Markt/2007/15/F – Study on International Standards on Auditing

Evaluation of the Possible Adoption of International Standards on Auditing (ISAs) in the EU

Final Report

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List of Abbreviations

AC .... Audit Committee

AFM .... Autoriteit Financiele Markten

AICPA .... American Institute of Certified Public Accountants

APAK .... Abschlussprüferaufsichtskommission

ASIC .... Australian Securities and Investment Commission

AU .... Auditing (Auditing Standard AICPA)

AUASB .... Auditing and Assurance Standards Board (Australia)

AuRC .... Audit Regulatory Committee

AUS .... Australian Standards

BCC .... Business Cost Calculator

C .... Company

CEPS .... Center for European Policy Studies

CNCC .... Compagnie National des Commissaires aux Comptes (France)

COM .... Commission Communication

CONSOB .... Commissione Nazionale per le Societáe la Borsa (Italy)

CPA .... Certified Public Accountant

CZ .... Czech Republic

DE .... Germany

DG .... Directorate General

DK .... Denmark

E.g. .... Exempli gratia

EC .... European Commission

ECGI .... European Corporate Governance Institute

ED .... Exposure Draft

Ed. .... Editor

EEC .... European Economic Community

ES... Spain

Et al. .... Et alii

EU .... European Union

F... France

FAR SRS .... Föreningen Auktoriserade Revisorer/Svenska Revisorsamfundet (Sweden)

FEE.. Fédération des Experts Comptables Europeéns

Fn. .... Footnote

FoF... Forum of Firms

FRC .... Financial Reporting Council

GAAS .... Generally Accepted Auditing Standards

H3C.. Haut Conseil du Commisariat aux Comptes (France)

HAI... Harmonisation-Index

HUN... Hungary

I .... Italy

I.C.J.C.E .... Instituto de Censores Jurados de Cuentas de España

I.e. .... Id est

IAASB.. International Auditing and Assurance Standards Board

ICAC... Instituto de Contabilidad y Auditoría de Cuentas (Spain)

IDW .... Institute of Public Auditors in Germany

IDW-PS .... IDW Auditing Standard

IFAC .... International Federation of Accountants

IFRS..International Financial Reporting Standards

ISA ....International Standard of Auditing

ISAE ....International Standard on Assurance Engagements

ISQC...International Standard on Quality Control

ISRE ....International Standard on Review Engagements

ISRS..International Standard on Related Services

IT ....Information Technology

Jr...Junior

Man. ....Member of the management

NEP..Normes d'exercice professionel

NL ....The Netherlands

No...Number

OBPR ....Office of Best Practice Regulation (Australia)

OECD ....Organisation for Economic Co-operation and Development

OROC...Ordem dos Revisores Oficiais de Contas

PCAOB ....Public Company Accounting Oversight Board

PIE...Public Interest Entity

PL..Poland

Rev. ....Revised

Royal NIVRA ....Koninklijk Nederlands Instituut van Registeraccountants (The Netherlands)

SAS .... Statement on Auditing Standards

SEC.. Statement of the European Commission

SLIM .... Simplification of the Legislation on the Internal Market

SME .... Small and Medium Size Entity

SMO.. IFAC Statements of Membership Obligation

SMP .... Small and Medium Size Practice(s)

SOEL .... Institute of Certified Public Accountants of Greece

UK.. United Kingdom

URL .... Uniform Resource Locator

US .... United States

USA.. United States of America

USD.. US-Dollar

Vs... Versus

WiFo .... Austrian Institute of Economic Research

1 Introduction

1.1 Purpose of the Study

This Study was commissioned by the Internal Market Directorate General of the European Commission. The objective of the Study should be seen in the context of Article 26 of the Statutory Audit Directive (Directive 2006/43/EC).[1.] This provision allows the European Commission to adopt International Standards on Auditing (ISAs) issued by the International Auditing and Assurance Standards Board (IAASB) through a binding legal instrument. Pursuant to the Statutory Audit Directive 2006/43/EC, statutory audits of annual and consolidated accounts[2] should be carried out on the basis of international auditing standards (ISAs). However, this would imply the adoption of those standards in accordance with Council Decision 1999/468/EC[3]. Apart from the other relevant provisions laid down in the "Invitation to Tender n° MARKT/2007/15/F", four necessary conditions for the adoption of ISAs in the European Union are crucial to the adoption decision: 1

(a) Development (due process, public oversight, transparency);

(b) International general acceptance;

(c) Contribution to a high level of credibility and quality of financial statements;

(d) Conduciveness to the European public good.

