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Regulation of statutory audit in the European Union

Introduction

Legislation plays an important role in ensuring the efficient and sustainable functioning of the economy and is the basis for interaction between enterprises, governments and civil society. Regulation of legislative initiatives is called upon to ensure the credibility of business and authorities, to develop mutual trust, and in this way support the functioning of markets.

The statutory regulation of audit, even in the countries which are pioneers of state regulation of audit activities, has a history of barely half a century, whereas in most countries statutory audit regulation in general has a history that spans only a few decades. This fact suggests that statutory audit regulation is not yet fully formed, and the its future development will remain important for some time.

In today's economy audit is considered to be an integral element of a complex mechanism of information. It assists capital markets participants. In addition to the external auditors, various organizations and regulatory bodies are responsible for ensuring the transparency and reliability of the information provided in financial statements that are essential for capital markets. The other components of this mechanism include the management of reporting eminent organizations, commission on financial credit documents and other bodies, regulating the activity of stock markets, as well as other sectoral supervisors. International audit standardization is an element of improving the whole mechanism of ensuring the transparency and reliability of the financial statements of corporations.

The European Union has made significant progress in the unification and harmonization of legislation and the development of supranational acts in the field of cor-

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porate regulation. Basic principles of the corporate law of the EU, which in this sense are the key to success, are based on the tendency to create, first of all, common principles for the functioning of supranational companies, a favourable environment for their establishment and protection of the rights of founders and shareholders of companies.

Checks and control of economic activity are, in this context, the main instruments which facilitate the implementation and improvement of the statutory requirements compliance level. They also help to ensure that the economic activities do not jeopardize human and environment safety. Carrying out effective checks is aimed at strengthening the trust between stakeholders, which is necessary for proper market functioning. In pursuing these aims checks and control of economic activity are based on the principles of adequate risk management and risk mitigation, as well as the proportionality of risks.

Analysis of recent publications

The need for control increased after the emergence of joint stock companies, where on the part of managing joint stock companies, theft and even fraud often took place. The famous German lawyer Rudolf Ihering noted in this regard that "all wars put together, did not cause so much damage to society as joint-stock companies" (Fedorenko, Zolotarev, 2012: 272: 32). Anyway, it is the ubiquity of joint stock companies that has led to the normative consolidation of the audit. In view of the foregoing, the most accurate definition of the audit is that formulated by Jack Robertson: "the audit – is the process of reducing to an acceptable level of information risk for users of financial statements" (Robertson, 1993: 496: 5).

The historical homeland of statutory regulation of audit is considered to be the UK. A number of laws regulating the activities of joint-stock companies were adopted there in 1844. In particular, companies were obliged to invite a person to verify the accounts and report to the shareholders at least once a year.

In early 2005 the European Corporate Governance Forum was created to co-ordinate activities in this area throughout the EU. The fundamental approach of the European Commission was formulated by its representative Charles McCreevy, who said: "[…] we are not going to create a European code of corporate governance. We see no need for this, and if we managed to create such a document now, it would be a messy political compromise which would hardly help investors to get complete information about corporate governance" (McCreevy, 2005). The priority of the forum was to study the existing national corporate governance codes in order to determine whether their convergence took place and whether there were possibilities for its implementation.

This approach continues to have a direct impact on the tax and financial control in the EU.

Theory and practice of mandatory audit were evolving in the conditions of a competitive environment. This process was followed by a variety of research and public discussion. As a result, it led to some consequences. So by now a solid international legal basis of the audit has been established, the forms of audit organization have been developed in detail, and, just as important, a huge amount of training materials for auditing is being published and constantly updated.

The directives – the secondary sources of EU law have become the most commonly used instruments aimed at harmonizing national corporate regulation in the EU. Just the acceptance of quite a significant number of directives which have harmonized a number of important aspects of company law allows mentioning the existence of a special European corporate regulation (Werlauff, 1993: 5). Historically, the need for harmonization of the corporate legislation of EU member states was caused by the inclusion in the Treaty establishing the European Community of provisions allowing a company established in one member state to open in other member states agents, branches or establish subsidiaries, as well as to transfer its own location (articles 49, 54 of the Treaty on the Functioning of the European Union[1]).

