



COMMISSION OF THE EUROPEAN COMMUNITIES

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Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

**on statutory audit of annual accounts and consolidated accounts and amending Council
Directives 78/660/EEC and 83/349/EEC**

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. CONTEXT OF THE PROPOSAL

1.1. Grounds and objectives

The recent spate of scandals in the US and the EU have emphasised that statutory audit is an important element in ensuring the credibility and reliability of companies' financial statements. Significant economic damage to the capital markets and the economy has resulted.

Recent scandals also confirm the urgency and the need for the envisaged EU initiatives on statutory audit outlined in the May 2003 Commission Communication "Reinforcing the statutory audit in the EU". This proposal is one of the most important initiatives of this Communication. It considerably broadens the scope of the former Eighth Council Directive by clarifying the duties of statutory auditors, their independence and ethics, by introducing a requirement for external quality assurance, by ensuring robust public oversight over the audit profession and by improving co-operation between oversight bodies in the EU.

The proposal also provides a basis for effective and balanced international regulatory co-operation with oversight bodies of third countries such as the US Public Company Accounting Oversight Board (PCAOB). This is crucial because capital markets today are globally interconnected.

This proposal is not a knee-jerk reaction to recent corporate scandals. It is the logical consequence of a reorientation of the EU policy on statutory audit started back in 1996. However, the initial thinking has been adapted to take account of the most recent scandals. For example, the proposal now states that the group auditor bears full responsibility for the audit report on the consolidated accounts of a group of companies and it requires an independent audit committee in all public interest entities.

1.2. General context and history

The Fourth Council Directive 78/660/EEC of 25 July 1978¹ on the annual accounts of certain types of companies, the Seventh Council Directive 83/349/EEC of 13 June 1983 on consolidated accounts², Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions³ and Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings⁴ require that the annual accounts or consolidated accounts are audited by one or more persons entitled to carry out such audits.

The Eighth Council Directive 84/253/EEC of 10 April 1984⁵ on the approval of persons responsible for carrying out the statutory audits of accounting documents deals primarily with the approval of statutory auditors in Member States. Although the Directive contains some requirements on registration and professional integrity, it does not include requirements on

¹ OJ L 222, 14.8.1978, p. 11

² OJ L 193, 18.7.1983, p. 1

³ OJ L 372, 31.12.1986, p. 1

⁴ OJ L 374, 31.12.1991, p.7

⁵ OJ N° L 126, 12.5.1984, p. 20

how a statutory audit should be conducted and the degree of public oversight or external quality assurance which is needed to ensure a high audit quality.

The lack of a harmonised approach to statutory auditing in the EU was the main reason behind the Commission's organisation in 1996 of a wide-ranging reflection on the scope and need for further action at EU level on statutory audit. This reflection was initiated by the Commission's 1996 Green Paper⁶ on "The Role, Position and Liability of the Statutory Auditor in the EU". Responses to the Green Paper suggested a need for action at EU level beyond that laid down in the Eighth Council Directive. The policy conclusions which the Commission drew from these reflections were included in the 1998 Commission Communication "The Statutory Audit in the European Union, the way forward"⁷.

The 1998 Communication proposed the creation of an EU Committee on Auditing, which would develop further action in close co-operation between the accounting profession and Member States. The objective of the Committee was to discuss ways and means to improve audit quality, where possible by agreeing on non-binding measures. Key subjects on its agenda have been external quality assurance, auditing standards and auditor independence.

On the basis of the preparatory work by the EU Committee on Auditing, the Commission issued a Recommendation on "Quality Assurance for the Statutory Auditor in the EU"⁸ in November 2000 and a Recommendation on Statutory Auditors' Independence in the EU in May 2002⁹. Preparatory work on the use of international standards on auditing (ISAs) has also been carried out.

This proposal maintains the basic conditions on education and training from the existing Directive. This means that the conditions for approval of statutory auditors and audit firms are not fundamentally changed. However, the proposal broadens the scope of application of EU legislation by introducing new requirements concerning the manner in which an audit should be carried out and the structures needed to ensure audit quality as well as ensure trust in the audit function.

Whilst statutory audit is of major importance in ensuring proper financial reporting, it is of course not the only factor under scrutiny following recent financial reporting scandals. Audit is an element of a larger system of actors and regulators involved in transparent financial reporting for the EU capital market such as the management of the reporting entity, securities markets supervisors and other sector specific supervisors. The proposed Directive on statutory audit should therefore be seen in the wider context of EU actions included in the Financial Services Action Plan. Particularly important in this respect are the Commission Communication of 21 May 2003 on 'Modernising Company Law and Enhancing Corporate Governance in the EU – A plan to Move forward'¹⁰; the move to international accounting standards from 2005 onwards; and the market abuse (2003/6/EC on insider dealing and market manipulation) and prospectus (2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading) Directives agreed recently in codecision.

⁶ OJ N° C 321, 28.10.1996, p. 1

⁷ OJ N° C 143, 8.5.1998, p. 12

⁸ OJ N° L 91, 31.3.2001, p. 91

⁹ OJ N° L 191, 19.7.2002, p. 22

¹⁰ COM(2003) 284 final

2. CHAPTER BY CHAPTER ANALYSIS

Chapter I Subject matter and Definitions (Articles 1 and 2)

In accordance with Article 1, this Directive only deals with statutory audit in so far as such audit is required by Community law (for instance by the Fourth and Seventh Council Directives).

Statutory auditor and audit firm are separately defined. This provides more clarity in the precise scope of regulation and takes account of the fact that a number of provisions deal specifically with audit firms. This reflects the fact that since the adoption of the Eighth Council Directive in 1984 audit firms have grown in size and importance.

Statutory audit is defined as the audit of annual or consolidated accounts of entities covered by Community law Directives. Member States may also require statutory audits in other situations and where they do so make them subject to the same requirements.

Public interest entities is a concept that was discussed and developed during the preparation of the Recommendations on quality assurance and auditor independence in the EU Committee on Auditing. Criteria used to define public relevance are having securities listed, the nature of the business (for example banks and insurance companies) or the size of the business (number of people employed). Recent scandals show the importance of further strengthening requirements concerning audits in public interest entities. However, it would be overly burdensome and disproportionate to extend these enhanced requirements to the large majority of other statutory audits. Chapter XI contains the specific requirements for statutory audits in public interest entities. For example, public interest entities shall have an independent audit committee; the audit firms of public interest entities shall be subject to more stringent independence requirements; and their auditors should publish an annual transparency report.

All listed companies whose securities are admitted to trading on a regulated market, all banks and insurance undertakings are by definition considered to be public interest entities. Member States may want to enlarge the scope by including for instance hospitals or pension funds into the definition.

Chapter II Approval, Continuous Education and Mutual Recognition (Articles 3 to 14)

This section basically repeats the present requirements of the Eighth Directive. For the approval of audit firms, Article 3 (3) (b) and (c) no longer allows a Member State to require that the majority of the voting rights and the majority of the administrative or management body should be only in the hands of statutory auditors or audit firms that are approved in that specific Member State. The proposal removes restrictions on ownership and management that are currently possible under the Eighth Council Directive. The proposal states very clearly that the majority ownership of an audit firm should be held by statutory auditors or audit firms approved in any Member State. This change enhances compatibility with internal market rules and will also allow for the creation of more fully integrated EU audit firms.

In this chapter, an aptitude test is prescribed for the approval of statutory auditors from other Member States. This departure from the recent proposal for a Directive on Services in the internal market (COM(2004)2 final.13.1.2004) is justified because of the need for statutory auditors to be fully aware of the specific legislation of Member States (such as company law, fiscal law and social security law) that is relevant for statutory audit. The theoretical training

now specifically covers international standards in the fields of accounting (IAS) and auditing (ISA).

Chapter III Registration (Articles 15 to 20)

Interested parties need to be able to determine rapidly whether a statutory auditor or an audit firm has been approved, where it is officially located and how (in the case of firms) they are organised. This will be facilitated through registration in a public electronic register. The information to be included in the register is limited to what is essential and access to such information is facilitated through the requirement that it must be accessible electronically.

The public register must also contain the name and address of the competent authorities in charge of oversight, quality assurance and investigations and sanctions in order to allow interested parties to contact these authorities if necessary.

Individual statutory auditors may be employed by an audit firm, they may be self-employed or otherwise associated with an audit firm, for example as a partner. The register must indicate the status of the statutory auditor in this respect.

For audit firms, the register must also show the size of the audit firm by indicating the number of all statutory auditors employed by or associated as partners or otherwise with the audit firm. Furthermore, the listing of individual statutory auditors clarifies who is related to the audit firm and via the registration number additional information is available. The register must contain information on the owners and members of the management of the audit firm. Furthermore, the register must also comprise information on the membership of a network. Information on the network indicates with which other audit firms/affiliates the audit firm cooperates and, by doing so, makes these networks more transparent to interested parties.