Although there is a vast amount of literature on the monitoring and the signalling function of audits for economic decision-making in general, neither theoretical nor empirical research has delivered a comprehensive picture of the impact of *harmonised* auditing standards in general, and of *ISAs* in particular. In this setting, the Study essentially addresses condition (c) above by evaluating whether such adoption by the EC would achieve this condition and analyses the related costs and benefits of such adoption. Conditions (a), (b) and (d) are outside the scope of the Study because these matters will be examined by the European Commission. 2

Consequently, the objectives of this Study are to: 3

(a) develop a conceptual framework of the economic effects of the adoption of ISAs by the EC with special consideration given to understandability and enforcement of auditing standards and audit quality; and

(b) describe, analyse and – if possible – quantify the effects identified in (a) using a wide-range survey instrument.

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1 Directive 2006/43/EC of the European Parliament and the Council of 17 May 2006 on Statutory Audits of Annual Accounts and Consolidated Account, Amending Council Directive 78/660/EEC and 83/349/EEC and Repealing Council Directive 84/253/EEC (Text with EEA Relevance). In: Official Journal of the European Union, L 157: 87-107. Hereinafter referred to as "Statutory Audit Directive".

2 Both annual and consolidated accounts are hereinafter referred to collectively as "financial statements".

3 Council Decision 1999/468/EC: Council Decision of 28 June 1999 Laying down the Procedures for the Exercise of Implementing Powers Conferred on the Commission. In: Official Journal of the European Union, L 184: 23-26. Hereinafter referred to as "Comitology Decision".

1.2 Design and Timing of the Study

The Study is based on a thorough literature review on potential effects of ISA adoption within Europe. Since there is virtually no theoretical or empirical research on the adoption of ISAs in a European context, literature on experiences with the adoption of ISAs in other regions and on the adoption of IFRS – if applicable – has been used. The review of literature focused, in particular, on research on audit quality, on the understandability and the enforcement of auditing standards, as well as on regulation and harmonisation issues, both from an economic and a legal point of view. The underlying methodological aspects of the Study, including impact assessment, cost benefit analysis, surveys and related statistical instruments were also considered. 4

The results of the literature review were synthesised into an extended cost benefit conceptual framework that was used as basis for the following empirical cost benefit analysis. As stipulated in the invitation to tender, special attention is given to audit quality effects, economic effects resulting from legal and regulators´ issues, audit market effects and potential costs and benefits at the audit firm and audit engagement level. 5

Since this Study was required to take into account in the final report all relevant ISAs and Exposure Drafts issued within three months of the issuance of the final report, the extended survey on the qualitative and quantitative cost benefit analysis of the adoption of ISAs from an audit firm as well from a stakeholder perspective was carried out with quality assurance measures in two phases, the first involving a survey in October 2008 and a review of results with the EGAOB ISA subgroup in December 2008, and the second involving a second meeting with the EGAOB ISA subgroup to take into account changes to the ISAs since September. 6

One major caveat in relation to surveys results from the potential lack of representativeness due to limitations in sample size and sample selection combined with a potential bias in the response rate. In this Study, response rate problems were not expected to occur, since all participants selected for the survey were expected to agree to take part. In addition, due to the expected differences in cost benefit effects relating to country, size and stakeholder-specific factors, sampling issues were already outlined in the tender. Pursuant to the requirement to cover 10 EU Member States (at least including Denmark, France, Germany, Poland and the United Kingdom) and to ensure to cover a sufficient variety of audit firms and stakeholders including regulators, shareholders, investors, insurance companies and banks, the sample was selected in way so as to achieve *a maximum coverage* of all *parties* and all *countries* affected by the adoption of ISAs by the EC. Figure 1 summarises the original sample selection. 7