Taking into account the wide public resonance caused by the collapse of the US Company Enron in 2002, the European Commission was forced to consider statutory audit issues in the broader context of improving corporate governance.

The audit expediency on the public company level is not generally disputed. In 2005 Jane Diplock, Chair of the IOSCO Executive Committee, in her speech expressed the opinion of a regulator about the value of audit (*Analytical report ACCA. Confirmation of audit value*, 2010).

Investor confidence is the foundation of global financial markets. Taking capital allocation decisions, investors should be confident that the financial information which is provided is accurate and reliable. And here audit quality and audit reports on financial statements are critical. Independent auditors have an important role in enhancing the reliability of financial information by confirming the reliability of financial reporting.

The purpose of the article

The author aims to explore the European Union's regulations in the context of statutory audit as one of the international capital market regulators which is an integral part of corporate management methodology. The article examines the statutory framework provided by: Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific require-

[1] *Consolidated versions of the Treaty on the functioning of the European Union* (OJ C115, 9.5.2008), URL, accessed on: 11.07.2010.

ments regarding statutory audit of public-interest entities and repealing Commission Decision 2005/909/EC.

Present-day global economy tendencies encourage a comparative analysis of Directives of the European Parliament for the European Business and Sarbanes-Oxley Act (SOX) for companies listed on US stock exchanges.

The main material

The institutional structure of the EU is strikingly heterogeneous due to differences inherent in member states' constitutions, cultures, and economies. International experience shows that the number of risks types is limited. They, in particular, should be taken as a basis for the construction of any inspection system and organization, responsible for the examination and control of economic activity. Institutional investors have long dominated in the UK and the USA and are becoming increasingly important in continental Europe. They play a significant role in ensuring proper management of companies in which they are shareholders. But they are only one of several mechanisms, both internal for companies and external which may contribute to the improvement of corporate governance. The effectiveness of these mechanisms and their effect on the behaviour of company executives differ from country to country, depending on the peculiarities of the historical development, institutional structure and ownership structure. These differences are reflected in the different methods which countries deal with the problem of corporate governance reforms.

The process of implementation of the regulatory framework of statutory audit adopted by the EU involves close collaboration between the European Commission and national regulators and supervisors.

The new requirements will be applied beginning from the first fiscal year after the date of appliance of the new regulatory framework adopted by the EU. For example, since the EU's new regulatory framework will be applied beginning from 17 June 2016, and the fiscal year ends on June 30, 2016, the first audit report, which has to be submitted in accordance with the new EU statutory framework, should cover the financial year ending on June 30, 2017.

The Directive in its new edition gives the European Commission authority to adopt International Standards on Auditing (ISA) at the EU level through delegated legislation in order to create equal conditions throughout the EU audit market and to prevent its possible fragmentation. The possibility of their adoption to audit the companies is also provided by Regulations to guarantee legal certainty and to avoid inconsistencies. Since the European Commission has not yet adopted international auditing standards, national standards, procedures and requirements which function in the Member States are still being applied (Easterl, Crawford, Reilly, 2007). A possible solution to be adopted later by the European Commission on this issue will depend on the results of the ISA evaluation on the criteria established

by their co-authors. In accordance with the Directive, ISAs can be adopted only if they:

- are developed in accordance with a due process of law, under public supervision and transparency of conditions;
- are generally accepted internationally;
- contribute to a high level of reliability and quality of the annual and consolidated financial statements;
- are in the interests of the EU society and do not change or supplement the requirements of the Directive and the Regulation, except for the requirements specified directly in the documents.

The reform of audit standards covers both horizontal and specific measures.

Horizontal measures can be applied to all auditors and audit firms, irrespective of whether they carry out the audit of financial statements of public interest companies or not, and involve:

- presenting more stringent requirements for independence by the way of improving the organizational requirements for auditors and audit firms;
- creating more informative reports for investors, providing them with the necessary information about the company which goes beyond the standardized report, in which an auditor expresses an opinion regarding the financial statements;
- strengthening the powers of the competent authorities responsible for community supervision of an auditor's profession;
- creating a more effective regime of sanctions application to auditors, including the development of the criteria which authorities must take into account while applying sanctions;
- conferring powers on the European Commission to adopt International Standards on Auditing (ISA) at the EU level.

