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Status Report on Auditing in the European Community*

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My comments will be principally directed towards practice within the European Economic Community (EEC). There are, of course, European countries who are not members of the EEC, but the nine member states of the EEC include Europe's largest economic entities, and the major developments in the accounting scene are taking place within the EEC. That scene is, however, one of deep contrasts, so that endeavoring to comment on any aspect of accounting or auditing within the EEC presents a considerable challenge.

The EEC encompasses the countries of Belgium, Denmark, France, Ireland, Italy, Luxembourg, The Netherlands, United Kingdom, and West Germany. The nine member states have a population of approximately 255 million and a gross national product of approximately $1,000 billion (the United States equivalents being approximately 211 million and $1,400 billion).

Historical Developments

A little history is helpful to put our topic in perspective. Considerable differences in accounting philosophies and practices have always existed among the original six member states. The admission in 1973 of Great Britain and Ireland (who share a substantially common approach) and of Denmark brought yet further and deeper diversities. The expanded EEC then had to resolve not only the differences already present in Continental practices but also to accommodate the very different philosophies and practices held by Great Britain and Ireland.

The result was an encounter which, sparing a blow-by-blow description, has fortunately moved the accounting harmonization process quite clearly in the direction of U.S. practices. This resulted not only from strong recognition of British-Irish practices but also because several member states have taken advantage of the time delay to make needed changes in their own professions and accounting practices. This encouraging progress should not, however, lead us to underestimate the magnitude of the harmonization task itself nor the time consuming nature inherent in the process of getting nine sovereign countries to first

* Author's note: For purposes of presentation at this symposium, comparison of the EEC generally was made to U.S. accounting and auditing practices. Such a comparison suffers on two accounts. First, European practices are so diverse that country-by-country analyses and comparisons are really needed to do justice to the subject. Michael Lafferty's recent book Accounting in Europe (Woodhead Paulkner Ltd., 1975), is highly recommended for the interested reader. Second, a more correct, but time-consuming and overly ambitious, approach would have been to compare European and U.S. practices to an international standard. Hopefully, the worldwide professions, including the U.S., will move in this direction.
agree and then to implement anything which is such a basic part of their political and economic structures.

Accounting harmonization within the EEC has received wide coverage in academic circles within the U.S. in recent years. The discussions have, however, tended to concentrate on accounting principles and reporting philosophies rather than upon auditing. Any meaningful discussion of auditing must first deal with the diverse accounting and reporting environment, after which we can explore the present and prospective auditing scene in more depth.

**Major Accounting Differences**

Accounting within the EEC is characterized by five important differences compared with the United States:

1. **Public interest** (largely a function of share ownership) in business varies tremendously between countries. In most member states, share ownership is either not extensive or is channeled through banks and other institutions (particularly in Germany) with the result that there is little demand for improved reporting standards. Hitherto, only in the British Isles and The Netherlands has there existed a sufficiently wide public interest in business for it to have an impact on financial reporting.

2. **Company law** in a number of countries, rather than "fairness," dominates financial reporting. In such countries, notably Germany and France, prime importance is attached to conformity of financial statements with the detailed provisions of the law rather than whether such financial statements provide a fair presentation. It is probably only in the British Isles and The Netherlands where "fairness" is at present considered to be the overriding objective in financial reporting.

3. **Tax laws** in certain countries, notably Belgium, France and Germany, have constituted a major obstacle to the development of meaningful financial reporting by requiring that income and expenses be treated the same for both book and tax purposes. Since the objectives of tax legislation and financial reporting frequently diverge, these countries have thus created a seemingly impenetrable barrier to the development of improved accounting standards.

4. **Creditor protection** is emphasized, rather than communicating with shareholders. In Belgium, for example, we observe that unions are working vigorously for adequate disclosure, while management, shareholders, and the financial community are disinterested. This attitude combined with the requirements and economics of the tax laws tends to result in more conservative financial statements and less complete disclosure than might otherwise prevail.

5. The **accounting professions** within the EEC have generally had only a weak to moderate influence in the establishment and development of accounting standards and, until recently, such endeavors were highly diffused.

In such an environment, it is not a surprise that auditing standards and procedures tend to vary from very poor to barely adequate by comparison with generally accepted auditing standards in use in the United States.
Fortunately, the seeds for reform are present in the form of the harmonization of accounting and reporting practices.