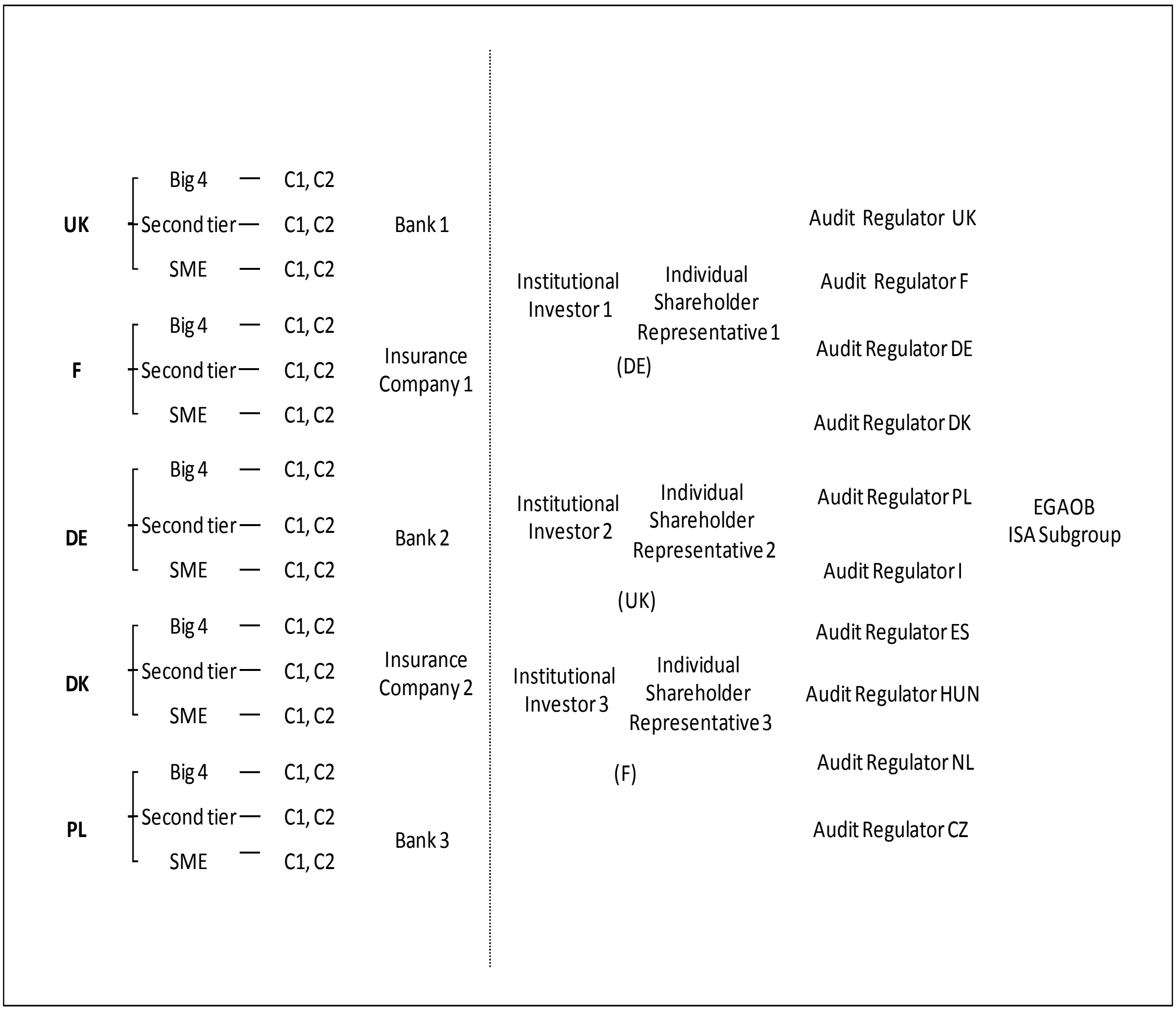

Figure 1: Sample

In October 2008, a survey was carried out on all ISAs and Exposure drafts, including the Agenda Papers for the September Meeting of the IAASB that were made available during September as well as all available documents agreed and released after the IAASB June meeting. The questionnaires were distributed to audit firms, audit clients (including banks and insurance companies), investors (and their representatives) and audit regulators. 8

As stipulated in the invitation to tender, the audit methodology as currently practiced in Europe was the starting point of the analysis. The aim therefore was to assess the methodologies and to also take into account differences in audit methodology between countries and across audit firm size, respectively big four firms, mid-tier firms and Small and Medium Size Practices (SMPs). The audit firms (one of each size category) were originally selected from the United Kingdom, France, Germany, Denmark and Poland. 9

Part I of the questionnaires that were distributed to the audit firms provided a detailed picture of current audit methodology and was used in the part II of the survey instrument for the cost benefit analysis on a larger scale (the questionnaires distributed to the other survey participants only contain questions on costs and benefits. 10

The potential costs and benefits from ISA adoption were derived from the conceptual framework and presented in questionnaires to the survey participants. Audit firms were asked to base their assessment on the expected changes from current audit procedures (as reported in part I of the questionnaire) to expected audit procedures compliant with ISAs after the completion of the clarity project. For qualitative effects, the survey participants were asked to evaluate the effects on a Likert Scale distinguishing between categories like "no change, slight, significant, and major". Where relevant, the scale was two-sided with "no change" as the midpoint. In all other cases the effects were needed to be assessed in a binary (yes/no) mode. For quantitative effects, the survey participants were asked to quantify the implications, either indicating ranges or stating concrete figures (in Euro). Since the effects vary between audit firms, clients, stakeholders from capital markets and audit regulators, four different questionnaires were developed. Ten audit regulators were asked to respond to questionnaires directed at audit regulators. The following audit regulators responded, (the response from the Netherlands was received too late to include in the calculations and tables, but was reviewed for overall consistency with other regulator responses):

