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Public oversight systems for statutory auditors in the European Union*

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Public oversight systems for statutory auditors in the European Union

Abstract

We provide a comparative overview of the process of implementation, harmonization and stabilization of public oversight systems for statutory auditors across the European Union (EU) after Directive 2006/43/EC. We build on institutional change theory to identify potential determinants as to why some countries still lag in this harmonization process. Oversight systems are a key institutional factor to guarantee the quality of financial information, essential to maintain investors' confidence and deep and stable capital markets. Thus, the harmonization of these systems has long been an objective of the EU. Our analyses serve to identify, analyse and compare how EU countries have incorporated European-wide requirements into their national legal systems. Particularly, we study: (1) basic characteristics of the system and bodies for public oversight, (2) organizational structure, (3) financing (4) transparency, (5) supervisory, and (6) disciplinary mechanisms. We show that significant diversity still exists across systems and that both the incentives for institutional change and the distance between pre-existing systems and the Directive are important explanatory factors of the achieved level of harmonization.

Keywords: *Auditing, Directive 2006/43/EU, Institutional differences, Oversight systems, Disciplinary systems, Harmonization, Accounting.*

JEL classification: G30, G38, K22, M40, M48

1. Introduction

Recent efforts to harmonize accounting practice and enhance the comparability of financial information worldwide have met with limited success. Extant research on the mandatory adoption of International Financial Reporting Standards (IFRS) in the European Union (EU) suggests only moderate advancements towards true comparability have been made, with national patterns persisting despite accounting harmonization (Naor 2006; Kvaal and Nobes 2010, Nobes 2011). This evidence gives credence to the view that other fundamental national institutions that drive accounting practice should also be harmonized to achieve genuine comparability (Zeff 2007) and *de facto* uniformity in accounting practice (Ball 2006).

In particular, statutory audits are considered a key determinant in promoting the success of the accounting harmonization process (Brown 2011; Wysocki 2011). The auditing function not only guarantees the quality of financial information, essential to maintain investors' confidence and deep and stable capital markets; but also, it guides firms in the appropriate adoption of IFRS. Aware of the role of statutory audits and its public-interest function, the EU has aimed to establish effective public oversight systems that ensure audit quality in its member states. Directive 2006/43/EC (the Directive, hereafter) requires member states to organize an oversight institution for regulating, supervising and disciplining statutory auditors and audit firms. These institutions are denoted national Public Oversight Bodies for Statutory Auditors (POBSA).

Despite this regulatory endeavour to harmonize public oversight systems, prior literature suggests that large differences remain in auditing quality across Europe (e.g., Francis and Wang 2008). This indicates that considerable challenges lie ahead to secure a homogenous and robust POBSA system, particularly, given a) the heterogeneity in the incentives to harmonize institutions across countries, and b) the large differences that existed before de issuance of the Directive. We argue that, before the issuance of the Directive, audit oversight systems in the EU could be categorised into three groups; as being either: (a) professionally self-regulated and peer-reviewed; (b) organized through governmental public oversight, or (c) mixed: i.e., oversight systems with either mixed, not clearly defined, or inexistent structures. We predict that this wide variation in pre-Directive systems means that additional supra-national efforts are still required to achieve harmonization. Indeed, heterogeneity in both the demand (incentives) and supply (actions and capacity) of regulation in member states in relation to the adoption of the requirements of the Directive is predicted to influence the process of implementation, harmonization and stabilization of public oversight systems across the EU.

To test these predictions, our research examines, for a representative group of member states, the efforts made by EU countries to adapt their systems to comply with the Directive. Our aim is to better understand what degree of harmonization has been achieved and what challenges lie ahead. Particularly, we perform a comparative analysis of the characteristics of the current public oversight systems for statutory auditors in six member states: Finland, France, Germany, Italy, Spain, and the UK. These countries are not only representative of the three identified groups of pre-Directive structures, but also, previous research has documented persistent differences in the quality of their audit systems (Van Tenderloo and Vanstraelen 2008; Maijoor and Vanstraelen 2012).

To carry out the comparative analysis, we first describe our framework for analysis. To develop it, we follow prior work (Baker et al. 2001; FEE 2001; Brown and Tarca 2005; Bebenroth et. al 2009; De las Heras 2009). This framework is based on the content of the Directive and therefore, on the current requirements for EU public oversight systems. In particular, we identify the following reference dimensions: (1) basic characteristics of the system and bodies for public oversight; (2) organizational structure; (3) financing; (4) transparency; (5) supervisory mechanisms; and (6) disciplinary mechanisms. Second, based on the theory of institutional change (Bush 1987; North 1990; Kolmar 2003; Weyland 2008; Judge et al. 2010) we build a simple model to explain the degree of harmonization achieved based on country market incentives (demand) and the distance from pre-existing oversight systems to the Directive (lines of actions and capacity; i.e., supply).

The analysis yields two key findings. Consistent with our expectations, we find that significant differences persist across systems, explaining, at least to a certain extent, the limited success of harmonized accounting standards in attaining the EU objective of full comparability. Second, we find that differences in the incentives, line of actions and capacity of member states explain the differences that still persist across systems. This is consistent with an ample literature on institutional change that shows that even when immersed in profound changes, institutions tend to remain remarkably stable in certain ways (e.g., Boas 2007). This potentially explains why some European economies have quickly implemented a stable public oversight system while others have only partially implemented one, and others are still in a very incipient process of implementation.

A systematic comparison that identifies the degree of current harmonization and consistency of the audit oversight systems across member states extends and contributes to the previous evidence that examines the European harmonization of auditing regulation (Baker et al. 2001; Stevenson 2002; Maijoor and Vanstraelen 2006), supervisory characteristics and procedures (De las Heras 2009), and disciplinary systems (Blij et al. 1998; Quick and Warming-Rasmussen 2002). We provide novel evidence on the existing efforts of EU member states to harmonize the national auditing oversight systems. Additionally, we also contribute to prior literature by providing a more structured understanding of how European countries have incorporated into their national legislations the requirements of the Directive and why some countries are yet to fully harmonize their oversight systems. This may serve as a reference guide for regulators and member states to continue improving their national systems. Particularly given that the public oversight systems for the audit profession across Europe are still in the early years of their remodelling process.

The remainder of the paper is organised as follows. Section 2 reviews the prior literature and develops our hypotheses on the harmonization of public oversight systems in the EU based on the theory of institutional change. Sections 3 and 4 describe the oversight systems in Europe, and the method used in the comparative analysis. Section 5 contains the comparison of the current oversight systems across Europe. Section 6 presents the results of the institutional change analysis, and finally, section 7 concludes.

2. The rationale of the public oversight system for statutory auditors in the EU and the role of institutional change: An overview

2.1. The role of public oversight systems: Financial reporting quality and capital markets

Significant efforts have been made to increase the comparability of financial reporting quality in Europe. Chief amongst these actions has been the adoption of a single set of accounting standards. However, differences in financial reporting quality have persisted despite harmonization (Houqe et al. 2012; Kvaal and Nobes 2012). Prior research argues that genuine comparability will not be achieved without harmonizing the institutions that promote a rigorous and consistent use of these standards (Brown 2011; Pope and McLeay 2011; Wysocki 2011).

In particular, adequate enforcement guarantees an appropriate application of accounting rules, and plays an important role in shaping financial markets and reporting practices (La Porta et al. 1997, 1998, 2006; Leuz et al. 2003; Burgstahler et al. 2006; Coffee 2007). Extant literature, summarized in Table 1, highlights the relevance of institutional differences in limiting the success of the harmonization process. In particular, enforcement mechanisms are identified as determinant factors. Consequently, member states' efforts to harmonize accounting practice are not only focused on the adoption of a single set of standards, but also, on creating a common institutional background, based on harmonized enforcement structures. Key steps towards this goal are the establishment of harmonized European institutional oversight systems for financial reporting (CESR 2003) and harmonized public oversight systems for auditing, through the enactment of the Directive. The overriding expectation is that, the more similar the institutional contexts are, the higher the probability of harmonization success (Wagner 2011). Therefore, it is crucial to understand the differences in the European institutional context within which financial reporting occurs and what factors may drive (or mitigate) the persistence of those differences.

Insert Table 1 about here

2.2. The demand and supply of public oversight systems for auditors in the EU

Without external shocks, institutions tend to persist. Previous literature posits that institutional change is driven by both the supply and demand sides (North 1990; Weyland 2008; Kingston and Caballero 2009). On the one hand, institutional change happens when there is a demand for reforms generated to solve the problems raised by particular events (shocks). On the other, change occurs when there is a supply of feasible and viable courses of actions with solutions, which are normally issued by political leaders.

In this section, we briefly develop a framework to explain institutional change of oversight systems for auditors in the EU. To do so, first we examine the incentives that drive the demand for change in these systems at the European level. Then, from the supply side, we review the solutions issued by the EU and the elements that may impact on the actions and capacity to evolve into a harmonized oversight system.

2.2.1. The demand for changes in the public oversight systems for auditors in the EU

Consistent with the literature on neo-institutional theory that claims that changes in institutional systems are often triggered by external events (Bengtsson 2011), the demand for reforms of the oversight system for auditors in the EU appears, in the beginning of the previous decade, as a reaction, primarily, to the loss of confidence in financial reporting and capital markets and, also, associated with the accounting harmonization process.