**Accounting Harmonization**

The Treaty of Rome establishing the original EEC provided for the eventual overall harmonization of corporate law within the Community, and to this end the Commission of the European Communities has issued a series of proposed directives. The proposed Fourth Directive, originally issued in 1971, is concerned with the presentation and content of annual financial statements, methods of valuation, and the publication of such financial statements. While it is hard to imagine nine countries with greater differences in their present practices, there is one unique common feature in that each member is charged under the Treaty with responsibility for minimizing these differences. There is thus a driving force behind their efforts which is not generally present in other forms of accounting cooperation. The Fourth Directive has been gestating for over a decade and it is now possible to see the likely content and to envisage its inclusion in the statute books of the member states by approximately 1980.

The underlying philosophy of the revised proposed Fourth Directive may be summarized as follows:

**Concept of fairness.** The overall concept of "fairness" rather than conformity with the law is to be the cornerstone of financial reporting. This, however, is to be achieved not by establishing detailed accounting rules but by the acceptance of existing practices backed by elaborate disclosures.

**Present practice accepted.** The proposals are principally based on existing laws, generally accepted accounting principles, and business practices within the Community. This does not mean that new norms have not been established—they have. But it does recognize that some practices (such as the insistence of certain member states that book and tax reporting be in conformity) cannot be overcome through the present legislation.

**Prescribed basic principles.** In spite of permitting a variety of accounting practices in certain areas, the proposed Directive establishes a number of highly desirable basic reporting standards. For example, depreciation of fixed assets will be required, and the use of hidden reserves to normalize income will be precluded. Although it can be argued that the basic principles represent little more than the lowest common denominator within the EEC, it must be continually emphasized that the EEC, because its accounting and reporting had languished, has had far to travel in recent years and must, therefore, frequently settle for pragmatic, partial advances.

**National standards may be established.** The proposed Directive permits the application of a variety of accounting principles. In addition, matters not covered may be prescribed by the legislature or, more likely, the professional bodies of the member states. Thus, the more progressive members of the EEC who have already established more ambitious standards or programs than those envisaged by the proposed Directive will generally be free to pursue these programs.

**Application is selective.** The proposed Directive will apply to all forms of companies that limit the liability of owners for the companies' debts; these types of companies in each of the member states are specified in Article 1 of the
proposed Directive. However, it contains a provision that would authorize member states to permit certain small private companies to publish abridged balance sheet and profit and loss information.

Auditing

With the foregoing background, I can now turn specifically to auditing standards and procedures within the EEC. My comments will be directed mainly to the more significant differences between the EEC and the United States. For this purpose, my comments will refer to the primary headings of generally accepted auditing standards as used in the United States; namely, general standards, standards of field work and standards of reporting. Auditing procedures as distinct from auditing standards are also discussed.

I will then offer some comments on the possible course of future developments.

Because of the many contrasts between member states, an overall comparison between the EEC and the United States becomes complicated. To cut through the diversity, one must concentrate on the factors that are common to a number of the EEC countries that differ from practice in the United States. Therefore, I must generalize and generalizations by their nature will be charitable to some and uncharitable to others.

Accounting and Auditing Contrasted

Probably the most striking difference between the EEC and the United States is the degree to which the development of auditing standards and procedures has lagged behind the development of accounting and reporting standards.

In most member states, auditing standards and procedures are far from maturity and in some member states are hardly embryonic. While differences in accounting and reporting have received much attention in recent years and the proposals for harmonization are at a relatively advanced stage, the establishment of generally accepted auditing standards is really still an embryo. Even in the British Isles, which is generally viewed as the most advanced of the member states, the accounting profession acknowledges it has yet to develop auditing standards and procedures in many areas and has therefore recently announced its intention to devote much greater effort in this area.

This is generally in deep contrast to the situation in the United States, where it has long been recognized that the development of accounting practices and auditing standards must move in unison if the end product is to be improved. Such unison of development has not generally been present in the EEC.

Concept of an Audit

While the accounting professions of most member states aspire to using the basic concepts of auditing accepted in the United States, the laws of certain countries, for example, Belgium and Italy, provide for the appointment of auditors in circumstances which do not even remotely resemble an examination using generally accepted auditing standards. In these countries, it is recognized that the statutory audits required by the law involve little more than a cursory review of the financial statements and that the whole exercise is very perfunctory.
Government Involvement

While the governments of the member states have established the legal framework for auditing by requiring audits of various types of entities, the approach has varied significantly between countries.