The registration information must be updated without undue delay and must be drawn up in the language permitted by the language rules in the Member State where the statutory auditor or audit firm has its seat. The registration information may also voluntarily be submitted in any other official language of the Community.

Chapter IV Professional ethics and professional secrecy (Articles 21 to 22)

Statutory auditors and audit firms must be subject to robust professional ethics. The starting point will be the code of ethics adopted by the Ethics Committee of the International Federation of Accountants (IFAC). However, further specific rules may be necessary to elaborate the principles established in Article 21.

Rules on confidentiality and professional secrecy must not stand in the way of enforcement of financial reporting requirements or the exchange of relevant information between competent authorities of Member States.

Chapter V Independence (Articles 23 to 25)

The basic principle of auditor independence included in the Commission Recommendation on Auditor Independence is incorporated into Article 23. The Directive establishes the principle that a statutory auditor or an audit firm must be independent from the audited entity and shall in no way be involved in management decisions of the audited entity. This means that the auditor must not be able to accept any audit engagement which would endanger his independence. An auditor must also refuse any non-audit engagement which might compromise his independence as an auditor. The auditor must document all significant threats

to his independence as well as the safeguards applied to mitigate those treats. The ultimate safeguard is of course to resign from the audit or to not accept a non-audit service. As announced in its 2003 Communication, the Commission intends to organise a study in order to examine whether further measures are necessary that might lead to the total prohibition for an auditor to offer non-audited services to his audit client.

Following from the 2003 Commission Recommendation on Statutory Auditors' Independence in the EU, it is made clear that the fee for a statutory audit should be adequate to allow proper audit quality, that the fee cannot be based on any form of contingency and that the fee cannot be influenced by the provision of additional services to the audited entity. The respect of these principles, together with that of independence will be the subject of audit quality assurance reviews.

Chapter VI Auditing Standards and Audit Reporting (Articles 26 to 28)

As stated in the 2003 Communication, the Commission proposes that all statutory audits prescribed by Community law should be carried out in accordance with International Standards on Auditing (ISA). At present, ISAs (International Standards on Auditing) are established by the International Auditing and Assurance Standards Board (IAASB), a private organisation. In order to be able to endorse international standards on auditing, the Commission needs to examine whether the standards are accepted internationally and whether they have been developed with proper due process, public oversight and transparency. Furthermore, the standards must be of high quality and contribute to the annual accounts and the consolidated accounts showing a true and fair view. Finally, the standards must be conducive to the European public good. The Commission is reflecting on a final decision whether and to what extent to endorse ISAs. This will largely depend on satisfactory governance arrangements relating to the operation of the IAASB being established.

In order to avoid Member States from introducing new requirements or from imposing further audit requirements that go beyond the procedures provided under ISA's, Article 26 (3) indicates that Member States may only impose additional audit procedures if these follow from specific requirements relating to the scope of the statutory audit. In accordance with Article 28 (2), the Commission may adopt a common standard audit report for annual or consolidated accounts which have been prepared in accordance with adopted international accounting standards.

Article 27 introduces the principle that the group auditor bears full responsibility for the audit report in relation with the consolidated accounts. This principle implies that the group auditor needs to ensure that he maintains sufficient documentation of the review performed by another auditor or audit firm which audits part of the group and that he obtains copies of the audit documentation if that auditor or audit firm has not been approved in a Member State.

Chapter VII Quality Assurance (Article 29)

Article 29 introduces the requirement for all statutory auditors and audit firms to be subject to a system of quality assurance. The criteria to be applied for such a quality assurance system are those identified in the Commission's Recommendation of November 2000 on 'Quality Assurance for the Statutory Auditor in the EU'. A review of the implementation of this Recommendation in late 2003 has shown that all Member States have introduced systems on quality assurance, or are in the process of doing so. A legal underpinning of the principles of the Recommendation will ensure that Member States apply these principles. Article 29

strengthens the aspect of public oversight and independent funding and the follow up of the recommendations from quality reviews.

Chapter VIII Investigations and sanctions (Article 30)

Member States' systems of investigations and sanctioning still vary to a large extent. Article 30 sets up the general principle that Member States shall organise effective systems of investigation and effective and dissuasive sanctions, which may be civil, administrative or criminal. Member States' shall provide for appropriate disclosure to the public. Sanctions must include the withdrawal of approval of statutory auditors or audit firms.

Chapter IX Public oversight and regulatory arrangements between Member States (Articles 31 to 34)

Effective public oversight over the audit profession is a vital element in the maintenance and enhancement of confidence in the audit function. The current lack of confidence is partly based on a public perception that a self-regulating profession runs a serious risk of conflicts of interests in dealing with its shortcomings. Therefore, a credible element of public oversight over the audit profession is crucial.

Article 31 sets out principles of public oversight. The public oversight requirement will ensure that oversight has sufficient public integrity and independence. However, there is no blueprint on how to set up an effective public oversight mechanism. The common EU principles proposed on public oversight represent a minimum requirement for an adequate public oversight at Member State level.

Credible supervision of the audit profession requires a clear majority of non-practitioners to oversee the audit profession. For public interest entities, the oversight of auditors should be carried out exclusively by non-practitioners. Nonetheless, those who govern the public oversight system should be sufficiently knowledgeable about accounting and auditing. Recent corporate scandals have proven that swift and effective investigations by public oversight systems are needed to ensure the efficient functioning of the capital markets. Nonetheless basic requirements on adequate and transparent due process must be respected.

In the light of the emerging EU capital market there is a need for an EU co-ordination mechanism to bring together the national systems into a cohesive, efficient pan-European network. This should serve to encourage convergence of principles and practice. Article 33 establishes the principle that Member States shall recognise each other's oversight and regulatory systems. For the audit of consolidated accounts and for the purpose of listings in another Member States no further requirements beyond those in the home country may be imposed.

Article 34 sets out the rules for effective cooperation between Member States in investigations of audit firms.

Chapter X Appointment, dismissal and communication (Articles 35 to 37)

The procedures for appointment of the statutory auditor or audit firm shall ensure that the statutory auditor or audit firm is independent from those who prepare the financial statements of the audited entity. Some Member States require the involvement of the supervisory authorities, courts or other organisations designated by law (e.g. for cooperatives) in the appointment of the statutory auditor or audit firm. The Directive takes does not prejudice this.

With regard to the dismissal and resignation of auditors, the Directive introduces the principle that the statutory auditor or audit firm can only be dismissed if there is a significant reason why the statutory auditor cannot finalise the audit. The reasons for dismissal and resignation shall be disclosed to the responsible oversight authorities.

Effective communication between the statutory auditor/audit firm and the audited entity is of significant importance for high quality audits. It should lead to the audited entity drawing the necessary conclusions. Due to the different corporate governance structures, it is the responsibility of Member States to establish effective detailed rules in this regard. As a minimum, communication shall be recorded by the audited entity in order to allow independent directors of the entity to get an overview of the relationship with the statutory auditor/audit firm.

Chapter XI Special provisions for the statutory audit of public interest entities (Articles 38 to 43)

It is appropriate that more stringent requirement should govern the statutory audit of public interest entities. Article 38 requires the audit firms that carry out statutory audit(s) of public interest entities to provide a detailed report to the public that gives an insight into the audit firm and the network to which it belongs. The audit firm shall provide a governance statement, a description of the Internal Quality Control System and a statement on the effectiveness of its functioning by the administrative or management body. The report shall include the date of the last quality assurance review, policies on continuous education requirements and a break-down of fees.

The requirement to set up an audit committee in Article 39 will strengthen monitoring the financial reporting process and the statutory audit and help to prevent any possible undue influence of the executive management on the financial reporting of the audited entity. In order to fulfil its tasks effectively, the audit committee shall have at least one independent member who is competent in accounting and/or auditing.

An effective internal control system minimises financial, operational and compliance risks, and enhances the quality of financial reporting. Such a system requires the maintenance of appropriate policies and processes that ensure a prompt dissemination of reliable information and compliance with applicable laws and regulations, and safeguard the proper use of the company's assets. The function of the audit committee is to monitor that control activities are performed and communication and reporting processes are in place for breaches of internal control policies and applicable laws and regulations. This should by no means undermine the fact that the responsibility for the operation, review and disclosure of the internal control system lies with the board of directors collectively.

In order to enhance the quality of financial reporting, the statutory auditor or audit firm and the audit committee should cooperate in the fields of audit and of the financial reporting process. To this extent, the statutory auditor or audit firm should communicate on a timely basis with the audit committee on those matters of governance interest that arose from the audit of the financial statements. Such key matters may include information about the audit, significant changes in accounting policies, significant risks and exposures facing the company, material audit adjustments and uncertainties, disagreements with management, going concern issues, expected modifications to the auditor's report, fraud involving management, and material weaknesses in internal control in relation to the financial reporting process. Because internal control is fundamental to the quality of the external financial

reporting, the communication towards the audit committee should be emphasised through the requirement of a report on these material weaknesses in the Directive.

