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**The implementation of the Statutory Audit Directive  
in Germany.**

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**Abstract**

This master thesis looks at how audit regulations is changed in the EU with special emphasis on the implementation process of the Statutory Audit Directive (SAD) into Germany. Various crises, the increasing globalisation as well as the aim of the European Commission to establish a harmonised capital market have led to continuous changes of the audit regulatory framework in the EU. The most recent change was thereby the SAD which has far-reaching impacts on the national audit systems of its Member States. Germany is taken here as a case country. The areas of the SAD which most affected Germany were cooperation, public oversight and quality assurance.

The purpose of this thesis is to look more specifically at the implications the SAD has for the German audit regulatory system with focus on the public oversight requirements. This research will be supplemented by several different theories, namely crisis management, institutional theory, travel of ideas, and auditing culture. The main empirical data has been obtained through extensive documentary research, and in addition, a telephone interview with the vice-chairman of the German auditor oversight committee.

The analysis showed that the anticipatory model can help to explain how audit regulations change in the EU. Factors, like differing expectations and the relevant audit environments influence what counteractive strategies are implemented. The SAD symbolizes thereby a counteractive strategy of the EU to regain the trust of investors into the capital markets again. The implementation of a public oversight is an important requirement but at the same time presents a challenge for national legislators by incorporating it into the their audit regulatory system.

The main conclusion of this research is hence that the SAD has led to major changes in the audit regulatory system of the EU Member States that will help to make the capital markets more secure and lead to more cooperation among each other. It remains however to be seen how well that new system will work with the emergence of another major crisis.

**Keywords:** SAD, anticipatory model, travel of ideas, SAD, BilMoG, public auditor oversight

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**List of Abbreviations**

APAG	Abschlussprüferaufsichtsgesetz (auditor oversight act)
APAK	Abschlussprüferaufsichtskammer (auditor oversight commission)
AuRC	Audit Regulatory Committee
BARefG	Berufsaufsichtsreformgesetz (disciplinary oversight reform act)
BilMoG	Bilanzrechtsmodernisierungsgesetz (codifying German Commercial Code law)
BilReG	Bilanzrechtsreformgesetz (accounting reform act)
EGAOB	European Group of Auditors' Oversight Bodies
EU	European Union
FEE	Federation of European Accountants
FSAP	Financial Stability Action Plan
FSF	Financial Stability Forum
HGB	Handelsgesetzbuch (German Commercial Code)
IAASB	International Audit and Assurance Standards Board
ICAEW	Institute of Chartered Accountants in England and Wales
IDW	Institut der Wirtschaftsprüfer (Institute of Public Accountants in Germany)
IFAC	International Federation of Accountants
IFIAR	International Forum of Independent Audit Regulators
IFRS	International Financial Reporting Standards
ISA	International Standards on Auditing
PCAOB	Public Company Accounting Oversight Board
SAD	Statutory Audit Directive
SEC	Securities and Exchange Commission
SOX	Sarbanes-Oxley Act
WPK	Wirtschaftsprüferkammer (Chamber of Public Accountants)
WPO	Wirtschaftsprüfungsordnung (German Public Accountant Act)
USA	United States of America

## **1. Chapter One: Problem Statement**

### **1.1 Introduction**

The modern function of auditing has existed ever since the capital market has started to emerge in the end of the 19<sup>th</sup> century. It is described as "the process of providing assurance about the reliability of the information contained in a financial statement prepared in accordance with generally accepted accounting principles or other rules." (Soltani, 2007:4)

There is however a distinction between the simple audit agreed between at least two parties and a statutory audit. The latter one describes an audit of financial statements as required by European Community law. That means a statutory auditor has to be approved in accordance with the respective Community law by a competent authority in order to carry out any statutory work. (EU, 2006)

The role of a statutory auditor is thereby influenced by the fast-changing environment of the various capital markets as well as by regulatory bodies. Each country has its own national laws and regulations but with the increasing harmonization of the capital market, regulatory bodies and governments started to cooperate and work together on finding a common basis for auditing regulations. The EU, where there is extensive cooperation between Member States, is a prime example of this. Its market environment is characterised by common regulations and European bodies that deal with coordinating the various issues arising in the volatile business world.

The increasing number of financial scandals in the last two decades as well as the contemporary financial crisis has however raised fundamental questions about the way capital markets are regulated and supervised. In such times of crises, investors and other market users would normally rely on auditors to restore the trust into the capital market again because they are responsible to ensure the true and fair financial statements of business organizations and therewith make the capital market reliable. Auditing scandals, like Arthur Andersen (2002) and the Parmalat audit (2004) have however made it more difficult for the public to believe that only this profession can make the capital market trustworthy again. For this reason regulatory bodies started among others to discuss about improving accounting and auditing standards and about establishing an efficient and transparent securities market system. That means the introduction of a new regulatory and legal environment, and a corporate accountability framework that would be globally recognized. (Braiotta, 2005) More precisely, it means to enhance the audit quality, restore the trust of investors into the audits of companies and define more specifically what is required of regulators, legislators and auditors. (Holmquist, 2008) In the United States, the strict framework of the Sarbanes-Oxley

Act (SOX) has for instance been introduced in 2002 as one consequence of the catastrophic scandals of Enron and WorldCom. The European Union in contrast has long debated in what way the broad framework of the EU 8<sup>th</sup> Directive from 1984<sup>1</sup> could be improved. In 1996, the Commission had reflected on further actions in regard to the duties of statutory auditors in their Green Paper "The Role, Position, and Liability of the Statutory Auditor in the EU". Also, further Communication documents proposed the creation of an EU Committee on Auditing (1998) and improvements on quality assurance for statutory audit work (2000). (EC, 2003) As result of this process it was decided that a modernised 8<sup>th</sup> Directive should be developed that was strongly focused on the environment and proceedings of auditing firms (EU, 2004). That means a greater scope on issues like quality assurance, auditors' independence, robust professional ethics and the overall use of international standards of auditing (ISA). The directive has been passed by the European Parliament and the Council on 17 May 2006 and should be adopted in all Member States of the EU before 29 June 2008. (EU, 2006) The modernised EU 8<sup>th</sup> Directive is nowadays often called the Statutory Audit Directive (SAD).

This new directive is not just better structured and provides more limitations to the work of auditors than the initial one from 1984, but also enables each Member State to find the appropriate measures to implement the EU requirements into their national legislation. That would be for instance for Italy law number 262 and for Germany the new law called 'Bilanzrechtsmodernisierungsgesetz' (BilMoG). (Kling, 2008) It is however now the question to what degree auditing firms can with the implementation of the provisions of the SAD be able to play a greater role in restoring trust into the capital market again.

## 1.2 Problem Statement

The aim of this master thesis is thus to analyse how the Statutory Audit Directive affects regulation in the field of auditing and how much a crisis and other triggering factors have an effect on changing existing regulation or establishing new regulation. I have chosen Germany as a case study to examine this. The reason for this lies firstly in Germany being one of the most powerful countries in the EU, and secondly in the considerable change of the Commercial Code German legislators had to make in order to follow the requirements of the SAD. That considerable change has been adopted by the German legislators in April 2009, and its application will be compulsory for all coming financial years after 31 December 2009.

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<sup>1</sup> The old EU 8th directive from 1984 will be referred to as 'EU 8th directive' throughout this master thesis. The modernised EU 8<sup>th</sup> directive will in contrast be referred to as 'Statutory Audit Directive'.



German auditors and regulatory committees however do not know exactly how much impact the implementation of the SAD will have on the German auditing profession. My research will thus contribute to providing a summarized information base for mainly German auditing firms when dealing with this new situation. It is a fact that most European accounting and auditing firms do not know the whole extent of how a European directive or regulation came into being, let alone know about the new internationally established institutions. I hope that with the results of this master thesis, I can help to bring these topics into more focus and to highlight the necessity of harmonised rules and regulation for the globalized world we are living in.

For that reason, I have formulated my problem statement in the following way:

**How is audit regulation changed in the EU?  
A case study of the implementation process of the SAD in Germany.**

In order to approach this topic in an efficient way, I have furthermore formulated three research questions that will help me to find more answers to the above mentioned problem statement. In addition, an interview with a representative of the German auditor oversight committee (APAK) will provide me with further insight to the implementation process of the Statutory Audit Directive and the German auditing profession.

These questions are:

- 1. Why has the Statutory Audit Directive been developed in the EU?**
- 2. How is the implementation of the Statutory Audit Directive affecting German audit regulation?**
- 3. How is that process affecting the auditor oversight in Germany?**

Audit regulations are changing over time, and are thereby influenced by external pressure or the culture of the profession itself. External pressure on the one hand could come from regulatory bodies, and their different traditions of implementing laws, or from triggering events like crises or financial collapses. The culture of the auditing profession on the other hand explains what cultural factors influence the regulatory system inside a country, and to what degree audit regulations need to be made comparable. (Zeff, 2007)

It is thus the case that auditing firms and regulatory bodies have to anticipate changes in the existing frameworks. In the course of this thesis, attention will particularly be placed on

investigating the factor of crisis as a trigger for the development of a new audit regulation. Moreover, analyzing crisis regulation is essential to understand why the SAD has been introduced and to see how it has then been implemented into Germany as Member State of the EU. The whole SAD implementation process has in fact just been completed in Germany, thus, it is of special interest to see what effects that process will have on the German regulatory system.

Another limitation of this master thesis is in regard to the content of the SAD. It looks at various issues like quality assurance, public oversight and cooperation with countries inside and outside of the EU. Due to the abundance of information about each of these topics, I have decided to concentrate on public oversight. It had the most important impact on changing national regulation in Germany and introduces a new independent body into the already existing regulatory structures. Public oversight is also the basis for guaranteeing audit quality and regaining the trust of the public into the audit profession.

The remaining part of this master thesis is structured in the following way. The second chapter will develop the frame of reference that consists of the anticipating crises theory, institutional theory, travel of ideas theory, and theoretical aspects of the differing auditing cultures across nations. The third chapter will then describe the methodology understanding of this research in looking at the research approach, design and how data was collected as well as at research limitations and the data evaluation. Chapter four to seven comprise of the empirical part of this thesis whereas chapter four will start off by providing background information necessary for the understanding of the research subject and the other chapters will present the empirical data that have been gathered to answer the three research questions. The eighth chapter will then in turn present an analysis of the empirical data and the theoretical models introduced in chapter two. Finally, the sixth chapter will not only conclude the theoretical and empirical findings of this thesis but also give a future perspective to the problematic of changing audit regulations and its impact on the national implementation in Member States. In addition, you can find the translated question guide I have used for my telephone interview in the appendix of this paper.

## 2. Chapter Two: Frame of reference

This chapter will start off by shortly explaining the main aspects of the statutory audit process by presenting the financial reporting supply chain. The following subchapters will then focus on what theoretical concepts are applicable to analyse how audit regulation is changed in the EU.

The 'anticipating crisis theory' will firstly illustrate the links between expectations and enactments in the relevant audit environments as both are important components for legislators and regulators when dealing with a crisis situation in the economic world. 'Institutional theory' will then help to explain how audit regulators in the EU deal with different pressures when aiming for a harmonised market environment. The theoretical concept of 'Travel of ideas' will in addition help to explain how new concepts, or in this case audit regulations, can be differently interpreted on different levels. Audit regulations are all issued on the European level but provide in most cases only a framework for national legislators of how to implement the issued requirements. Member States can thus choose the form and methods of how to implement the EU regulations. And that means, the initial idea on the EU level might be differently (but within limits) interpreted on the Member State level. Lastly, the concept of 'auditing culture' will help to analyse why certain legislators and regulators act the way they do. The term 'culture' is however not used here in the traditional sense (describing values, behaviours etc.) but aims to illustrate how the regulatory system in the field of auditing varies between nations.

Auditing has the functions to ensure that organizations firstly operate with integrity, accountability and a true and fair view, and secondly, act in the interests of all their stakeholders and the public in general. In order to guarantee that statutory auditors fulfil these responsibilities, regulatory bodies have to set efficient guidance mechanisms. The financial reporting supply chain, which is illustrated in diagram 1, can for that purpose help to explain how auditors and regulators are linked with each other.

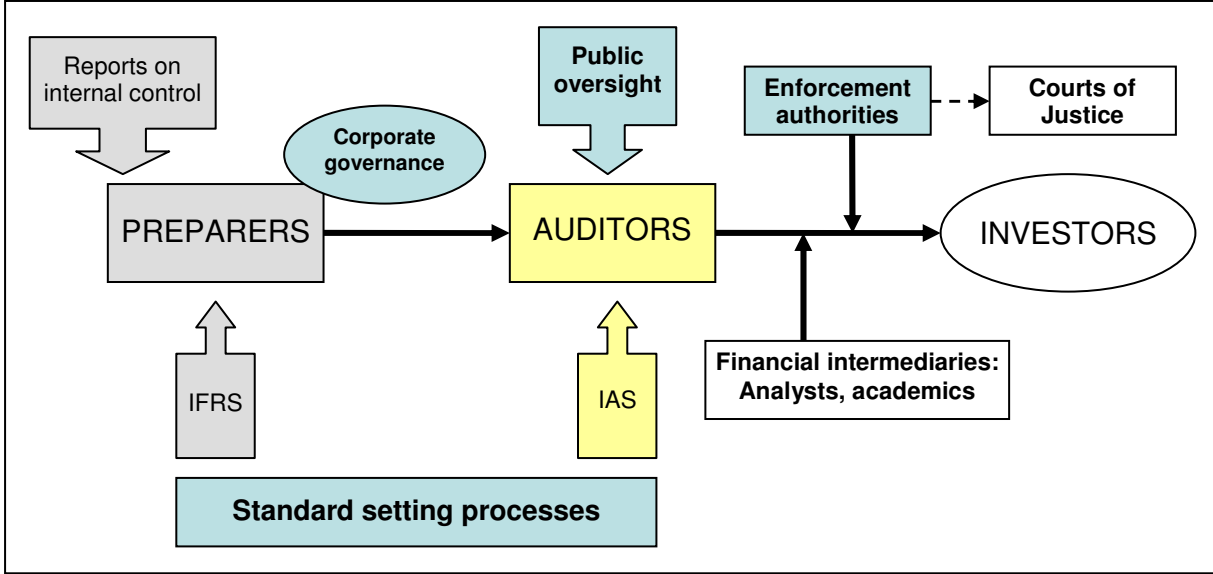
Preparers on the left side are responsible for the provision of financial statements and reports on internal control that are in compliance with general standards, like rules on corporate governance and IFRS. Statutory auditors are thereby required to audit these financial statements in compliance with international standards on audit but are at the same time monitored by a public oversight body in regard to their quality, integrity and value. That means the aim of preparers is to produce financial records for their investors and of auditors to verify them.

Enforcement authorities and financial specialists have however also an influence on the work of auditors. The first one can force auditors to adapt to new rules and regulations, e.g. to change working practices. It is however important to clarify what of the following enforcement levels the authorities are part of: the international, European, or national level. If an auditing firm has not complied with the rules set by the enforcement authority, this could be transferred to the respective Courts of Justice.

Financial specialists can in contrast influence the presentation of the auditing work by their way of analysing the verified financial statements. Investors are in most cases no financial experts, i.e. they trust the analyses of specialists or take their opinions into account.

In summary it can be said that the financial reporting supply chain illustrates the process of how financial records are produced, verified and published and what other factors influence this process.

**Diagram 1: The Financial Reporting Supply Chain**



adapted from Danjou, 2006, p.30

**2.1 Anticipating crises theory**

The emergence of crises is a common part of the economic world as downturns and recoveries are essential for a healthy economic cycle. But what is considered to be a crisis? There are many different views of how to define it. The most traditional one describes a crisis as a specific event that symbolizes a threat during a limited timeframe and thus requires a quick response in order to control and reduce the possible damage. A threat in turn is seen as an external force that harms an organization's products, reputation, and markets. Managers

should therefore implement post-crisis information publication and strategies to recover the damage. (Seeger et al., 2001)

The more current definitions of a crisis describe the event in contrast as a natural phase of an organization's life cycle. It is a holistic point of view that looks upon the two parts: crisis and daily business, as well as collapse and recovery as basis for an organization. That means that a crisis is not only a threat but can also be seen as an opportunity for future development. Managers are thus meant to participate in that specific crisis by monitoring, assessing, communicating and planning the whole process. (Seeger at al., 2001) As a consequence, organizations do not only use post-crisis management but also ex-ante crisis prevention.

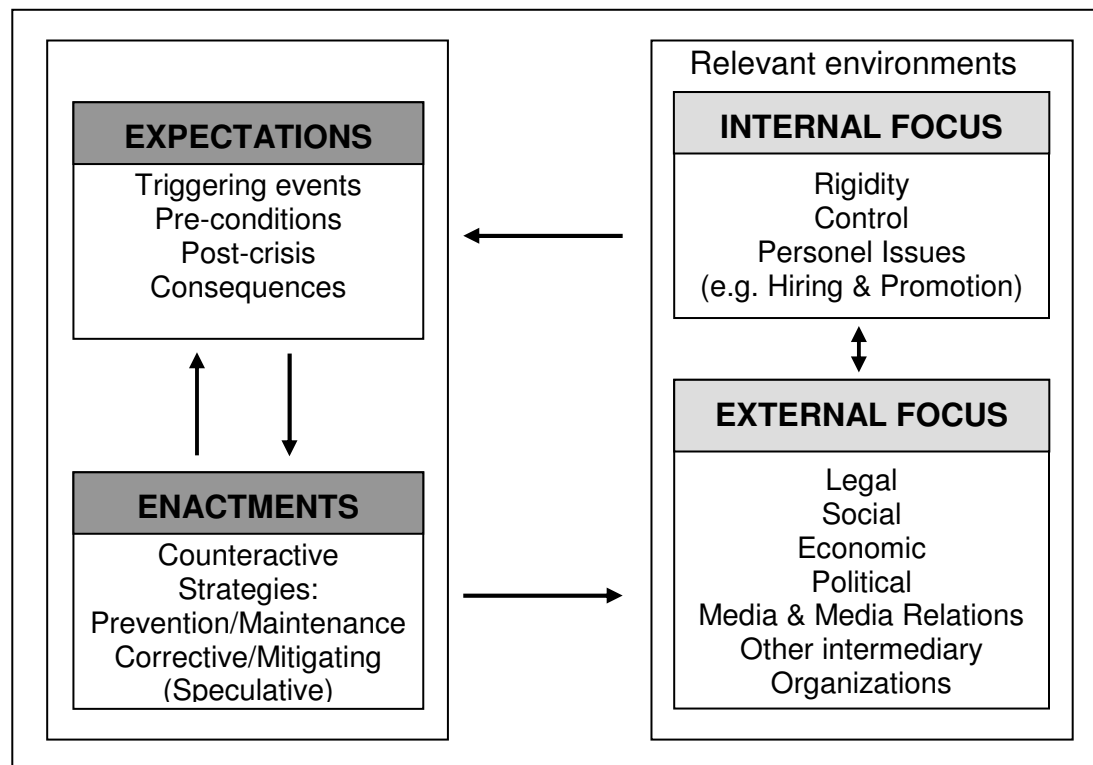
Moreover, it is important to deal with a crisis pro-actively because measures implemented make possible consequences easier to handle, and the anticipation of a potential crisis helps to prepare and analyse the environment better.