In the early 2000s, there was a worldwide loss of confidence in auditors and the auditing process, as a consequence of a number of severe financial scandals (e.g., Vivendi, Worldcom, or Parmalat). The most identifiable shock was the collapse of Enron in 2001, immediately followed by the demise of its auditor Arthur Andersen (one of the largest accounting firms in the world), signalling a failure in the existing auditing institutional structures. A second event that triggered the demand for new oversight systems in Europe, was the ratification in 2002 of the adoption of a single set of accounting standards for the presentation of consolidated accounts for listed companies across Europe (Regulation 1606/2002/EC).

While the first event had a negative impact on capital markets' confidence, the second one was understood as a significant effort to restore the confidence lost.[1] These two external events required changes to the principles, rules, beliefs and practices of the auditing institutional structures. As argued in Arruñada (2004), the increasing lack of confidence triggered an institutional change in the auditing industry worldwide.

As Velte and Freidank (2014) explain, the audit process is delegated by the investors of a company due to their lack of time and professional resources. The investor-auditor relationship can be framed in terms of a principal-agent relation where auditors are

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[1] The Regulation states its aim as follows: "(The Regulation) aims at contributing to the efficient and cost-effective functioning of the capital market. The protection of investors and the maintenance of confidence in the financial markets is also an important aspect of the completion of the internal market in this area."

considered as agents of investors, providing monitoring services that serve as an assurance mechanism to strengthen the confidence on financial information and therefore, guarantee the stability in capital markets. Therefore, following these capital markets shocks that questioned the role of the auditors, and due to the significant changes in the financial reporting system that took place from 2005 onwards, there appears a demand for adequate enforcement that can reduce auditors' malpractice, prevent financial fraud, contributing to the harmonization process and the adoption of IFRS. i.e., a demand for changes in oversight systems.

Given the origin of the shocks, we expect that the extent to which particular countries have adapted their oversight systems likely depends on the depth and relevance of their capital markets. In line with this expectation, it is not surprising that the US led the way to institutional change. After the Enron collapse, the US government reacted immediately, passing in August 2002 the Sarbanes Oxley Act (SOX) in order to overhaul the existing regulatory oversight mechanisms (Klumpes, 2013). Particularly, the Sarbanes-Oxley Act created a new POBSA, the Public Company Accounting Oversight Board. Other countries with strong capital markets, such as Canada, Japan or Australia followed. They all restructured their public oversight systems.[2] This is as anticipated by prior theory on institutional change (Weyland 2008), which posits that institutional changes do not usually happen in isolation because reform in one country often increases the probability of change in other countries.

2.2.1. The supply of changes in the public oversight systems for auditors in the EU

In Europe, a number of actions have encouraged the institutional change of national oversight systems. The strongest line of action followed is the Directive, but concerns about the lack of

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[2] Canada set up the Canadian Public Accountability Board in 2003; and Japan set up the Certified Public Accountants and Auditing Oversight Board in 2004. The same year, the competences of the Australian Securities and Investments Commission were extended to cover the public oversight for the auditing profession.

harmonized oversight structures were already present a decade before. In 1998, the European Commission proposed, in its Communication on "*the statutory audit in the European Union: the way forward*," the creation of a Committee on Auditing which could develop further actions in close cooperation with the accounting profession. On the basis of the work of that Committee, the Commission issued in 2000 a recommendation on "*Quality assurance for the statutory audit in the European Union: minimum requirements*" which included minimum requirements to implement and/or harmonize the structure of the external quality assurance system in each member state. Additionally, in 2003 the Communication "*Reinforcing statutory audit in the EU*" (2003/C236/02) included a plan with different measures to harmonize public oversight systems in Europe.

More recently, the requirements of the Directive aim to harmonize the procedures for the regulation, supervision and discipline of statutory auditors, to minimize differences in the levels of quality across audit services in Europe and thus, to enhance the quality of the audit procedure. To achieve these objectives, the Directive requires that all member states shall "*organize an effective system of public oversight for statutory auditors and audit firms*," governed by non-practitioners, who are knowledgeable and have competences in the audit field, and also, who are independent from statutory auditors and audit firms. Each oversight system may include several competent public bodies (the POBSAs) holding the ultimate responsibility for regulating, supervising and disciplining statutory auditors and auditing firms in the EU (FEE 2002, 2003).[3]

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[3] Particularly, the public oversight system has the responsibility to oversight: (a) the approval and registration of statutory auditors and audit firms; (b) the adoption of standards of professional ethics and internal quality controls for auditors and audit firms; and, (c) continuing education, quality assurance and the investigative and disciplinary systems. In addition, the POBSAs are required to cooperate in the oversight activities at the European and international levels. All these POBSAs belong to the European Group of Auditors' Oversight Bodies and are members of the International Forum of Independent Audit Regulators.

Consequently, the Directive requires all member states to start a reviewing process of their systems that would culminate by introducing changes to their pre-Directive structures. However, the processes across countries are different. Member states have opted for different formulas to adapt their national oversight systems to the requirements of the Directive, particularly, given the large differences that existed pre-Directive.

Countries with an established tradition of self-regulation were required to introduce a new public oversight body governed by non-practitioners (e.g., Denmark, France, Ireland, and the UK). Others had to extend the responsibilities of already exiting POBSAs (e.g., Finland, Sweden, and Spain) or of other supervisory bodies such as the stock exchange regulator or the Chamber of Commerce, resulting in a non-clearly defined system (e.g., Italy, Luxemburg, and the Netherlands). Finally, countries with a mixed pre-Directive system (e.g., Belgium, Germany) or countries with an inexistent one (e.g., Austria, Greece, or Portugal) opted to create new bodies to meet the new oversight requirements.

Most member states have decided to allocate all the oversight responsibilities to a unique POBSA. Nevertheless, some countries have opted to distribute the oversight and disciplinary competences across several POBSAs. A majority of POBSAs have an intensive and collaborative relationship with the professional organizations. Table 2 presents a detail of the existing POBSAs within each oversight system across the EU-15 area.

Insert Table 2 about here

Although the requirements of the Directive are common to all member states, domestic politicians have opted to incorporate them at the national level through different formulas. As argued in Crettez (2014), countries adapt their systems to reduce the cost of institutional diversity. However, they are also predicted to be more willing to implement the requirements that are consistent with their institutional framework (Legrand 1996), and indeed, diversity may lead to regulatory conflicts across member states' oversight systems (Bagheri & Jahromi

2014). In the following sections, we provide a comparative overview of the oversight systems adopted and formulate hypotheses on why some countries may lag in this harmonization process.

2.2.3. The relative success of institutional change: From pre-Directive structures to fully harmonized public oversight systems

Based on our previous discussion, we develop two hypotheses on the implementation, harmonization and stabilization of the public oversight systems in Europe, based on the demand (incentives) and supply (line of actions and capacity) of member states to adopt the requirements of the Directive. Testing these hypotheses permits understanding why some European economies have quickly implemented a stable public oversight system, while in others, the implementations has been achieved only partially or it still is on a very incipient stage of implementation.

As noted above, the demand for this institutional change originates from capital market pressures to restore confidence in auditors and financial reporting (Schmid, 1994; Arruñada 2004; Velte and Freidank 2014). An extant prior literature identifies that in countries with strong capital markets there is a strong demand for reliable and comparable financial reporting quality to enhance confidence and facilitate capital flows (DeFond et al. 2011; Isidro and Raonic 2012; Glaum et al. 2013). We expect that in these countries there will be a strong demand for reforms of the oversight system to recover from the loss of confidence in auditors and to facilitate the accounting harmonization process. Thus, countries with stronger capital markets will have stronger incentives to implement and harmonize their public oversight systems. We hypothesize that:

H1: The depth and importance of capital markets is positively associated with the harmonization of the public oversight system for statutory auditors.

As argued in previous literature on institutional change (Suchman, 1995; Weyland 2008), even though the demand of an oversight system provides incentives for institutional change, the change only occurs if there is also a supply of political proposals (and capacity) to adopt them. There is a common root to the political proposals across all the member states, as the national governments are required to adopt the content of the Directive. Thus, the EU has *equally* encouraged political and professional actors at each member state level to restructure their oversight systems and reach a new institutional equilibrium. However, before the enactment of the Directive, oversight systems have appeared in equilibrium, and therefore, the greater the differences between the pre-Directive system and the new Directive requirements, the greater the changes required, the greater the resistance of political actors to change institutions, and also, the longer it will take these actors to adapt to the new equilibrium (Legrand 1996; Crettez, 2014). Member states may thus have different capacities to adopt the requirements of the Directive. Our second hypothesis is therefore as follows:

H2: The distance between pre-Directive and Directive structures is negatively associated with the harmonization of the public oversight system for statutory auditors.

Analysing the member states' incentives and capacity to implement the requirements of the Directive allow us to better understand the current process of implementation, harmonization and stabilization of public oversight systems across the EU and explain why there may be differences across member states. Next, we describe the pre-Directive structures for oversight systems in the EU.

3. The Pre-existing structures for oversight systems in the European Union

The pre-Directive structures for oversight systems for statutory auditors in EU members can be grouped into three types: (a) professionally self-regulated peer-reviewed; (b) governmental public oversight; and, (c) mixed or not clearly defined oversight systems. Figure 1 show two graphics that classify European countries based on the level of audit quality (vertical axis).[4] In Panel A, the horizontal axis represents the period of implementation of a public oversight audit system, while the graph in Panel B maps countries based on the year in which the first sanction to auditors was imposed directly by the POBSA or by another competent authority, (under the supervision of the corresponding POBSA).[5] These two events help us identifying when the POBSAs were formally created, and when they started to conduct their duties.