Article 40 gives the audit committee a central role in guarding auditor independence. Article 43 foresees that the audit committee shall assist in the nomination process for the statutory auditor or audit firm by selecting the statutory auditor or audit firm for the proposal for appointment to the general meeting of the audited entity.

Article 41 shortens quality review cycles to every three years.

Article 42 sets stricter requirements for public oversight by excluding any practitioner from the governance of public oversight systems.

Chapter XII International Aspects (Articles 44 to 47)

The measures proposed in this Directive will help to ensure high quality audits within the EU and hence underpin the confidence in the functioning of the EU capital market. This should not be undermined by possible poor audit quality from third country auditors who issue audit reports in relation to securities traded in the EU. Auditors and/or audit firms from third countries that issue audit reports in relation to securities traded in the EU, need to be registered in the EU on the basis of Article 45 and be subject to Member State systems of oversight, quality assurance and investigations and sanctions. The requirements of Article 45 warrant that only auditors or audit firms that meet quality criteria equivalent to this Directive can be registered.

In order to prevent unnecessary international regulatory overlap Article 46 allows for exemption from registration, oversight, quality assurance and investigations and sanctions if audit firms from third countries are subject to equivalent systems of registration and oversight. Exemption from the registration and oversight requirement is only possible if the third country audit firm is subject to an equivalent system of oversight as defined by articles 29, 30 and 31. Another important obligation is reciprocal treatment of Member States by the third country. To have a common EU assessment and, thus, secure equal treatment of third countries throughout the EU, the Commission will perform this assessment at EU level in cooperation with Member States.

The European capital market is strongly interrelated with other capital markets. As recent scandals have shown, the loss of confidence in the functioning in one market affects the trust in the functioning of the other market. It is therefore important that international regulators and supervisors co-operate on the basis of a true partnership and confidence. Several Articles of this Directive include appropriate requirements for registration, public oversight, quality assurance, investigations and sanctions on audit firms and could underpin reciprocal co-operative arrangements with third country regulators and supervisors.

These activities will include the need for access to audit working papers which, under a cooperative approach, will be possible if they are transferred by national competent authorities. Such a transfer requires reciprocal cooperation by the third country. Again, to have a common EU assessment and, thus, secure equal treatment of third countries throughout the EU, the Commission will perform this assessment at EU level in cooperation with Member States. As the exchange of audit working papers remains a sensitive matter for all parties involved, Article 47 imposes some additional requirements in comparison to the intra-EU cooperation in investigations as defined in Article 34. Namely, the purpose of the exchange shall be justified. The request shall respect professional secrecy requirements and

the working papers shall only be used for the oversight on auditors. In general, such requests shall not challenge the sovereignty, security and public policy of Member States or their judicial proceedings and shall conform with Community law.

Chapter XIII Transitional and final provisions (Articles 48 to 55)

Article 49 introduces a new audit regulatory committee composed of representatives of Member States and chaired by a representative of the Commission which will assist the Commission in establishing the implementing measures under the comitology procedures foreseen in this article. Without doubt, the technical expertise of the audit profession is needed to ensure high quality audit regulation. The new audit regulatory committee will have to consider how the audit profession can continue to provide its technical expertise in an effective and efficient manner in order to support the EU's regulatory activities.

Furthermore, Article 50 introduces changes to the 4th and 7th Council Directives by requiring audited companies to disclose fees paid to the statutory auditor or audit firm broken down by fees for audit services, other assurance services, tax services and other non-audit services.

Due to the repeal of the present 8th Council Directive in Article 51, Article 52 secures the approval of statutory auditors and audit firms approved under the repealed Directive.

Proposal for a

DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

on statutory audit of annual accounts and consolidated accounts and amending Council Directives 78/660/EEC and 83/349/EEC

(Text with EEA relevance)

THE EUROPEAN PARLIAMENT AND THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 44(2) (g) thereof,

Having regard to the proposal from the Commission¹,

Having regard to the opinion of the European Economic and Social Committee²,

Acting in accordance with the procedure laid down in Article 251 of the Treaty³,

Whereas:

- (1) Currently, the Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54(3)(g) of the Treaty on the annual accounts of certain types of companies⁴, the Seventh Council Directive 83/349/EEC of 13 June 1983 based on Article 54(3)(g) of the Treaty on consolidated accounts⁵, Council Directive 86/635/EEC of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions⁶ and Council Directive 91/674/EEC of 19 December 1991 on the annual accounts and consolidated accounts of insurance undertakings⁷ require that the annual accounts or consolidated accounts are audited by one or more persons entitled to carry out such audits.
- (2) The conditions for the approval of persons responsible for carrying out the statutory audit have been laid down in the Eighth Council Directive 84/253/EEC of 10 April 1984 based on Article 54(3)(g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents⁸.

¹ OJ C [...], [...], p. [...].

² OJ C [...], [...], p. [...].

³ OJ C [...], [...], p. [...].

⁴ OJ L 222, 14.8.1978, p. 11; Directive as last amended by Directive 2003/51/EC of the European Parliament and of the Council (OJ L 178, 17.7.2003, p. 16).

⁵ OJ L 193, 18.7.1983, p. 1, Directive as last amended by Directive 2003/51/EC.

⁶ OJ L 372, 31.12.1986, p. 1; Directive as last amended by Directive 2003/51/EC.

⁷ OJ L 374, 31.12.1991, p. 7; as amended by Directive 2003/51/EC.

⁸ OJ L 126, 12.5.1984, p. 20.

- (3) The lack of a harmonised approach to statutory auditing in the Community was the reason why the Commission proposed in its 1998 Communication on ‘The Statutory Audit in the European Union, the way forward’⁹ the creation of a Committee on Auditing which could develop further action in close cooperation between the accounting profession and Member States.
- (4) On the basis of the work of this Committee, the Commission issued a Recommendation on ‘Quality Assurance for the Statutory Auditor in the EU’¹⁰ in November 2000 and a Recommendation on ‘Statutory Auditors’ Independence in the EU’ in May 2002¹¹. Both these Recommendations are being implemented by Member States.
- (5) Audit qualifications obtained by statutory auditors on the basis of this Directive are considered equivalent. It should therefore no longer be possible for Member States to insist that a majority of the voting rights in an audit firm must be held by locally approved auditors or that a majority of the members of the administrative or management body of an audit firm must be locally approved.
- (6) The statutory audit requires adequate knowledge of matters such as company law, fiscal law and social law. Such knowledge should be tested before a statutory auditor from another Member State can be approved.
- (7) In order to protect third parties, all approved auditors and audit firms should be registered in a register which is accessible to the public and which contains basic information about the statutory auditor or the audit firm.
- (8) Statutory auditors should adhere to the highest ethical standards. They should therefore be subject to professional ethics.
- (9) It is important that statutory auditors and audit firms respect the privacy of their clients. They should therefore be bound by strict rules on confidentiality and professional secrecy which, however, should not impede proper enforcement of accounting standards.
- (10) Statutory auditors and audit firms should be independent when carrying out a statutory audit. If they find themselves in a situation that might lead to an impairment of their independence, they should resign from the audit engagement. They should also refuse to undertake any non-audit service that might constitute a threat to their independence.
- (11) It is important to ensure a consistent high quality of all statutory audits required by Community law. All statutory audits should therefore be carried out on the basis of international auditing standards. Member States should only be allowed to impose additional audit procedures if these follow from specific requirements relating to the scope of the statutory audit.

⁹ OJ C 143, 8.5.1998, p. 12

¹⁰ OJ L 91, 31.3.2001, p. 91

¹¹ OJ L 191, 19.7.2002, p. 22

- (12) To adopt an international auditing standard for application in the Community, it is necessary that it is generally accepted internationally and that it has been developed with full participation of all interested parties following an open and transparent procedure, that it adds to the credibility of annual accounts and consolidated accounts and that it is conducive to the European public good.
- (13) In the case of consolidated accounts, it is important that there is a clear definition of responsibilities between the statutory auditors who audit components of the group. This can best be assured when the group auditor bears full responsibility for the audit report.
- (14) In order to increase comparability between companies applying the same accounting standards, the Commission should be able to adopt a common audit report for the audit of annual accounts or consolidated accounts prepared on the basis of approved international accounting standards.
- (15) Regular inspections are a good means to achieve a consistent high quality of statutory audits. Statutory auditors and audit firms should therefore be subject to a system of quality assurance that is organised in a manner which is independent from the reviewed statutory auditors and audit firms.
- (16) Investigations and appropriate sanctions contribute to preventing and correcting inadequate execution of a statutory audit.
- (17) Member States should organise an effective system of public oversight for statutory auditors and audit firms on the basis of home country control. The regulatory arrangements for public oversight should enable an effective co-operation at Community level between oversight activities of Member States. Competent authorities of Member States should co-operate with each other whenever necessary for the purpose of carrying out their oversight duties on statutory auditors or audit firms approved by them. Such co-operation can make an important contribution to ensuring a consistent high quality of the statutory audit in the Community.
- (18) The statutory auditor or audit firm should be appointed by the general meeting of shareholders of the audited entity. In order to protect the independence of the auditor it is important that dismissal is only possible where there are proper grounds and if these grounds are communicated to the authority or authorities responsible for public oversight.
- (19) Public interest entities have a higher visibility and are economically more important, stricter requirements should apply in the case of a statutory audit of their annual or consolidated accounts.
- (20) Audit committees and effective internal control system contribute to minimise financial, operational and compliance risks, and enhance the quality of financial reporting.
- (21) The interrelation of capital markets emphasises the need to ensure also high quality work performed by auditors from third countries in relation with the Community capital market. The auditors concerned should therefore be registered so as to make them subject to quality assurance reviews and to the system of investigations and sanctions. Derogations on the basis of reciprocity should be possible subject to an

equivalence testing to be performed by the Commission in co-operation with Member States.