- France: H3C (Haut Conseil du Commissariat aux Comptes)
  Mme. Christine Thin
  19, avenue George V, 75008 Paris
- Germany: APAK (Abschlussprüferaufsichtskommission)
  Dr. Volker Röhricht
  Rauchstraße 26, 10787 Berlin
- The Netherlands: AFM (Autoriteit Financiele Markten)
  Prof. Dr. Steven Maijoor
  Vijzelgracht 50, 1017 HS in Amsterdam
- United Kingdom: FRC (Financial Reporting Council)
  Paul Boyle
  Aldwych House 5th Floor, 71-91 Aldwych, London WC2B4HN
- Denmark Erhvervs- og Selskabsstyrelsen (Danish commerce and company agency)
  Niels Henrik Englev
  Kampmannsgade 1, 1780 Copenhagen V, Denmark
  e-mail: nhe@eogs.dk, Tel: +45 (33) 307629
- Spain ICAC
  Ana Manzano Cuadrado
  C/Huertas 26, 28014 Madrid, Spain
  e-mail : ana.manzano@icac.meh.es, Tel +34 (913) 895635
- Hungary Pénzügyminisztérium/Auditors' Public Oversight Committee
  László Miklós
  Jozsef nador ter 2-4., 1051 Budapest, Hungary
  e-mail: kkb@pm.gov.hu, Tel: (+36-1) 327 - 2437

1.3 Main Issues Arising in the Study

1.3.1 Legal Basis for the Adoption of ISAs in the EU

1.3.1.1 Fourth and Seventh EU Directives

Directive 78/660/EEC[4] and Directive 83/349/EEC[5] deal, inter alia, with the preparation and presentation of "annual accounts" (annual financial statements) and "consolidated accounts" (annual consolidated financial statements), respectively, of certain types of companies and the audit and publishing of those financial statements. Financial statements prepared, presented and published in accordance with the requirements of the Fourth and Seventh Directives represent general purpose financial statements, since the financial reporting framework prescribed by the Fourth and Seventh Directives are general purpose financial reporting frameworks designed to meet the common financial information needs of a wide range of users (see Proposed ISA 200.A3 (Revised and Redrafted)). 11

1.3.1.2 Statutory Audit Directive

The adoption provisions in the Statutory Audit Directive only apply to the "audit of annual accounts and consolidated accounts insofar as required by Community law" (see Article 2 (1) of the Statutory Audit Directive). As noted above, these represent general purpose financial statements. 12

Pursuant to the Statutory Audit Directive, statutory audits of financial statements shall be carried out on the basis of international auditing standards. This implies the adoption of those standards in accordance with the Comitology Decision.[6] The objective of the Statutory Audit Directive is to ensure a high quality for all statutory audits required by EU law by providing that all statutory audits be carried out on the basis of international auditing standards.[7] The Statutory Audit Directive has given implementing powers to the European Commission (EC) in order to adopt the ISAs[8] in accordance with the Comitology Decision. Within this context, the EC will need to be satisfied: 13

- that the ISAs have been developed with proper due process, public oversight and transparency, and are generally accepted internationally;

4 Directive 78/660/EEC: 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 Companies. In: Official Journal of the European Union, L 222: 11-31 last amended by Council Directive 2006/99/EC of 20 November 2006 Adapting Certain Directives in the Field of Company Law, by Reason of the Accession of Bulgaria and Romania. In: Official Journal of the European Union, L 363: 137-140. Hereinafter referred as "Fourth Directive".

5 Directive 83/349/EEC: Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts. In: Official Journal of the European Union, L 193: 1-17 last amended by Council Directive 2006/99/EC of 20 November 2006 Adapting Certain Directives in the Field of Company Law, by Reason of the Accession of Bulgaria and Romania. In: Official Journal of the European Union, L 363: 137-140. Hereinafter referred as "Seventh Directive".

6 Schockaert, D./Houyoux, N. (2007): 521.

7 Recital 13 of the Statutory Audit Directive.

8 Article 26 (2) of the Statutory Audit Directive.

- that they contribute to a high level of credibility and quality in relation to the true and fair view of the annual or consolidated accounts;
- and that they are conducive to the European public good.