Insert Figure 1 about here

The graphical representation of the distances between countries allows us to map them in accordance to the level of audit quality in audit markets, and the process of implementation of the audit oversight systems. We identify three groups. Group (a) includes countries with high audit quality despite the late adoption of a public oversight system. This is the case of Denmark, France, Ireland, the Netherlands and the UK. Before the issuance of the Directive, these countries have had a long-standing self-regulated audit oversight system where the audit profession has played a significant supervisory role. Group (b) includes countries with a long-standing tradition on governmental public oversight, with high levels of audit quality, such as Finland and Sweden. This group includes early adopters with a high level of audit quality where most of the requirements included in the Directive were already in place. Group (c) includes countries with low audit quality. This group comprises countries that had a pre-Directive mixed oversight system such as Belgium, Germany and Spain, and countries

[4] The level of audit quality is proxied by the country negative value of the aggregate earning management measure for the period 1996-2005 provided by Leuz (2010). As a proxy for the level of audit quality in the market of a country we also use the aggregate earning management proxies provided from Leuz et al. (2003) and Burgstahler et al. (2006). The graphical representation of the distances between countries indicates the same groups and draw to the same conclusions.

[5] This helps to identify the first instance when the POBSA was *de facto* functioning. The cut off point to identify early and late adopters is 2002, because it is the year when the self-regulation of the audit profession starts to be questioned and therefore, when public oversight system are proposed and encouraged.

with a non-clearly defined system, such as Austria, Greece, Italy and Portugal. Most of the countries included in this group are late adopters, except for Belgium, Italy and Spain.[6]

The descriptive evidence in Figure 1 highlights two issues. First, there is no systematic evidence of higher audit quality among the countries with a longer tradition in the adoption of the EU models of public oversight systems, indicating that the adoption, by itself, may not be sufficient to affect the level of audit quality. Second, the grouping in Figure 1 responds mostly to characteristics of the pre-existing systems, confirming our expectation that pre-Directive systems likely emerged in equilibrium and that, without significant efforts to modify other institutions, it is unlikely that the oversight systems will play the role the EU has assigned them. Alternatively, these groupings could indicate that despite the adoption and harmonization efforts, oversight systems are yet to be truly harmonized, and thus, to lead to homogeneous consequences over audit quality. In order to investigate these issues, we provide a comparative overview of a number of oversight systems across EU members that are representative of the three previously defined groups: (a) professionally self-regulated peer-reviewed: France and the UK; (b) governmental public oversight: Finland and (c) mixed or not clearly defined oversight systems: Germany, Italy and Spain. The next section offers a small introduction to each of the six public oversight systems in these sample countries.

3.1. Countries with a professionally self-regulated and peer-reviewed oversight tradition

France (H3C): The *Haut Conseil du Commissariat aux Comptes* (H3C) is the current POBSA in France, set up under the Financial Securities Act (2003-706). It depends on the Ministry of Justice. Prior to its creation, the auditing profession was self-regulated through professional accounting and auditing bodies: the *Compagnie Nationale des Commissaires aux*

[6] Even though Panel A identifies Belgium as an early adopter, we might consider it a late adopter. The Conseil Supérieur des Professions Economiques (CSPE), the main body, was set up in 1985. However, the responsibilities for public oversight are delegated to several bodies created in 2007, year when the audit regulatory system is deeply restructured.

Comptes (CNCC) and the *Compagnie Regionale des Commissaires aux Comptes* (CRCC). Currently, the H3C and the CNCC and CRCC cooperate in the quality assurance controls for statutory audits and auditing firms, albeit the ultimate responsibility lies on the H3C, they partially delegate the quality controls to CNCC and CRCC. The H3C has its own supervisors (*controleurs du corps*) who are responsible for the quality assurance controls for statutory audits and auditing firms of public-interest entities (PIE's). Disciplining responsibilities rely not only on the H3C but also on the Ministry of Justice and the Securities Regulators (AMF). Professional bodies are very active in the disciplining process, initiating most of the investigations. The CNCC and CRCC periodically inform the H3C about the investigations and sanctions imposed. Sanctioned companies can appeal to the H3C who will review the investigation procedure conducted by the professional bodies.

The UK (POB)**:** The Public Oversight Body (POB), created in 2005 after the 2004 Companies Act is the POBSA in UK. The POB is a subsidiary of the Financial Reporting Council (FRC), a public independent regulator that depends on the Ministry of Trade and Investment, responsible for securing financial reporting and auditing quality. Together with the POB, the FRC delegates the investigation and sanction responsibilities of specific cases to the Accountancy & Actuarial Discipline Board (AADB), which is only competent for issues related to publicly traded companies, significant financial institutions, insurance undertaking or pension funds, public bodies, significant charities or large utilities firms. Before the 2004 Companies Act, the audit profession was self-regulated by: (1) recognized qualifying bodies (RQB) regulating auditors, and (2) recognized supervisory bodies (RSB) regulating audit firms. These professional accounting and auditing bodies are: (1) The Association of Chartered Certified Accountants (ACCA), (2) The Institute of Chartered Accountants in England and Wales (ICAEW), (3) The Institute of Chartered Accountants of Ireland (ICAI), (4) The Institute of Chartered Accountants of Scotland (ICAS), (5) The Association of

Authorized Public Accountants (AAPA), (6) The Association of International Accountants (AIA) and (7) The Chartered Institute of Public Finance and Accountancy (CIPFA). The ACCA, ICAEW, ICAI and the ICAS are all RSB and RQB, the AAPA is only RSB, and the AIA and the CIPFA are RQB. Each professional body regulates its members on matters related to audit regulation, supervision and discipline. However, since 2005, the oversight of the current activities of all RSBs and RQBs corresponds to the POB.

3.2. Countries with a governmental public oversight tradition

Finland (TILA): The *Tilintarkastuslautakunta* (TILA) is recognized as the responsible organism for the public oversight in Finland, where statutory auditors and audit firms are classified in two different groups: HTM and KHT. The HTM auditors or audit firms are those approved by the Local Chamber of Commerce, while the KHT ones are those approved by the Central Chamber of Commerce. The TILA approves statutory auditors since 1925 and audit firms since 1983. The role of the TILA have been recently updated in the Auditing Act (459/2007), to adjust the auditing regulatory framework to the requirements of the Directive.

3.3. Countries with a mixed or not clearly defined oversight systems tradition

Germany (APAK): In Germany, the *Abschlussprüferaufsichts Kommission* (APAK) is the responsible organism for the public oversight process. The APAK, created in 2004 by the Auditor Oversight Act (WPO, 12/2004) has the ultimate responsibility of the public oversight system, and delegates the executive role of its activities on the *Wirtschaftsprüferkammer* (WPK), the Institute of Chartered Accountants, set up in 1961 and subject to state supervision. Both bodies depend on the German Ministry of Economy. Therefore, the German oversight system is a two-tier public system with an executive (WPK) and a supervisory (APAK) organism. The regulatory, supervisory and discipline procedures of the oversight system are functions operated by the WPK, under the constant supervision of the

APAK. Minor violations of professional rules are investigated and sanctioned by WPK under public oversight of the APAK. Severe violations of professional rules are sanctioned by special divisions of criminal courts.

Italy (CONSOB): The stock exchange regulator, the *Commissione Nazionale per le Società e la Borsa* (CONSOB) is responsible for the oversight system of the audit profession in Italy. The CONSOB, founded in 1974 (Legislative Degree 216/1974), depends on the Ministry of Economy and Finance and it is recognized by Legislative Degree (281/1985) as an independent administrative authority with legal personality and full autonomy. The legal responsibilities of the CONSOB only extends to auditors and audit firms for listed companies or other public-interest entities such as insurance and financial services firms (Legislative Degree 58/1998). Auditors and audit firms of listed companies are required to enter in a specific public register controlled and supervised by the CONSOB. The Ministry of Economy and Finance is responsible for regulating, supervising and disciplining the statutory auditors and audit firms of non-listed companies.

Spain (ICAC): The responsibilities of the public oversight system in Spain rely on the *Instituto de Contabilidad y Auditoría de Cuentas* (ICAC), the public Institute of Chartered Accountants responsible to regulate, supervise, investigate and sanction the audit profession since the 1988 Auditing Act. The ICAC is a government organism that depends on the Ministry of Economy. The ICAC roles on regulatory, oversight and discipline matters of the audit profession were updated after the issuance of the Financial Act 44/2002 and the New Auditing Act 12/2010. Nowadays, the ICAC cooperates intensively in the quality assurance controls for statutory audits and auditing firms with the Spanish Professional Auditing Bodies: The *Registro de Economistas Auditores* (REA), The *Registro General de Auditores* (REGA) and The *Instituto de Censores Jurados de Cuentas de España* (ICJCE).

4. Conceptual framework for the oversight system of the auditing profession in the EU

To facilitate comparisons across member states, we develop a conceptual framework based on the content of the Directive that serves as a benchmark to compare how countries have adapted their regulations and also, to empirically measure the harmonization achieved. As previously mentioned, the conceptual framework contains six dimensions. We relate each of these dimensions to the Directive in the explanations that follow. Each dimension is measured through several variables that capture differences across the competent oversight bodies. Table 3 offers the detail of the variables incorporated to each comparative dimension.

Insert Table 3 about here

The first dimension describes the general characteristics of the public oversight bodies. It refers to the broad institutional objective of the oversight body; the specific responsibilities in terms of regulating, supervising and disciplining the audit profession; [7] the year of foundation and initiation of its activities and finally, the governmental Act that established its roles.