- (22) The complexity of international group audits requires a good co-operation between the competent authorities of Member States and those of third countries. Member States should therefore ensure that access to audit working papers and other documents to competent authorities of third countries is made possible through the national competent authorities. In order to protect the rights of the parties concerned and at the same time facilitate the access to these papers and documents, Member States should be allowed to grant direct access to the competent authorities of third countries subject to the agreement of the national competent authority.
- (23) The measures necessary for the implementation of this Directive should be adopted in accordance with Council Decision 1999/468/EC of 1999 laying down the procedures for the exercise of implementing powers conferred to the Commission and with due regard to the declaration made by the Commission in the European Parliament on 5 February 2002 concerning the implementation of financial services legislation. For that purpose a committee which assists the Commission shall be set up.
- (24) Since the measures necessary for the implementation of this Directive are measures of general scope within the meaning of Article 2 of the Council Decision 1999/468/EC, they should be adopted by use of the regulatory procedure provided for in Article 5 of that Decision.
- (25) In accordance with the principles of subsidiarity and proportionality as set out in Article 5 of the Treaty, the measures provided for in this Directive, in requiring the application of a single set of international auditing standards, the update of the educational requirements, the definition of professional ethics, and the technical implementation of the co-operation between competent authorities of Member States and between those authorities and the authorities of third countries, are necessary to achieve the objectives of further enhancing and harmonising the quality of statutory audit in the Community and facilitating cooperation between Member States and with third countries in order to strengthen confidence in the statutory audit.
- (26) With a view to provide more transparency on the relationship between the statutory auditor or audit firm and the audited entity, Directives 78/660/EEC and 83/349/EEC should be amended so as to require the disclosure of the audit fee and the fee paid for non-audit services in the notes to the annual accounts and the consolidated accounts.
- (27) Council Directive 84/253/EEC should be repealed because it lacks a comprehensive set of elements for ensuring an appropriate audit infrastructure, such as public oversight, disciplinary systems and systems of quality assurance and because it does not provide specific rules concerning regulatory co-operation between Member States and third countries. In order to ensure legal certainty it is however necessary that it is clearly indicated that statutory auditors and audit firms that have been approved under Directive 84/253/EEC are considered as approved under this Directive.

HAVE ADOPTED THIS DIRECTIVE:

Chapter I

Subject matter and Definitions

Article 1 *Subject matter*

This Directive establishes rules concerning the statutory audit of annual and consolidated accounts in so far as such audits are required by Community law.

Article 2 *Definitions*

For the purpose of this Directive, the following definitions shall apply:

- (1) "Statutory audit" means an audit of annual accounts or consolidated accounts in so far as required by Community law and carried out in accordance with the provisions of this Directive;
- (2) "Statutory auditor" means a natural person who is approved in accordance with the provisions of this Directive by the competent authorities of a Member State to carry out statutory audits;
- (3) "Audit firm" means an entity that is approved in accordance with the provisions of this Directive by the competent authorities of a Member State to carry out statutory audits regardless of its legal form;
- (4) "Group auditor" means the statutory auditor or audit firm that carries out the statutory audit of the consolidated accounts;
- (5) "Network" means the larger structure to which a statutory auditor or an audit firm belongs and which makes use of a common brand-name or through which professional resources are shared;
- (6) "Affiliate of an audit firm" means any undertaking, regardless of its legal form, which is connected to the audit firm by means of common ownership, control or management;
- (7) "Audit report" means the report referred to in Article 51 (a) of Directive 78/660/EEC and Article 37 of Directive 83/349/EEC issued by the statutory auditor or audit firm.
- (8) "Competent authorities" means authorities or bodies designated by law that are responsible for the regulation and supervision of statutory auditors and audit firms;
- (9) "International auditing standards" means International Standards on Auditing (ISA) and related International Audit Practice Statements, in so far as relevant to the statutory audit;

- (10) "International accounting standards" means International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) and related Interpretations (SIC-IFRIC interpretations), subsequent amendments to those standards and related interpretations, future standards and related interpretations issued or adopted by the International Accounting Standards Board (IASB);
- (11) "Public interest entities" means entities that are of significant public relevance because of the nature of their business, their size or their number of employees, in particular companies governed by the law of a Member State whose securities are admitted to trading on a regulated market of any Member State within the meaning of Article 1(13) of Council Directive 93/22/EEC¹², banks and other financial institutions and insurance undertakings.

Chapter II

Approval, Continuous Education and Mutual Recognition

Article 3

Approval of statutory auditors and audit firms

1. Each Member State shall designate competent authorities which are responsible for approving statutory auditors and audit firms.

The competent authorities may be professional associations provided that they are subject to public oversight as referred to in Articles 31 and 42.

2. Statutory audits shall be carried out only by statutory auditors or audit firms which are approved by the Member State where the statutory audit is carried out.
3. The competent authorities of the Member States shall approve as statutory auditors natural persons who satisfy at least the conditions laid down in Articles 4 to 10.

They shall approve as audit firms only those entities which satisfy the following conditions:

- (a) the natural persons who carry out statutory audits on behalf of the audit firm must at least satisfy the conditions imposed in Articles 4 to 10 and must be approved as statutory auditors in the Member State of the audit firm;
- (b) the majority of the voting rights must be held by statutory auditors or audit firms which are approved in a Member State;
- (c) the majority of the members of the administrative or management body of the audit firm must be statutory auditors or audit firms that are approved in any Member State. Where such a body has no more than two members, one of those members must be a statutory auditor or an audit firm approved in any Member State.

¹² OJ L 141, 11.6.1993, p. 27

Article 4
Good repute

The competent authorities of a Member State shall grant approval only to natural persons or firms of good repute who are not engaging in any activity which is incompatible with the statutory audit function.

Article 5
Withdrawal of approval

1. Approval of a statutory auditor or an audit firm shall be withdrawn if the good repute of that person or firm has been seriously compromised.
2. Approval of an audit firm shall be withdrawn if any of the conditions imposed in Article 3 is no longer fulfilled. Member States may, however, provide for a period of grace of not more than six months for the purpose of meeting those requirements.

Article 6
Educational qualifications

A natural person may be approved to carry out a statutory audit only after having attained university entrance level, then completed a course of theoretical instruction, undergone practical training and passed an examination of professional competence of university final examination level, organized or recognized by the State.

Article 7
Examination of professional competence

The examination of professional competence referred to in Article 6 shall guarantee the necessary level of theoretical knowledge of subjects relevant to statutory audit and the ability to apply such knowledge in practice. Part at least of that examination must be written.

Article 8
Test of theoretical knowledge

1. The test of theoretical knowledge included in the examination shall cover the following subjects in particular:
 - (a) general accounting theory and principles,
 - (b) legal requirements and standards relating to the preparation of annual and consolidated accounts,
 - (c) international accounting standards,
 - (d) financial analysis,
 - (e) cost and management accounting,

- (f) risk management and internal control,
 - (g) auditing,
 - (h) legal requirements and professional standards relating to statutory audit and statutory auditors,
 - (i) international auditing standards,
 - (j) professional skills,
 - (k) professional ethics and independence.
2. It shall also cover the following subjects in so far as they are relevant to auditing:
- (a) company law and corporate governance,
 - (b) the law of insolvency and similar procedures,
 - (c) tax law,
 - (d) civil and commercial law,
 - (e) social-security law and law of employment,
 - (f) information technology and computer systems,
 - (g) business, general and financial economics,
 - (h) mathematics and statistics,
 - (i) basic principles of the financial management of undertakings.
3. The Commission may in accordance with the procedure referred to in Article 49 (2) adapt the list of subjects to be included in the test of theoretical knowledge referred to in paragraph 1.

Article 9
Exemptions

1. By way of derogation from Articles 7 and 8, a Member State may provide that a person who has passed a university or equivalent examination or holds a university degree or equivalent qualification in one or more of the subjects referred to in Article 8 may be exempted from the test of theoretical knowledge in the subjects covered by that examination or degree.
2. By way of derogation from Article 7, a Member State may provide that a holder of a university degree or equivalent qualification in one or more of the subjects referred to in Article 8 may be exempted from the test of the ability to apply in practice his theoretical knowledge of such subjects if he has received practical training in them attested by an examination or diploma recognized by the State.

