capital market regulators cannot afford to neglect these auditor independence concerns but they should consider these concerns within a comprehensive set of factors that ensure auditor quality and not single them out.

4.3. Threats to audit quality

Despite the fact that it may seem difficult to prove that an auditor's breaches of independence rules actually result in poor audit quality one should acknowledge that there are some general real threats to the audit quality:

- 1 Absolute audit fees get lower.⁸ This could be a manifestation of price competition that possibly affects audit quality to the extent that lower prices are not compensated by real efficiency gains. For example, the application of new, more business risk-oriented, audit approaches with less substantive testing, cheaper input (lower qualified staff), lowballing and/or cross-subsidy from non-audit services.
- 2 In some countries there is increasing competition to recruit good qualified staff for the audit teams.
- 3 Additional pressure on audit clients' management for earnings management due to the widespread use of stock options as a part of their remuneration.
- 4 Audit firms' turnover from non-audit services increases in absolute and relative terms.⁹ For most large audit firms turnover from additional services exceeds turnover from audit services. In terms of profitability the relative importance of non-audit services will be even higher since higher fee rates are usually charged for these services. This development could give the audit client, in its desire to manage the earnings, more bargaining power in discussing accounting and audit issues with the auditor. An additional problem is that due to the goal congruence effect of stock options the interests of investors and management coincide. Investors and managers have at least in the short term mutual benefit to match earnings with capital

market expectations. From this short-term angle it could even be argued that investors, up to the point where they would risk a loss of their investment due to undisclosed going-concern problems, are in favour of a 'flexible' auditor. In particular the last point could be related to auditor independence and could lead to a loss of auditor objectivity and less than reasonable assurance. The ratio of audit fees to non-audit fees per audit client is probably the only objective risk indicators of possible impairment of auditor objectivity.

4.4. Regulatory options

A regulation can only be justified if its (hidden) cost does not exceed the economic benefits. Unfortunately this is easier said than practised. In order to identify (and justify) appropriate regulations, the regulator could break this general notion of the added value of regulations down into somewhat more pragmatic questions. From a capital market point of view the regulator could consider whether a proposed measure/regulation on auditor independence is (1) likely to increase the functionality of the capital market; (2) necessary to increase the efficient functioning of the capital market; (3) could be substituted by less harming regulation for companies and auditors, for example by regulating other 'quality drivers' (see Section 4.2); (4) proportionate; (5) brings increased efficiency which is sufficient to outweigh the additional cost burden for companies (and auditors).

For the purpose of this article, four regulatory alternatives for auditor independence will be distinguished: state-run audit service; strict prohibition of additional services; balanced regulation of auditor independence; *laissez-faire*, *laissez-passer*.

4.4.1. State-run audit service

At one extreme side of the regulatory spectrum is the theoretically defensible possibility of a state-run audit service that would replace the statutory audit profession. For a number of reasons I do not believe that this is a real option. It would not be easy for a Member State to create or transfer to and to maintain the statutory audit knowledge base in a public sector body. An increasingly dynamic and complex business environment requires more multidisciplinary audit approaches and a rapid adoption of audit methodologies to ensure audit effectiveness. The market mechanism often offers better response capacity to such developments than a state-run organization. Although the creation of a state statutory audit function would solve the independence problem, it can be argued that it would not *per se* increase investors' trust in the quality of the statutory audit and the functioning of the capital market. And with good reason: compared to the advantages of the present system where competition, even in an oligopolistic market structure, and the possibility of cross-subsidization from non-audit

services result in competitive audit fees (which are often 0.00x% of the audit clients' turnover) and where liability exposures and quality assurance are flanking quality drivers it will be difficult to outperform the price/quality ratio.

What is the added value of this option? Is it qualified to improve confidence in the functioning of the capital market: probably not; is it needed: no; is it proportionate: doubtful.

4.4.2. Strict prohibition of non-audit services

A strict prohibition of any non-audit services would solve to a large extent the present auditor independence problems. It could lead to an increase of audit cost due to less optimal use of resources, lower economies of scale, and the absence of cross-subsidy from the non-audit services. In theory the cost increase would not be a fundamental hurdle to apply a strict prohibition regime. For larger audit clients the statutory audit fee is something like 0.00x% of their turnover.