The second dimension comprises variables related to the characteristics of the organizational structure of the POBSAs, the nomination procedure for members of the Board, establishing the number of members and their professional profile The Directive establishes that: (a) the competent body should be organised in such a manner that conflicts of interests are avoided (Article 35.2) and, (b) it should be governed by non-practitioners who have expertise on auditing matters,[8] that are selected in accordance with an independent and transparent nomination procedure (Article 32.3). When independence is maintained, potential

[7] Following Article 32 of the Directive, we identify as *regulatory* functions those (a) related to the *approval* and *registration* of statutory auditors and audit firms; (b) the *adoption of standards on professional ethics and internal quality controls* of audit firms and auditing; and finally, (c) the establishment of *continuing education* mechanisms. The *supervisory* functions include: (a) the control and programming of the *quality assurance* system; and (b) the *investigation* procedures. Finally, the disciplining functions relate to the competencies to impose sanctions, ranging from censure or fines to the revocation of registration.

[8] The Directive allows a minority of auditors (practitioners) to be designated as Board Members, as long as they are selected in accordance with a transparent and independent procedure (Art. 32.3).

conflicts of interest or cases of corruption are significantly reduced and therefore, there is a higher probability of identifying and constraining non-compliance cases (Wagner 2011).

The third dimension relates to financing. To ensure the independence of the system, Article 32 recommends a funding source that enables the POBSA to avoid the risks of economic dependence. To assess differences in financing structures, the variables included in this dimension refer to the different budget funding sources.

The fourth dimension is transparency. This relates to: (a) the requirement to offer publicly available information about its activities and working programme (Article 32.6), and (b) whether there is enough information about disciplinary sanctions (Article 30.3).

The fifth dimension analyses the supervisory mechanisms and the scope of supervision, since the supervisory competencies of the POBSA may vary across countries, depending on the scope of the auditing work and the competences of the appointed auditor or audit firm. The Directive explicitly considered two supervisory mechanisms: quality assurance controls as "*proactive*" controls and investigation procedures as "*reactive*." Thus, while quality controls or inspections involve an independent periodic supervision (Art. 29), investigations or technical controls deal with supervising a specific audit work to detect, correct, and prevent minor or serious deficiencies in the execution of the audit.[9]

Finally, as a result of the investigation procedures, auditors can be subjected to disciplinary actions and sanctions, ranging from censure or fines, to the revocation of the auditor registration. Thus, the sixth dimension analyses the disciplinary mechanisms, identifying the disciplinary body, the year of the first sanction and the scope of discipline.

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[9] Investigation procedures are carried as a result of several triggers: (a) as a result of the deficiencies identified through quality controls; (b) as a results of a direct request from other public supervisory body (e.g. stock market regulators, fiscal controls, national central banks etc.) and (c) a third party direct claim (e.g. professional organizations) to the POBSA.

5. Comparative analysis: Differences and similarities between key EU oversight systems

5.1. Basic characteristics: Creation, establishment and functions

Table 4 compares the basic characteristics of the six POBSAs under analysis, briefly described above. All the bodies under analysis are governed by a similar common objective: guaranteeing *the public oversight of auditors and auditing firms* and the *audit regulation*.

Insert Table 4 about here

Finland and Spain have oversight bodies with decades of working history, either operating in isolation (Finland) or within mixed supervisory systems (Spain). The TILA was created in 1925 and the ICAC in 1988. Both POBSAs have responsibilities on the three main oversight functions: regulation, supervision and discipline. The CONSOB was set up in 1974, and therefore, can be also considered a well-established body. However, its competences have mainly been within the scope of capital markets supervision. Oversight responsibilities were initially consolidated by the Legislative Decree 58/1998 and have been recently updated by the Legislative Decree 39/2010. Therefore, the CONSOB is a well-established governmental body with extended competences in audit oversight since 1998.

The H3C and the POB were created in 2003 and 2005, respectively. The creation of these bodies represents a significant change over the pre-Directive oversight systems, moving from professional, self-regulated systems to public oversight systems. Unlike the TILA, ICAC and CONSOB, the H3C and the POB do not concentrate the three responsibilities of the public oversight system. The H3C is responsible only for the regulatory and the supervisory functions. Meanwhile, the POB is only competent in supervisory matters, while regulatory responsibilities rely on the Auditing Practice Board and the disciplinary body is the aforementioned AADB. In addition, as we will discuss later, the professional accounting and auditing bodies collaborate on supervisory activities with the POB. Therefore, we can assert that there seems to be a *de facto* extension of their pre-Directive oversight system. Similarly, while disciplinary competences in France rely on the Ministry of Justice, the professional accounting and auditing bodies are very actively involved in supervising and disciplining auditors, and have competence on disciplinary matters. The H3C acts as a control and appellations organism of the disciplinary processes addressed by the CNCC and CRCC. Thus, some POBSAs (H3C, ICAC or POB) actively collaborate with the professional bodies in the execution of their supervisory activities. We find that, irrespective of the pre-Directive systems, countries with strong, long-standing and knowledgeable professional bodies tend to have POBSAs that collaborate intensively with professional bodies in the execution of the quality controls.

Yet a different case is Germany, where the reforms led to a two-tier system, with the creation of the APAK in 2005. In the pre-Directive model, the oversight activities were the responsibility of the German Institute of Chartered Accountants (WPK). However, since 2005, the ultimate responsibilities of the oversight system rely on the APAK, with the WPK acting as an executive body. Therefore, compared to other countries, we can conclude that the German legal reforms have likely led to the strengthening of the previous system.

The information contained in Table 4 also indicates that the restructuring process of oversight systems began before the publication of the Directive in 2006. A significant number of member states began changing their systems from 2002 to 2005, thereby responding to the previously identified shocks of the early 2000s.[10]

[10] Finland was an exception, enacting the Auditing Act (459/2007) in 2007. Austria, Belgium, Ireland, Luxemburg, the Netherlands or Portugal complete to group of "late-adopters", embracing the content of the Directive in the period 2006-2010.

5.2. Structure

Table 5 Panel A compares the structures of the six POBSAs under analysis. The nomination procedure of Board members is controlled directly by a competent public authority in all cases except the POB, whose Board members are hired through a competitive selection process managed by the FRC. However, the FRC is a public body whose Board members are designated by a governmental competent authority: the Ministry of Trade and Investment. Board sizes range from 4 to 14 members. Professional profiles comply with the EU requirements introducing non-practitioners experts on auditing and accounting matters, selected following an independent and transparent nomination procedure. The Boards, which comprise a wide range of professionals linked to careers in the fields of auditing, accounting, economics and law, are commonly auditors, preparers, managers, politicians, judges, academics, and civil servants. We find that auditors are present in all Boards.

Insert Table 5 about here

5.3. Financing

The financing dimension refers to the budget. Article 32 of the Directive requires a funding system free of any undue influence on the independence of the public oversight body. We compare the funding systems, focusing on two issues: a) the source of funding and b) the total budget amount in 2011, usually the latest available year. Excluding the CONSOB, whose funding comes directly from the Ministry of Economy and Finance (CONSOB 2009; 2011), the most extended financing model across the oversight bodies is a mixed model with a double funding source: public funds and revenues from *service fees*. Fees are charged for admission to the examination procedure or the entrance to the official register for statutory auditors or audit firms; fees are also charged for quality or supervisory controls. In most cases the fees are collected by the professional accounting and auditing bodies.[11]

Regarding budgets, the H3C financial autonomy has increased from a budget of 650.000€ in 2003 to 8.9 million € in 2011 (H3C, Annual Report 2011). The ICAC has a similar budget to the H3C (ICAC, Activity Report 2011). The POB and the TILA have the smallest budgets (FRC, Annual Report 2012; TILA, annual Report 2012). However, recall that the POB is only competent in supervisory matters, and its funds are directly dependent on a higher-rank body: the FRC. The CONSOB has the largest budget, which is explained by its wider scope of activities as a capital market regulator (CONSOB, 2011). No information has been found on the financing of Germany's APAK. Access to the amount and source of funding is not always easy, as transparency in these matters is somewhat limited, despite the EU efforts to enhance transparency. The national auditing legislations regulate the funding source while the detail on the funding is provided in the annual reports. See Table 5 Panel B for a summary of this comparative information.

5.4. Transparency

Table 5 Panel B presents a comparison on the level of transparency across POBSAs. All the analysed bodies publish either (a) annual reports and activity reports as separate documents or (b) a unique report that includes all the required information. Reports are easily available through the POBSAs websites. However, there are not standardised reports and therefore, the amount and type of information differs across countries.

The lack of information is particularly a problem when trying to gather data on disciplinary procedures and sanctions imposed. Access to these data is very limited. In addition, the information on disciplinary sanctions is only published in the country's official

[11] Additional details on financing sources can be provided by the authors under request.

language. POBSAs annual reports generally offer information on the amount of quality assurance reviews and investigations. However, firm specific details on disciplinary sanctions are not always easily available. This information has only been found in Spain and the UK. In Finland, after the enactment of the Auditing Act 459/2007, the disciplinary sanctions are annotated on the register of statutory auditors, and information on recent disciplinary sanctions is published on the website of the TILA. In Italy, the CONSOB has a registry for disciplinary sanctions and publishes the information in its webpage. Finally, Germany and France only provide a general report of global results on disciplinary sanctions.