The anticipatory model argues thereby that an effective crisis management is used for prevention as it is easier for an organization to deal with a crisis for which it is prepared for. (Olaniran and Williams, 2001) Trying to prevent a crisis from happening means thus to have preparatory practices in place that will help the management to reduce uncertainties. Olaniran and Williams (2001:489) state: "the less attention devoted to understanding the nature of a crisis, the more likely the crisis will escalate." Consequently, decision makers need to understand the circumstances of a crisis happening and deal with them through a post-crisis action plan. Another factor is the behaviour of human beings. No theoretical model can account for any human action. Thus, human errors should be considered in an effective crisis management.

As a result of these interpretations, it becomes obvious that Olaniran and Williams were looking at a model that explains how business should anticipate a crisis. I will however use the anticipatory model to analyse the regulatory system in the auditing profession. Regulators and legislators also need to anticipate critical situations, whether in form of a financial scandal or an economic crisis. It is especially important for them to understand the different expectations which are involved before developing the appropriate actions to deal with a crisis. Therefore, I have decided to use Olaniran and Williams's business model to explain the changing audit regulatory system within the EU.

In order to fully understand the anticipatory model, illustrated by the following diagram, it is however important to firstly define the two components of expectations and enactments. (Olaniran and Williams, 2001)

**Diagram 2: Anticipatory model**



Adoption of the anticipatory model from Olaniran and Williams (2001: p.491)

Expectations on the one hand describe the assumptions people make about a specific situation. Assumptions in turn identify whether an error will have a dimension of a crisis or of a catastrophe. Decision-makers then have to deal with the environment of the potential crisis and set actions in motions that correspond with their assumptions. In view of the audit regulatory system in the EU, people have different expectations of the respective legislators and regulators and that has to be taken in consideration by them when dealing with a potential crisis environment.

Enactment on the other hand can be explained in the way that anticipating a crisis will determine the actions a decision-maker will undertake to deal with that situation and these are dependent on the derived information. The reason for that lies in the fact that decision-makers have to anticipate opportunities, strengths, threats and weaknesses of the appropriate environments and then decide what measures are appropriate to preserve their interests. That means, legislators and regulators have to evaluate the audit environment before developing measures that preserves their initial goal to harmonise the audit market.

In sum, expectations and enactment both constitute the crisis anticipation process in which firstly the emergence of a crisis is predicted and secondly actions taken to decrease or even eliminate the extent of the whole situation. (Olaniran and Williams, 2001)

An effective crisis management should moreover be vigilant to the relevant internal and external audit environments. Anticipating a crisis always involves looking for the triggering event that is defined by a specific place, time and agent. It represents the signal for the starting point of a catastrophic disaster. Consequently, decision-makers try to reduce the effects of the occurring crisis but will at the same time increase the stress-level. It is thus an essential part of the anticipatory model to focus on the two key elements of rigidity and control in order to facilitate a stress-free environment and enable the decision-makers to respond to the occurring crisis in the best possible way.

Rigidity can be seen as the degree of inflexibility in regard to the actions that are publicly taken to deal with a certain situation. Furthermore, the quality of these actions is determined by how the decision-maker looks at the problem. Justifications are thereby essential to clarify how and why certain steps were taken in a crisis situation and also to avoid confusion and ambiguity. (Olaniran and Williams, 2001)

Control can in contrast be seen as the influence of decision-makers to change a certain crisis situation. Ability and authority are thereby important elements that are linked to empowerment and thus facilitate a vigilant response of the decision-makers. Giving individuals or groups control enables a quicker respond to crisis-triggering events that might be caused by either internal failures or external circumstances that are of political or economic nature. It is therefore essential to establish a crisis management that considers both internal and external factors. (ibid)

Recapitulating, the anticipatory model provides a pro-active view of crisis management. The actions of decision-makers are thereby dependent on the three components: expectations, enactments and the relevant environments. Hence, the anticipatory model helps to prepare and analyse for an potential crisis, which is here a crisis in audit regulation.

## 2.2 Institutional theory

Institutional theory as part of the New Institutional Sociology describes how organizations behave while being under the pressure of the wider society. Organizations will always seek for external legitimacy by adhering to rules and norms. Their reason lies in the wishful compliance with what the society and certain institutions consider as values. Consequences are similar adoption processes which are also called 'institutional isomorphism'. Isomorphism can thereby be explained as "a constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions". (DiMaggio & Powell, 1983:149) That means isomorphism is not just restricted to businesses but to a unit in a population. And that could in turn be interpreted as the auditing profession and its regulatory system. Regulators are dependent on constraining processes that could come from governments, international standard setters or other professional institutions and thus be forced to change their regulatory system.

There are two main forms of isomorphism (competitive and institutional) that can influence a unit in a population. Competitive isomorphism describes the power of competitive forces and institutional isomorphism the political power and wish for institutional legitimacy. For the purpose of this master thesis, I will only focus on institutional isomorphism as that helps to firstly understand the influence of politics and ceremonies a specific unit of a population is surrounded with and secondly explains why certain units seek for an increasing legitimacy.

DiMaggio and Powell (1983) have identified three mechanisms in that context that make organizations change and become more alike: coercive, mimetic and normative isomorphism. Coercive isomorphism describes thereby pressure from formal and informal sources on an organization to change. These sources might come from other organizations, cultural expectations or from governments. The pressure does not necessarily have to be a force but could also be a persuasion or an invitation. Organizations might become more alike due to changing regulation or due to specific societal preferences. DiMaggio and Powell argue however that these changes are rather ceremonial but that organizations are continuously aware of the preferences of the society. And that in turn helps them to obtain more power and influence. In the case of the audit regulatory system, regulators feel the pressure from coercive sources, like the European Commission and as a consequence adapt their national audit system to these pressures.

Mimetic isomorphism describes that organizations might also change or imitate others due to the factor of uncertainty. Ambiguous goals, unclear technologies and uncertain environments



encourage organizations to model other organizations in their field. The term 'modelling' is thereby one response to uncertainty. Some organizations might be aware of it, others might not. Modelling can be seen as borrowing practices and is diffused by employees, consultancies or industry trade associations. DiMaggio and Powell claim that most organizational structures are homogenous because there are not so many different models existent in reality. Thus, in order to deal with uncertainty and ambiguity organizations tend to choose similar structures.

Normative isomorphism in contrast explains pressures that come from professionalization. It is the "collective struggle of members of an occupation to define the conditions and methods of their work, to control "the production of producers", and to establish a cognitive base and legitimation for their occupational autonomy". (DiMaggio & Powell, 1983:152) Professionals can not only follow their own norms but must compromise with the ones from non-professionals or regulators. When looking at the auditing profession, normative pressures arise from professionals and thus force audit regulation to be revised. There is a collective struggle of European regulators to establish an effective framework and to define appropriate measures. Another aspect is that professional power does not only come from inside the profession but is also assigned by the government. Sources for normative isomorphism are thereby based on firstly the cognition of education and legitimation by university specialists and secondly the diffusion of new models via professional networks. Universities can be seen as knowledge centres that have an influence on the development of norms and values. And with the help of these established norms, professionals can be made comparable.

Summarizing, institutional theory describes that organizations or units of a population are forced to change over time. These environmental pressures can arrive from different sources but consequently all emphasize on the role of conformity and convention.

### **2.3 Travel of ideas**

Organizations change over time, whether through the use of different business practice patterns or through changing visions of the management for their business future. The consequence is then a planned innovation or environmental adaption which can be described with the help of certain theoretical approaches. Planned innovation on the one hand involves strategic considerations, whereas an environmental adaption on the other hand involves contingency and institutional theories.

The whole phenomenon is analysed by Czarniawska and Joerges (1996) through their understanding of the travel of ideas: starting with an idea and ending with its translation into actions. I will use this understanding to show how the idea of a new audit regulation travels from the EU to the Member State (i.e. Germany in this case) level. Developed, proposed or issued legal measures of the EU have to be implemented into national legislation. These measures are however not precisely defined, meaning that Germany for instance has some kind of freedom in what way it implements the requirements. Thus, the new idea on the EU level travels to the national legislators and regulators level which is then in turn translated into actions that are appropriate for the situation.

Ideas are powerful instruments that become true after their successful translation but consequently also lead to changes in their environment. They are "images which become known in the form of pictures of sounds" (Czarniawska and Joerges, 1996:20) and then will be transformed into objects. That in turn will lead to further changes because firstly there will always appear some unknown objects, secondly known objects might change the outcome more than expected, and thirdly used working practices might also be altered.

Applying ideas can thereby only be done via communication and are either of political nature, an imitation wish, subordination or to follow others. No matter what reason is behind forming and translating a new idea, the two factors of time and space are of crucial importance.

According to Czarniawska and Joerges (1996) ideas always travel from a problematic to a more satisfied environment. The impulse comes however from people, "whether we see them as users or creators, who energize an idea any time they translated it for their own or somebody else's use" (ibid:23). This so-called translating model explains that ideas emerge in order to resolve an existent problem / crisis or to create new possibilities for a stagnated situation. Some ideas will thereby become fashionable and be translated and others will just stay at the local level. All the important features of an idea as well as the attributes of the respective problem are either created, negotiated or enforced throughout the translating process.

Another notion of ideas is that people can only perceive something that they already know or that is somehow connected with a known issue. Meaning people "cannot translate what is wholly unrecognizable" (Czarniawska and Joerges, 1996:28). It is however a fact that people always choose something that has a purpose for them. For instance, a regulator in a booming economy in the EU focuses on ideas that either help to enhance the harmonised audit market or lead to further actions. Whereas a regulator in a crisis-driven economy looks for an idea to

overcome the obstacles and to regain the trust of investors into the capital market again. Thus, it all depends on the purpose and what people make out of it.

Sometimes a confirmation of the initial notion can be reached, and in other times the initial beliefs and purposes are re-arranged and then create new ideas as well as new market players. Moreover, an idea or initial notion can only catch on after existing in people's minds for some time. That means being a part of a master plan in a translocal space and time. The advantage of a master plan is hence the taken-for-granted attribute that allows the user to apply it in all possible situations. Some regulators tend to form collectives that allow them to interact, enhance international structures, provide an exchange of information, and to develop a group awareness. External forces, like the economic situation, political influence or professional networks, are thereby influencing the structure of these collectives. According to Czarniawska and Joergen (1983) collectives continuously look for new ideas which then could achieve an institutional status. However, fashion is an important feature as it causes a variety of different ideas. Regulators try them out, and either create a new fashion or establish institutions by applying certain working practices, continuing to use previous fashions or by launching the newest fashion as their final solution. For instance, American regulators might develop a new fashion that European regulators can then decide to copy or instead to develop a counter-fashion that is more suitable for them.

In order to get an idea enacted, it has to be objectified at a certain time and space, translated into a global setting and ultimately to be debated about the means by which it travels.

That means ideas have to be made into action. In most cases, action takes place because it is like a routine and not because people remember the initial notion of it. Nevertheless, all actions need to be legitimized. In order to accomplish a simple action, many ideas are needed that not only serve the goal to translate the specific action but that will also produce counter-ideas. (ibid)

Another reason why ideas need to be objectified is that it is easier to make them of public knowledge. Political agents, contingent events and fashion notions are thereby supporting the process of ideas travelling from local places to translocal time and space ones.

Recapitulating, ideas travel through time and space. They become objectified at the level they emerge and then travel towards a more global time and space where they will be translated into actions. It is however the question by which means they travel and be put into actions.

## 2.4 Auditing culture

Standard setters, regulators, auditors, and companies all try to promote the ongoing improvements of financial reporting. It is however challenging for these parties as not only regulatory frameworks for auditing across countries vary but also traditions and rules on statutory books. (Holmquist<sup>2</sup>, 2008)

Thus, pressures arrive from cultural practices and then contribute to the changes in auditing practices and regulations.

The first pressure is the culture of governance. It "relates to the effectiveness of regulatory initiatives to penetrate the organization and ensure compliance with rules via specifically designated officers, audit committees, and other internal representatives". (Power, 1999:41) In addition, it describes intra-organizational issues related to control and motivation because working practices have to be made more sensitive to stakeholders. And that in turn requires an ongoing alertness and improvement. (ibid)

The second pressure is concerned with the regulatory culture in a country itself. There are different traditions whether a regulator is taking a proactive stance when dealing with annual reports or not. The American statutory authority on the one hand has a great decision-making power and strong opinions on accounting matters. That means the responsible regulatory body SEC can be seen as oppressive. (Zeff, 2007) The German statutory authority on the other hand is influenced by political and academic debates for certain issues and thus, does not have such a great deal of oppressive power than the USA. It requires a more institutionalised lobbying process but is still powerful in enforcing its rules and regulations. (Evans and Honold, 2007) Another factor influencing the regulatory culture in a country is the degree of regulation issued. Some countries have strong and forceful regulators, i.e. companies are less willing to use international financial reporting standards because their national regulators would object plus insist upon changing the annual reports again. Other countries have softer regulators. That means companies are more willing to implement international financial reporting standards because their national regulators would not disagree but rather support the use of them. Lastly, the regulatory culture differs in countries following Civil Code or Common Law. The Civil Code is mostly applied in non-English-speaking countries, like Germany, France and Italy. That means the respective regulators find it more difficult to change the

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<sup>2</sup> Jörgen Holmquist is the Director-General of the Internal Market and Services at the European Commission since 2007.

statement of the annual reports after the approval by the company's shareholders. It would rather have to wait until the next shareholders meeting or go to the Civil Court. Common Law regulators, like the USA and Great Britain, have however less difficulties to get a restatement as the respective regulators have the powers to simply construct the respective company to do so. Shareholders do not vote for the approval of the annual reports and thus do not have any decision-making power in this matter. (Zeff, 2007)

It is however to mention that factors influencing the strength of any regulator symbolize at the same time the authority issued by national legislators to their responsible regulators as well as the issue whether the respective country follows Common Law or Civil Code. (ibid)

The last pressure that contributes to changes in the auditing practices and regulations is the issue of comparability. Uniformity or flexibility in auditing are thereby two approaches legislators have to choose from. Stephen A. Zeff (2007:294) raises the question: "Does the same method to be used by all companies around the world produces 'genuine' comparability or 'superficial' comparability?" It is a fact that auditing varies among countries. National auditing practices are dependent on the mentality of people, the auditing culture itself as well as the historic influence of governmental bodies. Auditing and assurance standards are initially issued by a single international body but each country has its own influence on its national auditing standards. Comparability is thus an important issue for the EU when making the effort to establish a common auditing market. Some people believe that comparability can be achieved by standardised and uniform accounting methods, but others believe that comparability can only be obtained to the degree that national circumstances are still taken into consideration. (Zeff, 2007) It is thus the question to what extent it is really possible to establish a common European or even global market with comparable auditing practices and regulations.

## **2.5 Summary**

The theoretical frame of reference has introduced several different theories that are relevant for analysing the changing audit regulations in the EU. Understanding statutory audit and its influencing factors is thereby the basis for this research. The introduced anticipatory model will further enable me to put changes of audit regulations in the context of a crisis situation and therewith allow me to look at what regulators and legislators have to deal with.

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Institutional isomorphism as well as the travel of idea theory have then introduced other aspects that can be used for explaining how audit regulation change in the EU. It is thereby important to distinguish between the EU and the Member State level as new ideas in the auditing field travel from the higher to the lower level.

Nonetheless, it is also necessary to understand the auditing culture when looking at the regulatory systems of the EU Member States. They differ across borders and thus, represent a crucial factor of how auditing regulation can be changed. That means that in order to fully understand how audit regulation changes in the EU and what impacts that might have on the implementation process in the Member State, it is important to acknowledge the different auditing cultures and to integrate that in the analysis.

### **3. Chapter Three: Methodology**

The aim of this chapter is to describe the overall approach of researching the problem statement and three research questions formulated in the first section. In that process, I will look upon the design, execution and evaluation of the research results as well as upon the tools and approaches used in this master thesis. Before looking at these details it is however important to understand what the term 'methodology' means and what philosophical positioning I will hold to justify my analysis of the empirical data.

#### **3.1 What is methodology?**

Researchers have to combine social science and philosophy in order to analyse and interpret their empirical data in a proper way. Theoretical and philosophical assumptions that are concerned with ontology, epistemology and methodology are thereby a useful bridge to link these two areas. (Hopper and Powell, 1985) Moreover, it is important to have a good understanding of philosophical issues because that will help the researcher to firstly clarify his/her research design, secondly help to find the appropriate design and thirdly identify the research designs that are not useful for his/her work. The three philosophical assumptions of ontology, epistemology and methodology are thus essential to fully understand the comprehension of the researcher. (Easterby-Smith et al., 2008)

Ontology as the starting point looks at the nature of reality, i.e. it provides a description of the facts of reality. It has furthermore two extremes (representationalism and nominalism) that are on the one side looking at the social world as being independent, empirical and external from the cognition of the individual, and on the opposite side depending on the individual's consciousness. (Hopper and Powell, 2007)

Epistemology inquires into the nature of knowledge, i.e. it explores how truth and belief can be justified. Its two extremes positivism and social constructionism describe on the one side the belief that knowledge can be obtained through observation and on the opposite side the belief that knowledge is more personal and thus can only be obtained by investigating the respective subject. (ibid)

Methodology as the final point of this chapter describes the methods and tools used to gain knowledge, i.e. it provides an understanding of how empirical data is collected and analysed. It refers to the choices the researcher will make when studying a specific phenomenon (Silverman, 2007) If the social world is thereby seen as being independent and external, then quantitative methods are used to help explaining social patterns and regularities. If the social

world is however seen as being dependent on subjective experiences, then qualitative methods are used to provide an insight into the world of the subject to be researched. (Hopper and Powell, 2007)

Researchers thus have to firstly position themselves in what way they want to investigate their chosen subject and secondly provide a sound methodology. (Riley et al., 2007) In the case of this master thesis, I want to look at the research topic from the social constructionist point of view. It is however challenging to do so when mainly concentrating on a documentary data collection basis because I will not be able to obtain first-hand knowledge myself but will have to trust the opinions and interpretations of the chosen authors instead. My goal is thus to investigate the relationship between auditing regulations and the phenomenon of crisis and to get data through the experiences of the participants and their environment. It is important to understand exactly how the audit regulatory system works in the EU as well as in Germany as my case study. The viewpoints of legislators, regulators and analysts will thereby provide me with empirical data that enables me to analyse the problem statement in a better way. My philosophical positioning will further allow me to look at how audit regulations change over time as the insights from those groups will allow me to not only look at historical and present events but to also make subjective assumptions and interpretations that could be used as future outlook.