Article 10
Practical training

1. In order to ensure the ability to apply theoretical knowledge in practice, a test of which is included in the examination, a trainee shall complete a minimum of three years' practical training in inter alia the auditing of annual accounts, consolidated accounts or similar financial statements. At least two-thirds of such practical training shall be completed with a statutory auditor or audit firm approved in any Member State.
2. Member States shall ensure that all training is carried out with persons providing adequate guarantees regarding training.

Article 11
Qualification through long term practical experience

Member States may approve a person who does not satisfy the conditions laid down in Article 6 as a statutory auditor, if he can show either:

- (a) that he has, for 15 years, engaged in professional activities which have enabled him to acquire sufficient experience in the fields of finance, law and accountancy and has passed the examination of professional competence referred to in Article 6, or
- (b) that he has, for seven years, engaged in professional activities in those fields and has, in addition, undergone the practical training referred to in Article 10 and passed the examination of professional competence referred to in Article 6.

Article 12
Combination of practical training and theoretical instruction

1. Member States may provide that periods of theoretical instruction in the fields referred to in Article 8 count towards the period of professional activity referred to in Article 11, provided that such instruction is attested by an examination recognized by the State. Such instruction must last not less than one year, nor may it reduce the period of professional activity by more than four years.
2. The period of professional activity as well as the practical training must not be shorter than the course of theoretical instruction and the practical training required in Article 6.

Article 13
Continuous education

Member States shall ensure that statutory auditors are subject to appropriate programmes of continuous education in order to maintain sufficient theoretical knowledge, professional skills and values, and that failure to respect the continuous education requirements is subject to appropriate sanctions as referred to in Article 30.

Article 14
Approval of statutory auditors from other Member States

The competent authorities of the Member States shall establish procedures for the approval of statutory auditors which have been approved in other Member States. These procedures shall not go beyond a requirement to pass an aptitude test in accordance with Article 4 of Council Directive 89/48/EEC¹³. The aptitude test shall only cover the statutory auditor's adequate knowledge of the laws and regulations of the Member State concerned in so far as relevant for the statutory audit.

Chapter III

Registration

Article 15
Public register

1. Member States shall ensure that statutory auditors and audit firms which have been approved are registered in a public register in accordance with Articles 16 and 17.
2. Member States shall ensure that each statutory auditor and audit firm is identified in the public register by an individual number. Registration information shall be entered and kept in the register in electronic form and shall be electronically accessible by the public.
3. The public register shall also contain the name and address of the competent authorities in charge of quality assurance as referred to in Article 29, investigations and sanctions on statutory auditors and audit firms as referred to in Article 30, and public oversight as referred to in Article 31.
4. Member States shall ensure that the public register referred to in paragraph 1 of this Article is fully operational not later than one year after the date referred to in Article 53(1).

Article 16
Registration of statutory auditors

As regards statutory auditors, the public register shall, at least, contain the following information:

- (a) name, address and registration number;
- (b) if applicable, the name and address of the audit firm by which the statutory auditor is employed, or with whom he is associated as a partner or otherwise.

¹³ OJ L 19, 24.1.1989, p. 16.

Article 17
Registration of audit firms

As regards audit firms, the public register shall, at least, contain the following information:

- (a) name, address and registration number;
- (b) legal form;
- (c) contact information, the primary contact person and, where applicable, the website address;
- (d) address of each office in the Member State;
- (e) name and registration number of all statutory auditors employed by or associated as partner or otherwise with the audit firm;
- (f) names and business addresses of all owners and shareholders;
- (g) names and business addresses of all members of the administrative or management body;
- (h) if applicable, the membership of a network and a list of the names and addresses of member firms and affiliates or an indication of the place where such information is publicly available.

Article 18
Update of registration information

Member States shall ensure that statutory auditors and audit firms notify without undue delay the competent authorities in charge of the public register about any change of information contained in the public register. The register shall be updated without undue delay after notification.

Article 19
Responsibility for registration information

The information entered into the public register in accordance with Articles 16 and 17 shall be signed by the statutory auditor or audit firm. This can be done by means of an electronic signature within the meaning of Article 2 (2) of Directive 1999/93/EC of the European Parliament and of the Council¹⁴.

Article 20
Language

1. The information entered into the public register shall be drawn up in one of the languages permitted by the language rules applicable in the Member State.

¹⁴ OJ L 13, 19.1.2000, p. 12.

2. Member States may allow the information to be entered into the public register additionally in any other official language(s) of the Community. Member States may require the translation of the information to be certified.

In all cases, the Member State shall ensure that the register indicates whether the translation is certified or not.

Chapter IV

Professional ethics and professional secrecy

Article 21

Professional ethics

1. Member States shall ensure that all statutory auditors and audit firms are subject to principles of professional ethics which at least cover the overall responsibility of the statutory auditor or audit firm towards the public, their integrity and objectivity, and their professional competence and due care.
2. The Commission may adopt implementing measures on professional ethics, in accordance with the procedure referred to in Article 49 (2).

Article 22

Confidentiality and professional secrecy

1. Member States shall ensure that all information and documents to which the statutory auditor or audit firm has access when carrying out a statutory audit are protected by adequate rules on confidentiality and professional secrecy.
2. Confidentiality and professional secrecy rules relating to statutory auditors or audit firms shall not impede enforcement of the application of accounting standards by national competent authorities or the exchange of relevant information with other auditors or the competent authorities of other Member States as referred to in Article 34, in case of international group audits.

Chapter V

Independence

Article 23

Independence and objectivity

1. Member States shall ensure that when carrying out a statutory audit, a statutory auditor or the audit firm is independent from the audited entity and is not in any way involved in management decisions of the audited entity. A statutory auditor or an audit firm shall not carry out a statutory audit if there is any financial, business, employment or other relationship, including the provision of additional services, with the audited entity that might compromise the statutory auditor's or audit firm's independence.

2. Member States shall ensure that the statutory auditor or audit firm documents in the audit working papers all threats to their independence as well as the safeguards applied to mitigate those threats.

Article 24

Independence and objectivity of the statutory auditors carrying out the statutory audit on behalf of audit firms

Member States shall ensure that the owners or shareholders of an audit firm as well as the members of the administrative, management and supervisory bodies of such a firm, or an affiliated firm do not intervene in the execution of a statutory audit in any way which jeopardizes the independence and objectivity of the statutory auditor who carries out the statutory audit on behalf of the audit firm.

Article 25

Audit fees

Member States shall ensure that adequate rules are in place which provide that fees for statutory audits:

- (a) are adequate to allow proper audit quality;
- (b) are not influenced or determined by the provision of additional services to the audited entity;
- (c) cannot be based on any form of contingency.

Chapter VI

Auditing Standards and Audit Reporting

Article 26

Auditing standards

1. Member States shall require statutory auditors and audit firms to carry out statutory audits in accordance with international auditing standards adopted by the Commission in accordance with the procedure referred to in Article 49 (2).
2. The Commission shall adopt international auditing standards for application in the Community only if they:
 - (a) are generally accepted internationally and are developed with proper due process, public oversight and transparency;
 - (b) provide a high level of credibility to the annual or consolidated accounts in conformity with the principles set out in Article 2 (3) of Directive 78/660/EEC and in Article 16 (3) of Directive 83/349/EEC;
 - (c) are conducive to the European public good

3. Member States may only impose additional audit procedures if these follow from specific requirements relating to the scope of the statutory audit. Member States shall communicate these additional procedures to the Commission.

Article 27
Statutory audit of consolidated accounts

Member States shall ensure that in the case of a statutory audit of consolidated accounts of a group of undertakings:

- (a) the group auditor bears the full responsibility for the audit report in relation with the consolidated accounts;
- (b) when a component of the group is audited by a statutory auditor or audit firm approved in a Member State other than that of the group auditor, the group auditor maintains documentation of his review of the audit work performed by the other statutory auditor or audit firm;
- (c) when a component of the group is audited by an auditor or audit firm that is not approved in a Member State, the group auditor retains a copy of the documentation of the audit work performed by the other auditor or audit firm, including a copy of the audit working papers, solely for the purpose of the group audit.

Article 28
Audit reporting

1. Where an audit firm carries out the statutory audit, the audit report shall be signed by the statutory auditor(s) carrying out the statutory audit on behalf of the audit firm.
2. The Commission may, in accordance with the procedure referred to in Article 49 (2) adopt a common standard audit report for annual or consolidated accounts which have been prepared in accordance with approved international accounting standards.