One of the most interesting differences is the type of entity that must be audited. Most continental member states began by requiring that only listed companies be audited and then expanded the requirement over the years to other companies meeting certain criteria, generally size. In contrast, the law in the British Isles requires that all companies with limited liability be audited irrespective of size. This means that in the British Isles, over half a million companies are audited annually, theoretically to the same auditing standards since neither the law nor the professional literature recognizes any differences in this regard. However, the profession tacitly recognizes the differences in the auditing procedures it applies and it would appear that legal and professional recognition of the impossibility of auditing all companies to the same standard is a necessary prelude to improvement of auditing standards in the British Isles.

In addition to stipulating the entities to be audited, the governments of most member states have established provisions relating to the qualifications, appointment, responsibilities, etc., of auditors. Although there are many differences, they are not significant to the overall view.

Professional Institutes

While the laws of most member states have provided a legal environment for auditing, the auditing standards to be applied have invariably been left to the respective national professional institutes. The standards established by the professional institutes have hitherto been principally concerned with what are termed “general standards” in the United States. They have thus been primarily concerned with training and proficiency, independence, and related professional matters.

Even in countries where the respective institutes have issued pronouncements on more detailed auditing procedures, the approach has been ad hoc. In no country within the EEC does there exist a comprehensive body of published auditing standards building from the general to the particular equivalent to that issued by the American Institute.

Qualifications

Most member states share the philosophy that auditing is a highly responsible activity that should be conducted only by parties who have obtained recognized professional qualifications. With a few exceptions, the obtaining of a professional qualification is essential to a right to practice and the laws of most member states restrict auditing to members of certain recognized professional institutes. Admission to such institutes is invariably by examination, accompanied by varying periods of internship aimed at providing a thorough grounding in accounting and auditing practices before admission. The educational standards necessary to commence training are generally high although a university degree is not universally required. Overall, the professional accountant within the EEC
is generally well prepared to play a more vigorous role as the auditing profession develops.

Independence

While it has generally been recognized that independence is a significant factor, the concept does not have the sanctity it has in the United States. Thus, while it is generally accepted that an auditor may not be an employee of the company and that no member of the auditing firm should participate in the management of the company, there are few rules with regard to share ownership in client companies. Thus, in the British Isles, share ownership by an auditor in a client company, which had been a requirement for appointment, has in the past year been finally officially viewed as an impairment to the independence. The current regulations do, however, provide for a period of transition in which auditors may continue to hold shares in client companies. In Germany, the commercial banks are among the major shareholders of most companies and a number of the major German auditing firms are owned wholly or partly by such commercial banks, thus creating a situation in which the auditor is also a shareholder.

Some examples can be cited in which EEC countries are ahead of the United States. Guidelines in the United Kingdom state that an auditor should derive no more than 15% of total fees from any one client; a guideline basic to independence which the United States could consider importing. Perhaps the U.S. was following a European lead in 1975 when the AICPA announced SAS 7, dealing with communications between predecessor and successor auditors, since the Dutch Institute had established a similar rule of conduct (specifically Rule 29) several years ago. The Dutch rules carefully cover the request of information from the preceding auditors and require receipt of such information (except for unreasonable delays) before acceptance of an appointment. Perhaps this is one of the major reasons why the Dutch profession has such stature, and members of the profession have such strong, yet independent, relationships with their clients.

Standards of Reporting

Standards of reporting in terms of expressing an opinion with regard to adherence to generally accepted accounting principles, the adequacy of informative disclosures and the overall “fairness” of the financial statements, present many contrasts with practice in the United States.

As we have seen, there are at present few generally accepted accounting principles recognized in all countries within the EEC, and two member states, notably Belgium and Italy, are virtually without any established accounting principles. Although this situation is in the process of change through the legislative efforts of the European Commission, the final directive will provide for no more than certain basic ingredients for financial statements. Accounting principles will still vary substantially between countries for the foreseeable future; in fact, the differences appear to be growing. Most Continental countries continue to be wedded to cost while the British Isles is moving rapidly towards value-based financial statements. (Of course, my friends in The Netherlands quickly point out that the introduction of replacement value accounting dates back to 1924;
however, there is by no means widespread application and no observable trend to
extensive usage such as exists today in the British Isles.)

Thus, an intelligent reading of financial statements from within the EEC
demands a thorough knowledge of the accounting principles pertaining in a
particular member state. However, even with such knowledge one is not neces­sarily fully equipped, in that no member state has developed a body of generally
accepted accounting principles which approach those in existence in the United
States. The absence of generally accepted principles in many areas combined
with an acknowledged reticence toward disclosure in many member states, fre­quent­ly leaves many unanswered questions concerning financial statements.