### **3.2 Research approach**

Before going into more detail about the specific research design, it is important to describe the main concepts used in this master thesis. Every researcher has to define how he/she will organise the research activities and what sources and methods will be used during the process of gathering data. It is also essential for the research approach to be in line with the philosophical positioning of the researcher because a clear strategy facilitates to deal with every aspect of the research and also in regard to the changing context throughout the whole process. (Mason, 2004)

I have thus chosen to do a deductive research as a tool to applying the relevant theories in this master thesis. That means relevant theories will lead to firstly the formulation of a hypothesis, secondly to the collection of empirical data and lastly to the testing of that hypothesis. The goal of the researchers is thereby to derive some explanations for the observed behaviour of the specific research topic. (Riley et al., 2007) That whole process is also seen as moving from the more general to the more specific and concrete view. (Punch, 2005) Deductive



reasoning is thereby mainly concerned with testing and confirming the initial formulated theories which means that it requires sufficient empirical data to verify or falsify them.

The choice of sources and methods is thereby essential for a successful research strategy. This master thesis will focus on using only qualitative sources for gathering data as that is fundamental for understanding how the research subject of auditing regulations has been changed in the EU and how that has ultimately changed the German regulatory system. That means that theories concerning the governance on the EU and Germany level as well as the subjective opinion of the interviewee – both written and orally expressed – are necessary to investigate this research topic. With the help of these methods, I will be able to apply the theories of chapter two and to analyse them in regard to my problem statement.

The next subchapter will then give a more narrow description of the research design in regard to specifying methods and procedures in order to collect the needed information for this master thesis.

### **3.3 Research design**

The main factors influencing the design of a research project are the chosen topic and how much empirical data is available for collection. In the case of this master thesis, I have chosen to investigate the relationship of the audit regulatory system between the EU and Germany under the assumption of an influence of crises. Thereafter, I have formulized a problem statement and three research questions in order to collect the essential information necessary to analyse this topic. The scientific design used for this research subject will consist of a mixture of descriptions and explorations.

Descriptive design on the one hand is based upon information and analyses questions that are concerned with the What, When, Where and Who of a chosen research topic. The goal of descriptive research is thus to establish a picture of the research object by collecting as much empirical data as possible. (Riley et al., 2007) Explorative design on the other hand goes beyond just describing a picture by investigating something new or something that is not very well known so far. The main goal is thereby to prepare the research for further studies or to develop methods that can be used in other studies. (Silverman, 2007) Descriptive knowledge is a first step to understanding phenomena but only with the help of explorative methods can something new be found or be better understood. (Punch, 2005) In addition, implementing a mixed design of description and exploration will give the research a flexibility to adapt

questions and methods to whatever has been explored during the investigation process. Thus, I will use the combination of both designs in order to firstly draw a picture of the situation of the audit regulatory systems within the EU and to secondly explore how much influence the European Commission has on the implementation of audit regulations in Member States. It is essential for this research to start off describing the regulatory system on the EU level as well as on the German level before exploring why and how audit regulations change. The audit regulatory system is quite complicated and so far not well known to outsiders. The description will therefore provide a basis for the reader to comprehend the explorative part of the thesis.

In order to collect the information that is necessary to investigate this research problem, I have furthermore chosen to concentrate on qualitative instead of on quantitative research.

There are many occasions where researchers do not want to quantify social phenomena or interaction. Instead they want to explain intangible factors like values, perceptions and feelings that will help to understand human behaviour. According to Riley et al. (2007, p.99) qualitative research 'seeks to describe, decode and translate ... the meaning ... of certain more or less naturally occurring phenomena in the social world' and is not looking on how often that specific phenomenon has happened.

Qualitative data is also not restricted to formal, fixed rules but consists of a variety of things. Examples are interview transcripts, documents, observational records and notes, audiovisual materials or personal experience notes like artefacts, journals and narratives. Due to this wide range of possibilities, qualitative researchers usually do not restrict themselves to only one data collection method. They use multiple data sources because the more data is collected from different sources, the more valid and reliable the research will be seen as. It is without any question more difficult for qualitative researchers to decrease the danger of human error and bias but only observations and interviews can provide the necessary insight into human behaviour. (Punch, 2005) The method of a case study is another technique how to combine various qualitative data sources, in most cases from documents, personal experience and interviews. It "aims to understand the case in depth, and its natural setting, recognizing its complexity and its context. It also has a holistic focus, aiming to preserve and understand the wholeness and unity of the case". (Punch, 2005:144) There are three different types of case studies: intrinsic, instrumental and collective. The two first ones are single case studies whereas the third type a multiple one is. An intrinsic case study is undertaken when a researcher wants to gain a better understanding of the particular case and does not attempt to generalize beyond it. An instrumental case study in contrast looks at a particular case in order

to get a better insight of an issue or to revise a generalization. The collective case study as last example is an extension of the instrumental case study that aims to look at general phenomena or population by covering several cases. (Silverman, 2007)

This master thesis will be designed as an intrinsic case study with the main focus on official documents and supplementary with an interview with a representative of the German auditor oversight board. I have chosen this design because the official documents will provide me with a better understanding of the different audit regulatory systems in the EU and the single interview will reveal me with a more precise viewpoint from the German auditor oversight board. Germany as a major representative of the EU will furthermore give me the opportunity to investigate the explicit impacts of European audit regulations onto the German regulatory system and therewith be able to analyse how regulations change in the EU.

The following subchapter will then describe more precisely how I have collected the qualitative data that are necessary to make a valid and reliable analysis of the problem statement.

### **3.4 Data collection methods**

As stated in the previous sub-chapters, qualitative methods seem to be more applicable for researching the changes of audit regulations in the EU than quantitative methods. In order to find answers to this research problem, an understanding of the environment, attitudes, perceptions and opinions of the subject involved is necessary. In regard to Punch (2005:141), qualitative methods are naturalistic by studying people, things and events in their natural settings.

There is however no best way on how to conduct a qualitative research. In most cases, research questions will be changed more than once during the whole process of the research work due to the outcomes from interviews or information found in documents. (Punch, 2005) It is thus important to describe the different data collection methods used within a research project.

The basis of qualitative research consists thereby of primary and secondary data which can furthermore be divided into various techniques, like interviews, observation, experiences, documents and so on. Primary data is the collection of new and original information whereas secondary data consists of the collection of existing sources, like books, reports from

governments, or documents. (Riley et al., 2007) Examples for primary data could be interviews, personal experiences or action research, and are directly collected by the respective researcher. They are usually used for a specific case study or comparative studies because first-hand experiences provide the researcher with empirical data from the real world and thus make the work more reliable and valid.

Secondary data in contrast can come from different sources which are either of academic or non-academic, or either of quantitative or qualitative nature. It is however more challenging to establish the quality in secondary data as it has come as a result of other research. Important characteristics are thus credentials, objectivity and justification. (Riley et al., 2007)

For the purpose of this master thesis, I have chosen to mainly do a documentary research as secondary data collection method and in addition, gain supplement information through a telephone interview as primary data collection method.

I have gathered the main empirical data from a documentary research in books, articles and electronic web pages because researching the audit regulatory system of the EU and of Germany requires a richness of historical and current data that are only provided by the respective legislators and regulators. A main feature of our society is to keep documentary evidence of events and developments (Punch, 2005), thus, it is important for me to collect those information that are relevant for my study. I have chosen to use documents that come from governmental pages of the EU and Germany because they provide me with the highest possible level of reliable and trustworthy information for the type of secondary data. In addition, I have gathered data from well-known analysts within the European audit profession and used speeches / recommendations from representatives of international recognised auditing bodies, like the Financial Stability Forum, the EGAOB and the Institute of Chartered Accountants in England and Wales. The electronic web has thereby supported my research by using keywords like 'auditor oversight', 'crisis regulation', 'Statutory Audit Directive' and so on.

In order to supplement the information gathered through the documentary research, I have chosen to conduct an interview with Prof. Dr. Marten<sup>3</sup> as a representative of the German auditor oversight board via telephone. Initially, I had planned to conduct more interviews with German auditors and another representative of the German regulatory system but due to time, location and circumstances limitations, I was not able to do so. Consequently, I have chosen

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<sup>3</sup> Prof. Dr. Kai-Uwe Marten is a professor at the university of Ulm since 2003 and has his research interests in the auditing field with focus on public oversight and quality assurance. He is furthermore the vice-chairman of the APAK since 2005 and is associated with the EGAOB.

to only conduct one telephone interview with the relatively new-established auditor oversight committee in Germany. That means gathering data from an independent body and therewith, get first-hand information about the implementation process of the SAD in Germany. These data will further on help me to analyse the relationship between the EU and the German audit regulatory system in a better way. The telephone interview was thereby semi-structured, i.e. an interview guide with several questions (attached in the appendix) was sent to the interviewee in advance but got changed during the overall duration of the conversation. The content of the answers has thus determined the course of the interview. The method of an interview – whether face-to-face or via telephone – has the advantage to firstly show me what meanings, feelings and values the interviewee has about the respective research topic and to secondly make me understand how the interviewee constructs the reality of the chosen topic, i.e. what constitutes as reality for the interviewee. That also means subjectivity plays an essential part. In order to tackle this problem, I have not only recorded the telephone interview but also transcribed it afterwards. Written word is easier to analyse because it gives me the opportunity to get a better grip on the subjectivity and thus enables me to use it in the right way. As last stage, I have sent the transcribed telephone interview back to the interviewee for confirmation. It has to be mentioned here that my telephone interview was conducted in German, i.e. any quotations used in the empirical and analysis chapters as well as the attached interview guide are translated into English by me.

### **3.5 Methodological limitations**

This master thesis has been limited in regard to the number of interviews, the data reliability and in regard to the collection methods used.

I have chosen to only use one interview with a representative of the German auditor oversight commission (APAK) due to a lack of time, different locations and circumstances. Germany is preoccupied with the implications of the contemporary financial crisis as well as with the introduction of the new amendments of the German Commercial Code and thus, potential interviewees did not have time to answer questions within the timeframe of this master thesis. Nonetheless, the interview with Prof. Dr. Marten has not only provided me with essential information about the German audit regulatory system but also reflected a fairly unbiased point of view as the APAK is an independent body that consists of non-auditors.

In regard to data reliability, there are of course some methodological limitations that arise during the process of an interview. A high subjectivity and biased opinions are the most likely

scenarios. I have however chosen Prof. Dr. Marten as my interviewee because he does not work as an auditor. Instead, he works more like an external consultant to the APAK and thus diminishes the danger of being too subjective. It is also difficult to generalize for only having conducted one interview. Generalization can be described as external validity, i.e. whether the theories and analyses found in this research work are relevant to other institutions or external parties. The main goal of this master thesis will thus be to understand the complexity and the context of my case study: the implementation of the SAD in Germany. I will not focus on generalizing my findings for other Member States of the EU but to build a valuable in-depth understanding of the German case.

In regard to the collection methods, it is difficult to address all important aspects of the reality the interviewee is living in. Even though the telephone interview was semi-structured and there was time for the interviewee to address certain aspects, it is easy to overlook some of them. I have however supplemented this lack by sufficient secondary data.

### **3.6 Data evaluation**

In order to demonstrate that this qualitative study is credible, the methods and sources used in this research have to be reliable and analyses and conclusions valid. Just because there has been no use of quantitative methods, does not mean that the quality, rigour and wider potential of this research is not scientific. (Mason, 2004) Every qualitative researcher should thus have a methodological awareness that "involves a commitment to showing as much as possible to the audience of research studies ... the procedures and evidence that have led to particular conclusions, always open to the possibility that conclusions may need to be revised in the light of new evidence." (Silverman, 2007:209) That means the relevant terms are validity and reliability.

#### **❖ Validity**

This criterion is associated with showing that the researcher's implemented concept can be identified, observed or measured in the way he/her has stated in the research work. It is however more difficult to prove validity for qualitative researchers. One way of proving validity could thus be to use the method of triangulation which combines different ways of looking at a certain situation or finding. (Silverman, 2007) Thus, I have chosen to combine the method of a telephone interview with the method of gathering secondary data that are mostly derived from reliable and unbiased sources, like from legislators and

regulators. These two methods will help to make my research findings not only valid in its context but also valid for the external reader.

#### ❖ Reliability

This criterion is associated with the accuracy of the methods and techniques employed in the research work. (Mason, 2004) Quantitative researchers would use tools like pre-testing, cross-checking and scales for assuring the reliability of their data. Qualitative researchers in contrast have to rely on error-free, faithful and verifiable findings. (Silverman, 2007) They must therefore ensure that their data collection and interpretation are firstly in line with their research questions, and secondly thorough, honest and accurate. Qualitative researchers should not make up or misrepresent data, or be careless in the interpretation of their findings. (Mason, 2004)

In order to show that my data is reliable and accurate, I have done an intense literature review prior to the telephone interview as well as collected written information concerning my problem statement and research questions. The interview itself has provided me with reliable and valid information as the APAK is independent from any governmental influence in Germany or the EU and thus represents the professional oversight of any German auditors. My own interpretations were based on these fairly unbiased empirical findings and thus decreased the danger of failing reliability.

## **4. Chapter Four: Background**

This chapter has the goal to provide the background information necessary for the reader to understand the research subject of this master thesis. The first part will give a short introduction to the history of financial scandals and economic crises whereas the second part will present an overview of the European auditing structure and explain what parties are legally responsible for changing audit regulations and what legal means they can use.

### **4.1 Time of changes: Crises 1997-2002**

The increasing number of financial crises and capital market turmoil has made it more and more important to have effective audit regulations in place.

The Asian financial crisis from 1997 to 1998 was the first important incident that triggered changes in the audit regulation. There were four basic problems: a shortage of foreign exchange in Asian countries, under-developed financial sectors as well as mechanisms to allocate capital, spill-over effects on the American market and on the rest of the world, and a reconsideration of the role of the International Monetary Fund. (Nanto, 1998) The consequences of this crisis were the development of a new international financial architecture, and the increasing importance of transparency in accounting and auditing practices. The SEC responded to this crisis by demanding more comparable, transparent and reliable information for investors in efficient capital markets. One result was then the establishment of the Financial Stability Forum in 1999 that enabled more accounting and auditing regulation but at the same time maintained the neo-liberalistic world order. The goal of this forum was in short to promote financial stability, to enhance cooperation between international authorities and to reduce the tendency for financial debacles to disseminate from one country to another. (FSF, 2009a)

Financial business debacles in the early years of the 21<sup>st</sup> century further reduced public confidence in external auditors and public listed auditing companies of the capital markets. The consequences were a credibility crisis and an overhaul of existing accounting and auditing regulations. Shareholder trust thus has to be restored as well as frameworks be revised, improved and made more effective. (Soltani, 2007)

One of the most prominent incidents is the catastrophic business failure of Enron and its responsible auditing firm Arthur Andersen. Enron was one of the world's biggest energy companies that was named "America's Most Innovative Company" for several times. Its filing



for bankruptcy protection in 2001 stirred up the capital markets worldwide. The collapse led to a first revision of the duties of auditors, as well as to a close examination of the practices audit firms were using. Up to that point auditing firms could engage as consultant, external and internal auditor at the same time. The Enron case uncovered gaps in the existing accounting and auditing regulations. The managers of Enron for example had to readjust their income from 1997 by half its size as a consequence of the increasing pressure of the SEC. The responsible auditing firm Arthur Andersen however decided that these new adjustments of passed financial statements were not material and thus did not publish them. As a consequence, the 100-year-old auditing firm was banned from any auditing practices in the United States and sold most of its international operations as well. (Soltani, 2007)

The auditing firm Arthur Andersen was responsible for the public to raise questions about the interpretations of sound auditing standards by individual auditors. The American auditing oversight body had consequently to react to these questions and growing mistrust by issuing a new law, called Sarbanes-Oxley Act. It symbolizes the most significant securities law reform since the Security Act came into being in 1933. The main tasks of the SOX were to increase requirements in regard to auditor's independence, to define ethical responsibilities of everyone involved in preparing and verifying financial statements, and to enhance disclosure requirements. Its most important measure was to introduce a new public oversight body called Public Company Accounting Oversight Body (PCAOB) which is responsible for overseeing the audits of public companies as well as the work of auditors themselves. It sets auditing standards, has the authority to perform inspections and has the power to bring in disciplinary actions against any public firms charged with violation of the rules set by the PCAOB or SEC. (Giles et al., 2004) In addition to that, the rules also apply to those foreign companies that are listed at the New York Stock Exchange or to foreign auditors working for American companies. It has thus extraterritorial spill-over effects on countries and their national oversight boards outside the USA. (Dewing and Russell, 2004a)

The SOX has however failed to make any exemptions for foreign companies and their auditors that are not listed in the USA. The SEC responded to this shortcoming in issuing a new rule that allows reliance on other national oversight boards. The downside was though that the SEC used an evaluation system and basically only relied on other national oversight boards that were structured in the same way than its own. (Giles et al., 2004)

Around the same time as the occurrence of the Enron scandal, major incidents also happened in the European Union and that made fast changes in the auditing and accounting structure

much more important. The business collapse of Parmalat (2004) had thereby probably the most far-reaching consequences on the European capital market in regard to auditor oversight. Parmalat was one of the largest and most successful companies in Italy that was producing dairy and food products. It was also a giant dairy supplier on the world market. By 2003 it became obvious that the company had borrowed money from various global banks by justifying these loans in inflating its annual revenues through fictitious sales to other retailers. Its responsible auditing firm did not discover that material fraud or choose to not disclose it. The consequence was that Parmalat's management was prosecuted for its financial statement misstatements and omissions under Italian jurisdiction. In addition, the Italian code of governance required the setting up of an internal audit committee consisting of three members that are partly non-executive directors of the respective company. Parmalat however had three executive directors in that committee that were not able to provide an objective assessment of internal control mechanisms. Another reason for the failure of Parmalat was that its external auditors did not discover the extensive fraudulent operations of the management. (Soltani, 2007) The external auditors were however a problem on their own. In 1999, Parmalat had to change its auditing firm due to mandatory rotation law in Italy. It employed another one but kept the services of the old auditing firm for their offshore entities. That means Parmalat employed two auditing firms which both failed to discover the fraudulent operations of the management.