Chapter VII

Quality Assurance

Article 29
Quality Assurance Systems

1. Member States shall ensure that all statutory auditors and audit firms are subject to a system of quality assurance which meets at least the following criteria:
 - a) the quality assurance system must be organised in a manner that it is independent from the reviewed statutory auditors and audit firms and subject to public oversight as described in Chapter IX;
 - b) the funding for the quality assurance system must be secure and free from any possible undue influence by statutory auditors or audit firms;

- (c) the quality assurance system must have adequate resources;
- (d) persons who carry out the quality assurance reviews must have appropriate professional education and relevant experience in statutory audit and financial reporting combined with specific training on quality assurance reviews;
- (e) the selection of reviewers for specific quality assurance review assignments must be made under an objective procedure so as to ensure that there are no conflicts of interest between the reviewers and the statutory auditor or audit firm under review;
- (f) the scope of the quality assurance review must include an assessment of the internal quality control system of the audit firm supported by adequate testing of selected audit files on whether they comply with applicable auditing standards and independence requirements;
- (g) the quality assurance review must result in the establishment of a report which contains the main conclusions of the quality assurance review;
- (h) quality assurance reviews must take place at least every six years;
- (i) the overall results of the quality assurance system must be published annually;
- (j) recommendations of quality reviews shall be followed up by the statutory auditor or audit firm within a reasonable period.

In case the recommendations referred to in point j) of the first subparagraph are not followed up, the statutory auditor or audit firm shall be subject to disciplinary actions or sanctions as referred to in Article 30.

2. The Commission may adopt, in accordance with the procedure referred to in Article 49 (2), implementing measures on systems of quality assurance.

Chapter VIII

Investigations and sanctions

Article 30

Systems of investigations and sanctions

1. Member States shall ensure that there are effective systems of investigations and sanctions to detect, correct and prevent inadequate execution of the statutory audit.
2. Without prejudice to Member States' civil liability regimes, Member States shall provide effective, proportionate and dissuasive civil, administrative or criminal penalties in respect of statutory auditors and audit firms, where statutory audits are not carried out in conformity with this Directive.
3. Member States shall provide that every measure taken or sanction imposed on statutory auditors and audit firms is appropriately disclosed to the public. Sanctions should include the possibility to withdraw the approval of statutory auditors and of audit firms.

Chapter IX

Public oversight and regulatory arrangements between Member States

Article 31

Principles of public oversight

1. Member States shall organise an effective system of public oversight for statutory auditors and audit firms based on principles set out in paragraphs 2 to 7.
2. All statutory auditors and audit firms must be subject to public oversight.
3. The system of public oversight must be governed by non-practitioners who are knowledgeable in the areas relevant to statutory audit. Member States may however allow a minority of practitioners to be involved in the governance of the public oversight system. Persons involved in public oversight must be selected under an independent and transparent nomination procedure.
4. The system of public oversight must have the ultimate responsibility for the oversight of :
 - (a) the approval and registration of statutory auditors and audit firms, and
 - (b) the adoption of standards on ethics, internal quality control of audit firms and auditing, and
 - (c) continuous education, quality assurance and investigative and disciplinary systems.
5. The system of public oversight must have the right, where necessary, to conduct investigations on statutory auditors and audit firms and must have the right to take appropriate action.
6. The system of public oversight must be transparent. This shall include the publication of annual work programmes and activity reports.
7. The system of public oversight must be adequately funded. The funding for the public oversight system must be secure and free from any possible undue influence by statutory auditors or audit firms.

Article 32

Cooperation between public oversight systems at Community level

Member States shall ensure that regulatory arrangements for systems of public oversight enable effective cooperation at Community level between oversight activities of Member States. To that extent, Member States shall make one entity specifically responsible for ensuring the co-operation. Such cooperation shall include the possibility for a review of the system of public oversight of each Member State by other Member States.

Article 33

Mutual recognition of regulatory arrangements between Member States

1. Regulatory arrangements of Member States shall respect the principle of home country regulation and oversight by the Member State in which the statutory auditor or audit firm is approved and the audited entity has its registered office.
2. In the case of a statutory audit of consolidated accounts, the Member State requiring the statutory audit of the consolidated accounts, may not impose additional requirements in relation to the statutory audit concerning registration, quality assurance review, auditing standards, ethics and independence on a statutory auditor or audit firm carrying out a statutory audit of a subsidiary established in another Member State.
3. In the case of a company whose securities are traded on a regulated market in another Member State than where the company has its registered office, the Member State where the securities are traded may not impose any additional requirements in relation to the statutory audit concerning registration, quality assurance review, auditing standards, ethics and independence on a statutory auditor or audit firm carrying out the statutory audit of the annual or consolidated accounts of the company.

Article 34

Regulatory co-operation between Member States in investigations

1. Competent authorities of Member States shall co-operate with each other whenever necessary for the purpose of carrying out their duties of oversight regarding statutory auditors or audit firms approved by them. Competent authorities shall render assistance to competent authorities of other Member States. In particular, they shall exchange information and co-operate in investigation activities with regard to statutory audits.
2. Competent authorities shall, on request, immediately supply any information required for the purpose referred to in paragraph 1. Where necessary, the competent authorities receiving any such request shall immediately take the necessary measures in order to gather the required information. If the requested competent authority is not able to supply the required information immediately it shall notify the requesting Competent Authority of the reasons. Information thus supplied shall be covered by the obligation of professional secrecy to which the persons employed or formerly employed by the competent authorities that received the information are subject.

The competent authorities may refuse to act on a request for information where:

- (a) communication might adversely affect the sovereignty, security or public order of the State addressed,
- (b) judicial proceedings have already been initiated in respect of the same actions and against the same statutory auditors and audit firms before the authorities of the State addressed, or
- (c) where final judgement has already been passed on such persons for the same actions by the competent authorities of the State addressed.

Without prejudice to the obligations to which they are subject in judicial proceedings under criminal law, the authorities which receive information pursuant to paragraph 1 may use it only for the exercise of their functions within the scope of this Directive and in the context of administrative or judicial proceedings specifically related to the exercise of those functions.

3. Where a competent authority is convinced that activities contrary to the provisions of this Directive are being or have been carried out on the territory of another Member State, it shall communicate and notify this in as specific a manner as possible to the competent authority of the other Member State. The competent authority of the other Member State shall take appropriate action. It shall inform the notifying competent authority of the outcome and, to the extent possible, of significant interim developments.
4. A competent authority of one Member State may also request that an investigation be carried out by the competent authority of another Member State, on the latter's territory.

It may further request that some of its own personnel be allowed to accompany the personnel of the competent authority of that other Member State during the course of the investigation.

The investigation shall be subject throughout to the overall control of the Member State on whose territory it is conducted.

The competent authorities may refuse to act on a request for carrying out an investigation as provided for in the first subparagraph, or on a request for its personnel to be accompanied by another Member State competent authority personnel as provided for in the second subparagraph, where such an investigation might adversely affect the sovereignty, security or public order of the State addressed, or where judicial proceedings have already been initiated in respect of the same actions and against the same persons before the authorities of the State addressed or where final judgement has already been passed on such persons for the same actions by the competent authorities of the State addressed.

5. The Commission may adopt, in accordance with the procedure referred to in Article 49 (2), implementing measures on the procedures of exchange of information and modalities for cross-border investigations provided for in paragraphs 2 to 4.

Chapter X

Appointment, dismissal and communication

Article 35

Appointment of statutory auditors or audit firms

The statutory auditor or audit firm shall be appointed by the general meeting of shareholders of the audited entity. In accordance with national law, Member States may provide that such appointment is subject to prior approval by a competent supervisory authority or that the appointment is made by a court or another organisation designated by national law.

Article 36

Dismissal and resignation of statutory auditors or audit firms

1. Member States shall ensure that statutory auditors or audit firms may only be dismissed where there are proper grounds; divergence of opinions on accounting treatments or audit procedures shall not be a proper ground for dismissal.
2. Both the audited entity and the statutory auditor or audit firm shall inform the authority or authorities responsible for public oversight about the dismissal or resignation and shall give an adequate explanation of the reasons thereof.

Article 37

Communication between the audited entity and the statutory auditor or audit firm

Member States shall ensure that adequate rules are in place which provide for an effective communication between the statutory auditor or audit firm and the audited entity and that such communication is properly recorded by the audited entity.

Chapter XI

Special provisions for the statutory audit of public interest entities

Article 38

Transparency report

1. Member States shall ensure that audit firms that carry out statutory audit(s) of public interest entities publish on their website an annual transparency report that includes at least the following :
 - (a) a description of the legal structure and ownership;
 - (b) where the audit firm belongs to a network, a description of the network and the legal and structural arrangements in the network;
 - (c) a statement on the governance structure of the audit firm;
 - (d) a description of the internal quality control system of the audit firm and a statement by the administrative or management body on the effectiveness of its functioning;
 - (e) an indication of when the last quality assurance review took place;
 - (f) a listing of public interest entities for which a statutory audit has been carried out during the last year by the audit firm;
 - (g) a statement about the audit firm's independence practices which also confirms that an internal review of independence compliance has been conducted;
 - (h) a statement on the policy followed by the audit firm concerning continuous education of statutory auditors referred to in Article 13;

- (i) financial information showing the importance of the audit firm such as the total turnover divided into fees from the statutory audit of annual and consolidated accounts, and fees charged for other assurance services, tax advisory services and other non-audit services;
 - (j) information about the basis for the partner remuneration.
2. The transparency report shall be signed by the audit firm. This can be done by means of an electronic signature within the meaning of Article 2 (2) of Directive 1999/93/EC of the European Parliament and of the Council.