Turning to the adequacy of disclosures, we have seen that conformity with
the law continues to be the benchmark for financial statements in certain states.
Even where “fairness” is an acknowledged objective, the law has continued to
play a significant role in financial statements. For example, while “fairness” may
be considered the overriding criterion for financial statements in the British
Isles, companies and the accounting profession have been slow to expand dis­closures beyond those required by the law. Thus, information relating to such
matters as pension costs, leasing obligations, and related party transactions are
rarely covered in financial statements in the British Isles. Overall, in the EEC
the adequacy of informative disclosures falls far short of present standards in the
United States.

With regard to auditors’ reports, we have seen that the range is from the
concept of conformity with the law (as in Germany) to one of “fairness” (as in
the British Isles and The Netherlands). A number of states specify additional
matters that must be included in auditors’ reports, but these are not significant
to an understanding of overall standards.

Auditing Procedures

Detailed auditing procedures within the EEC are almost unbelievably varied
and hence generalizations are particularly difficult.

Generally, there is much less emphasis on what is termed in the United States
“competent evidential matter.” While some independent corroborative procedures
are followed, they tend to be limited. Circularization of receivables has been
endorsed by the professions in the British Isles, Germany, France, and The
Netherlands as has the observation of physical inventories. Accounts payable are
not generally circularized and the obtaining of legal representations is rare.

Even greater differences are created by the fact that professional endorsement
of a procedure does not necessarily mean it is universally followed since pro­fessional pronouncements in auditing are generally no more than recommenda­tions and compliance is not mandatory. Thus, while the confirmation of
receivables and the observation of physical inventories are recommended by the
professions in the British Isles, France, and Germany, such procedures are by no
means universally followed in those countries.

It should be noted that in many respects auditing is a relatively new science in
certain member states. For instance, in France prior to 1966 only listed companies
had to be audited and the most that other companies received was a cursory
review. Thus, the present Commissaires aux Comptes are very much in the early

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stages of developing and implementing procedures that approach generally accepted standards in the more advanced member states. Actual practice in France is still far behind the professional pronouncements. An even more embryonic situation prevails in Belgium and Italy. In these countries, significant improvements will require a generation to change significantly, which requires a time consuming educational process.

What of the Future?

My comments so far have painted a picture of somewhat backward auditing practices in the EEC. On a positive note, recent years have seen the establishment of the foundations that should provide a base on which to elevate auditing standards, and it is clear that there is a growing awakening to this problem. Generally, the accounting professions within the member states are increasingly well-equipped to elevate their standards. Further significant developments in the area of auditing will undoubtedly take place in the coming years and I will mention the more significant likely developments.

In this connection, I have emphasized the magnitude of the task facing our European contemporaries. When we consider the energy, devotion, and traumas, that have accompanied some of the major auditing developments in the United States, the prospect of conducting the same exercise with the representatives from nine different member states with deeply rooted traditions, practices, etc., presents a task that is, to say the least, formidable. Great credit is due to our European contemporaries for undertaking this endeavor and for the efforts that have and will be made. My feeling is one of guarded optimism about the probable outcome.

What has to be done? In summary, the effort hitherto brought to accounting by member states and combined institutions now needs to be mirrored by similar efforts in auditing. Without such redirection, financial statements may look fine but whether they are right will remain questionable.

Fourth Directive

The Fourth Directive has now received a second reading by the Council of Ministers working party and will probably be enacted by the Council within the next year. The enactment of the Fourth Directive by the Council will require each member state to incorporate its provisions into its national laws within a period of 30 months. The enactment of the Fourth Directive will, I suspect, act as a sort of watershed for progress within the EEC. The professions will realize how much has been achieved and begin to see the potential for further progress.

Fifth Directive

The Fifth Directive on the Structure of Sociétés Anonymes (1972) contained a number of important measures with regard to auditors. The proposed directive would apply to each company that is organized under the law of a member state as a société anonyme, which term is used to describe a corporation whose capital is represented by freely transferable shares and whose shareholders have no personal liability to creditors beyond the amount of unpaid subscriptions for shares. Among the more important provisions concerning auditors are the provisions concerning the independence of auditors and the appointment of auditors.
A person would not be eligible to become the auditor of a company if then or during the last three years the person was a member of the company's supervisory board, management board, or staff. Similar restrictions would apply to an enterprise or firm if any member or partner in the firm or member of its supervisory or management board or person having power to represent the firm is or during the past three years was a member of the company's supervisory board, management board, or staff. Auditors would be appointed for a specified period, which would have to be at least 3 and not more than 6 years although auditors would be eligible to be reappointed to successive terms.

While the provisions of the Fifth Directive relating to auditors will undoubtedly find their way to the statute book eventually, the overall Directive contains many contentious matters with regard to worker participation in management and it may be necessary to present the provisions relating to auditors in a new document.