14 In the context of the adoption of ISAs in the EU, the applicable statutory instrument is the Statutory Audit Directive, which confers on the Commission implementing powers to adopt ISAs (Article 26) in accordance with the comitology procedure. Furthermore, the Commission can make use of the assistance of a committee pursuant to Article 48 (1) of the Statutory Audit Directive. To this effect the "Audit Regulatory Committee" (AuRC), which is composed of the representatives of the member states and chaired by the Commission, has been established. Under the comitology procedure the Commission is required to consult the AuRC in relation to the adoption of ISAs. The AuRC is then expected to form an opinion on the measures proposed by the Commission. The Statutory Audit Directive also introduces a requirement for member states to organise an effective system of public oversight for statutory auditors and audit firms and to co-ordinate public oversight systems at the EU level.[9]

1.3.1.3 Article 26 of the Statutory Audit Directive

15 Pursuant to Article 26 (1) of the Statutory Audit Directive, member states may apply a national auditing standard as long as the EC has not adopted an international auditing standard covering the same subject matter. Consequently, when the EC adopts the ISAs, all national standards related to the same subject matter dealt with by the ISAs would no longer be applicable. However, member states always have the option to adopt a standard on a subject matter that is not related to an ISAs adopted by the Commission.[10]

16 Furthermore, pursuant to Article 26 (3) – (4) of the Statutory Audit Directive, member states may impose audit procedures or requirements in addition to – or in exceptional cases, by carving out parts of – the ISAs, only:

- if the procedures or requirements have not been covered by adopted ISAs;[11]
- if these stem from specific national legal requirements relating to the scope of statutory audits, meaning that those
    - comply with a high level of credibility and quality to the financial statements in conformity with the principles of true and fair view and with the European public good and
    - are communicated to the Commission and the member states before their adoption.[12]

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9 Article 33 of the Statutory Audit Directive; Commission Decision 2005/909/EC: Commission Decision of 14 December 2005 Setting up a Group of Experts to Advise the Commission and to Facilitate Cooperation between Public Oversight Systems for Statutory Auditors and Audit Firms. In: Official Journal of the European Union, L 329: 38-39.

10 Article 26 (1) of the Statutory Audit Directive

11 Recital 13 of the Statutory Audit Directive.

12 Article 26 (3) of the Statutory Audit Directive.

Pursuant to the Statutory Audit Directive member states may impose additional requirements relating to the statutory audits of financial statements for a period expiring on 29 June 2010 (but not for the carve-outs).[13] If the adopted international auditing standards contain audit procedures that would create a specific legal conflict with national law, stemming from specific national requirements related to the scope of the statutory audit, member states may carve out the conflicting part of the international auditing standard as long as these conflicts exist,[14] provided that: 17

- they communicate the specific national legal requirements, as well as the ground for maintaining them, to the EC and the other member states at least six months before their national adoption, or in the case of requirements already existing at the time of adoption of an international auditing standard, at the latest within three months of the adoption of the relevant ISAs[15] and
- the carve-outs comply with a high level of credibility and with the European public good.[16]

1.3.2 Relevant IAASB Pronouncements

A key issue for the Study is which IAASB pronouncements ought to be covered. Strictly speaking, only those pronouncements relevant to statutory audits required by the Fourth and Seventh EU Directives should be examined. It is necessary to describe the relevance of particular standards to the potential adoption of ISAs pursuant to the Statutory Audit Directive to determine the scope of IAASB standards covered by the Study. Based on the analysis in Appendix 3, ISAs 800 and 805 are not relevant for ISA adoption in the EU and therefore will not be covered by this Study. The analysis in Appendix 3 notes that ISAs 810 and ISAE 3402 could be relevant to statutory audits in the EU, but are not necessary for an adoption of the ISAs. Because these two standards are not directly necessary for ISA adoption in the EU and no intention exists at this stage to consider adoption, Commission Services requested that these standards be excluded from the scope of the Study. 18

The ISAs deal with the responsibilities of auditors when conducting an audit of financial statements[17] – that is, with the performance of audits of financial statements and the auditor's communication to relevant parties of the results of the audit. International Standard on Quality Control 1 (ISQC 1) is not an ISA and therefore does not address these issues directly, but rather deals with a firm's responsibilities for its system of quality control for audits of financial statements, as well as for other engagements.[18] As such, ISQC 1 does not deal directly with the performance of audits or audit reporting, but it does deal with the firm quality controls that make the performance of audits and audit reporting in accordance with applicable standards, law and regulation more likely, or perhaps even possible in the case of larger audits. The question as to whether adoption of ISQC 1 at a technical level is necessary or desirable when adopting the ISAs hinges upon the following issues: 19

13 Article 26 (4) of the Statutory Audit Directive.

14 Recital 13 of the Statutory Audit Directive.

15 Article 26 (3) in connection with 26 (2) of the Statutory Audit Directive.

16 Recital 13 of the Statutory Audit Directive.

17 Proposed ISA 200.A43 (Revised and Redrafted).

18 Paragraph 1 of ISQC 1.

a. Are there inextricable explicit connections between ISQC 1 and the ISAs that make an analysis of the costs and benefits of adoption of the ISAs without analysing the costs and benefits of adoption of ISQC 1 a reasonable proposition?

b. Even if there were no inextricable explicit connections between ISQC 1 and the ISAs, is it reasonable to analyse the costs and benefits of adopting auditing standards without assessing the impact of concomitant quality control standards for audit firms on their ability to provide reasonable assurance that audits will be performed by audit firms in accordance with applicable standards, law and regulation?