Article 39
Audit committee

1. Public interest entities shall have an audit committee, composed of non-executive members of the administrative body or members of the supervisory body of the audited entity with at least, one independent member with competence in accounting and/or auditing.
2. The audit committee shall inter alia:
- (a) monitor the financial reporting process;
 - (b) monitor the effectiveness of the company's internal control, internal audit where applicable, and risk management systems;
 - (c) oversee the statutory audit of the annual and consolidated accounts;
 - (d) review and monitor the independence of the statutory auditor or audit firm and in particular the provision of additional services to the audited entity;
 - (e) perform the function set out in article 43.
3. The statutory auditor or audit firm must report to the audit committee on key matters arising from the statutory audit, in particular on material weaknesses in internal control in relation to the financial reporting process, and shall assist the audit committee in fulfilling its tasks.

Article 40
Independence

In addition to the provisions laid down in Articles 23 and 24 Member States shall ensure that:

- (a) the statutory auditor or audit firm shall annually disclose to and discuss with the audit committee of the audited entity threats to their independence and the safeguards applied to mitigate those threats, as well as the additional services provided;
- (b) the statutory auditor or audit firm shall also annually confirm in writing their independence to the audit committee of the audited entity;

- (c) the statutory auditor or the key audit partner responsible for carrying out the statutory audit on behalf of the audit firm, shall rotate from the statutory audit engagement within a maximum period of five years, or alternatively, the audit firm shall rotate within a maximum period of seven years;
- (d) the statutory auditor or the key audit partner who carries out the statutory audit on behalf of the audit firm shall not be allowed to take up a key management position in the audited entity before a period of at least two years has elapsed since he resigned as a statutory auditor or key audit partner from the audit engagement.

Article 41
Quality Assurance

The quality review referred to in Article 29 must be carried out at least every three years for statutory auditors or audit firms that carry out statutory audits of public interest entities.

Article 42
Public oversight

The option provided for in Article 31 (3), to allow a minority of practitioners to participate in the governance of the system of public oversight, shall not apply to the governance of the public oversight system concerning statutory auditors and audit firms that carry out statutory audits on public interest entities.

Article 43
Appointment of the statutory auditor or audit firm

In public interest entities, the proposal of the administrative body or supervisory board for the appointment of a statutory auditor or audit firm shall be based on a selection made by the audit committee.

Chapter XII

International aspects

Article 44
Approval of auditors from third countries

On the condition of reciprocity, the competent authorities of a Member State may approve, auditors from a third country as statutory auditor if the person has furnished proof of:

- (a) being approved as an auditor;
- (b) theoretical knowledge, practical skills and integrity equivalent to the provisions of this Directive;

- (c) legal knowledge relevant in that Member State in so far as relevant for the statutory audit in the Member State.

Article 45

Registration of auditors and audit firms from third countries

1. The competent authorities of a Member State shall register in accordance with Articles 15 to 17 all auditors and audit firms from third countries which provide an audit report concerning:
 - (a) the annual or consolidated accounts of a company established outside the Community whose securities are admitted to trading on a regulated market of that Member State within the meaning of point 13 of Article 1 of Directive 93/22/EEC ;
 - (b) the consolidated accounts of a larger body of undertakings drawn up by a parent undertaking not governed by the law of a Member State, to which the parent undertaking, governed by the law of the Member State belongs, when the latter is exempted from drawing up consolidated accounts on the basis of Article 11 of Directive 83/349/EEC.
2. Article 18 shall apply.
3. Member States shall subject registered audit firms from third countries to their system of oversight, their quality assurance system and their systems of investigations and sanctions.
4. Without prejudice to Article 46, audit reports concerning annual accounts or consolidated accounts referred to in paragraph 1 issued by audit firms from third countries that are not registered in the Member State shall not have legal effect in that Member State.
5. Member States may only register audit firms from third countries, if:
 - (a) they meet requirements which are equivalent to those of the second subparagraph of Article 3(3);
 - (b) the majority of the members of the administrative or management body of the audit firm meet requirements which are equivalent to those of Articles 4 to 10;
 - (c) the auditor carrying out the audit on behalf of the audit firm meets the requirements which are equivalent to those of Articles 4 to 10;
 - (d) the audits of the annual or consolidated accounts referred to in paragraph 1, are carried out in accordance with international auditing standards as referred to in Article 26, as well as the requirements laid down in Chapter V;
 - (e) they publish on their website an annual transparency report which includes the information referred to in Article 38.

Article 46
Derogation in the case of equivalence

Member States may disapply or modify the requirements in Article 45 (1) and (3) on the basis of reciprocity only if these audit firms are subject to systems of public oversight, quality assurance and investigations and sanctions in the third country that meet requirements equivalent to those of Articles 29, 30 and 31. The equivalence shall be assessed by the Commission in co-operation with Member States and shall be decided upon by the Commission in accordance with the procedure referred to in Article 49 (2).

Article 47
Cooperation with competent authorities from third countries

1. Member States may allow the transfer to the competent authorities of a third country of audit working papers or other documents held by statutory auditors or audit firms approved by them, provided that:
 - (a) these audit working papers or other documents relate to audits of companies which have issued securities in that third country;
 - (b) the transfer takes place via the home competent authorities to the competent authorities of that third country and upon their request;
 - (c) the competent authorities of the third country concerned meet requirements which have been declared adequate according to paragraph 3;
 - (d) there are working arrangements on the basis of reciprocity agreed between the competent authorities concerned.
2. The working arrangements referred to in paragraph 1(d) shall ensure that:
 - (a) justification is provided by the competent authorities of the purpose of the request for audit working papers and other documents;
 - (b) the persons employed or formerly employed by the competent authorities of the third country that receive the information are subject to obligations of professional secrecy;
 - (c) the competent authorities of the third country may use audit working papers and documents only for the exercise of their functions of public oversight, quality assurance and investigations that meet requirements equivalent to those of Articles 29, 30 and 31;
 - (d) the request from a competent authority of a third country for audit working papers or other documents held by a statutory auditor or audit firm can be refused where the provision of those working papers or documents would adversely affect the sovereignty, security or public order of the Community or of the Member State concerned, or where judicial proceedings have already been initiated in respect of the same actions and against the same persons before the authorities of the Member State concerned.

3. The adequacy referred to in paragraph 1(c) is decided upon by the Commission in accordance with the procedure referred to in Article 49(2). The assessment of adequacy shall be carried out in cooperation with Member States and be based on the requirements of Article 34 or essentially equivalent functional results. Member States shall take the measures necessary to comply with the Commission's decision.
4. In exceptional cases and by derogation to paragraph 1, Member States may allow statutory auditors and audit firms approved by them to transfer audit working papers and other documents directly to the competent authorities of a third country, provided that:
 - (a) investigations have been initiated by the competent authorities in that third country;
 - (b) the transfer is not in contradiction with the obligations which statutory auditors and audit firms have to comply with in relation to the transfer of audit working papers and other documents to their home competent authority;
 - (c) there are working arrangements with the competent authorities of that third country that allow the competent authorities in the Member State reciprocal direct access to audit working papers and other documents of audit firms;
 - (d) the requesting competent authority of the third country informs in advance the home competent authority of the statutory auditor or audit firm of each direct request for information, indicating the reasons thereof;
 - (e) the conditions referred to in paragraph 2 are respected.
5. The Commission may, in accordance with the procedure referred to in Article 49 (2), define the exceptional cases referred to in paragraph 4.
6. Member States shall communicate to the Commission the working arrangements referred to in paragraphs 1 and 4.

Chapter XIII

Transitional and final provisions

Article 48 *Implementing measures*

In addition to the other implementing measures referred to in this Directive and in order to take account of developments in and related to statutory audit and to ensure uniform application of this Directive in the Community, the Commission may adopt implementing measures, in accordance with the procedure referred to in Article 49 (2).

Article 49
Committee

1. The Commission shall be assisted by an audit regulatory committee (hereinafter referred to as the Committee) composed of representatives of the Member States and chaired by a representative of the Commission.
2. Where reference is made to this paragraph the regulatory procedure laid down in Articles 5 and 7 of Decision 1999/468/EC shall apply, having regard to Article 8 thereof.

The period laid down in Article 5(6) of Decision 1999/468/EC shall be set at three months.