It is 'safe' for a regulator to prohibit non-audit services because it would prevent nearly every possible circumstance that could impair auditor objectivity. However, it could lead to disproportionate prohibitions of services that would not impair auditor objectivity and therefore would be permanently challenged in practice. Such an approach could result in a 'meta-physical' improvement of investors' trust in the efficient functioning of the capital market. Breaches of formal disproportionate independence rules that would not really impair auditor objectivity would create an unnecessary loss of investors' trust in the functioning of the market and the credibility of the audit profession. Moreover, strict prohibitions can be relatively easily circumvented by creating liaisons with consultancy firms. At present some Member States in the EU have a strict prohibition regime. The proposed SEC rules do not opt for a strict prohibition of additional services, but the list of prohibited services is pretty comprehensive.

From a more macroeconomic point of view, regulators should not be unhappy with the possibility of cross-subsidy from non-audit services. In this situation one stakeholder (the investor) is subsidizing regulatory requirements (statutory audit) that benefit all other stakeholders.

What is the added value of this option? Is it likely to improve confidence in the functioning of the capital market: yes; is it needed: not necessarily for all services; is it proportionate: tendency to be disproportionate.

4.4.3. Balanced regulation of auditor independence

A balanced regulation of auditor independence means that the regulator considers all the quality drivers ensuring audit quality. The regulator tries to identify what additional services or what circumstances would impair auditor objectivity without being sufficiently mitigated by the other quality drivers. If well communicated to the market this would provide the best level of real investor protection and would therefore contribute to the efficient functioning of the capital market.

More proportionate independence rules would also run less risk of being impaired and would further contribute to the trust in the functioning of the capital market.

In an ideal world balanced regulation would lead to proportionate prohibitions or safeguards on the provision of non-audit services. The increased risk of impairing auditor independence by the provision of certain types or magnitude of non-audit services could also be mitigated by raising the (regulatory) requirements on other quality drivers such as auditor liability or quality assurance reviews.

What is the added value of this option? Is it qualified to improve confidence in the functioning of the capital market: yes; is it needed: yes; is it proportionate: yes.

4.4.4. *Laissez-faire, laissez-passer*

This is the other extreme (by comparison with the option of a state-run audit service) on the regulatory spectrum which can be theoretically defended. On the basis of agency theory it is probable that even in the absence of regulation, the shareholders (principals) would require audit services to control the management (agents). However, the absence of regulation of audit in general and auditor independence in particular would not guarantee the functionality of the capital market as a whole. Furthermore, non-regulation would possibly result in a patchwork of different independence requirements on various capital markets and would also be very difficult to apply to global networks of audit firms. This would certainly not contribute to the realization of a single EU capital market which allows cross-border investments with the same level of investor protection. To preserve investors' trust in the functionality of the capital market, and also to create a level playing field for competition for audit services, regulation of auditor independence is required. The credibility of financial information is probably too important an issue to be left to the market.

What is the added value of this option? Is it qualified to improve confidence in the functioning of the capital market: no; is it needed: not applicable; is it proportionate: not applicable.

5. THE EU WORK ON STATUTORY AUDIT

The European Commission policy initiatives in the area of statutory audit aim at further improving, harmonizing and ensuring the quality of statutory audit throughout the EU. At this moment the main issues on the agenda of the EU Committee on Auditing are:

- *Quality assurance* for the statutory audit. A Commission Recommendation containing minimum requirements for quality assurance systems was issued on 15 November 2000.¹⁰

- *Auditor independence.* A draft working paper is currently being discussed in the EU Committee on Auditing. An exposure draft was published on 15 December 2000 on DG Internal Market's website.
- *Standards on auditing.* A benchmark exercise between ISAs (International Standards on Auditing) relevant for statutory audit and audit requirements of the Member States showed a high degree of compliance. There may be a Commission proposal some time in 2001.
- *Auditor liability.* A comparative study on auditor liability within the EU is being conducted and the summary of the results will be published on the Internet before the end of 2000. Depending on the outcome, the need for further policy initiatives will be considered within the EU Committee on auditing.

The policy initiative on auditor independence is basically in line with the third regulatory option (not to be confused with 'the third way') as described in the previous section. This balanced regulation is considered to be the most effective in terms of real investor protection and keeping or even increasing the functionality of the EU capital market. Since discussions on the draft working paper on auditor independence are still ongoing in the EU Committee on Auditing, it is not opportune to disclose the present working draft in detail before it is published as an exposure draft.