There are various explicit references to ISQC 1 or firm systems, policies or procedures in the ISAs. One refer- 20
ence in the introduction to ISA 220 permits auditors to rely on their firm's quality control system and is therefore of particular importance to the application of ISA 220. Furthermore, ISA 220 clarifies that it is premised on the basis that the firm is subject to ISQC 1 or to national requirements that are at least as demanding, which means that even where ISQC 1 is not applied, it remains the benchmark. None of the references to ISQC 1 are in the objectives, requirements or definitions.

However, the remaining references are in the introduction and application material, which are a part of the 21
ISAs. For these reasons, as long as the IAASB retains the references to ISQC 1 in the ISAs, it would be reasonable to assert that ISQC 1 is a "related Standard" to the ISAs (and in particular, to ISA 220) and that it is "relevant to the statutory audit". For these reasons, there do not appear to be legal barriers within the Statutory Audit Directive prohibiting the adoption of ISQC 1 – that is, at first analysis, adoption of ISQC 1 by the EU appears legally possible.

The next issue as to whether these explicit connections between ISQC 1 and the ISAs are inextricable depends 22
upon an evaluation of the nature of these connections. Although some of the ISAs, such as ISA 600, would be difficult to understand without the reference to ISQC 1 or firm quality control policies and procedures in their application material or introduction, the importance of application material is a separate issue that needs further treatment. Whether the explicit references in particular ISAs to ISQC 1 or firm quality control policies and procedures in the definitions and requirements are inextricable depends upon whether these ISAs are capable of "functioning" without such references. A quick review of these references indicates that the noted requirement in ISA 620 would not "function" without its reference, and that noted requirements in ISA 220 would not "function" without some of these references (in particular, ISA 220.07. 220.11, 220.22, 220.23 and 220.25). For these reasons, the references to firm quality control policies and procedures appear to be inextricable, but this does not imply that these references need to be the quality control requirements in ISQC 1. However, these references in the requirements and definitions are predicated upon certain minimum standards of firm quality control being fulfilled – that is, not any quality control system will do. This is particularly the case for the reference in ISA 220.02 in the introduction, for which a quality control system of certain effectiveness is required, which is defined as being a system that is at least as demanding as ISQC 1. Some regulators in the EU suggest

that audit firms following firm quality control standards other than ISQC 1 may result in quality control over auditing that would suffice for the purposes of the ISAs and that therefore the Study cannot focus only on ISQC 1. Although it may be true that other firm quality control standards may be adequate for purposes of the ISAs, the question here is not whether other standards may be adequate, but whether the benefits of adoption of ISAs would exceed the costs with or without the concomitant adoption of ISQC 1. Furthermore, firm quality control over auditing is a key issue in audit quality, and the primary basis for the determination of the potential benefits of ISA adoption relate to potential increases in audit quality. For these reasons, it is unlikely that analysis of the costs and benefits of adoption of the ISAs without analysis of the costs and benefits of adoption and non-adoption of ISQC 1 would represent a reasonable proposition.

In accordance with request of the contractual authority, the empirical assessment of the costs and benefits of adopting ISAs is based on two scenarios: an impact assessment of adopting and not adopting ISQC 1, when adopting ISAs. 23

1.3.3 Clarity Project Implications

The primary objective of the clarity project is to clarify the degree of obligation imposed on auditors for different parts of the ISAs. For this reason, the basic principles and essential procedures are being changed into requirements, and present tense sentences in the other text, are being classified as either requirements or application and other explanatory material. Furthermore, to emphasise the principles-based nature of the ISAs and the judgment required to apply them, objectives are being introduced into each ISA. To this effect, the ISAs have been completely restructured. 24

The ISAs as proposed in the clarity project include the following parts: 25

- Introduction;
- Objectives;
- Definitions;
- Requirements;
- Application and other explanatory material;
- Appendices.

While all of these parts of an ISA constitute an integral part of each ISA (that is of each standard), each of these parts is associated with different degrees of obligation for an auditor seeking to comply with the ISAs when performing an audit in accordance with the ISAs. Furthermore, ISA 200 contains a number of objectives and requirements that clarify what “compliance with the ISAs” means. In particular, it includes the following objective: 26

The overall objective of the ISAs as described in ISA 200.11 is: 27

> "In conducting an audit of financial statements, the overall objectives of the auditor are:
>
> (a) To obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework; and
>
> (b) To report on the financial statements and communicate in accordance with the auditor's findings."