5.5. Supervisory mechanisms: quality assurance controls and investigations procedures

Table 6 reports information on the scope of supervision and the delegation of the supervisory activities to other public or private bodies. There are two monitoring mechanisms: quality assurance controls and investigation procedures. All of the analysed POBSA's are the ultimate responsible body to select their own reviewers involved in the quality assurance process. However, the requirements and detailed procedures vary across countries.

Insert Table 6 about here

The TILA, the WPK, and the POB have the necessary infrastructure to develop quality controls without a significant collaboration of the professional bodies.[12] Conversely, in Italy, Spain and France, the number of technical staff suitable for acting as a reviewer to conduct quality assurance controls is limited. In Italy, the reviewers only supervise listed companies and the CONSOB provides information on the periodicity of the quality controls (CONSOB, Annual Report 2011). Additionally, the ICAC and the H3C collaborate intensively in the quality assurance reviews with the national professional accounting bodies, to extend the

[12] Additional details on quality controls developed in Germany, Finland and the UK can be provided by the authors under request.

scope of the revisions. In Spain, reviewers are former auditors (ICAC, Annual Report 2011) while in France, auditors can be appointed as professional reviewers (*contrôleurs*) as long as they have more than fifteen years of professional experience (H3C, Decision 2009-04).

As previously explained, quality controls are "*proactive*" mechanisms, and technical controls or investigation procedures are "*reactive*" and may potentially turn into disciplinary sanctions. Due to the strong link between investigations and disciplinary sanctions, most of the POBSAs have also competences in disciplinary procedures. The exception is the POB, that is not entitled to proceed in disciplinary matters. The AADB is the British public body responsible for the investigation in cases that affect the public interest in the UK. All other cases of potential misconduct are transferred to the relevant professional bodies. In the UK, individual complaints about accountants, accountancy firms or actuaries should be directed first to the professional body that the individual professional or firm belongs to. In France, professional bodies also cooperate intensively in the investigation processes. In fact, they are responsible for the initial disciplinary process and the technical investigation. The H3C acts as an appellations organism and its final decision can be submitted to a judicial review. In Germany, the investigations procedures are functions operated by the WPK, under the constant supervision of the APAK. In Finland and Spain, investigations are carried out by the TILA and the ICAC, respectively. Finally, we should mention that the CONSOB in Italy does not publish specific information on technical controls (CONSOB, Annual Report 2011).

Generally speaking, the scope of supervision of these POBSAs covers all auditing firms. The exception is Italy, as the CONSOB is the only public oversight body in charge of regulating, supervising and disciplining the auditors of listed companies. Oversight responsibilities for the rest of auditors and auditing firms lie on the Ministry of Economy.

5.6. Disciplinary mechanisms

Table 6 above presents information about the disciplinary mechanisms in all countries. Except for the H3C and the POB, the other POBSAs have disciplinary competencies. Nevertheless, some disciplinary bodies are more established than others. In countries such as Finland, Germany, Italy and Spain, with a well-established public oversight system, sanctions have been publicly available for decades (ICAC 1992; Viitanen 2000; Quick et al. 2002; Stevenson 2002; TILA, Annual Report 2012). The TILA has been issuing sanctions against auditors since 1927 (TILA 1927); the ICAC since 1992 (ICAC 1992); The CONSOB since 1986 (CONSOB, Annual Report 1986);[13] and the WPK since 1962, but under the ultimate responsibility of the APAK since 2008 (Quick et al. 2002; APAK 2010). In countries with a recently established system, as France and the UK, disciplinary sanctions has been published from 2004 and 2007, respectively (H3C, Annual Report 2004; De las Heras 2009). However, both countries have traditionally an intensive supervisory and disciplinary activity conducted by the professional accounting and auditing bodies. Professional accounting and auditing bodies in France, Germany and the UK have published disciplinary sanctions previous to the creation of the public oversight bodies.

Similar to the scope of supervision, the scope of discipline of most of the analysed POBSAs covers all auditing firms. The exception is Italy, as the CONSOB is only in charge of disciplining the auditors of listed companies. The comparative overview of the disciplinary systems of the countries under analysis indicates that the harmonization of the public oversight systems across member states is not complete. Supervisory mechanisms are essential to guarantee audit quality, but its efficacy is only attained when they are reinforced through appropriate disciplinary sanctions (e.g. Maijoor and Vanstraelen, 2006). Audit

[13] Written reprimands are used by the CONSOB to request for clarifications and additional information to auditors. Information on written reprimands is firstly published in the CONSOB annual report in 1986.

quality enforcement is significantly limited if the disciplining and sanctioning measures are not properly articulated. Thus, the final success of the process for harmonizing audit quality may depend on how soon disciplinary systems are truly harmonized.

6. Analysis of the institutional status and changes achieved

As a final analysis of the process of implementation, harmonization and stabilization of the oversight systems for auditors in the sample state members, we examine more granular data that permits a direct test of our hypotheses. In particular, we test our hypotheses that the level of implementation, harmonization and stabilization of public oversight systems across the EU depends on the impact of the demand for institutional change (driven by the depth of capital markets) and the supply of regulatory changes (driven by the distance between the pre-Directive systems and the requirements in the Directive) on. To do so, we use the following simple model:

$$\text{Harm\_POBSA} = \beta_o + \beta_1 \text{ CapMKT\_DM} + \beta_2 \text{ Distance\_SP} + \varepsilon \qquad (1)$$

In model (1), the dependent variable is a harmonization score (Harm_POBSA) that measures the level of harmonization of the national oversight systems to the content of the Directive created based on the comparative analysis of the above sections. Harm_POBSA is obtained by creating 15 items that measure the degree of implementation, harmonization and stability achieved in each of the previously analysed dimensions across the analysed countries. All items have the same maximum and minimum that is, each item is scored from 0 to 1. This permits creating our harmonization score.[14] Table 7 Panel A presents the description and codification of the 15 items.

Insert Table 7 about here

To test H1, we use a proxy for the depth of capital markets (CapMKT_DM) calculated as the ratio of market capitalization for all listed companies to GDP, obtained from the World Bank (Kaufmann et al. 2007). We expect the depth and importance of capital markets to be positively associated with the harmonization of the public oversight system for statutory auditors. Thus, we expect coefficient β_1 to be positive and significant. To test H2, we use a proxy for the distance between the pre-Directive systems and the requirements in the Directive (Distance_SP). Based on the previous discussion, Distance_SP for each country is constructed as the average of two proxies. The first one: (a) a dummy variable that identifies if the pre-existing system did not have a POBSA, this proxy takes the value of 1 if the country did not have a pre-Directive POBSA, 0 otherwise. The second one, (b) an index variable that measures the relative distance between the pre-Directive and the Directive systems in each country and that takes the value of 1 for maximum distance (UK and Italy), 0.5 for intermediate distance (Germany and France) and 0 for minimum distance (Spain and Finland). We expect the distance between pre-Directive and Directive structures to be negatively associated with the harmonization of the public oversight system for statutory auditors. Thus, we expect a negative correlation between Harm_POBSA and Distance_SP. Therefore, we expect β_2 to be negative and significant.

[14] In constructing Harm_POBSA we allocate the same weight to each of the 15 items and thus assume that they all have equally importance. This assumption is common in previous studies on enforcement (e.g. Brown et al. 2014; La Porta et al. 2006) because of the difficulty involved in defining a specific weight for each item.

6.1. Descriptive evidence

The descriptive analysis of the conceptual framework of the oversight system of the auditing profession in the six representative members states (Finland, France, Germany, Italy, Spain, and the UK) indicates that although the member states formally comply with the requirements of the Directive, significant differences still persists across systems.

Under H1 and H2, we predict that the degree of harmonization would depend on the demand for institutional change (driven by the depth of capital markets (CapMKT_DM)); and the supply of regulatory changes, driven by the distance between the pre-Directive systems and the requirements in the Directive (Distance_SP). As can be seen in Table 7 Panel B, capital market pressures are stronger (weaker) for the UK and Finland (Italy and Germany), potentially leading to greater demand for institutional change. With regards to the supply of regulatory changes, in Finland and Spain most of the requirements included in the Directive were already in place. The differences between the pre-Directive and post-Directive structures are the smallest. Hence, these countries have to make few changes and are thereby predicted to easily reach a new equilibrium. Any difference in their degrees of harmonization would then be driven by differences in the demand side (capital markets).

Conversely, Table 7 Panel B shows that in UK, France and even in Germany and Italy, there are significant differences between the pre- and post- Directive structures. UK and France have had a long-standing self-regulated system where the audit profession has played a significant supervisory role. Germany had a mixed pre-Directive system which was mainly self-regulated, and Italy did not have a clearly defined pre-Directive system, with the stock exchange regulator being responsible for supervising the auditors of listed companies. Therefore, in these countries, significant regulatory changes are needed to harmonize their systems and thus, we predict that it will take longer for the political and professional actors to move the system towards a new equilibrium.

The evidence in Table 7 is consistent with Finland and Spain being the first countries to align their oversight systems with the content of the Directive. As expected, in these countries with minimal differences between the pre-Directive and post-Directive structures, the public oversight systems are about to be fully harmonized. Only few details need to be harmonized. For instance, in Finland, the number of Board members rises to 14 which seems quite large compared to the structure of the rest of the POBSAs under analysis. Similarly, in Spain the quality controls and the board of the public oversight body still needs to become more independent from the audit profession.