3. The Committee shall adopt its Rules of Procedure.

Article 50
Amendment of Directive 78/660/EEC and Directive 83/349/EEC

1. Directive 78/660/EEC is amended as follows:

(a) In Article 43 the following point is added:

"(15) the fees for the financial year paid to the statutory auditor or audit firm for the statutory audit of annual accounts and the fees paid for other assurance services, tax advisory services and other non-audit services.";

(b) Article 44(1) shall be replaced by the following:

"1. Member States may permit the companies referred to in Article 11 to draw up abridged notes on their accounts without the information required in Article 43(1)(5) to (12), (14)(a) and (15). However, the notes must disclose the information specified in Article 43(1) (6) in total for all the items concerned."

2. In Article 34 of Directive 83/349/EEC the following point is added:

"(16) the fees for the financial year paid to the statutory auditor or audit firm for the statutory audit of the consolidated accounts and the fees paid for other assurance services, tax advisory services and other non-audit services.".

Article 51
Repeal of Directive 84/253/EEC

Directive 84/253/EEC shall be repealed with effect from the date indicated in Article 54 (1). References to the repealed Directive shall be construed as references to this Directive.

Article 52
Transitional provision

Statutory auditors or audit firms that are approved by the competent authorities of the Member States in accordance with the provisions of Directive 84/253/EEC before the entering into force of the provisions referred to in 53 (1), shall be considered as having been approved in accordance with the provisions of this Directive.

Article 53
Transposition

1. Member States shall adopt and publish before 1 January 2006 the provisions necessary to comply with this Directive. They shall forthwith inform the Commission thereof.
2. When Member States adopt those provisions, they shall contain a reference to this Directive or be accompanied by such a reference on the occasion of their official publication. Member States shall determine how such reference is to be made.
3. Member States shall communicate to the Commission the texts of the main provisions of national law which they adopt in the field covered by this Directive.

Article 54
Entry into force

This Directive shall enter into force on the twentieth day following that of its publication in the *Official Journal of the European Union*.

Article 55

This Directive is addressed to the Member States.

Done at Brussels,

For the European Parliament
The President
[...]

For the Council
The President
[...]

LEGISLATIVE FINANCIAL STATEMENT

Policy area(s): INTERNAL MARKET
Activit(y/ies): AUDIT AND ACCOUNTING

TITLE OF ACTION: "PROPOSAL FOR A DIRECTIVE OF THE EUROPEAN PARLIAMENT AND THE COUNCIL ON STATUTORY AUDIT OF ANNUAL ACCOUNTS AND CONSOLIDATED ACCOUNTS AND AMENDING COUNCIL DIRECTIVES 78/660/EEC AND 83/349/EEC"

1. BUDGET LINE(S) + HEADING(S)

A0-7031, ABB 12.010211.01.03, "Expenditure on meetings of Committees" (Compulsory committees).

2. OVERALL FIGURES

2.1. Total allocation for action (Part B): € million for commitment

€ 0

2.2. Period of application:

N.A.

2.3. Overall multi-annual estimate of expenditure:

(a) Schedule of commitment appropriations/payment appropriations (financial intervention) *(see point 6.1.1)*

€ million *(to three decimal places)*

	Year [n]	[n+1]	[n+2]	[n+3]	[n+4]	[n+5 and subs. Years]	Total
Commitments							
Payments							

(b) Technical and administrative assistance and support expenditure *(see point 6.1.2)*

Commitments							
Payments							

Subtotal a+b							
Commitments							
Payments							

- (c) Overall financial impact of human resources and other administrative expenditure
(see points 7.2 and 7.3)

Commitments/ payments	0.047	0.047	0.047	0.047	0.047	0.047	0.280
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TOTAL a+b+c							
Commitments	0.047	0.047	0.047	0.047	0.047	0.047	0.280
Payments	0.047	0.047	0.047	0.047	0.047	0.047	0.280

2.4. Compatibility with financial programming and financial perspective

Proposal is compatible with existing financial programming.

2.5. Financial impact on revenue:

Proposal has no financial implications (involves technical aspects regarding implementation of a measure)

(€ million to one decimal place)

Budget line	Revenue	Prior to action [Year n-1]	Situation following action						
			[Year n]	[n+1]	[n+2]	[n+3]	[n+4]	[n+5]	
	<i>a) Revenue in absolute terms</i>								
	<i>b) Change in revenue</i>	Δ							

3. BUDGET CHARACTERISTICS

Type of expenditure		New	EFTA contribution	Contributions from applicant countries	Heading in financial perspective
Non compulsory	Non-differentiated	NO	NO	NO	No 3

4. LEGAL BASIS

Measures fall under the **institutional prerogative** of the Commission.

5. DESCRIPTION AND GROUNDS

5.1. Need for Community intervention ¹

Recent scandals such as Parmalat confirm the urgency and the need for the envisaged EU initiatives on statutory audit outlined in the May 2003 Commission Communication “Reinforcing the statutory audit in the EU”. The proposal for a new Directive on statutory audit is one of the most important initiatives of the Commission Communication. The proposed Directive will considerably broaden the scope of the former Eighth Council Directive by clarifying the duties of statutory auditors, their independence and ethics, by introducing a requirement for external quality assurance, by ensuring robust public oversight over the audit profession and by improving co-operation between oversight bodies in the EU.

The new Directive is not a knee-jerk reaction to recent corporate scandals. It is the logical consequence of a reorientation of the EU policy on statutory audit started back in 1996. However, the initial thinking has been adapted to take account of the most recent scandals.

5.2. Action envisaged and budget intervention arrangements

5.3. Methods of implementation

The Proposal reinforces the statutory audit function in the EU. The Directive provides a comprehensive legal underpinning on how statutory audits should be conducted and what audit infrastructure Member States should have in place to ensure audit quality. A new decision making structure with an audit regulatory committee will allow fast and more detailed implementing measures of certain provisions of the Directive. It is foreseen that the Audit regulatory committee, chaired by the Commission will meet three times a year.

6. FINANCIAL IMPACT

6.1. Total financial impact on Part B - (over the entire programming period)

(The method of calculating the total amounts set out in the table below must be explained by the breakdown in Table 6.2.)

6.1.1. Financial intervention

Commitments (in € million to three decimal places)

Breakdown	2004	2005	2006	2007	2008	2009 (et seq.)]	Total
Action 1							
Action 2							
etc.							
TOTAL							

¹ For further information, see separate explanatory note.

6.1.2. *Technical and administrative assistance, support expenditure and IT expenditure (commitment appropriations)*

	[Year n]	[n+1]	[n+2]	[n+3]	[n+4]	[n+5 and subs. years]	Total
1) Technical and administrative assistance							
a) Technical assistance offices							
b) Other technical and administrative assistance: - intra muros: - extra muros: <i>of which for construction and maintenance of computerised management systems</i>							
Subtotal 1							
2) Support expenditure							
a) Studies							
b) Meetings of experts							
c) Information and publications							
Subtotal 2							
TOTAL							

6.2. Calculation of costs by measure envisaged in Part B (over the entire programming period)²

Commitments (in € million to three decimal places)

Breakdown	Type of outputs (projects, files)	Number of outputs (total for years 1...n)	Average unit cost	Total cost (total for years 1...n)
	1	2	3	4=(2X3)
<u>Action 1</u> - Measure 1 - Measure 2				
<u>Action 2</u> - Measure 1 - Measure 2 - Measure 3etc.				
TOTAL COST				

² For further information, see separate explanatory note.

7. IMPACT ON STAFF AND ADMINISTRATIVE EXPENDITURE

7.1. Impact on human resources

Types of post		Staff to be assigned to management of the action using existing and/or additional resources		Total	Description of tasks deriving from the action
		Number of permanent posts	Number of temporary posts		
Officials or temporary staff	A				
	B				
	C				
Other human resources					
Total					

The needs for human and administrative resources shall be covered within the allocation granted to the managing DG in the framework of the annual allocation procedure.

7.2. Overall financial impact of human resources

Type of human resources	Amount (€)	Method of calculation
Officials (€108.000)		
Temporary staff		
Other human resources (specify budget line)		
Total		

The amounts are total expenditure for twelve months.

7.3. Other administrative expenditure deriving from the action

Budget line (number and heading)	Amount €	Method of calculation
Overall allocation (Title A7)		
A0701 – Missions		
A07030 – Meetings		
A07031 – Compulsory committees ¹	46.800 (per year)	3 meetings of 21.000 (3x (24 x 650)) per meeting with 25 delegations.
A07032 – Non-compulsory committees ¹		
A07040 – Conferences		
A0705 – Studies and consultations		
Other expenditure (specify)		
Information systems (A-5001/A-4300)		
Other expenditure - Part A (specify)		
Total	46.800	

The amounts are total expenditure for twelve months.

¹ Specify the type of committee and the group to which it belongs.

I.	Annual total (7.2 + 7.3)	€ 46.800
II.	Duration of action	6 years
III.	Total cost of action (I x II)	€ 280.800

8. FOLLOW-UP AND EVALUATION

8.1. Follow-up arrangements

Not applicable

8.2. Arrangements and schedule for the planned evaluation

Not applicable

9. ANTI-FRAUD MEASURES

Not applicable