ISA 200.19 states: "The auditor shall have an understanding of the entire text of an ISA to understand its objectives and apply its requirements properly." This means that when applying the requirements of an ISA, the parts of the ISA other than the requirements (introduction, objectives, definitions, related guidance) must be taken into account by the auditor in interpreting the requirements, even though these other parts do not lead to separate requirements. 28

ISA 200.21 states: 29

> "To achieve the overall objectives of the auditor, the auditor shall use the objectives stated in relevant ISAs in planning and performing the audit, having regard to the interrelationships among the ISAs to:
>
> (a) Determine whether any audit procedures in addition to those required by the ISAs are necessary in pursuance of the objectives stated in the ISAs; and
>
> (b) Evaluate whether sufficient appropriate audit evidence has been obtained."

Pursuant to ISA 200.22: 30

> "Subject to paragraph 23, the auditor shall comply with each requirement of an ISA unless, in the circumstances of the audit:
>
> (a) The entire ISA is not relevant; or
>
> (b) The requirement is not relevant because it is conditional and the condition does not exist."

ISA 200.23 stipulates further: 31

> "In exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement in an ISA. In such circumstances, the auditor shall perform alternative audit procedures to achieve the aim of that requirement. The need for the auditor to depart from a requirement is expected to arise only where the requirement is for a specific procedure to be performed and, in the specific circumstances of the audit, that procedure would be ineffective in achieving the aim of the requirement."

This leads to the following requirement in ISA 200.24: 32

> "If an objective in a relevant ISA cannot be achieved, the auditor shall evaluate whether this prevents the auditor from achieving the overall objectives of the auditor, and thereby requires the auditor, in accordance with the ISAs, to modify the auditor's opinion or withdraw from the engagement."

When adopting the ISAs in the EU by means of an EU statutory instrument, the EU will be giving ISAs legal sanction. However, there are questions about how to reflect the different degrees of obligation embodied in the different parts of each ISA by means of an EU statutory instrument, and whether it is possible to faithfully transpose the degrees of obligation set forth into the ISAs by means of EU statutory instruments. 33

Since it is not possible for a study on the costs and benefits of ISA adoption in the EU to examine the costs and benefits of all of the different possible variations in the means of adoption, the EU Commission proposed that this Study be performed on the basis that the introduction, objectives, definitions, and requirements be adopted by means of an EU regulation and that the related guidance (application and other explanatory material, including any appendices) be adopted by means of an EU regulation. Consequently, this Study focuses on assessing the costs and benefits of ISA adoption by the means as proposed by the EU Commission for the purposes of the Study. 34

However, in assessing the costs and benefits of ISA adoption by the means as proposed, the Study needs to examine the impact on the costs of benefits of adoption of any departures, from the degree of obligation set forth in the ISAs, resulting from those means of adoption. 35

Comparison of ISA adoption within the EU with current audit firms´ methodologies implied the consideration of the content, status and form of the ISAs and ISQC 1 in a timely manner. Given the IAASB Project Timetable, some relevant standards were expected to be approved in September 2008, whereas other approvals were planned for December 2008. Hence, the subject matter of this Study was a “moving target”. The requirement expressed in the invitation to tender, to include all ISAs after revision or redrafting under the clarity project, available in the final form or, if not, otherwise available as an exposure draft, up until three months before the completion of the Study, had major implications for the Study design and timing. First, the Study involved continual follow-up of the development of the ISAs and ISQC 1 during the course of the Study. Consequently, for all descriptions and analyses of the standards the survey was carried out in October 2008 on the basis of all ISAs and Exposure drafts, including the Agenda Papers for the September 2008 meeting of the IAASB, that were available in September, as well as all available ISAs approved and released after the IAASB’s June 2008 meeting. For quality assurance reasons, a first meeting was held with the EGAOB ISA subgroup in December 2008 to assess the results achieved. Second, after the completion of the Clarity Project, the extrapolated impact of the last ISAs issued by the IAASB (i.e. the potential additional costs and benefits resulting from differences between the final standards, including conforming amendments, issued upon completion of the clarity project and the Agenda Papers and Exposure drafts extant prior to the September meeting) was investigated. The results were reviewed in a second meeting with the EGAOB ISA subgroup in January 2009 as a final quality assurance measure. A summary of the milestones and their timing is provided in Appendix 1. 36

1.3.4 Assumptions, Data Base and Related Caveats

The objective of this Study is to analyse the effects of ISA adoption from a broad stakeholder perspective, taking into account all consequences from a legal point of view, including regional differences within the European Union and audit market particularities, i.e. potential differences between big four firms, mid- tier firms (i.e. non big four firms that are linked to international networks) and non big four firms that do not have access to international networks (SMPs). In addition, as pointed out above, follow-up of changes to the relevant standards had to be performed continually and in a timely manner. It is not possible to survey all EU member states and every audit firm or other stakeholder therein, a sample of different stakeholders within a selection of representative EU member states was drawn. The actual sample was structured as follows: 37