Recapitulating, these two prime examples of business failure and misperception of the general public in the USA and the EU have revealed weak internal controls of the respective companies as well as flaws in the duties of auditors. Up to that point, auditing firms could work in fields that did not require full independency from their clients and also did not have to take over full responsibility for misstatements. That shows that national as well as international audit regulations were clearly not effective enough and did not cover all eventualities that might happen in the fast-changing business environment. As consequences of these corporate scandals, oversight bodies revised their regulatory framework and introduced stricter laws. The SEC implemented the SOX as their consequence of the Enron scandal and the EU rewrote the EU 8<sup>th</sup> Directive and required its members to implement these new regulations into national law by mid 2008.

Looking back at these continuous appearances of financial scandals, it becomes obvious "that self-regulation of the audit profession is not an appropriate model anymore" (Holmquist, 2008:3). The setting up of independent public oversight systems was seen as one way to

restore the trust into the audit market again. Cooperation is essential for its success, because only by relying on other Member States' oversight systems can the model of mutual cooperation work. Regulators and legislators thus should follow the example of multinational companies and their auditors and adapt to internationalisation. The crises had however highlighted that there was a lack of cooperation and coordination between the various Member State regulators and legislators. The goal of the Statutory Audit Directive is thus to eradicate this lack and provide a common framework every Member State has to implement and follow. (Holmquist, 2008)

#### **4.2 The general structure of the EU in the field of auditing**

In order to achieve a single European market, the regulatory environment needs to be improved. Businesses need to be able to operate in a European dimension as well as being competitive on the international scale. The harmonisation of the company law is thereby a first step. It aims to provide a simplified legal environment with less red tape. (EU, 2009)

New legislation is proposed by the European Commission, but only the European Parliament and Council can pass the law. There are several ways on how the EU can achieve this object: either by a new treaty, international agreement, or by secondary legislation. The latter one is most important for internal market affairs, like the harmonisation of the European market. It comprises of legal binding instruments, such as regulations, directives, and decisions, and of non-binding instruments, such as recommendations and opinions. (EU law, 2009)

The most powerful instrument is thereby a regulation as it is a general measure that is binding in all its parts. It becomes effective without passing the actual national legislation procedures. That means a regulation creates a law that has an immediate affect in all Member States.

A directive, in contrast, is less powerful as it is aimed to all Member States and has to be incorporated in national law. Unlike a regulation, it however gives the Member State the freedom to decide upon the form and method of its adoption. If the directive is not translated into national law by the end of its deadline, it will be convicted by the respective national court.

A decision, as last binding measure, is an instrument that the EU uses to rule on a certain matter. It is an individual measure directly addressed to a specific Member State or citizen of the EU and only counts for that occasion. It is not legally binding for all Member States. (EU law, 2009)

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Other legal instruments often used in the auditing field are recommendations and opinions. A recommendation reflects a specific line of action and opinion of any European institution but without the legal obligation, whilst an opinion on the other hand is a way to express one's statement without any legal strings attached. (ibid)

Legislative power in regard to the adoption of regulations and directives lies with both the European Parliament and the Council. (EU law, 2009) They are responsible to monitor the correct and timely transposition by all Member States or at the worst to penalise the incorrect or late implementation. Binding legal instruments force thereby Member States to achieve the specified results but are free in choosing the form and means of how to achieve them. If one member infringes this procedure, the Parliament and Council are allowed to take legal actions before the Court of Justice. That means potential sanctioning threats can lead to a relatively fast implementation. Yet, the EU aims to help the correct and timely transposition by providing additional assistance from the Commission to the Member States since 2002. In addition, a transposition scoreboard is frequently published that helps to inform and update all European citizens and businesses about the progress of the national implementations. (EU, 2005)

## **5. Chapter Five: Why has the SAD been developed in the EU?**

This chapter will explore why the Statutory Audit Directive has been developed in the EU by presenting three subchapters that are according to specific timeframes. The first one will describe and analyse the changes of audit regulations in the EU between the 1984 issued EU 8<sup>th</sup> Directive and the 2001/2002 Enron scandal. The second subchapter will look closer at the development of the SAD by starting with the Enron implications and ending with the issuance of the SAD in 2006. The last subchapter will then explore more specifically the actual implementation of the SAD after its issuance.

### **5.1 Audit regulation changes before the Enron scandal**

The EU 8<sup>th</sup> Directive was first adopted in 1984 and was at the same time the first measurement of the European Union attempting to somehow unite the different auditing requirements of all its Member States by issuing common standards on statutory audit. It involved regulations towards the general scope of statutory auditing, the approval of auditors, professional integrity and independence, publicity, and final provisions. (EU, 1984) That means, the 8<sup>th</sup> Directive established common standards for the approval of statutory auditors in the scope of defining minimum conditions for their educational qualification and required experience level. (Dewing, 2004a) The directive did however not contain any precise specifications in regard to auditor's independence, a quality assurance system and the public oversight function which then consequently led to varying national legislation and professional rules throughout the following years. (Inwinkl et al., 2008) So contrary to the initial aim, the 8<sup>th</sup> Directive did not achieve to establish a completely harmonised auditing area in the European Union. (Soltani, 2007)

The following diagram will thus help to see how audit regulation in the EU got changed as consequence of the dissatisfaction with the EU 8<sup>th</sup> Directive.

**Diagram 3: EU audit regulations before Enron**

Date	EU response	Details
1984	EU 8 <sup>th</sup> Directive	common standards for statutory audit
1996	Green Paper	role, position and liability of statutory auditors
1998	Communication	establishment of a committee on auditing; strengthened role of auditor; revised legislation not necessarily envisaged
2000	Recommendation	minimum standards for external quality systems for statutory audits
2001	Study	civil liability of statutory auditors
2002	Recommendation	fundamental principles; specific requirements on the independence of statutory auditors

The first reaction of the European Commission to the dissatisfying EU 8<sup>th</sup> Directive was the publishment of a Green Paper in 1996 which defined the role, position and liability of statutory auditors. It furthermore suggested an approval of statutory auditors in the EU which goes beyond the scope of the EU 8<sup>th</sup> Directive. (EC, 2003a)

These suggestions were then included into the EC Communication from 1998 about the statutory audit in the European Union. It firstly included the establishment of a Committee on Auditing with the purpose to enhance the cooperation between accounting firms and Member States. The Committee comprised of government experts by each Member State and representatives of the European accountancy profession. Its duties were a review of the external national quality assurance systems across the EU, an examination of auditor's independence and a review of the international standards on auditing. A second issue of the Communication was that auditing should be more connected with corporate governance, i.e. the position of an auditor within an organization should be strengthened. (Dewing and Russell, 2004a)

The work of the Committee on Auditing led however to further EU actions: the Recommendation on quality assurance for the statutory auditor in November 2000 and the Recommendation on statutory auditor's independence in May 2002. Both require Member States to make a full implementation into their national auditing systems. The 2000 Recommendation set out minimum standards for external quality assurance systems and had the aim to make every Member State adopt at least the minimum requirements for their quality assurance systems. The reason for that strong focus on quality assurance was that a

good audit quality is essential to satisfy the stakeholders of a company with its conform auditing standard performance. A downside of the recommendation was however that it did not impose common standards, e.g. different mechanisms for the public oversight function were allowed. As a consequence, the European Commission issued an improved version of this recommendation in 2008. (Dewing and Russell, 2001) Details to this recommendation can be found in the in chapter 5.3. The 2002 Recommendation is in contrast concerned with establishing common independence rules for statutory auditors. It defines specific requirements an auditor has to fulfil and therewith, provides guidance on how to apply the general rules in specific situations. (ibid)

This long list of audit regulations before the emergence of the Enron scandal shows the attempt of the EU to improve the quality of auditing practices and to establish a common market. There were however also other events that influenced the work of the European Commission in this field. The most prominent one is the Financial Service Action Plan (FSAP) that has been introduced in 1999 and was scheduled to be implemented by 2005. It recognised "the central importance of financial reporting, statutory audit and corporate governance". (Dewing and Russell, 2004a:289) The overall goal was thus to harmonise the European market by launching several regulations in the earlier mentioned fields. International developments as well as an increasing globalization have moreover made a fast consolidation of EU financial markets more pressing. It was stated in the FSAP that increasing contagion effects will call for more cooperation at the international level between legislators and regulators. (Dewing and Russell, 2004a)

## **5.2 Development of the SAD**

The steady improvement of audit quality and of establishing a harmonised market in Europe was however interrupted by the Enron scandal in 2001/2002.

It revealed deficiencies of the American auditing system and ultimately led to criticism in regard to external quality assurance systems and auditor's independence, as well as to highlighting the ineffectiveness of the present oversight bodies and audit committees inside an organization. As a consequence, stakeholders from all over the world lost their confidence in the capital markets and international legislators and regulators had to find a way to restore their trust. The Americans responded to all this by issuing the SOX in 2002 and therewith introduced extraterritorial requirements for all in the USA listed companies as well as for

auditing firms engaged with the verification of annual statements of American firms. The initial response of the EU was in contrast issued shortly after the business collapses and before the passage of the SOX. It is summarized in a note for the informal Ecofin council meeting in April 2002 and describes three main international policy areas – financial reporting, statutory audit and corporate governance. The area statutory audit comprises thereby of strategies to improve external quality assurance, auditor independence and quality standards. (EC, 2002)

The EU was consequently deeply concerned about the American imperialism for foreign organization and auditors but with the increasing communication between the European Commission and SEC, that concern diminished. Frits Bolkestein<sup>4</sup> put it that way: "we believe the outcome has been quite positive ... we feel many of our comments have been taken into account" (Dewing and Russell, 2004a:307) That does not mean all problems were solved but the extraterritorial requirements of the US triggered a faster response of the EU to deal with the after-effects of Enron and then consequently also with the Parmalat scandal.

Diagram 5 thus presents a timeline of the issued audit regulations that were issued by the European Commission after the Enron scandal and finishes off with the introduction of the Statutory Audit Directive in 2006.

**Diagram 4: EU audit regulations after Enron**

Date	EU response	Details
2002	Note	application of IFRS; implementing of 3 statutory audit strategies; improvement of corporate governance
2003	Communication	reinforcing statutory audit; modernizing company law; enhancing corporate governance; recognition of ISAs; establishment of Audit Regulatory
2006	Statutory Audit Directive	clarifies the role and position of auditors; requirements for the audit infrastructure

The post-Enron EU response was mainly concerned with demonstrating a political determination to the American standard setters in improving the European accounting and auditing market. The result was thus the issuance of two Communications in 2003.

<sup>4</sup> Frits Bolkestein was the EU-Commissioner for the internal market from 1999-2004 and was then replaced by Charlie McCreevy.



The first one identifies the new reinforced area of statutory audit by presenting a 10-point action plan with short-term and mid-term goals. The four short-term goals were on the one hand the modernisation of the EU 8<sup>th</sup> Directive, the improvement of the regulatory infrastructure within the EU, the recognition of the use of ISAs, and the strengthening of the public oversight in all Member States. The mid-term goals on the other hand were an improvement of the sanctioning system, the attempt to make the audit profession more transparent, strengthening of audit committees and internal controls, and enhancing auditor independence and liability. This Communication is furthermore significant as it demands the establishment of an Audit Regulatory Committee to prove that auditing regulators are independent from EU policy-makers. (Dewing and Russell, 2004a) The second one involves amendments to the company law and corporate governance in the EU. It proposes among others the adoption of annual corporate governance statements and more independence of audit committees. (ibid)

Following these two Communications, the European Commission had issued the Statutory Audit Directive in 2006 as a major rewrite of the initial EU 8<sup>th</sup> Directive from 1984. The basic notion was to make legislators and regulators fully aware of what they are supposed to do by providing a proper due process, public oversight and transparency across the EU Member States. (McCreevy, 2006)

Looking back at this timeline, one could think that the Enron scandal was the only trigger for why the SAD has been developed in the EU. That is however only the half-truth. The SAD has been developed due to several reasons that are not all related to the Enron scandal or to a crisis situation. The factor of crisis is certainly important but other events have equally triggered the major change of the audit regulation. The following part will thus describe all crisis-related and other reasons that led to the issuance of the SAD in the EU.

The Enron debacle has given the European Commission an important incentive to work further on a harmonised audit market and on rewriting the EU 8<sup>th</sup> Directive. Reasons were on the one hand the new introduced SOX in the United States and on the other hand also the pressure of the national parliaments to work together in order to improve audit quality and reliability. The American PCAOB introduced a new regulatory framework, called SOX, shortly after the financial scandal of Enron. Sarbanes Oxley included in that scope to conduct extraterritorial oversight of all EU companies and EU auditing firms that were listed in the US. The EU's response was an expression of concern towards these extraterritorial outreach effects. The reason for that was not a disagreement over the measures of the new SOX but the

different cultural and legal audit environments both the USA and EU were situated in. According to the EU, mutual recognition of each other's high quality regulatory systems needed to be achieved. That meant, the US had to accept that the EU is able to find effective solutions to the issues raised by the scandals. (EC, 2003a) The SEC and the PCAOB had however not recognised this concept and as a consequence the EU started to develop an improved regulatory framework that would establish independent public oversight in all Member States. Frits Bolkestein, former member of the European Commission, stated in that context (EC, 2003b): "I do not accept the imposition of US Standards on our firms and that is why the EU strongly opposes registration of EU audit firms with the US' PCAOB. The EU will regulate its own business."

The 2004 Parmalat scandal symbolises another trigger for the development of the SAD. The EU had felt the post-Enron reaction of the American standard-setters via their extraterritorial requirements but were not directly pressured by European stakeholders to improve the audit regulatory system. That changed however when financial scandals also emerged in Europe. Parmalat was the most prominent scandal that involved two firms of auditors as well as fraudulent management behaviour. As a consequence, the EU parliament exerted pressure to develop new, more efficient and stricter audit regulations for all its Member States. (FEE, 2005)

The growing financial globalisation symbolizes the third trigger for the issuance of the SAD. In order to follow the ongoing globalisation of multinational companies, audit regulatory systems also need to be adapted. The EU tried to react to that by expressing their wish to create a common market in audit services. That means the issuance of similar laws and regulations, as well as the principle of mutual recognition for professional qualifications across its Member States. Only a common level of assurance and credibility could thereby provide common auditing practices standards and clarify how an audit should be performed. (Dewing, 2004) Thus, the abrogation of the EU 8<sup>th</sup> Directive and implementation of the SAD would lead to harmonised auditing practices across the EU and that would in turn enhance the status of European auditing practices with third countries. (Inwinkl et al., 2008) In addition, the EU tried to minimize the "audit expectation gap" that arises through corporate business failures and the perception of the public of what managers and auditors should have done. (Dewing, 2004) The public expects managers and their respective auditors to always act ethical. When a business fails whether due to managerial fraudulent behaviour, auditor's mistakes or other economical reasons, the audit expectation gap increases because the public gets more and more dissatisfied with the outcome. In order to minimize that audit expectation

gap, the European Commission has decided to develop a stricter auditing framework in form of the SAD, that will restore the trust of the public in a sound audit work.

The last reason that could be held responsible for the development of the SAD is the Financial Service Action Plan from 1999. It aimed to harmonise the European capital market by issuing several regulations in the fields of financial reporting, statutory audit and corporate governance within specific timeframes set for the next six years. That means, the FSAP had already recognised that legislators and regulators needed to work together on an international level in order to protect the capital markets from coming economical and financial crises and to meet the demands of the increasing globalization. (Dewing and Russell, 2004a)

### **5.3 Implementation of the SAD**

The SAD had been approved in September 2006 and "provides a basis for effective and balanced co-operation between regulators in the EU and with regulators in third countries, such as the US Public Company Accounting Oversight Board (PCAOB). It also includes the creation of an Audit Regulatory Committee to complement the revised legislation and allows the speedy adoption of necessary implementing measures." (Soltani, 2007:162) That means, the SAD has not only been introduced to enhance the audit quality and restore the trust into the audits of companies but also provides specification for what is required of legislators, regulators, and auditors. (Holmquist, 2008)

The general content of this directive describes thereby firstly the required duties, independence and ethics of auditors, secondly the emergence of a public oversight for the accounting and auditing profession, and thirdly the implementation of an external quality assurance system for both auditing and financial reporting processes. In addition, international standards on auditing were introduced as the new common language across the European Union as well as a tool to improve the cooperation between international regulatory oversight bodies. (Braiotta, 2005)

The explicit measurements of the SAD are as following:

- approval, continuing education and mutual recognition;
- registration;
- professional ethics, independence, objectivity, confidentiality and professional secrecy;
- auditing standards and audit reporting;

- quality assurance;
- investigations and penalties;
- public oversight and regulatory arrangements between member states;
- appointment and dismissal;
- special provisions for statutory audits of public-interested entities;
- international aspects;
- transitional and final provisions. (EU, 2006:91-107)

These measurements are described via various articles that specify exactly how Member States are supposed to implement the requirements into their national law and when they need to latest comply with this EU directive. (EU, 2006) The deadline for implementing all SAD requirements had thereby been set for June 2008. Thus, the EU is at the moment engaged in checking the actual state of compliance of all its members. It publishes for that purpose a scoreboard on the transposition of the SAD on a regular basis. The latest one from March 2009 illustrates that more than half of all Member States have accomplished the transposition process. Non-transposed requirements comprise areas like third-country cooperation, audit committee, and some smaller auditor duties. (EC, 2009)

In spite of those small non-transposed areas, the requirement of establishing an independent public oversight board has presented the biggest challenge for the EU Member States. Its introduction is supposed to help restoring the confidence of investors into the capital market again but at the same time calls for changes in all national audit regulatory systems. Most Member States do not have an independent public oversight incorporated into their regulatory system but rather trust the government or appropriate governmental groups to oversee the audit profession. (Holmquist, 2008) Thus, the question arises why an independent public oversight for every Member States is so important. An answer is surely the extraterritorial oversight of the USA and the attempt to establish equal bodies on the EU and Member State level. Another answer could be in regard to the public interest, i.e. independent oversight will provide more credibility and trust into the audit work and thus, reassure the unsatisfied stakeholders. (Manuzi, 2009)

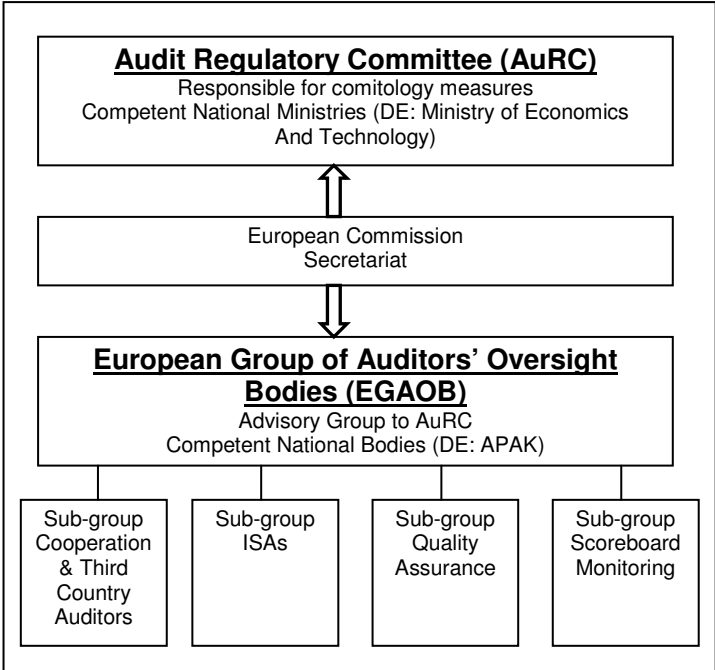
There are though different levels of public oversight that have to be implemented. It does not just work to have an oversight function on the global scale but it has to be persistent on all levels. When looking at the SAD implementation, the IFIAR has been established on the global level, the EGAOB on the European level, and the respective national auditor oversight committees on the Member State level. (ibid)

The articles 32-36 of the SAD describe thereby what is expected of the individual Member States in regard to the public oversight. Article 32 defines the principles of the new to-be-established oversight board in every Member State. Articles 33 and 34 include requirements to cooperate and mutually recognise others' regulatory arrangements. And articles 35 and 36 describe ethical aspects, like the designation of another competent authority to support the work of the oversight board, and professional secrecy. (EU, 2006)

In order to support that transposition process of the Member States, two other international forums were established on the EU-level as a by-product of the SAD: the Audit Regulatory Committee (AuRC) and the European Group of Auditors' Oversight Bodies (EGAOB). The first one cooperates with the Commission by analyzing the existing national public oversight systems and by developing some minimum standards for them. The latter one represents rather the equal counterpart for the other levels of implementation, i.e. at global level with the International Forum of Independent Audit Regulators (IFIAR) as well as with the International Federation of Accountants (IFAC), and at national level with the appropriate oversight boards. (Manuzi<sup>5</sup>, 2009)

There is however also an inter-relationship between the AuRC and the EGAOB which diagram 3 will now illustrate.