In intermediate positions, there are countries such as the UK, with strong incentives to implement the changes, but an initial pre-Directive system largely distant to the content of the Directive. The UK has made strong efforts to reach stability faster, however the system is still changing. Further efforts should be made to harmonize the Board structure and the disciplinary mechanisms. In this intermediate position we also find countries that have intermediate situations with regards to incentives and distance, such as Germany and France, where still significant efforts should be made to improve both transparency and independence of their supervisory and disciplinary activities.

Clearly lagging behind is Italy, a country with large distance to the Directive and low incentives to implement institutional changes. Due to the lack of incentives and feasible national proposals, very few changes have been accomplished in this system. This is a country in which the POBSA is mainly in charge of other functions rather than the oversight of the audit profession. In many dimensions (e.g. financial independency, scope of supervision and discipline) the Italian system is not even formally adapted to the Directive.

Table 8 Panel A displays descriptive statistics of the main variables. The evidence shows that the dependent variable (Harm_POBSA) ranges from 0 to 1, with mean and median values of the harmonization score (Harm_POBSA) ranging between 0.71 and 1. These results indicate that although there are some differences, the analysed oversight systems tend to be harmonized.

Insert Table 8 about here

For completeness, Table 8 Panel B presents the correlation matrix among the variables included in our empirical model. As expected, there is a positive and statistically significant correlation between the dependent variable Harm_POBSA and the independent variable CapMKT_DM (coeff=0.28, *p*-value<0.01), consistent with the prediction underlying H1. Similarly, consistent with H2, the analysis shows a negative and statistically significant correlation between the dependent variable Harm_POBSA and the independent variable Distance_SP (coeff=-0.45, *p*-value<0.01). Finally, we observe a low correlation coefficient between the two independent variables CapMKT_DM and Distance_SP (coeff=-0.20, *p*-value<0.10), which confirms the lack of multicolinearity problems.

6.2. Results

Table 9 presents the results from running model (1), where we formally study the impact of the demand for institutional change (CapMKT_DM) and the supply of regulatory changes (Distance_SP), on the level of harmonization of EU public oversight systems (Harm_POBSA).

Insert Table 9 about here

The results of Table 9 indicate that both the incentives (demand) for harmonization as measured by CapMKT_DM and the distance to the Directive (supply) as measured by Distance_SP drive the level of individual harmonization achieved. In particular, and consistent with H1, we find that CapMKT_DM is positively associated with the degree of harmonization (coeff=0.03, *t*-stat=2.79 in model 1, and coeff=0.02, *t*-stat=2.13 in model 3). We also find evidence consistent with H2, as Distance_SP is significantly negative (coeff=-

0.39, *t*-stat=-4.77 in model 2, and coeff=-0.36, *t*-stat=-4.34 in model 3), indicating that the greater the distance in pre-Directive systems, the lower the achieved degree of harmonization. Overall, these findings confirm our expectations and would indicate that both the strength of capital markets and pre-Directive differences are important in explaining the degree of harmonization achieved across the oversight systems of member states. These results are consistent with institutional theories that posit that institutions emerge in equilibrium and evolve very slowly over time, even in the presence of external shocks.

7. Summary of findings and discussion on future prospects

We provide a comparative overview of public oversight systems for statutory auditors across a representative number of EU member states. Based on Directive 2006/43/EC, we develop a conceptual framework that we use as our benchmark for the comparative analysis of the structure, the funding source, the level of transparency, the supervisory procedures and the disciplinary sanctions across the public oversight bodies under study. We focus on countries linked to any of the three different pre-Directive oversight systems in Europe: (a) countries moving from a professionally self-regulated and peer-reviewed supervision to a public oversight system; (b) countries with an well-established governmental public oversight system, embracing the Directive to update the responsibilities of the oversight bodies; and finally, (c) countries with an oversight system which had either a mixed public-professional structure, or a not clearly defined system.

We report that significant differences remain across systems, raising the concern on whether the issuance of the new Eight Directive has succeeded in its commitment to homogenize the oversight mechanisms of the auditing profession in the EU. Nevertheless, the analysis shows that a considerable number of the Directive requirements have been adequately implemented. For example, the sources of finance and the nomination procedures for Board members are almost completely harmonized. However, differences arise particularly in terms of transparency. This is a key issue as well as a limitation of the current research. Without greater harmonization of the annual reports prepared by the POBSAs, it is not possible to carry out more in depth comparisons of the activities and results across the different bodies.

Additional differences arise in quality controls and investigation procedures. Particularly, differences relate to the degree of collaboration with professional accounting and auditing bodies in quality controls, and the collaboration with the judicial system during the investigation procedures. The wide dispersion on the degree of collaboration across competent bodies in each country, raises a concern on the effectiveness and strength of the supervisory mechanisms in place across member states. Indeed, the scope of supervision for quality controls seems to be incomplete in some countries.

Finally, we identify that there is no homogeneity in the penalties imposed against auditors. While in Finland, Italy and Spain there is a long tradition of disciplinary sanctions imposed by the POBSA, in France, Germany and the UK sanctions within a public oversight system are more recent because, in these countries, the disciplinary sanctions were only a competence of the professional accounting and auditing bodies.

Thus, despite the existence of a Directive that requires the harmonization of these oversight systems, we find that some of the characteristics of the pre-Directive oversight systems are perpetuated into the current systems, and thus, additional supra-national efforts are required to truly harmonize the supervisory procedures of the audit profession in Europe. Our evidence suggests that both the incentives (demand) for institutional change and the distance (supply) between pre-existing systems and the Directive are important explanatory factors of the achieved level of harmonization.

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Table 1. Literature review: The influence of institutional factors on IFRS accounting harmonization

Reference: author(s) (year of publication)	**Sample: countries, years, (observations*)**	**Persistent of differences in: accounting outputs (proxy)**	**Influence of: institutional factors**
Dasket et al. (2008)	26 continental countries 2001-2005 (105,527 firm-year obs)	disclosure & financial reporting comparability (cost of equity capital)	enforcement
Aharony et al. (2010)	14 European countries 2003-2005 (2,298 firms)	financial reporting comparability (equity value relevance of accounting numbers for goodwill, R&D expenses & revaluation of PPE)	legal origin & national GAAP's
Kvaal & Nobes (2010)	4 European countries & Australia 2005-2006 (232 firms)	financial reporting comparability (accounting policy choices)	legal origin & national GAAP's
Li (2010)	18 European countries 1995-2006 (6,456 firm-year obs)	disclosure & financial reporting comparability (cost of equity capital)	enforcement
Byard et al. (2011)	20 European countries, 2003-2006 (1,418 firms)	disclosure & financial reporting comparability (analysts' information: absolute forecast errors, forecast dispersion & the number of analysts following a firm)	enforcement
DeFond et al. (2011)	14 European countries, 2003 & 2005 (8,995 firms)	financial reporting comparability (number of industry peers using the same accounting standards in countries with credible implementation)	capital markets forces & enforcement
Gebhardt & Novotny-Farkas (2011)	12 European countries, 2000-2007 (90 banks)	financial reporting comparability (earnings smoothing & timely loss recognition)	enforcement
Nobes (2011), Kvaal & Nobes (2012)	4 European countries & Australia, 2008-2009 (287 firms)	financial reporting comparability (accounting policy choices)	legal origin & national GAAP's
Florou & Pope (2012)	24 countries, 2003-2006 (10,852 firms)	disclosure & financial reporting comparability (institutional investor decision outcomes: equity investments by international institutional investors)	enforcement & national GAAP's
Houqe et al. (2012)	46 continental countries, 2000-2007 (104,348 firm-year obs)	accounting earnings comparability (discretionary accruals)	investor protection & enforcement

Table 1. continued

Reference: author(s) (year of publication)	**Sample: countries, years, (observations*)**	**Persistent of differences in: accounting outputs (proxy)**	**Influence of: institutional factors**
Isidro & Raonic (2012)	26 continental countries, 2006-2007 (7,854 firm-year obs)	accounting earnings comparability (value relevance of earnings & discretionary accruals)	capital markets forces, enforcement, economic development & competition
Jeong-Bon & Shi (2012)	34 continental countries, 1998-2004 (15,382 firm-year obs)	disclosure comparability (stock price synchronicity)	investor protection, enforcement & national GAAP's
Landsman et al. (2012)	13 European countries, Australia, Hong Kong & South Africa 2002-2007 (21,703 firm-year obs)	disclosure & financial reporting comparability (information content of earnings announcements: abnormal return volatility & abnormal trading volume)	enforcement
Yip & Young (2012)	17 European countries, 2006-2007 (1.800 firms)	disclosure & financial reporting comparability (similarity of accounting functions, degree of information transfer & value relevance of accounting numbers)	legal origin
Ahmed et al. (2013)	20 continental countries, 2002-2007 (3.262 firms)	accounting earnings comparability (earnings smoothing, earnings targeting & timely loss recognition)	legal origin & enforcement
Glaum et al. (2013)	17 European countries, 2005 (357 firms)	disclosure comparability (compliance with disclosure requirements of IAS 3 & IAS 36)	capital markets forces & enforcement

* The number of observations refers either to the final number of firms or the number of firm-year observations, when detailed information on the number of firm observations is not retrievable from the corresponding study.

Table 2. Competent authorities, audit profession public oversight systems in the EU.