National Progress

The gradual integration of many EEC institutions and the advent of a single capital market is likely to provide a tremendous impetus to certain national laggards. In other words, the example being set in certain member states will undoubtedly be emulated by others. The changes that have occurred in France in the last decade illustrate the sort of development that is likely to evolve in other member states.

However, leaving developments to individual member states may result in slow and fortuitous progress and it seems likely that substantive progress will only be made through the combined efforts of the member states.

International Development

As in the United States, governments appear content to leave the logistical aspects of auditing to the accounting professions—provided, of course, satisfactory progress is made. Accordingly, responsibility for raising auditing standards presently rests squarely with the professions.

A number of organizations presently exist which could act as a catalyst to improve auditing standards. The Union Européenne des Experts Comptables Economiques et Financiers (the “UEC”) and the EEC Accountants Study Group (the “Study Group”) would be the natural forums. The UEC, which is an international organization embracing virtually all the European countries, has already issued some statements on auditing but they have been relatively low key and are no more than recommendations. Accordingly, a much more likely forum is the Study Group.

The Study Group comprises representatives of the professional bodies of the member states. For a number of years, the Study Group has assisted the European Commission in the study and development of accounting, and it has become recognized as the principal body with which the Commission and its various agencies consult on accounting matters. The Study Group has played an active role in the development of the Fourth Directive but hitherto its efforts have been largely confined to accounting principles and reporting practices. As I have illustrated, there is an urgent need within the EEC for the harmonization of
accounting and reporting practices, to be followed by the harmonization and elevation of auditing standards. This will require the combined efforts of the professional institutes of the various member states and I believe that it is inevitable that the Study Group or similar body will be charged with the harmonization of auditing standards. Exactly how this will be achieved is unknown. However, countries are presently cooperating in accounting and reporting matters in a manner which was almost inconceivable only a few years ago, and it is clear that such study and eventual harmonization must, of necessity, reach auditing standards and procedures.

Value Reporting

No current commentary on the accounting scene within the EEC would be complete without mention of the move towards value orientated reporting in the British Isles. Following the issue of the Sandilands Committee recommendations last year, the accounting profession is now rapidly developing the disciplines necessary to implement a system known as Current Cost Accounting (CCA). This system will report fixed assets and inventories at current value and also report the impact of inflation on reported results. The end product is a system very similar to that set forth in the Arthur Andersen & Co. publication Accounting Standards for Business Enterprises Throughout the World.

The significance of value reporting to auditing lies in the fact that it demands a significant change in mentality on the part of the auditor. The auditor is charged with reporting on amounts which are highly relevant but not necessarily subject to the precise determination that has been possible under the historical cost system. This will, of course, inject greater subjectivity into the role of the auditor and as a result, demand much greater judgment and caution.

Auditors' Liability

And now to end on a lighter note. One significant memorandum issued by the Study Group in 1974 concerned the liability of auditors. It clearly reflects recognition that with progress will come responsibilities that must be defined and limited. The principal recommendations and conclusions contained in the memorandum were that:

1. Any damage arising from reliance placed on a company's annual financial statements that do not present a true and fair view should be primarily the responsibility of the company's management board.

2. Legal liability proceedings should be brought against auditors only after all recourse against members of the management board relating to the statements has been exhausted.

3. Because all auditors in member states do not have professional liability insurance, the present unlimited liability of auditors in certain member states offers false security in that compensation frequently cannot be made beyond the means of the auditor and thus the right to unlimited damages is purely theoretical. Accordingly, it is proposed that in any case of civil liability, where the wrongful act was not committed intentionally:
a) any loss that is estimated at an amount of approximately $100,000 or less, must be made good in full, and
b) any loss of a higher amount shall be made good up to an amount equal to ten times the annual audit fee relating to the accounts in question or an amount of approximately $1,000,000, whichever is less.

4. Professional insurance up to the recommended maximum liability amounts should be made obligatory.

In the light of experience in the United States, our contemporaries within the EEC may have many shortcomings, but they most certainly have communicated the message loud and clear with regard to reasonably limiting their obligation.

This is but one example of an area where the U.S. may have much to learn—that of working out an effective, constructive working relationship between government and the profession. This may, in fact, be one of the main reasons for the U.S. to take increased interest in future EEC developments. If the past few years are any guide, the EEC countries will increasingly encounter terrain familiar to the United States, and their highly pragmatic solutions may increasingly provide comparisons and contrasts to be studied, and additional lessons to be learned.