**Diagram 5: Audit regulation on the European level**



adopted from ICAEW, 2009

<sup>5</sup> Martin Manuzi is the European director of the Insitute of Chartered Accountants in England and Wales.

The Audit Regulatory Committee (AuRC) on the one hand has been established in 2005 and consists of representatives of the relevant national ministries, i.e. the Ministry of Economics and Technology for Germany. The European Commission acts thereby as the chairman. Its main goal is to delegate authority in respect to implementing measures. In other words, the committee is responsible for the comitology measures<sup>6</sup> in the EU. In the last two-year transposition period, several comitologies were issued by the AuRC. Examples can be found in the Recommendation on quality assurance (2008) and the Decision on a transitional period for third country auditors (2008). (ICAEW, 2009)

The European Group of Auditors' Oversight Bodies on the other hand was established in December 2005 and consists of representatives of the public auditor oversight committees in Member States that are non-practitioners. The representative of Germany will in this case be the APAK. (ICAEW, 2009) The establishment of the EGAOB has thereby resulted from two events: the emergence of various public oversight bodies all over the world and the modernisation of the EU 8<sup>th</sup> Directive. The group has however not been entirely new founded. The in 1998 established Committee on Auditing was replaced by the new body EGAOB but did not exactly adopt the same functions. That means it was only a replacement of bodies than an adoption of same working methods. (EC, 2008a)

Its main goal is to ensure an effective coordination of all the auditor oversight committees from the Member States. Subgroups are thereby supporting the work of the EGAOB by assisting in technical matters about what the SAD requires from Member States for their national implementation. According to McCreevy<sup>7</sup> (2005) the EGAOB is to help "make public supervision systems a reality in all 25 Member States. ... It is a key initiative in our drive to bring EU audit rules into the 21<sup>st</sup> century and restore faith in the profession." (EC, 2005) A second task is to prepare comitology measures that are important for delegating decision-making procedures from the European Commission to the right national committees. (EC, 2005) It is however not able to make any formal decisions or votes. The last task involves the preparation of current discussion matters for the meetings with the national ministries at the AuRC. (EC, 2008a)

Additionally, all EGAOB members are also a member of the new established International Forum of Independent Audit Regulators (IFIAR) which has the purpose to provide a basis for an exchange of information and experiences between the different audit regulators. The forum comprises of independent oversight authorities from all over the world that are responsible for

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<sup>6</sup> The term 'comitology' describes where a directive delegates the implementation of specific measures to a specialised Committee.

<sup>7</sup> Charlie McCreevy is the EU Commissioner for the internal and financial services markets since 2004.

not only sharing knowledge about the audit market and the experiences of its supervisory bodies, but also for promoting international cooperation. (IFIAR, 2009) That means, the APAK is the representative for Germany and participates in the various meeting within a year.

Recapitulating does that mean that these international forums help not only the Member States to exchange information and experiences but also contribute to the ongoing communication between the European Commission and the national oversight boards. The consequences are that additional opinions, recommendations and regulations are issued after the initial issuance of a specific audit regulation from the European Commission.

One of the most important one is thereby the 2008 Recommendation on external quality assurance for statutory auditors and audit firms auditing public interest entities. It has been issued by the European Commission because of the increasing number of external quality assurance systems in audit firms and oversight bodies across Europe and elsewhere. In order to avoid any conflicts, the Commission had decided that inspections should be performed by independent oversight bodies instead of the audit firms themselves. Another reason lies in the requirement of the SAD to establish a quality assurance system in all the EU Member States. The national legislators and regulators need to have a common understanding on how auditor oversight and inspections should work before being able to establish a common basis for cooperation. (EC, 2008c)

#### **5.4 Conclusion**

In summary, it can be stated that there has been a long history of audit regulations in the European Union. Starting off with the EU 8<sup>th</sup> Directive in 1984, the European Commission had set a first sign to achieve a harmonised capital market. The following two decades were however characterized by global financial scandals, economical crises and extraterritorial pressures from the USA which led in turn to more changes in the regulatory system of the EU. Efforts of the European Commission to overcome these obstacles, as well as to minimize the audit expectation gap and create a common audit market were ultimately brought together with the issuance of the SAD. That new directive aims to firstly enhance the audit quality by specifying more requirements for auditors and demanding an independent public oversight board in every Member State, and to secondly restore the trust of investors into the capital markets again. The transposition of the SAD symbolizes thus a major challenge for every single Member State as it requires considerable changes in the national regulatory systems.

## **6. Chapter Six: The SAD and German audit regulations**

Developing audit regulations is a complex task for any regulatory body, whether national or international. It is dependent on cultural, legal-political, and economic factors. That means not one legislation is uniform with another one. Traditionally, most national governments determine which audit requirements and standards will be put into law. Germany in contrast is a different matter. Its auditing profession is already incorporated into German law and that means that the profession itself can make recommendation on which standards should be incorporated. (Radebaugh et al., 2006) That means that whilst legislation is made by lawyers and the Ministry of Justice and Finance, it is at the same time open to consultation by individuals, practitioners and academics. The consequence of this openness is that legislation is quite often politically debated. (Evans, 2007)

The following sections will describe how the SAD has been translated into German legislation, introduce the general audit regulatory system of Germany and explain what the Bilanzrechtsmodernisierungsgesetz (BilMoG) has to do with the implementation of the SAD.

### **6.1 Adoption process in Germany**

The Statutory Audit Directive provoked by financial scandals, the globalised economy and the accelerated internationalisation of the auditing profession has led to an incremental implementation process in Germany.

European legislators started discussing ways on how to improve the audit regulatory system after 2003 which means that people got an idea of what was on the way. The passage of the SAD took however a couple years time before it got accepted on 17 May 2006 and requires all Member States to enforce the requirements until 29 June 2008.

In the case of Germany, a part of this new directive had already been a component of its national law. To mention are thereby especially the two amendments of the 'Bilanzrechtsreformgesetz' (BilReG) and the 'Abschlussprüferaufsichtsgesetz' (APAG) from 2004 that introduced regulations towards the independency of auditors as well as led to the establishment of the Auditor Oversight Commission (APAK). Up-to that moment, the German auditing profession had been self-regulated by a professional body. Investors and the general public had however problems with trusting that self-regulatory system in view of the various emerging financial scandals of that time. Furthermore, an international cooperation is only possible between equal parties, i.e. independent oversight bodies. Yet, German



legislators had to establish the APAK in order to be part of that international cooperation and to pave the way for its international acknowledgment. (Inwinkl et al., 2008)

After the issuance of the SAD in mid 2006, European legislators and regulators discovered that there were still many issues left for further discussion and hence, started a negotiating period in order to decide on what type of implementing measures were applicable.

German legislators decided throughout that period to introduce the 'Berufsaufsichtsreformgesetz' (BARefG) in 2007 in order to meet the European requirements. It symbolizes another amendment of the Public Accountant Act by enhancing the authority of the authority of the regulatory commission. Special focus was set on the new inspection system, foreign auditor requirements, and on the cooperation with equivalent regulators outside the EU. (Marten, 2008)

There are however still parts of the SAD that have not been transposed in Germany. The goal of German legislators is thus to complete the requirements of the EU directive by issuing or revising further regulations. They also hope to gain more credibility within the public auditor oversight on a national and international scale as well as to guarantee a permanent trust into the auditing methods and system by implementing all the requirements of the SAD. (APAK, 2009d)

The published draft bill of the BilMoG from May 2008 is thereby the attempt of the German government to transpose the remaining requirements into national regulation. It has just been passed by the German Parliament on 27 March 2009 as well as later on by the Federal Council of Germany on 3 April 2009. The whole process has taken longer than expected due to more pressing issues like the financial crisis and its impacts on the German capital market. (WPK, 2009b)

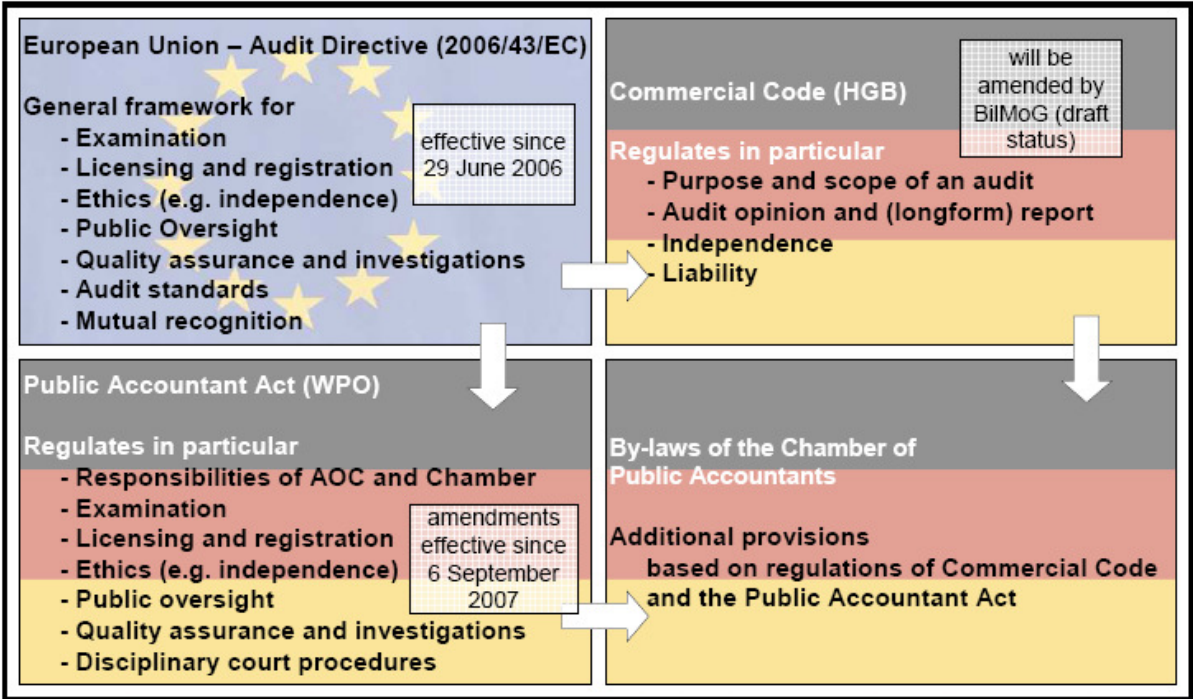
Altogether, there had been lots of discussion among German politicians about the way the SAD should be implemented into German legislation. The requirements of the SAD are a task the German government has to deal with and to integrate in the best possible way into their national legislation. Prof. Dr. Marten also stated throughout the telephone interview that "the implementation of the SAD is not a challenge but a task the German legislator has to cope with. It is a task, a task for cooperation that will take some time but will be manageable".

And that is true when looking at the implementation process in Germany. Legislators and regulators have continuously worked on incorporating the EU requirements by starting with the establishment of the auditor oversight commission in 2005, amending the German Public Accountant Act several times in the period of 2004 to 2007 and by finishing with the new

BilMoG which will furthermore have considerable implications towards the German Commercial Code as well as the Public Accountant Act. (Marten, interview)

Diagram 6 does not only illustrate exactly these impacts of the SAD on the German legislation but also emphasizes on the additional provisions Germany has to deal with while transposing the EU requirements into its regulatory system.

**Diagram 6: Impact of the SAD on German legislation**



adapted from Marten (2008:3)

The SAD has become effect on 29 June 2006 and demands from the EU Member States to transpose its details within a two-year transposition period. The left upper box of diagram 6 illustrates some details of the general framework of the SAD. Public oversight, quality assurance and investigations as well as mutual recognition are thereby of special interest for the implementation into national legislation. As described in the beginning of this chapter, Germany had the luxury of already having some of these requirements incorporated into their legal framework. The remaining parts were dealt with in 2007 by the BAREfG and in 2009 by the BilMoG. The 2007 amendments are here illustrated in the left lower box of diagram 6 and refer to the Public Accountant Act. The 2009 amendments are in contrast illustrated in the right upper box and symbolize changes in the German Commercial Code.

Both amendments have however led to by-laws that are issued from the Chamber of Public Accountants and are not specifically asked for by the SAD but are necessary for the German legal framework to implement the European requirements.

The following subchapters will thus focus on these two amendments by introducing the German audit regulatory system before and after the issuance of the SAD and by describing more specifically the contents of the BilMoG.

## **6.2 Structure of the German audit regulatory system**

The German audit profession emerged from two historical roots: the foundation of the first association of auditors in 1896 and the setting-up of trust companies by larger audit firms.

It has however first been formally organised in 1931, together with a revision of the company law. The first big systematic change happened with the establishment of the WPK in 1961. Auditors were then forced to be members of the WPK and the chamber was given certain legal rights by the German government, like to carry out the professional examinations, supervision of the profession and disciplinary actions. That means in other words that the WPK with its employed auditors, self-regulates its own profession. In addition to that, the Public Accountant Act (WPO) had been established as the basis for all audit and accounting regulation in Germany. (Evans, 2007)

The new guidelines of the Statutory Audit Directive have however lead to a change in the existing auditing regulatory system in Germany by demanding the establishment of an independent oversight. The basic notion of the SAD is that a high auditing quality across all member states can only be achieved via continuous monitoring. (Heininger<sup>8</sup>, 2008) Thus, all auditors and auditing firms have to be under supervision of a public independent body that is responsible for the following sectors:

- approval and registration;
- acceptance of auditing principles and standards, as well as of standards for internal quality assurance;
- further training as well as quality assurance, investigation and disciplinary control systems.

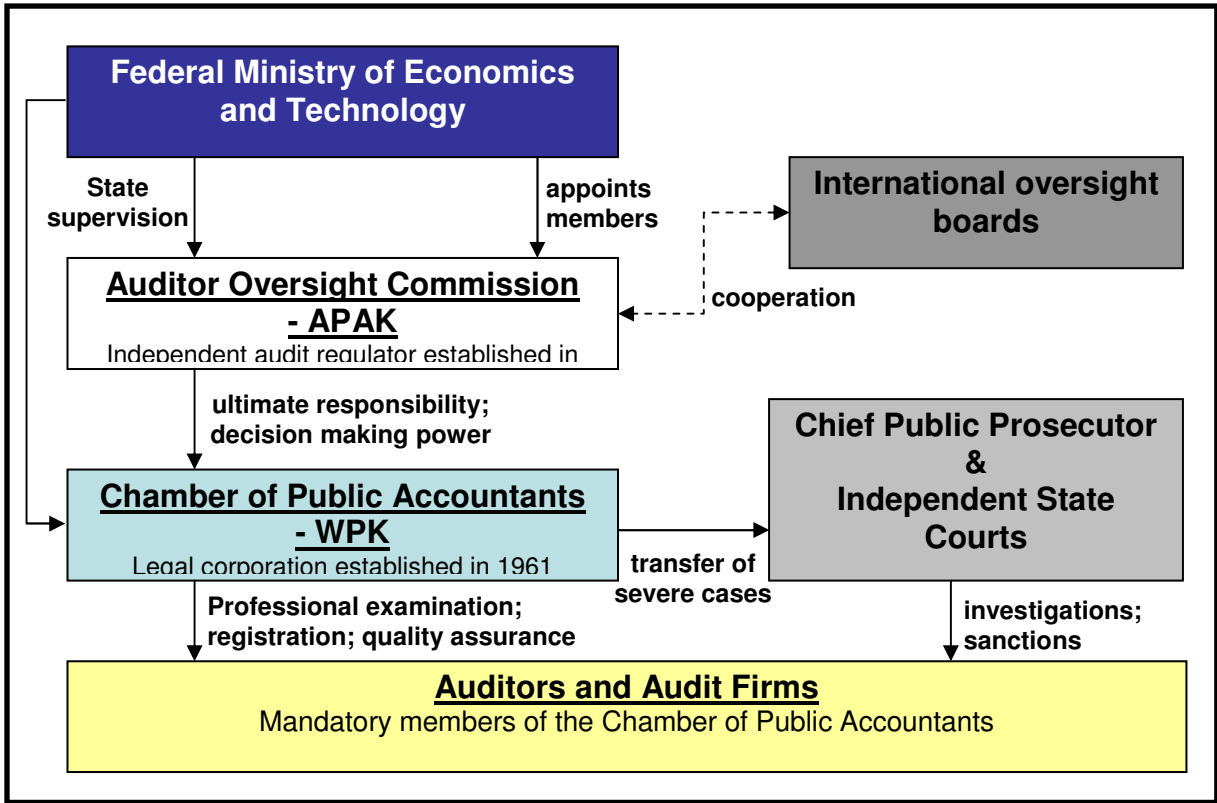
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<sup>8</sup> Heininger is a German auditor and member of the board of the Institute of German Auditors.