Country	Competent bodies	Website
Austria	Qualitätskontrollbehörde für Abschlussprüfer und Prüfungsgesellschaften (QKB)	www.bmwfj.gv.at
	Arbeitsausschuss für externe Qualitätsprüfungen (AEQ)	www.aeq.or.at
Belgium	Conseil Supérieur des Professions Economiques (CSPE)	www.cspe-hreb.be
	Chambre de renvoi et de mise en état (CRME)	www.oversight-audit-belgium.eu
Denmark	Danish Commerce and Companies Agency (DCCA)	
	Danish Supervisory authority on Auditing (Revisortilsynet)	
	The Disciplinary Board on Auditors (Revisornaevnet)	www.eogs.dk
Finland	Tilintarkastuslautakunta (TILA)	www.tilintarkastuslautakunta.fi
France	Haut Conseil du Commissariat aux Comptes (H3C)	www.h3c.org
Germany	Abschlussprüferaufsichts Kommission (APAK)	www.apak-aoc.de
	Wirtschaftsprüferkammer (WPK)	www.wpk.de
Greece	Accounting & Auditing Oversight Board (ELTE)	www.elte.org.gr
Italy	Commissione Nazionale per le Società e la Borsa (CONSOB)	www.consob.it
Ireland	Irish Auditing & Accounting Supervisory Authority (IAASA)	www.iaasa.ie
Luxemburg	Commission de Surveillance du Secteur Financier (CSSF)	www.cssf.lu
The Netherlands	Autoriteit Financiële Markten (AFM)	www.afm.nl
Portugal	Conselho Nacional de Supervisão de Auditoria (CNSA)	www.cnsa.pt
Spain	Instituto de Contabilidad y Auditoría de Cuentas (ICAC)	www.icac.meh.es
Sweden	The Supervisory Board of Public Accountants (Revisorsnämnden)	www.rn.se
United Kingdom	Professional Oversight Board (POB)	
	Accountancy & Actuarial Discipline Board (AADB)	www.frc.org.uk

Source: Prepared by the authors on the basis of the European Group of Auditors' Oversight Bodies (EGAOB) meetings and reports.

Table 3. Details of the content of the General Framework' dimensions of public oversight systems for auditors in the EU

Dimensions	Analysed Aspects	Description
Creation, establishment & functions	Main objective	General objective, as established in the official website
	Specifics functions over the audit profession	Identified competencies: (1) Registering (2) Supervising and/or (3) Disciplining
	Year of creation	Year in which the body was officially established
	Year initiating the activities	Year in which the body begins to exercise its functions
	Legislation that establishes the competencies	Official Act that establishes the POBSA competencies
Structure	Nomination procedure for the Board members	Nomination process of the POBSA Board members
	Nº of member of the Board	Number of Board members
	Professional Profile	Professional profile of the members of the Board (auditors, preparers, managers, politicians, judges, academics, civil servants).
Financing	Funding source	Funding sources: (a) 100% governmental, (b) Mixed model: governmental funding and fees charged to statutory auditors and auditing firms.
	Funding amount	Total funds received in 2011
Transparency	Annual reports	Is the POBSA publishing an annual report?
	Activity reports	Is the POBSA publishing an activity report?
	Disciplinary sanctions	Are disciplinary sanctions publicly available?
Supervisory mechanisms	Quality assurance controls	Is the POBSA responsible for the quality controls?
	Investigations procedures	Is the POBSA responsible for the Investigation procedures?
	Scope of supervision	All audit firms, audit firms of listed companies or PIE's
Disciplinary mechanisms	Disciplinary competence	Is the POBSA the disciplinary body?
	First sanction	Date on which the disciplinary body imposed the first disciplinary sanction under the supervision of the POBSA
	Scope of discipline	All audit firms, audit firms of listed companies or PIE's

Source: Prepared by the authors based on the requirements of the Directive 2006/43/EC

Table 4. Details of the general characteristics of the POBSAs

Country	Body	Main objective	Specifics functions on auditing	Year it was set up	The first year of functions as POBSA	Most recent legislation updating their competencies
Finland	TILA	(1) Public oversight of auditors	(1) Regulation (2) Supervision (3) Discipline	1925	1925	Auditing Act 459/2007 New Auditing Act 1454/2011
France	H3C	(1) Public oversight of auditors (2) Guarantee audit regulation	(1) Regulation (2) Supervision	2003	2003	Financial Securities Act (2003-706)
Germany	APAK	(1) Public oversight of auditors	(1) Regulation (2) Supervision (3) Discipline	2004	2005	Auditor Oversight Act, WPO 12/2004 Professional Oversight Reform Act, WPO 2007
Italy	CONSOB	(1) Italian Stock Exchange Regulator (2) Public oversight of auditors	(1) Regulation (2) Supervision (3) Discipline	1974	1974	Legislative Decree no. 216/1974 Legislative Decree no. 58/1998 Legislative Decree no. 39/2010
Spain	ICAC	(1) Public oversight of auditors (2) Guarantee audit regulation	(1) Regulation (2) Supervision (3) Discipline	1988	1988	Auditing Act 19/1988 Financial Act 44/2002 New Auditing Act 12/2010
United Kingdom	POB	(1) Public oversight of auditors	(2) Supervision	2005	2005	Companies Act 2004

Table 5. Details on the structure, finance structure and transparency of the POBSAs

Panel A. Details on the structure of the POBSAs

Country	Body	Responsibility of the nomination procedure	Board members	Professional Profile
Finland	TILA	By the government	14	Auditors, preparers, managers, politicians, judges, academics & civil servants
France	H3C	By the government	12	Auditors, politicians, judges & civil servants
Germany	APAK	By the government	9	Auditors, politicians, judges & academics
Italy	CONSOB	By the government	4	Auditors, preparers & civil servants
Spain	ICAC	By the government	9	Auditors, preparers, academics & civil servants
United Kingdom	POB	By the selection process of the FRC	9	Auditors, preparers, managers and academics

Panel B. Details on the finance structure and transparency activities of the POBSAs

Country	Body	Funding (Source)	Funding (year)	Publishing annual reports	Publishing activity reports	Publishing disciplinary sanctions
Finland	TILA	Mixed model	1.81 Million € (2011)	Yes	Yes	Yes
France	H3C	Mixed model	8.9 Million € (2011)	Yes	Yes	Yes
Germany	APAK	Mixed model	Non disclosed	Yes	Yes	Yes
Italy	CONSOB	100% from the government (Ministry of Economy and Finance)	142.9 Million € (2011)	Yes	Yes	Yes
Spain	ICAC	Mixed model	6.8 Million € (2011)	Yes	Yes	Yes
United Kingdom	POB	Mixed model	2.4 Million £ (2011)	Yes	Yes	Yes

Table 6. Details on the oversight and disciplinary mechanisms

Country	Body	Quality assurance controls	Investigations procedures	Scope of supervision	Disciplinary competence	The year of the first sanction	Scope of discipline
Finland	TILA	Yes	Yes	All	Yes	1927	All
France	H3C	Yes. Together with the professional bodies	Yes. Together with the professional bodies and the Judicial system	All	No. Disciplinary competencies rely on the Ministry of Justice and the professional bodies. The H3C is the appellate authority.	2004	All
Germany	APAK	Yes. Together with the WPK	Yes. Together with the WPK and the Judicial system	All	Yes. Together with the WPK and the Judicial System	2008	All
Italy	CONSOB	Yes	Non disclosed	Auditors of listed companies	Yes	1986	Auditors of listed companies
Spain	ICAC	Yes. Together with the professional bodies	Yes	All	Yes	1992	All
United Kingdom	POB	Yes	No. AADB and the professional bodies carry on the investigations.	All	No. The disciplinary body is the AADB	2007	All

Table 7. Data for the analysis of the process of harmonization of the oversight systems for auditors in Europe

Panel A. Description for the dependent variable: Degree of implementation, harmonization and stability of the public oversight systems

Item	Description	FI	FR	GE	IT	SP	UK
	Basic Characteristics						
Objective	Equals 1 if the general objective is the public oversight of auditors; and 0 otherwise.	1	1	1	0	1	1
Number of bodies	Equals 1 if all the public oversight functions are under the same body; and 0 otherwise.	1	0	0	0	1	0
Establishment	Equals 1 if the POBSA is created before the year 2002; equals 0.5 if the POBSA is created after the year 2002; and 0 if no POBSA has been created and another supervisory body has extended their competencies to the oversight of the audit profession.	1	0.5	0.5	0	1	0.5
	Structure						
Nomination	Equals 1 if the nomination procedure of Board members is controlled directly by a competent public authority; and 0 otherwise.	1	1	1	1	1	0
Board size	Equals 1 if the number of Board members is equal of the mean of members from the six analysed POBSASs (nine); and 0 otherwise.	0	0	1	0	1	1
Profile	The ratio of the number of types of profile of the Board members by the maximum number of types of profile from the six analysed POBSASs (seven).	1	0.57	0.57	0.43	0.57	0.57
	Financing and Transparency						
Funding model	Equals 1 if the funding model is mixed; and 0 otherwise.	1	1	1	0	1	1
Reports transparency	Equals 1 if there is complete information on the annual and activity reports; equals 0.5 if there is a lack of information on the annual and activity reports; and 0 if no reports are published.	1	1	0.5	0.5	1	1
Disciplinary sanctions transparency	Equals 1 if detail information on disciplinary sanctions is publicly available; equals 0.5 if only general information on disciplinary sanctions is publicly available; and 0 if no information is available.	1	0.5	0.5	1	1	1
	Supervisory mechanisms						
Quality controls	Equals 1 if the quality controls are only carried out by the POBSA's reviewers; equals 0.5 if the controls are carried out together with the professional bodies; and 0 if there is no information on quality controls.	1	0.5	0.5	0.5	0.5	1
Investigations	Equals 1 if the investigations are only carried out by the POBSA; equals 0.5 if the investigations are carried out together with the professional bodies; and 0 if there is no information on investigations.	1	0.5	0.5	0	1	0.5
Scope of supervision	Equals 1 if all the audit firms are under the scope of supervision; and 0 otherwise.	1	1	1	0	1	1