Specific measures relate to the statutory audit of financial statements of public interest companies:

- compulsory rotation of auditors and audit firms every ten years;
- the establishment of a list of non-audit services which cannot be provided in addition to the statutory audit procedures;
- introduction of restrictions on non-audit services fees;
- strengthening the role and powers of the Audit Committee;
- the extension of the committee composition and giving it the authority to appoint an auditor / audit firm and monitor audit;
- toughening the requirements for audit reports, introduction of additional and more detailed report of the Audit Commission;
- the establishment of the dialogue between the auditor / audit firm and the head of the public interest.

For European business, Directive 2006/56 / EC of the European Parliament means as much as the Sarbanes-Oxley Act (SOX) for the companies listed on US stock exchanges. This is a complex and thoroughly researched package of legisla-

tive reforms that impact on the very heart of big business. Echoing the regulations of SOX, the Directive is a necessary and long-awaited step towards convergence of corporate law on a global scale. At its core, as well as at the core of the SOX, there is the desire to re-establish the lost confidence of investors in the financial markets.

The increase of top managers' responsibility (Section 906 of the SOX) led to a sharp increase in bonuses which are paid to them. Even Paul Sarbanes acknowledged that the SOX and especially Section 404 has resulted in corporations making a number of complaints. According to him, currently the SEC and the Accounting Oversight Board, established in accordance with the SOX are researching this issue.

The case of the Enron Company has also affected market institutions engaged in external control activities of American corporations. It dented the credibility of auditing firms, stock analysts and rating agencies. In 2007 German public prosecutors initiated investigation into the company KPMG Germany. It regularly gave a positive assessment of the internal control system in Siemens and didn't "notice" suspicious transactions in the amount of 420 million euro carried out in the past seven years (money transfers resulting from fictitious consulting contracts intended to bribe potential customers in Egypt, Greece, Indonesia, Kuwait, Saudi Arabia and Vietnam). And this is by no means a complete list of auditors' problems.

Features common to both legislative approaches are the following:

- strengthening of the emphasis on the independence of the Board of Directors, including toughening of the standards of independence, requirements for independence and taking into account other factors that affect independence;
- demand for the establishment of three key Board Committees – Audit, Nominations and Remunerations, which should consist mostly (or fully) of the independent directors;
- emphasis on internal and external audit function, leading to the introduction of new requirements for members of the Audit Committee (the prohibition to receive remuneration from the company, the financial work experience) and more careful attention to relations with the external auditor (independence);
- heightened disclosure requirements, such as the Corporate Governance section of the annual report and the disclosure of remuneration policy and individual remuneration of each director (however, the use of this latter requirement in Europe is debatable).

In the USA stock markets demand that a company executive confirms that he does not know about any violations of the listing standards of corporate governance, and that a company has adopted a code of conduct and business ethics for directors, executive officers and employees. In Europe, the presentation of the report on corporate governance is usually obligatory (either by law or in accordance with listing requirements), formal requirements for its format, at the same time, is often not established and the decision concerning the assessment of the content quality of such

reports is left to the discretion of the shareholders. Bringing these two approaches to a common denominator is currently the subject of negotiations between the European Union and the United States. These negotiations are held with a view to ensure equal treatment of companies and equal protection of shareholders' rights in different markets.

The USA and the EU are negotiating the establishment of a so-called zone of TTIP (The Transatlantic Trade and Investment Partnership). Germany and Northern European countries favour the creation of a single market, while countries such as Italy, France and Spain took a tough stand. They wish European companies to gain full access to US government procurements. In its present form, this economic initiative reduces itself to the unification of trade and political standards of the EU and the North American Union.

As in the case of the Pacific trade pact, corporate interests, that is, the interests of transnational corporations will rank above national ones. Moreover, private business receives the particular right to defend its interests in private international arbitration courts. At the same time they will be guaranteed independence from the national legal institutions.

In the meantime the results of the referendum in the UK will have a huge impact on the European Union, which will lose a major military and diplomatic power in its ranks. The loss of the UK will undermine the credibility of the EU which confronts slow economic growth, high unemployment, the migrant crisis and debt problems in Greece and military conflict in Ukraine.

The economies of Europe and the United States urgently need new incentives and monetary injections otherwise they risk sliding into a deflationary spiral. Weakening consumer demand strengthens investors' suspicions that they were too positive about the future. And the collapse in the oil market creates problems not only to the countries with commodity-dependent economies.