In order to fulfil these tasks, the public oversight body has to have certain legal rights that enables it to investigate auditors and to initiate appropriate measures. (Heininger, 2008) Its high ethical standards are thereby necessary to avoid any conflicts of interest. Only non-practitioners are allowed to be nominated. Otherwise the prospective employee has to follow a three-year cooling off-period by not being employed or in other ways involved with an auditing firm. Also, oversight board members shall be nominated by a proper, transparent and independent process and that means not to be employed by the government either. (EC, 2008b)

Diagram 7 will thus show how this basic notion has been incorporated into the German regulatory system and in what way it differs from the self-regulation by professionals that existed beforehand.

**Diagram 7: German audit regulatory system**



Adapted from Marten (2008:6)

The legal corporation of the **WPK** was the responsible regulator of the audit profession since its establishment in 1961 and consists by now of more than 20.000 members. The overall aim is thereby to guarantee that the demands and expectations of the public and the State towards the auditing profession will be fulfilled. It is however not an independent oversight body as it

employs auditors and chartered accountants. Before the SAD had been issued in 2006, the WPK was supervised by the Federal Ministry of Economics and Technology in regard to the compliance with laws and regulations. In order to deal with all the different issues arising throughout the years, the WPK cooperates closely with other professional bodies, like the Institute of Public Auditors in Germany (IDW<sup>9</sup>). Together, they discuss urgent matters and then publish a common statement. The issuance of the SAD in 2006 however changed that legal framework a bit. The WPK is now also supervised by the APAK in regard to specialised professional auditing subjects and all matters regarding the cooperation with foreign oversight bodies got reassigned to the APAK. (WPK, 2009a) That means that the WPK and the IDW deal with issues inside Germany and the APAK with issues that affect also other countries.

The main statutorily regulated tasks of the WPK are though the supervision of the profession with the conduct of quality assurance inspections, the appointment of auditors and chartered accountants, and the representation of the concerns and opinions of the profession towards the public and the politics. (ibid) Furthermore, the WPK has the right to take actions against legal violations, i.e. to impose sanctions. Its conduct is thereby supervised by the APAK, as the latter one has the right to scrutinize the decision of the WPK. The potential sanctions are divided into three ranges: a 50.000 EUR sentence followed by a Court decision; a 500.000 EUR sentence followed by a temporary suspension from active audit work; and an exclusion from the audit profession altogether. (EC, 2008b)

With the establishment of the Auditor Oversight Commission (**APAK**) in 2005, Germany set not only an important sign for the independent self-regulation of its auditors and auditing firms but was also one of the first Member States to incorporate a public oversight into their national regulatory auditing system. Before the SAD got developed, the Chamber of Public Accountants (WPK) had played the most important role in the German auditor oversight regime. That changed however with the establishment of the APAK. (APAK, 2009a)

The six to ten members of the APAK are required by article 32 of the SAD to be non-auditors as this should ensure the independency of the public oversight. (EU, 2006) They are furthermore nominated by the Ministry of Economics and have a cooling off-period of five years, which in turn symbolizes a stricter rule than the three years required by the SAD. (EC, 2008b) This structure is unique in the history of audit regulation in Germany as it shows that

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<sup>9</sup> The IDW consists of German public auditors and public audit firms and has the aim to represent the interests of its members at national and international level. For that purpose, it does not only cooperate closely with the WPK but is also a member of the IFAC. (IDW, 2009)

the APAK is not governed by public law but symbolizes an independent regulation of the audit profession. (APAK, 2009a)

The overall goal of the APAK is thus to enhance the compliance with rights and duties of statutory auditors. More explicit tasks are the professional oversight, quality control, the establishment of professional ethics as well as national and international cooperation with equal partner organizations. In order to carry out these tasks, the APAK has been given the ultimate decision-making power, i.e. it is free and independent of instructions, as well as the ultimate competency in all of its supervised areas, i.e. its competency is beyond the typical state supervision. (APAK, 2009b) Furthermore, it supervises the fulfilment of all the legal obligations of the WPK by having been provided with certain comprehensive rights:

- participation in meetings and information update;
- right to perform inspections in proceedings that are related to public oversight;
- right to ask for a re-examination of a WPK decision;
- right to give instructions to the WPK under the abrogation of its decision;
- right to arrange a consultation meeting with all experts. (APAK, 2009c)

The APAK is thereby divided into two panels that are responsible for the main fields of public oversight and quality assurance. (APAK, 2009d) In order to provide a high degree of expertise, the APAK is also a member of several European and international forums as well as cooperates with other public oversight bodies. The participation in the IFIAR and EGAOB are important to exchange experiences and information regarding the changing auditing environment and practices used all over the world. The cooperation function of the APAK furthermore enables Germany to represent its interests with one independent body and at the same time obtains acknowledgement on a global scale.

Looking back at the overall new structure of the German audit regulatory system and the requirements of the SAD, it becomes obvious that Germany has complied. It has not only established an effective system for auditor oversight, equipped the APAK with ultimate responsibility and filled with non-practitioners, but also kept the initial regulating bodies before the issuance of the SAD in place. The WPK is still an important regulator for the oversight of auditors and auditing firms in Germany but it is now subject to the APAK. In order to make that transitional period smoothly, certain by-laws are necessary. This topic will however be thoroughly covered by chapter 7.

### **6.3 Bilanzrechtsmodernisierungsgesetz**

In order to implement the remaining requirements of the SAD, Germany's legislators and regulators have decided to do that in form of the Bilanzrechtsmodernisierungsgesetz (BilMoG). It provides in general comprehensive alterations of the German accounting and auditing rules, as well as reforms to the annual report verification and corporate governance.

The introduction of the BilMoG has however taken a longer time than expected by any legislators or regulators. After year-long delays, the draft bill had finally been published in November 2007. However, according to the nature of the legislation process in Germany, politicians and academics are allowed to give their inputs to the new proposed law. That means that over the course of these discussions, the BilMoG had been modified several times. A reason for this lies in the necessity to account for all possible occurring financial problems and to incorporate solutions into the new to-be-established law. In regard to the latest events, the German parliament and Federal Council needed to deal with questions that emerged due to the contemporary global financial and economic crisis. Sensitive subjects, like the 'fair-value-accounting' for financial instruments in trade, had to be considered before passing the new law. (Marten, interview) As a consequence, the BilMoG has been passed by the German parliament on 26 March 2009 and by the Federal Council on 3 April 2009. That means German auditing firms will have to comply with the new requirements for all the financial years after 31 December 2009. Though, organizations can already voluntarily follow the BilMoG for the coming financial year.

The BilMoG is with regard to the interview with Prof. Dr. Marten thereby "nothing else than a re-modelling of the German Commercial Code (HGB)". Germany has regulated all its accounting and auditing rules by law in the HGB. In comparison, the SAD requires among others changes in the auditing process as well as the implementation of ISAs, and that means the German legislator can only obey these requirements by changing its Commercial Code. There is no alternative law in Germany that allows changes in this dimension. Prof. Dr. Marten furthermore stated that the BilMoG did not symbolize a "surprise for the German audit profession. Yet, it remains to be seen if the extent of changes and amendments will be accepted and can fulfil the wish of the German legislator to not only comply with the requirements of the SAD but also to make the Commercial Code more modern and competitively viable. "

Another aspect is that the significant amendments of the BilMoG are not only limited to commercial laws but also include the German tax law and corporate governance codex. One

explicit measure in regard to the public oversight is the establishment of an audit committee within an organization (No.59 BilMoG). The tasks of this committee are to monitor the accounting process, the effectiveness of the internal control system, and the audit of all statements within a financial year especially in regard to the independence of auditors. (Deloitte, 2008)

Another measurement is the international required networking rule. A network is thereby considered as the collaboration of people to pursue common interests for a certain period of time. If a person of this network audits an organization's financial reports, then other members of the same network are not allowed to offer any consulting services to the same organization. This new rule has been introduced to fulfil the requirement for auditor independency by the SAD. As a consequence, the German legislator has decided to enhance the networking rule even further and not allow any person who is considered to be part of a network (i.e. having auditing and consulting firms in the same network), to conduct an audit of annual accounts. In addition, a five-points catalogue has been issued that distinguishes exactly who is considered to be in a network and who is not. (Inwinkl et al., 2008)

The BilMoG also contains the obligation to use ISAs for the conduct of an audit for any size of company that is situated in Germany as well as the requirement to link the audit of annual accounts from public interest entities with the cooling off-period. The latter one is an important instrument to guarantee the independence of auditors. The responsible audit partner of a company is thereby not allowed to take up a manager position within two years after the completion of the audit work in exactly this business. (Inwinkl et al., 2008)

These three new rules of the BilMoG represent the biggest changes for the audit profession in Germany as they have far-reaching impacts on both, the audit firms and their clients. In the past, the HGB has been changed in a two-year rhythm but has never reached the extent of the BilMoG. And that shows that the BilMoG will in fact be the biggest change of the HGB since 1985. (Marten, interview)

#### **6.4 Conclusion**

The Statutory Audit Directive was required to be translated into national law by June 2008. The German regulatory system has shown that some parts of the directive have however already been incorporated by former amendments of the WPO and the establishment of an independent public oversight board, called APAK. The latter one was a unique step for the German legislators, as the APAK is not governed by public law. It has furthermore led to a



restructuring of the audit regulatory system by putting the APAK in charge of the WPK and therewith modifying the decision-making power.

The remaining parts of the SAD are expected to be implemented with the help of the new BilMoG. It was a tedious process to get that new law passed by the Federal Council and Parliament, as the German legislation is open to consultations from practitioners and academics. Accordingly, the BilMoG got postponed several times but got finally adopted in April 2009. It provides significant amendments to the HGB by for example demanding the establishment of an audit committee in every organization and by introducing a network-related independence rule for auditing firms.

The following chapter will thus focus on special issues that affect the German auditor oversight.

## **7. Chapter Seven: Effects on the German auditor oversight**

The Statutory Audit Directive had to be translated into each EU Member State law by summer 2008. According to Prof. Dr. Marten (2009), the implementation of the SAD is thereby an obligation of each Member State and not a task of the European Union itself. The Commission is only responsible to monitor the transposition and if necessary to impose sanctions for non-compliance.

German legislators and regulators are thus responsible for finding the appropriate legal ways of how to best integrate these European requirements. The independent auditor oversight is thereby probably one of the most important measures to regain the trust of stakeholders into the capital market. Germany has for that reason incorporated the APAK. It has however already been established in 2005 before the SAD was published, i.e. the German government had anticipated the coming European audit developments. (Heininger, 2008) As a result, the APAK had a longer time than most other Member States to deal with its new role and implement the requirements of the SAD. In this context, Prof. Dr. Marten stated that on the one hand the establishment of a public oversight in Germany has been fulfilled but on the other hand, there are still little areas remaining that are in need of amendments. These areas mainly comprise of ambiguities in regard to the EU requirements of inspecting the quality assurance systems of audit firms and cooperation with other oversight bodies.

Thus, this chapter will describe more explicitly how these two areas are being dealt with in Germany and what issues are in need for more clarification.

### **7.1 Inspections**

The main task of German regulators is to comply with audit duties, i.e. to implement a quality assurance system that ensures a high audit quality and enhances the trust in the effectiveness of the German oversight system.

The initial idea of inspecting the different quality assurance systems of auditing firms has thereby arisen from mainly two sources. The first one derived from the European aim to obtain international acknowledgement, especially in regard to the PCAOB. (Heininger, 2008) And second from the Recommendation on external quality assurance that was issued by the European Commission in May 2008. It concretizes the requirements of the SAD in regard to methods, organizational structures and independent inspections. As a consequence to this Recommendation, Germany restructured its process of the auditor oversight and quality assurance system. The reasons for that were the attempts of the German legislators to not only

obtain the European Commission's and international acknowledgement by making the oversight body APAK more independent from auditing firms, but to also enhance the importance of the German capital market and business location. The APAK itself stated in this context that it is necessary to translate the Recommendation of the European Commission in order to show that Germany is compliant with the SAD and to get the necessary international acknowledgement. (APAK, 2009d)

There are however some obstacles that arise when looking at the current practices of the APAK. They are mainly to be seen in regard to the ways inspections are integrated into the German legislation.

Quality assurance procedures for German audit firms have already existed prior the EU required inspections. German legislators had implemented a system which evaluates the various quality assurance systems of small- and medium sized German auditing firms by so-called monitored peer-reviews issued by a government agency. Nonetheless, Germany introduced the active oversight measure of inspecting the quality assurance systems of auditing firms in 2007 but had the difficulty that it was not immediately linked to the operational decision-making power of the APAK. The WPK established a division called unprovoked inspections that consists of only professionals. Its operational responsibility as well as the execution of its inspections lies thereby with the WPK. The first problem is however that the WPK is an entity of public interest that oversees auditors but at the same time employs professionals and that is contrary to the requirement of the SAD to be an independent public oversight body. The APAK is the only auditor oversight in Germany that complies with the independent oversight requirement but it can only influence decisions of the WPK with external legal effects. That means operational decisions, like the design of the inspection process, are not part of the ultimate decision-making power of the APAK. This second problem has to be dealt with as the European Commission requires all Member States to inform them to what extent the inspection process has been implemented until May 2009. (APAK, 2009d)

The German legislators have thus started to work on solving these obstacles. In summer 2008, the WPK introduced a project panel on inspections with the aim of developing recommendations for the reform of organizations and the execution of inspections which then shall be incorporated in the WPO. In order to support the work of this panel, the APAK has participated in all its meetings. The result was the issuance of several recommendations for the reform of organizations and the conduct of inspections (2008) which did not only assign

the decision-making power for the execution of unprovoked inspections and the public auditor oversight to the APAK, but also enabled the APAK to ask for help from an appropriate body, like the WPK. The difference to the present system is that the APAK will get the unlimited decision-making authority on the operational level. (APAK, 2009d) A future task is thus to enshrine these recommendations in German law and show the European Commission that it symbolizes the appropriate translation of the European requirements on quality assurance systems within audit firms.

Up-to-now, the APAK and WPK, have as a result of this cooperation, revealed several shortages of quality assurance throughout the 34 inspections they have conducted in 2008. (APAK, 2009d) However the question is, how will the German regulators will deal with these shortages. Will they impose tough sanctions even though Germany is still in the early stages of translating the requirements of the 2008 EU Recommendation into national legislation?

In order to find the appropriate measures for dealing with this, a cooperation with the EGAOB and IFIAR is essential to exchange experiences as well as to ultimately find a German solution that complies with European and international practices for independent inspections. (APAK, 2009d)

Nonetheless, it is important to clarify who is chosen to be inspected before looking at the outcomes. There are three approaches the WPK as the responsible inspector can follow.

The first one is a combination of a conscious selection of WPK employees that is based on risk factors, and statistical randomness. The risk factors are thereby based upon profession characteristics, affiliation to certain stock markets or professional key issues. The second approach is linked to the APAK because it has the right to assign the WPK to conduct an inspection. That means, if the APAK suspects a specific audit firm of malpractice or simply wants to investigate a certain auditor, it has the power to order the WPK to do that job. (Heininger, 2008) The third approach is related to a certain number of engagements. The German legislators have determined that audit firms with more than 25 audit engagements will have to be inspected annually, whereas audit firms with less than 25 engagements only have to be inspected once every three years. (EC, 2008b)

The representatives of the WPK have thereby the right of access and inspection, i.e. they are allowed to visit the offices of auditors and auditing firms during the official business hours to search documents as well as to make copies. When looking at Germany, that means there are about 180 auditing firms and approximately 4.500 auditors that could be inspected. (Heininger, 2008) These high numbers represent in turn a lot of work for the WPK as it is also

obliged to take legal actions against those audit firms that are not complying as well as to convey the collected information to the European Commission. (ibid)

Thus, the process of an inspection is important. First, the to-be inspected firms will be informed at short notice of the inspection in order to guarantee the effectiveness of the procedure. Auditors and firms are obliged to completely cooperate with the respective inspectors, i.e. the rule of confidentiality is lifted by law and employees of firms only have the 'right to silence' in regard to orally given information. Second, the inspectors examine two main areas: the internal quality control system (e.g. partner remuneration, policies) and selected audit engagements (e.g. compliance with professional rules). At the end of the inspection process, the APAK receives a draft report from the WPK employed inspectors that will then be publicly but anonymously published. If the inspectors find any non-compliance with professional rules, the respective firm will be charged with disciplinary sanctions. If the inspectors however find any deficiencies in the internal control system, then the findings will be presented to the quality assurance department and might lead to a withdrawal of the certificate to perform statutory audit in the EU. (Marten, 2008)

Of special interest is moreover the spill-over effects of the EU required inspection measure on the established monitored peer-review in Germany. It remains to be seen if that will rather lead to a disqualification of the existing German measurement, a double burden or to an improvement. (Heininger, 2008) Generally speaking, German legislators want to keep the monitored peer-review tool as that has proven to be efficient. In order to combine both methods, they will however have to find a way to define each other's boundaries and make them supplement each other.

For example, the monitored peer-reviews are specified in accordance with §319a HGB, i.e. the scope of who is to be monitored. The paragraph demands of all German companies to hire an audit firm to check the financial statements. If the European Commission required inspections that relied on the same paragraph, medium-sized auditing firms would feel a significant extra burden as they would have to follow the European requirements as well. The American PCAOB has in contrast dealt with that problem by restricting its inspections to the audit of capital market oriented companies. That means medium-sized audit firms are not part of any inspections. (Heininger, 2008)

These listed challenges of integrating the EU requested inspection process into the existing German legislation show that there are still issues that need to be further resolved. The

European Commission together with the APAK will work on improving that by continuous updates and an exchange of experiences with the other Member States' regulators.

## 7.2 Cooperation

Cooperation is one of the most important words in today's globalised economy and hence plays an essential role in the Statutory Audit Directive. The national public oversight bodies of all Member States are required to work together, exchange experiences and other information as well as to cooperate with supervisory committees from third countries.

Germany as the prime example has legally established the APAK as the counterpart for national and international oversight bodies as well as for other international organisations. The APAK has thereby the agenda to convey the German oversight status to other countries, establish new relations as basis for a successful cooperation and to achieve full reliance with third country standard setters. Yet, there are some challenges that arise with this agenda, like mutual recognition, homeland principle or full reliance of the PCAOB. (APAK, 2008)

In order to describe these challenges of cooperating in a more structured way, I will divide them into three parts: challenges within the EU, with third countries, and with international bodies.