Item	Description	FI	FR	GE	IT	SP	UK
	Disciplinary mechanisms						
Disciplinary competence	Equals 1 if the disciplinary actions are imposed by the POBSA; equals 0.5 if these actions are imposed together with the professional bodies; and 0 if there is no information on disciplinary actions.	1	0.5	0.5	1	1	0.5
Sanctions establishment	Equals 1 if the first disciplinary sanction is imposed before the year 2002; equals 0.5 if it is imposed after the year 2002; and 0 if no disciplinary action has been imposed.	1	0.5	0.5	1	1	0.5
Scope of discipline	Equals 1 if all the audit firms are under the scope of discipline; and 0 otherwise.	1	1	1	0	1	1
	Global institutional change						
Public oversight global institutional change index	*Equals the arithmetic mean of (1) Basic Characteristics items; (2) Board Structure items; (3) Independency & transparency requirements items; (4) Supervisory mechanisms items; and (5) Disciplinary mechanisms items.*	***0.93***	***0.64***	***0.67***	***0.36***	***0.94***	***0.70***

Panel B. Description for the independent variables: Demand and Supply of public oversight systems

Item	Description	FI	FR	GE	IT	SP	UK
	Demand for institutional change						
Depth of capital markets	The ratio of market capitalization for all listed company stock to GDP obtained from the World Bank (Kaufmann et al. 2007)	10.71	8.19	4.38	4.49	8.49	13.41
	Supply of regulatory changes						
Distance to the Directive	The average between (a) a dummy variable that identifies if the pre-existing system did not have a POBSA, and (b) an index variable that measures the relative distance between pre-Directive and Directive systems and that takes the value of 1 for maximum distance (UK and Italy), 0.5 for intermediate distance (Germany and France) and 0 for minimum distance (Spain and Finland).	0	0.75	0.75	1	0	1

Table 8. Analysis of harmonization achieved in public oversight systems

Panel A: Descriptive statistics

	Q1	Mean	Median	Std.	Q3	Min	Max
Harm_POBSA	0.50	0.71	1	0.37	1	0	1
CapMKT_DM	4.49	8.27	8.34	3.23	10.71	4.38	13.41
Distance_SP	0.00	0.58	0.75	0.43	1	0	1

Panel B: Correlation Matrix

	HARM_POBSA	CapMKT_DM	Distance_SP
Harm_POBSA	1		
CapMKT_DM	0.28***	1	
Distance_SP	-0.45***	-0.20*	1

This table presents descriptive statistics in Panel A and correlations between the variables of our model 1 in Panel B. The dependent variable is a harmonization score (Harm_POBSA) that is measured by combining the granular data in Table 7 into a single variable. The independent variables are as follows. The depth of capital markets (CapMKT_DM) that is calculated as the ratio of market capitalization for all listed company stock to GDP obtained from the World Bank (Kaufmann et al. 2007). The distance to the Directive (Distance_SP) that is constructed as the average between (a) a dummy variable that identifies if the pre-existing system did not have a POBSA, and (b) an index variable that measures the relative distance between the pre-Directive and the Directive systems in each country and that takes value 1 for maximum distance (UK and Italy), 0.5 for intermediate distance (Germany and France) and 0 for minimum distance (Spain and Finland).

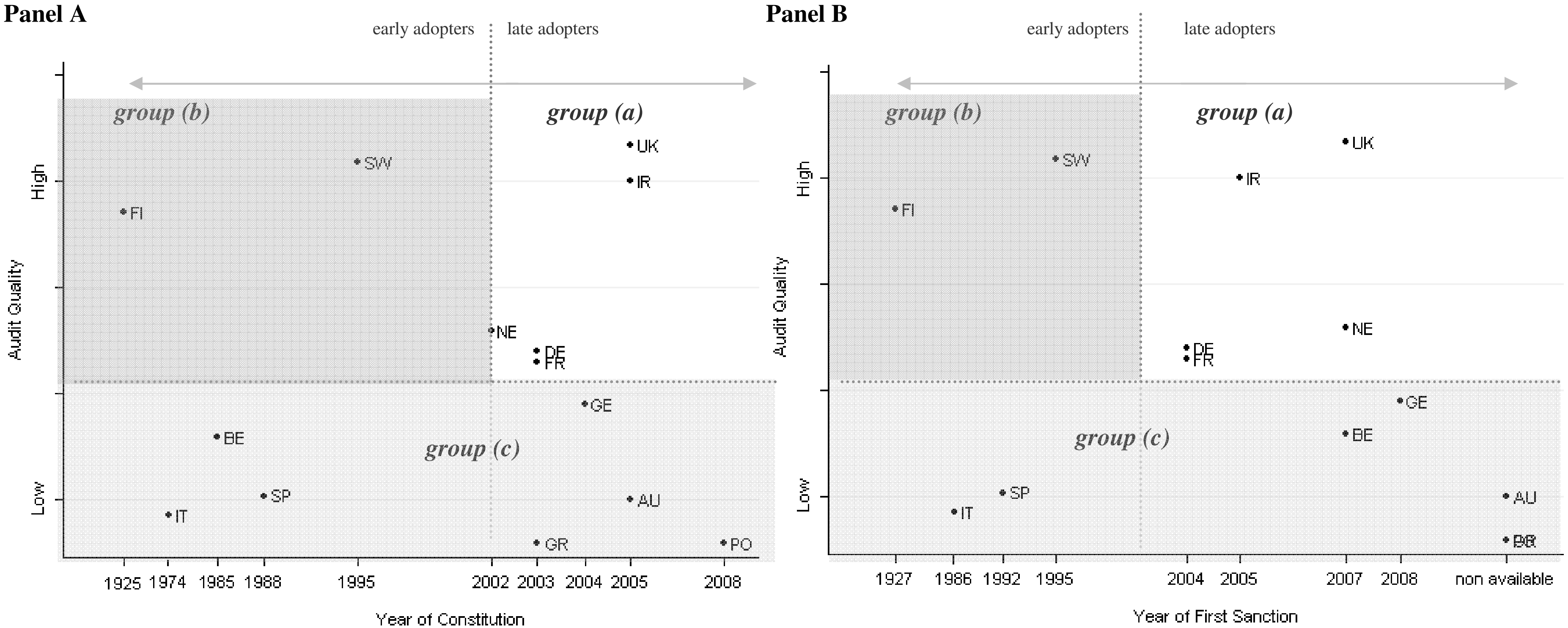
***, **, * indicates significance at the 10%, 5% and 1% level, using a two-tail test.

Table 9. Analysis of harmonization achieved in public oversight systems

	Pred. sign	Model (1) Coeff. *t-stat*	Model (2) Coeff. *t-stat*	Model (3) Coeff. *t-stat*
Intercept		0.43^{***}	0.94^{***}	0.72^{***}
		[*4.15*]	[*15.68*]	[*6.22*]
CapMKT_DM	(+)	0.03^{***}		0.02^{**}
		[*2.79*]		[*2.13*]
Distance_SP	(-)		-0.39^{***}	-0.36^{***}
			[-*4.77*]	[-*4.34*]
F-statistic		7.80^{***}	22.79^{***}	14.11^{***}
Adj. R-sq.		0.07	0.20	0.23
N		90	90	90

We more formally test the link between harmonization and both incentives and distance by combining the granular data in Table 7 into a single variable measuring harmonization (Harm_POBSA). This measure is regressed on a proxy for the depth of capital markets (CapMKT_DM) calculated as the ratio of market capitalization for all listed company stock to GDP obtained from the World Bank (Kaufmann et al. 2007), and a proxy of the distance to the Directive (Distance_SP) constructed, based on the previous discussion, as the average between (a) a dummy variable that identifies if the pre-existing system did not have a POBSA, and (b) an index variable that measures the relative distance between the pre-Directive and the Directive systems in each country and that takes value 1 for maximum distance (UK and Italy), 0.5 for intermediate distance (Germany and France) and 0 for minimum distance (Spain and Finland). Below each coefficient, in parentheses, we show the corresponding *t-student statistics*. ***, **, * indicates significance at the 10%, 5% and 1% level, using a two-tail test.

Figure 1. Country classification analysis of audit quality and period of implementation of its public oversight system



Graphs in panel A and B represent the European countries as a configuration of points where: AU stands for Austria, BE for Belgium, DE for Denmark, FIN for Finland, FR for France, GE for Germany, GR for Greece, IR for Ireland, IT for Italy, NE for Netherlands, PO for Portugal, SP for Spain, SW for Sweden and UK for the United Kingdom. The horizontal axis of the graph in panel A indicates the year of the POBSA establishment, while the horizontal axis of the graph in panel B indicates the year of issuance of the first sanction to auditors imposed for a POBSA or under the supervision of the POBSA. For presentational purposes the timeline in the horizontal axis does not follow a proportional distribution of time. Vertical axes represent the level of audit quality proxies for each country, based on the aggregate earning management measure provided by Leuz (2010). 2002 can be considered a cut off year, when the self-regulation quality procedures of the audit profession start to be questioned and public oversight system start to be proposed and encouraged. Source: Prepared by the authors based on public information available on the websites of the Competent Authorities, Audit Profession Public Oversight systems in the EU and Leuz (2010).