The Directive and the SOX have laid a solid foundation for a stronger and more internationally comparable system of corporate governance. They have clarified and enhanced the role of both directors and auditors of companies. The states of the European Union and other interested countries, considering the Directive, put forward various proposals concerning the supervision and regulation with a view to reform financial markets and raise investors' confidence, demonstrating the seriousness of their intentions and readiness for large-scale transformations.

The importance of the Directive is underlined by the fact that the measures proposed in it touch upon not only the members of the European Union, but also extend their impact beyond the EU. The Directive establishes the key, common to all, principles and hereby lays the foundations for harmonization, but at the same time retains space for maneuver and taking into account the differences.

International capital markets need modes of regulation and standardization that would ensure consistency and continuity. The apparent harmony of the Di-

rective and the SOX is a powerful impetus in this direction, while common sense and the spirit of mutual cooperation, contained in them serve as a good guiding line for other countries.

Regardless of the polarity of the reached conclusions, the company receives a list of "weak points" in its structure and working processes. Following this list, the management can retain the team entrusted to it in the same place or contribute to its development – increase labour productivity, comfort conditions, optimization of the working process, etc. Actually, it is the aim of carrying out of the statutory audit.

The second advantage is the obtaining of a positive result, which is accompanied by the appropriate certificate and is evidence of compliance by the firm of all norms, requirements and standards.

The third benefit is a reputation in the service sector and the business world. A company which has "a quality certificate" is a reliable companion, profitable partner and tried-and-true performer for partners and customers.

Conclusions

In the EU the most attention at the international level continues to be given to one of the types of tax and financial control – the statutory audit. Information and administrative infrastructures, including legislative regulation have already been created to improve it. At the same time, the development of such kinds of tax and financial control, as an internal control and audit, is viewed in the context of corporate governance. The formation of a single European corporate governance code is not considered to be a promising task. This approach takes into account the considerable diversity of corporate control mechanisms used in the EU Member States, and in addition to that does not create a basis for the qualitative improvement of the tax and financial control on a fundamentally new conceptual framework.

Publicity in the EU is regarded as a major tool to prevent possible offenses in the sphere financial reporting and penalties for offenses (Belikova, Inshakova, 2010: 30–35). Establishing guidelines concerning financial statements contain practically identical formulas: the EU Member States must provide the competent authority with the right to publicly disclose any taken actions and imposed sanctions for violation of legal acts adopted in accordance with the relevant directive. Such disclosure should not be carried out only if it would create a serious threat to the financial markets or cause disproportionate damage to the parties involved in the case. Common for all the EU countries approaches of establishing civil and administrative liability for violations in the periodic reporting are fixed with an allowance for the principles of effectiveness, proportionality and adequacy to prevent such violations. As for criminal penalties, the directive regulation leaves the resolution of this issue to the discretion of member countries.

Thus, the characteristic feature of the directive regulation of companies activity in the EU, in the result of which uniform rules arise, is the exclusive competence of the national legislator in matters of choice of means and methods of achieving results specified in the directives, which determines the soft approach of the European legislator to the regulation of corporate relations. Harmonisation of European law concerning companies focuses on issues of publicity, transparency and the financial accountability of corporations, as well as the establishment of liability for corresponding violations. This has overcome many problems EU countries faced in the past and has improved the regulation of trade.

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Summary

Regulation of statutory audit in the European Union

The article deals with the regulatory policy of statutory audit with the purpose of strengthening confidence in the European financial markets and consolidating the foundations of international cooperation of market regulators under the conditions of a functioning information economy. The EU not only defines the target strategy of an auditor and the method of auditing – it directs the establishment of the structures necessary for ensuring audit quality and raises the confidence in audit functions.

Attention is drawn to information transparency, which is the result of systematization of financial information made public by European companies. The authors have investigated a number of legislative acts of the European Union in audit and the Sarbanes-Oxley Act of investor protection. These acts are important elements in the global convergence of corporate legislation and contribute to the creation of a single market.

The harmonization of audit activity is a step in the right direction in the area of corporate governance and the protection of potential investors' interests in the European market.

Keywords: financial markets, audit, European Union

Słowa kluczowe: rynki finansowe, audyt, Unia Europejska