The EU regulatory system shows that the European Commission has no influence whatsoever on the national oversight boards of its members. The German APAK is only bound to the German legislator. The European Commission and Parliament can however provide consulting services that will allow a certain information flow between them and the various national auditor oversight boards. An important requirement of the SAD is furthermore the cooperation between these boards about transnational matters. For example, if a French organization is listed on the Frankfurt stock exchange, the APAK will not enforce an inspection of the respective French auditor. Instead it will trust the inspection results of the French auditor oversight committee. The principle of homeland regulation is thereby the basis for all cooperation. (Marten, interview) More precisely, the homeland principle says that foreign auditors and auditing firms do not have to register when the foreign country's oversight board is equivalent. (APAK, 2008) That shows the effort of the EU to avoid a double oversight. Transnational cooperation of inspections has in fact been accomplished several times in 2008. Yet, mutual recognition is not a given. Legislators and regulators tend to rather trust their own oversight boards than foreign ones. The SAD requires nonetheless

that Member States have to acknowledge the sound work of each other's oversight boards. That means that only mutual trust can lead to successful cooperation among the national oversight boards.

There are further challenges that arise while European oversight boards cooperate with countries outside the EU. The most important country is thereby the USA as its standard setters have established a very strict regulatory system that also has extraterritorial impacts on the EU. Issues are thereby in regard to joint inspections and full reliance. The SAD requires that inspections of auditing firms outside the EU are done cooperatively. However, up-to-now there has not been any intention from neither the European side nor the American side to fulfil this requirement. Prof. Dr. Marten stated in the interview that "this might be a future challenge but it will all depend on the political and economical situation of both parties involved". There have been several meetings between the PCAOB and the APAK in order to solve this ongoing issue. The APAK together with the other members of the EU strive to get the full reliance of the PCAOB in regard to their audit regulatory systems. And that means no joint-inspections but mutual recognition of each other's sound work. For that purpose, all national oversight boards tend to issue a so-called 'adequacy decision' that would clarify the issue of confidentiality. It should determine that the foreign audit oversight boards follow confidentiality rules and thereby allow the transfer of working papers. Hence, a new basis for the cooperation with third countries would be established. The PCAOB in contrast does not want to abolish the instrument of joint inspections as it firstly likes to keep its extraterritorial influence on the EU and secondly does not entirely trust the new regulatory system whose transposition deadline has just passed in mid 2008. (APAK, 2009d, p.17)

Other challenges for the public oversight boards in the EU can be seen in regard to their cooperation with international bodies. The EGAOB was foremost established to provide an exchange of experiences within the EU. It is however also an advisor to the European Commission and is responsible to develop cooperation plans. The SAD awaits from the establishment of the EGAOB that national oversight boards, like the APAK, provide their own experience in order to refine the requirements set by the Commission and improve the regulatory system in Europe even further. (APAK, 2008) The new established IFIAR in contrast consists of independent oversight authorities from all over the world. It is a platform for an exchange of information and experiences. According to Prof. Dr. Marten, an exchange of information however has though no implication on the auditing market in any Member

State. Moreover, most German auditors and auditing firms do not know of the existence of the IFIAR. And that shows that the IFIAR as platform of information exchange has not yet accomplished to reach the lowest level, the audit profession itself. The German APAK tried to deal with that obstacle by being elected for the Advisory Council of the IFIAR in September 2008. That new Council consists of representatives of different public oversight boards and is responsible to support the work of the chairman of the IFIAR. With the election into that Council, Germany was able to host one of the several workshops about inspection that are organised throughout the year. The purpose of them is to enhance cooperation between the EU members and to also make the IFIAR as international platform more known to the national auditing firms of the respective host-country. (APAK, 2009d) As if these were not enough challenges for the national oversight bodies to cooperate with the EGAOB and IFIAR, the SAD also requires them to cooperate with other international groups, like the World Bank or the International Organisation of Securities Commissions. (APAK, 2008) And that means additional work for exchanging information with those groups or even to cooperate on establishing additional agreements or rules.

### **7.3 Conclusion**

The public auditor oversight in Germany has been established partially due to the crisis-related situation in Europe, and partially due to the requirements of the SAD. New tasks and assignments were therewith introduced but at the same time led to challenges for the German legislators and regulators. Inspection processes and required cooperation efforts with other European oversight boards or international bodies play thereby a central role.

The SAD requirement of inspection intervenes into the existing quality assurance system of the German auditor oversight, i.e. German legislators have to find a solution to either combine the old system with the new inspection process or to develop an alternative. Regardless of what solution is found, the APAK is exposed to an extra load of work to ensure a sound quality in all German auditing firms. The required cooperation of the national oversight boards with other parties symbolizes additionally a challenge of coordinating this task. Mutual recognition is thereby the key for success but it remains to be seen how well national oversight boards in the EU will in fact deal with that. It is not only the acknowledgement of each other's regulatory systems but also the successful cooperation with the PCAOB and international bodies that will lead to a complete implementation of this SAD requirement.



**8. Chapter Eight: Analysis**

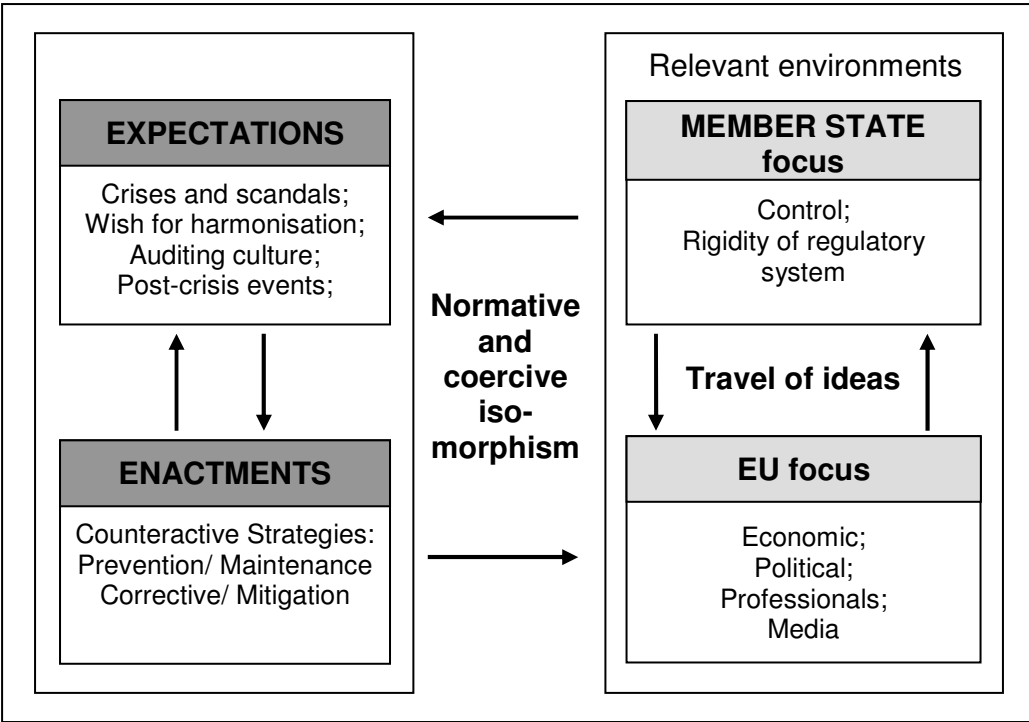
The aim of this chapter is to analyse the empirical data presented in the previous chapters, in regard to my problem statement and research questions and to link that to the theories of chapter two.

I will start off by looking back at the anticipatory model from chapter 2.1 and analysis that in regard to the audit regulatory system in the EU. 'Travel of ideas', institutional theory and the audit culture will additionally help to explain why audit regulations change. The second part of this chapter will then look closer at the initial problem statement and analyse that in regard to the SAD implementation and more specifically to the auditor oversight in Germany.

**8.1 The anticipatory model in the context of the changing audit regulations**

As explained in the theoretical chapter 2.1, the anticipatory model was initially developed by Olaniran and Williams (2001) for any kind of businesses. I will however use this model to show how audit regulations change in the EU and will thereby emphasis on Germany as my prime example. Diagram 8 thus illustrates an adapted anticipatory model that links all the theories from chapter two to the main research topic of audit regulation within the EU.

**Diagram 8: Adapted anticipatory model**



According to Seeger et al. (2001), the emergence of a crisis symbolizes a common part of an economic cycle. Both, crisis and economic recovery help to exploit the full potential of an economic sector. The auditing profession is thereby no exception. Looking back at the last decade's history of crises (as described in chapter 4.1), it becomes obvious that crises triggered changes in the audit regulation. It is not the only trigger that leads to audit changes but it is most certainly an important one. A crisis either in form of an economic downturn or a financial scandal leads in most cases to a reconsideration of the existing audit regulatory system. Investors lose their trusts into the capital markets and ask the responsible governments for solutions. In the past, the EU has dealt with this by making amendments to its audit regulations, i.e. issuing directives, recommendations, and communications, in order to force its Member States to change their national regulatory system as well. And that shows that a crisis is not only a threat but also an opportunity for future development. The EU had always had the aim to harmonise its capital market. The different emergences of crises might have interrupted that development at first but ultimately triggered a faster response of the respective EU legislators and regulators to make the situation better and therewith accelerated the process to achieve a harmonised capital market.

For this reason, I have chosen to use the anticipatory model to explain in more detail how audit regulation changes in the EU. I will furthermore focus on my case study Germany in order to analyse how a new idea, i.e. an amendment, travels onto the national Member State level.

Having an anticipatory model in the auditing field in place helps to deal with a crisis because pro-active measures allow for a much faster and more efficient response of the respective legislators and regulators. Understanding the circumstances of a specific crisis is thereby inevitable for the decision-makers in order to develop a post-crisis action plan. The anticipatory model as presented above in diagram 8 consists thereby of three components: expectations, enactments, and the relevant environments.

**Expectations** are assumptions of people that have an interest in a certain topic. In the case of the European auditing profession, stakeholders, auditing firms and international standard setters, like the SEC, have expectations of how auditing should be. That means, they expect the regulatory system to be stable and to ensure the credibility of the capital market. The EU strives to obtain a harmonised audit market which leads in turn to even higher expectations of all parties involved. Thus, the decision-makers need to take the potential crisis environment

into consideration and implement measures that assure the overall aim for a harmonised market.

Events that trigger audit changes might be on the one hand economic crises or financial scandals, and on the other hand the objective of having a common audit market within the EU. Those events are however all dependent on a place, time and agent. When looking for example on the Enron scandal: it took place in the United States in 2001/2002 and its agents were the company itself as well as its responsible auditing firm Arthur Andersen. Thus, it represented the signal for the starting point of the global financial crisis that ultimately led to the issuance of the SOX in the USA and amendments of the European audit regulatory system.

Pre-conditions as another aspect for varying expectations could be interpreted in regard to the different auditing cultures in every Member State. There are different traditions for issuing regulations. Some countries have oppressive regulators that make it more difficult to adopt new laws and others have softer regulators that are more open to changes. Thus, pre-conditions are an important factor to be considered when trying to understand the different expectations of stakeholders, auditing firms and international standard setters. Depending on what the expectation is based upon, one might expect much more from the audit regulatory system in the EU than others. For instance, Germany's regulatory system is based upon a more democratic arrangement. Legislators make a recommendation for a new law which is then open to political and academic input. The Federal Council and Parliament discuss this input in many sessions before issuing the actual law. That shows that expectations from German stakeholders and auditing firms will be influenced by the auditing culture that is existent in their country. They expect that the regulators deal with a specific issue when occurring but do not expect an immediate action. The BilMoG is a prime example for that. The German government had proposed this law in the end of 2007 but it had taken one-and-a-half years to be legally accepted. Yet, the German public has not protested or demanded a faster procedure.

Post-crisis events can be considered as another factor for expectations. Most crises bring consequences to the economic sectors they are emerging in. And that in turn affects the expectations of the parties involved. When looking at the Enron scandal for instance, post-crisis events like the SOX with its extraterritorial requirements as well as encompassing effects on the international financial sector have led to changing expectations in the EU. Stakeholders from all around the world demanded stricter auditing regulations, and

international standard setters expected the regulatory system of the EU to adapt to the standards set by the SOX.

The analysis of these factors showed that expectations of stakeholders, auditing firms and international standards setters are dependent on the context of an emerging crisis. Expectations are however also influenced by the relevant environments, i.e. in the case of the European audit profession by the EU and national level. Before going into more detail of how much the respective environments promote changes in expectations, I will however analyse the interrelationship between expectations and actual enactments for the European audit regulatory system.

**Enactments** are actions that are undertaken to deal with a critical situation and are dependent on how well information is available. That means decision-makers have to develop some kind of post-crisis action plan to satisfy the expectations of other interest groups and to find the measures that are appropriate to preserve their own interests. When looking at crises in the auditing field, European legislators on the highest level develop an action plan which is then sent to the lower level, i.e. to each Member State. For instance with the emergences of the Enron scandal in the US and the Parmalat scandal in the EU, the European Commission and Parliament had collected the needed information, took expectations of different interest groups into consideration and then developed a post-crisis action plan by issuing the Statutory Audit Directive. The latter one is a specific action that was needed to deal with the critical situation in the financial markets at that time. The SAD gave the Member States however a certain degree of freedom for how to implement its requirements into national legislation. That means Germany, as my case study, chose certain actions which were again dependent on information derived from the German audit market. German legislators had to develop a post-crisis action plan that suited the situation in Germany and not elsewhere, i.e. their actions were only developed to deal with the situation in Germany and to help anticipate for future crises. That action plan consisted thereby of the issuance of two amendments (the BilReg and the BARefG), the establishment of the APAK and lastly the development of the BilMoG.

Counteractive strategies are thereby satisfying tools to develop actions. They can be used in form of prevention, maintenance, correction or mitigation. These tools are used by legislators and regulators on both the EU and the Member State level. On the EU level, secondary legislation in form of directives, recommendations and decisions, enables the supervising authorities to implement its counteractive strategies. It depends thereby on whether the respective crisis leads to a preventive, maintaining, corrective or mitigative mode. On the

Member State level, German legislators and regulators have the same choices but are controlled by the framework set by the EU. Evaluating the relevant environments is thus a necessity to find the right measures.

The original anticipatory model – illustrated in diagram 2 – from Olaniran and Williams (2001) has the **relevant environments** divided into an internal and external focus. In order to make that model suitable for the audit regulatory system in the EU, I have thus exchanged the internal with the Member State focus and the external with the EU focus.

Audit regulations are developed on several levels whereby the EU level symbolizes the higher one. That means regulations are developed, issued and passed on to the lower level, the Member States. External forces, like the economy, politics and media, have an additional impact on the EU level as the ultimate decision-maker in the auditing profession. All economies are nowadays intertwined which means that the emergence of a crisis in one economy will lead to spill-over effects. As a consequence, several fundamental questions were raised about how capital markets are regulated and supervised. Charlie McCreevy answered that accordingly: "We need to build a global dialogue to work together towards independent high quality audit oversight." (McCreevy, 2008:4) That means regulatory cooperation on the EU level is important to minimize the external economy forces that become intense during a crisis. The external force of politics plays furthermore a significant role as political pressure from other countries could lead to changes in the regulatory system. The EU level represents thereby the unified entity of all Member States and it is thus more exposed to political decisions in the field of auditing that especially come from the USA.

The Member State level in contrast is more exposed to internal forces, like rigidity and control. Audit regulatory systems vary between countries because the national auditing culture determines how effective governance in a country can be, what type of regulator is needed and how much comparability is achievable. Rigidity symbolizes thereby the inflexibility of the regulatory system to implement fast and efficient actions to deal with a certain situation. Some Member States have audit regulators that are unable to react fast to a crisis situation because the regulatory system they are embedded in does not allow for quick changes and rather leads to controversies. Germany in contrast has a regulatory system that encourages the dialogue with non-regulators in order to issue rules and regulations that help to cope with a crisis situation in the best possible way. Yet, that makes the process of enactment rather slow. One example is the passage of the BilMoG. It was scheduled for 2008 but with the emergence of the financial crisis, new issues had arisen that regulators and academics had

to firstly clarify. And that whole process led to a 6-months postponement of the new law. The internal factor of control symbolizes moreover the influence of national legislators and regulators to change the respective crisis situation with the help of legal means. Germany's legislators and regulators chose to use the legal means of amending its Commercial Code as answer to the EU issued SAD and therewith maintain control of how to deal with future crises. The current financial crisis for instance has led to many new issues in the financial world and ultimately to a mistrust into the capital market. The recently incorporated legal measures (e.g. independent public oversight committee, and inspections procedures) will however help the German legislators and audit regulators to control the crisis impacts in the future in a better way.

That implies that although the audit environment is influenced by various internal and external forces, there is a significant need for legal measures that are issued on the EU level and then have to be implemented on the Member State level. Audit regulations are however rarely precisely defined, meaning that Member States have some kind of freedom in what way they can implement the requirements. It is thus important to analyse the **travel of ideas** (in form of new regulations) in the sense of how do they travel from the EU level to the Member State level and how are they then translated into national legislation. According to Czarniawska and Joerges (1996) are ideas powerful instruments that after their successful implementation lead to changes in their environment. The application is thereby dependent on how well the new idea is communicated and thus also dependent on space and time. Most ideas emerge indeed in a crisis situation. Some might become translated and some might just stay an idea. But in order to get an idea implemented, it has to be objectified in a specific space and time on the EU level, translated into the Member State legislation and lastly be debated about the exact means by which the idea travels.

So, let's take a closer look at how the new idea of the SAD travelled from the EU level to Germany.

The SAD was among others developed as a consequence of the Enron and Parmalat scandals, i.e. the European Commission proposed a modernization of the 1984 EU 8<sup>th</sup> Directive and objectified that by issuing the Statutory Audit Directive in 2006. The legal nature of a directive requires all Member States to incorporate the EU requirements into national legislation within a certain transposition period. Germany thus had two years time to decide upon the form and methods of implementing the SAD. The chosen forms were several amendments of the Commercial Code and the establishment of an independent public

oversight board. The initial notion of the SAD was outlined in a framework and that means communication has to be an important instrument to ensure that the implementation on the Member State level represents that notion from the EU level. A framework allows for interpretations, e.g. Germany chose to significantly amend its Commercial Code and authorize the oversight board with considerable power. Yet, the SAD did not ask for changes in the Commercial Code or for how to integrate the independent oversight board into the national regulatory system. It requested independence, certain responsibilities, ethical aspects and cooperation efforts with other oversight boards. The German legislators adopted these requirements but at the same time chose to advance some of them. Examples for them are the stricter networking rule for audit work and the longer cooling off-period for members of the APAK. It has however to be stated that the regulators on the EU level try to communicate their vision by providing an advisory role for their Member States. On the one hand, the European Commission ensures a certain information flow to its Member States and on the other hand, international committees (e.g. the EGAOB and IFIAR) were established to provide an exchange of information and experiences between all EU members.