The broad outline of the auditor independence regulation in discussion will be a framework approach establishing definitions of auditor independence and objectivity, the responsibility of the auditor to ensure his independence, and a distinction of threats and risks to auditor independence. This will include elements of the audit infrastructure such as: quality assurance systems, audit firms' internal audit quality systems and the audit clients' safeguards to ensure auditor independence. An elaborate definition of scope ('the statutory auditor') will allow for variations in scope of application for specific safeguards in accordance with the potential threat to auditor independence. The second part of the proposal deals with specific examples/requirements of how to deal with specific situations and the application of safeguards to mitigate the risk to auditor independence.

The EU Committee on Auditing follows a quite unique approach by also including the EU audit profession in the preparation of audit policy initiatives. As regards auditor independence this approach should lead to realistic, but sufficiently demanding, regulation. Furthermore, the involvement of the EU audit profession, should result in a 'moral commitment' for the audit profession to comply with auditor independence regulation in practice. This approach also exploits the knowledge and experience of the profession in a constructive dialogue between the profession and Member State regulators. However, the European Commission services chairing the meetings need to maintain the delicate balance of interests between regulators and the audit profession. This

approach is less overtly confrontational and will not unnecessarily undermine the confidence in statutory audit.

6. CONCLUSION

At least two (theoretical) perspectives can be applied to assess the importance of financial reporting and statutory audit from a regulatory point of view: the capital market and the contract perspective. The recent EU financial reporting strategy, requiring companies whose securities are listed on EU regulated securities markets to use IAS for consolidated financial statements, should be seen in the context of the realization of an integrated EU capital market. An adequate enforcement infrastructure is a crucial element for truly increasing the functionality of the EU capital market. Statutory audit is at this moment the most commonly applied instrument for ensuring the correct application of accounting standards within the EU.

From the contracts perspective it can be argued that additional requirements for financial reporting and audit as well as to broaden the scope to 'public interest entities' should be applied. It is a regulatory challenge for the EU to combine the capital market approach with the contracts perspective.

Auditor independence is ultimately considered as an audit quality problem. Any regulation should be able to pass the proportionality test to ensure a real added value for the functionality of the capital market. In the light of this the regulator should explicitly take into account other audit quality drivers when regulating auditor independence. This balanced approach is preferred above three other possible approaches for regulating auditor independence.

NOTES

- 1 This article is written in a personal capacity and does not reflect (but is also not necessarily contrary to) the official views of the European Commission.
- 2 Commission Communication on the financial reporting strategy of 13.06.2000 COM(2000) 359 Final. Website: http://europa.eu.int/comm/internal_market/en/company/account/news/strategy.htm
- 3 See for terms of reference and questionnaire DG Internal Market's what's new? website: http://europa.eu.int/comm/internal_market/en/whatsnew.htm
- 4 Whereas generally speaking capital market law governs the functionality of the capital market, company law regulates the formation, functioning and termination (as well as prevention of abuse) of companies as legal instruments to engage in economic transactions.
- 5 Communication, the statutory audit in the EU; the way forward of 8.05.1998 can be found on website: http://europa.eu.int/comm/internal_market/en/company/audit/official/7013en.pdf
- 6 The Panel on Audit Effectiveness report concluded that the quality of audits is fundamentally sound.
- 7 Recent articles in the *Financial Times* and the study of brand finance carried out for the SEC indicated that the public and the financial analysts in London are indeed concerned about auditor independence.

- 8 According to the Brand Finance plc survey on auditor independence on the FTSE 350 audit and non-audit fees. The total audit fees for the FTSE 350 went down from £315 million in 1998 to £296 million in 1999 (−6%).
- 9 According to the Brand Finance plc survey on auditor independence on the FTSE 350 audit and non-audit fees. The total non-audit fees for the FTSE 350 went up from £497 million to £598 million (+ 20%). The relative share of non-audit fees increased from 61% to 67%.
- 10 Commission Recommendation, 'Quality assurance for the statutory audit in the EU: minimum requirements'. DG Internal Market website: http://europa.eu.int/comm/internal_market/en/company/audit/news/quality.htm.

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