As the transposition period has passed in summer 2008, the EU is now concerned with examining the national implementation status and if necessary to impose sanctions. It is however already obvious that the idea of the SAD and its travel to the Member States has changed the audit environment in Europe. National audit systems are not self-regulated anymore; instead a more harmonised market environment with mutual recognition and cooperation has been established. Jörgen Holmquist as the Director General for the Internal Market and Services at the European Commission argued that only cooperation, i.e. relying on others and the establishment of independent public oversight systems can help to restore the trust in the capital markets and work of auditors again. (Holmquist, 2008)

That shows that the many expectations on the audit regulatory system in the EU have led to various counteractive strategies whether issued on the EU level in form of secondary legislation, or on the Member State level in form of the transposition of EU regulations or additional by-laws. Yet, it remains to be seen why the auditing profession changes its regulations at all.

With regard to the **institutional theory** from DiMaggio and Powell (1983), every unit of a population seeks for external legitimacy by adhering to specific rules and norms. And that in turn will lead to similar adoption processes that are called 'institutional isomorphism'. The resulting change can thereby be caused by political power, the desire for institutional

legitimacy or competition. The audit profession with its regulatory system is no exception to that. Audit regulations in the EU change because the legislators and regulators want to legitimate their regulatory system towards the other international standard setters outside the EU, and because the emergence of any kind of crisis leads to a political necessity to regain the trust of investors into the European capital market.

DiMaggio and Powell (1983) have identified three mechanisms that are responsible for making a unit of a population change: coercive, normative and mimetic isomorphism. I will however only use the first two mechanisms to analyse how audit regulations in the EU change because the factor of uncertainty does not account for any mimetic pressures in the audit regulatory system.

Coercive isomorphism represents the pressure from other organizations, cultural expectations or governments. The audit regulatory system in the EU is exposed to pressures of foreign standard setters, like the PCAOB, cultural expectations that arise in the different auditing cultures of the Member States and of the European Commission itself. The result is that the regulatory systems will become more and more alike due to the changing audit regulations (e.g. SAD, Recommendation on external quality assurance) and maybe even lead to a global harmonised audit market in the far future. Furthermore, these coercive pressures lead to an increasing awareness of the preferences of the society by taking the expectations of the stakeholders and auditing firms in consideration before issuing any new audit regulations.

Normative isomorphism symbolizes in contrast the pressures from the professionalization, i.e. the audit profession. The members of an occupation define rules and regulations, control the outcome and establish a cognitive base and legitimation for their occupational autonomy. The European Commission together with other consulting bodies, that mainly consist of professionals, define what rules and regulations are appropriate for the audit occupation. They further control the adoption and implementation of these rules in all Member States. In order to establish a cognitive base, the European Commission has issued the SAD that shall represent the starting point for the EU audit autonomy from other foreign regulatory systems. These normative pressures can lead to a revision or renewal of the existing audit regulations. Furthermore, professionals must not only conform to the standards set by the European Commission but also to the ones set by the respective Member State legislators. For instance, German auditing firms have to adapt to the translated national requirements of the SAD and in addition to the ones German legislators and regulators have set in the German Public Accountant Act (WPO).



That means altogether, the audit profession as the respective unit of a population here, will always seek for external legitimacy by adhering to rules set by the EU and the national governments.

Summarizing, the theoretical reflections of Olaniran and Williams have firstly helped to analyze the different influences the audit regulatory system in the EU is exposed to and secondly provided a model that incorporates other theories, like travel of ideas, institutional theory and auditing culture. All theories together have shown that auditing regulations are dependent on the relevant environments, the expectations of the involved parties and on the enactments of the respective regulators.

It is thus important to look back at the problem statement and to specify what implications thereby arise for the changing audit regulations in the EU and in Germany.

## **8.2 Implications**

The initial problem statement asked how audit regulation is changed in the EU. The recent issuance of the Statutory Audit Directive on Germany as member of the EU, has thereby formed the basis for my research as it symbolizes a major change of the audit regulatory system in the EU. Thus, the question remains how that change had exactly taken place and how it had affected the German regulatory system.

The triggering events can thereby be related to the crises emergences in the last two decades as well as to non-crisis related issues. Starting in the 1980s where the public asked why auditors had not done anything to prevent the financial scandals from that time. The consequence was the development of the EU 8<sup>th</sup> Directive in 1984 and with the following years, the directive got more and more important as other scandals came along. Yet, the EU also issued a Recommendation on independence and quality control as well as developed the FSAP whereby both had nothing to do with a crisis. These two events were rather related to the power of the regulatory bodies themselves and their wish to create a harmonised capital market in the EU.

Hence, audit regulation does not only change through the event of crisis but also through factors, like globalisation, increasing pressure from other international standard setters and the aim of the EU itself to establish a harmonised market environment.

The SAD for example was on the one hand an answer to the Enron and Parmalat scandals and the American issued SOX but on the other hand symbolized the European wish for a standardised audit market as well as a response to the increasing globalisation of the organizations to be audited. The financial scandal might have advanced the process that would have otherwise taken a longer time to evolve.

Also, the European issued SAD has led to major changes in the existing regulatory systems of its Member States. Germany as my prime example here amended its Commercial Code, established a whole new independent public oversight board and is still working on how to integrate the specific tasks for that oversight board into national legislation. It is much easier to issue a new regulation on the EU level as it provides a framework but not specific measures on how to translate the requirements. That is the task of national legislators and their interpretations of the framework issued on the EU level. It is however true that the issuance of the SAD had the effect to make national auditing regulations less important. There is no self-regulation anymore, instead every Member State has to follow the rules and regulations of the SAD. The aim is thereby not to determine that high quality audits are sufficient. It rather means that stakeholders need to trust the audit opinion. The independent oversight boards required by the SAD will thereby contribute to that high level of quality assurance by making sure that auditing firms follow the necessary rules. Yet, that alone will not promise the needed success. National governments also have to take responsibility by ensuring the establishment of fully operational and staffed audit oversight systems and that within the transposition period issued by the European Commission. (McCreevy, 2008)

The German legislators have done that by providing the legal basis for the establishment of the APAK and for all its tasks and responsibilities, i.e. it is fully operational. That process was however not as easy as it sounds. The APAK was established over the course of a two-year transformation process and has still some areas that need to be further discussed. Examples for these are in regard to the decision-making power and the required inspection measure.

The APAK was established with a certain degree of decision-making power, yet, it was initially not assigned to make any operational decisions in regard to the inspection process. That means the effectiveness of the APAK was limited because the measure of inspection is crucial to ensure the audit quality of all German auditors and auditing firms. In order to overcome that obstacle, the German legislators have recently issued a Recommendation that will transfer the decision-making power for the execution of any inspections to the APAK. It is however only a recommendation and that means it remains to be seen how long it will take to incorporate that into the German legislation. The advantages of this new recommendation

are though not only that it associates with the initial notion of the 2005 published APAG to redesign the regulatory system in Germany, but that it also enables the prompt and easy communicable translation of the 2008 EU Recommendation. And finally, the implementation of the German recommendation could lead to an enhanced international acknowledgement of the German regulatory system. (APAK, 2009d)

The measure of inspection as second example bears challenges in itself. The APAK has yet not decided in what dimension the EU measure should be incorporated into German legislation. Small- and medium sized German auditors and auditing firms are already subject to the monitored-peer review system. Is it thus wise to impose a double burden on these firms by introducing inspections with the same dimension? The APAK is currently discussing on how to solve this problem and some members tend to abolish the old German measure of monitored-peer reviews in favour for the inspection measure. This suggestion would however entail further amendments of the German Commercial Code as all measures have to be made statutory. Another solution could be to follow the American model that restricts the inspections to capital market oriented companies. That would mean that German small- and medium-sized auditing firms are not subject to any inspections from the APAK and hence, do not have to comply with the additional requirements set by the EU. They will only have to follow those rules that are established both in the German Public Accountant Act and the German Commercial Code for their size of enterprise. In spite of that exception, small- and medium-sized auditing firms will still be monitored in regard to their quality assurance system by the help of monitored peer reviews that are under the oversight of the APAK.

These two examples demonstrate that the issue of having an independent national auditor oversight board in place is challenging. It requires precise definitions that need to be stated in the national laws and regulations as well as to be in compliance with the SAD requirements, and it should encounter for every possible scenario that might arise in the near future. The contemporary financial crisis is thereby an important subject. It had led to a postponement of the BilMoG which is supposed to implement the remaining requirements of the SAD into German legislation. The main reason for that was probably the concerns of the Parliament and Federal Council towards the implications of the financial crisis. Their members wanted to considerate more closely those areas that were touched by the crisis, e.g. the fair-value-accounting for financial instruments in trade or the going-concern assumption of the to-be-audited companies. In addition, influencing lobby groups (e.g. banks, other regulating bodies) were also asking the German legislators for a postponement of the BilMoG as it entails a time

requirement to create the legal basis for it. The financial crisis has influenced the economy in Germany, thus, legislators, regulators and lobby groups are more concerned with overcoming these problems first than introducing a new time-consuming law that will lead to a major amendment of the Commercial Code. Yet, this postponement could be a problem for the German legislators as the European Commission had set the transposition deadline for the SAD for June 2008. That means that those parts of the BilMoG that represent the remaining implementation of the SAD could have only been introduced after the final passage by the German Parliament and Federal Council in April 2009. It remains to be seen how the European Commission will react to that after the current revision of the implementation status of the SAD. The fact is however that the contemporary financial crisis is not only affecting Germany but all the other Member States of the EU as well and that means that the European Commission will probably be more considerate. The most important goal at the moment is to overcome the financial crisis and the tool of inspection is a starting point to provide a stable capital market. The German inspectors will for that purpose not only look at the coming financial statements of all capital market oriented companies and their auditors but also do a retrospective review until the financial year 2008. (APAK, 2009d) This will enable a consistent application of the new requirements of the German interpretation of the SAD as well as help to prevent future crises from happening.

Altogether, the contemporary financial crisis has shown once more that it has an effect on the change of audit regulations. The EU issued another Recommendation on external quality assurance in 2008 and the German legislators postponed the BilMoG until April 2009 in order to solve new arisen questionable issues. The Recommendation demands thereby the execution of inspections by the independent national oversight board and closer cooperation between the regulatory systems of Member States. That means that legislators on both the EU and the Germany level, have taken the expectations of the stakeholders into consideration, discussed on how to improve the audit regulatory framework and then enacted new strategies. These legal measures have in turn lead to changes of the surrounding environment as the Recommendation demands for a statutory integration of inspections into national law as well as mutual recognition and reliance on foreign inspection processes, and the BilMoG entails a major amendment of the German Commercial Code that will not only affect auditors and auditing firms but also all organization with headquarters located in Germany. Diagram 6 (from chapter 6.2) has illustrated exactly this context: the impact of the SAD on German legislation. On the one hand, the directive has led to changes of the Public Accountant Act by

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establishing a public oversight committee, implementing the inspection process and by providing disciplinary court procedures. On the other hand, the directive has led to amendments of the Commercial Code and that does not only implement the remaining SAD requirements like defining the scope of an audit and demanding the establishment of an audit committee in every public interested company but also led to by-laws that will have a major impact on all German organizations. The reason behind those additional by-laws lies in the attempt of the German legislators to make its regulatory and accounting system more competitive and comparable and therewith obtain the acknowledgement of other standard setters within and outside the EU.

That last example shows that audit regulations are influenced by various factors and hence change. It depends on the context and environment but audit regulations can be changed both on the EU and Member State level, whereas the initiative will always come from the EU as the top level. The implementation process of the SAD into German legislation has furthermore illustrated that European requirements are not only translated but also advanced to adjust to the national circumstances and needs of the Member State level. The consequence is that audit regulations that are issued on the EU level, will lead to their implementation on the Member State level but can therewith also lead to different interpretations, i.e. Member States can implement the audit regulations within a certain framework and thus, introduce either stricter or more lax national regulations.

## 9. Chapter Nine: Conclusion

This research was concerned with the audit regulatory system of the EU by having formulated the following problem statement: "How is audit regulation changed in the EU? A case study of the implementation process of the Statutory Audit Directive in Germany." In that context, I have started off by presenting an introduction to the history of crises from the last two decades and by describing the general audit regulatory structure in the EU. Thereupon, I have explored why the SAD has been developed, how its implementation is affecting German audit regulation, and lastly how that process is explicitly affecting the auditor oversight in Germany.

It was shown that crisis is an important trigger for changing audit regulation. Various crises from the last two decades have led to amendments of the European regulatory system. The Enron and Parmalat scandals were thereby the most important incidents that triggered the modernisation of the EU 8<sup>th</sup> Directive from 1984. Other factors have however also played an important role in this change. Firstly, the increasing globalisation of multinational companies demanded from auditing firms and their regulatory framework to adjust to that in order to keep up with the fast-changing environment. Secondly, the EU aimed to establish a harmonised European audit market and the crises in the beginning of the 20<sup>th</sup> century had given the European Commission another incentive to achieve that as fast as possible. And lastly, the European legislators wanted to diminish the audit expectation gap between the public and auditors that becomes relevant during every emerging crisis situation. The result was the issuance of the Statutory Audit Directive in 2006 and a two-year transposition deadline for the implementation into each Member State's national legislation.

Germany as my case study, had the advantage of already having some parts of the European directive incorporated in their national legislation. The required independent auditor oversight board had been developed in the course of two amendments of the German Commercial Code from 2004. That means that the APAK was officially established in 2005 and German legislators could thereupon work on enhancing its authority. The remaining parts of the SAD were however more difficult to incorporate into the German legislation. A new recommendation from the European Commission in 2008 as well as the contemporary financial crisis led to postponements. Yet, the German Parliament and Federal Council have accomplished to pass the BilMoG in April 2009 that will translate the last requirements of the SAD.

The analysis showed that although audit regulations are issued on the EU level, their implementation on the Member State level is dependent on the interpretation of the national legislators and can be influenced by coercive and normative pressures. The legal means of the EU are in most cases a framework and thus, Member states will translate the requirements in the way they fit the best into their environment. That means institutional isomorphism as well as the travel of ideas theory have an impact on how audit regulation is changed in the EU. Public oversight was thereby the prime example in this thesis.

The European Commission demanded the establishment of an independent auditor oversight board with ultimate decision-making power, and the tasks to trust other regulatory system within the EU as well as to cooperate with other oversight boards inside and outside of the EU. Germany had established the APAK that has ultimate decision-making power and is not only active in cooperating with other oversight boards in the EU but is also member of various international forums. Yet, the measure of inspection is probably the most controversial issue as there are many open questions that need to be answered in Germany before having accomplished a successful instrument to regain the trust of the investors into the capital markets again. Inspections had been introduced in 2007 but were linked to the operational decision-making power of the WPK. German legislators have tried to solve this problem by making several recommendations in 2008. It remains to be seen how long it will in fact take to incorporate these recommendations into German legislation and therewith fulfil the EU Recommendation on external quality assurance. The German regulatory system is predominantly legalistic but is, before any new law is passed, open to consultation from non-legislators. That means the legislation process might take longer than in other countries.

The issue of mutual recognition is furthermore challenging as it requires every Member State to have the same level of auditor oversight established. The German APAK tries to cooperate with other European oversight committees by following the homeland principle. It is however a different matter when looking at standard setters outside the EU. The PCAOB, as the counterpart to the national auditor oversight committees in the EU, has not yet fully acknowledged the European audit regulatory system by not entirely trusting the sound work of national auditor oversight committees. It requires instead the execution of joint-inspections and up-to-now does not allow the transfer of working papers. Whether or not that issue will be resolved, will depend on the future political and economical situation of both parties and if a consensus about confidentiality issues can be reached.

Nonetheless, the issuance of the SAD has led to major changes in the European audit regulatory system that will help legislators and regulators to regain the trust of investors into the capital market again. It will also enhance every Member State's regulatory system by establishing independent auditor oversight committees that cooperate with each other. That means, the European Commission has accomplished to be a further step closer to having set up a harmonised market environment within the EU. Yet, the factor of crisis will always play an important role as it is part of the economic cycle. The implemented requirements of the SAD will however help to anticipate prospective crises in a better way and thus, make the capital markets of each Member State more secure. In addition, the FSF has published new principles for cross-border cooperation on crisis management in April 2009. These principles describe firstly international cooperation between relevant supervising authorities about how to deal and manage financial crises and secondly, the setting up of a meeting point for national authorities to exchange information. (FSF, 2009b) This plus the ongoing communication of international forums, like the EGAOB or the IFIAR, will help to find common measures to best deal with emerging crises.

The audit regulatory system of the EU will probably change several more times within the coming years, but the SAD has represented the biggest change so far. The final task of the European Commission is thus to monitor the transposition of the directive. Prof. Dr. Marten believes that the SAD has been implemented for its main parts in Germany. Whatever smaller areas still need amendments, every requirement of the SAD can or will be found in German legislation very soon. (Marten, interview) It remains however to be seen how well that new audit regulatory system will work in the future and if it will in fact help to make the capital market more secure. Cooperation as the basic notion of the SAD is a good thought but it depends on the willingness of the parties involved to work together. That means only the coming years will show how well thought-out the SAD really is.

Additionally, the EU strives to get the acknowledgement of the PCAOB in regard to their auditor regulatory system. The SAD is a very good foundation to achieve similar systems of oversight within the Member States but will the PCAOB accept these without pressing to make inspections? Frits Bolkestein stated in 2003 that "The EU will regulate its own business." (EC, 2003b) and that means that the European Commission will make its audit regulatory system as strong and powerful as it needs to be to get acknowledged international-wide and that it will not accept any foreign interference.



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**Appendix****Appendix 1: Question guide for telephone interview with Prof. Dr. Marten (26.03.2009)  
– translated from German into English**

1. What are the implications of the Statutory Audit Directive on the German audit profession?
2. What were the biggest challenges for Germany by adopting the requirements of the SAD?
3. What was the reaction of the German WPK when the European Commission issued the SAD in 2006? And how did members of the APAK react to this new development?
4. Germany is a member of the newly established IFIAR. What are the impacts of this organization on the German audit profession?
5. Did the APAK have any kind of influence on how the Statutory Audit Directive had been translated into German legislation?
6. Do you think the SAD has been completely implemented in Germany?
7. The passage of the BilMoG has been postponed several times now. The original plan was to pass the new law in 2008. Do you know the reasons behind this postponement?
8. Did the current financial and economic crisis have an influence on this postponement?
9. What were the reasons for the remaining requirements of the SAD to be implemented in the form of the BilMoG?
10. Does the EU have an influence on the working practices of the APAK in any way?
11. Can you tell me about the cooperation efforts between the APAK and other members of the EU?
12. What is the status of the acknowledgement of the German regulatory system from the PCAOB?