- Capital Market Participants: Although the call to support and participate in the Study (including the questionnaires) was sent out by the European Commission to 20 potential participants only six capital market participants provided responses to the survey. For this reason, the Study can only provide a rough indication of the views of capital market participants rather than representing a reliable indicator of their views. 38
- Audit Regulators: Although the survey questionnaire was provided to ten audit regulators that had committed to responding to the questionnaire, only six responses were received in time. Furthermore, some of the responses were not complete in terms of covering all of the questions that were posed. For this reason, for some questions for which only few responses were received, the responses only provide a rough indication of audit regulator views rather than any conclusive evidence. 39
- Audit Clients: Although the survey questionnaire was intended to be provided to 35 audit clients, the audit firms participating in the survey and supporting the distribution of the questionnaires in a transparent manner were only able to provide the survey to 5 audit clients; no audit clients could be convinced to participate in the survey directly. Even the split of the questionnaire into somewhat quantitative and somewhat qualitative questions and the extension of the deadline did not improve the response rate. Additionally, in the questionnaires received, some questions were not answered. It appears that audit clients generally do not have much experience with auditing standards and their effects on the audit, and in particular, are not very aware of the potential significance of the potential adoption of ISAs for audit costs and their costs for the preparation of the financial statements so that they can be audited. Furthermore, just as the survey was being circulated, the credit crisis began to make itself felt upon audit clients' businesses. Consequently, answering a survey on auditing standards is currently not a very high priority for audit clients. This explains the very low response rate from audit clients. Given the large number of audit clients compared to the limited response rate, the responses are not representative. They are provided solely to provide some indication of the views of some clients. However, some audit firms did provide data on client-related matters that reflect the expectations of those firms of the direct impact on the financial statement preparation costs of audit clients. 40

- Audit Firms: Originally, the survey sought responses from five national firms that are in "big four" international firm networks, five mid-tier national firms that are in international mid-tier networks or other forms of international association, and five small and medium-sized practices (SMPs) that are not members of any international firm network or other form of international association. All of these were spread across five different EU member states (UK, Germany, France, Denmark and Poland) to achieve adequate coverage of the EU audit market and some degree of representativeness. To achieve a higher response rate, the big four and mid-tier networks/associations chose to centralise the receipt and distribution of the survey questionnaires to their national firms and to collect the survey questionnaires and return them to the tenderer. With the exception of one mid-tier network/association, which only responded at the international audit network level, the effectiveness of this procedure is reflected in the relatively high response rate for national firms that are members in international networks/associations. In all, 23 responses were received from firms part of the big four international networks; 9 responses were received from firms part of the mid-tier international networks. The geographic spread of the responses reflects the relative economic and audit market weight of the different regions in the EU: 24 responses were from countries in North-Western Europe; 8 responses were from Southern and Eastern Europe. The following table shows the distribution of responses by country: 41

Country	**Number of Responses**
CZ	1
DE	5
DK	6
ES	1
F	6
HUN	1
NL	1
PL	5
UK	6
Total	**32**

Table 1: Distribution of Responses by Country

- The high rate of response eased the calculation of costs and benefits for the EU for the segment of the audit market covered by big four networks and mid-tier networks or associations. However, the mid-tier networks responding are all part of the Forum of Firms (FoF)[19], which brings with it commitments to incorporate the ISAs into firm audit practices and incorporate ISQC 1 into firm quality con- 42

19 The Forum of Firms brings together audit firms that perform transnational audits of financial statements and involves them more closely with the activities of the International Federation of Accountants (IFAC) in audit and other assurance related areas. The objective of the Forum of Firms is to promote consistent and high quality standards of financial reporting and auditing practices worldwide. The firms in the Forum of Firms have provided commitments to incorporate the ISAs into their firm audit methodologies and ISQC 1 into their firm quality control policies and procedures.

trol policies and procedures. Consequently, the data received from the mid-tier firms and international networks or associations can be extrapolated only for those mid-tier audit firms whose network or association is a member of the FoF (see Appendix 8 for a list of the audit networks or associations of firms in the FoF that are active in Europe for which the extrapolation is done). However, less success was achieved in obtaining responses from SMPs: only two responses were received and only one of these delivered sufficient quantitative data. For this reason, the Study is unable to draw any persuasive conclusions with respect to the impact of ISA adoption on mid-tier firms that are not in the FoF and SMPs and their clients. Both the firms from the big four networks and from the mid-tier networks or associations responding pointed out that due to the fact that the clarified ISAs had not yet been issued in final form, they had not yet really begun the process of assessing the impact of the clarified ISAs on their practices and that the survey was rather early in this respect. Furthermore, unlike the big four and mid-tier firms, SMPs generally do not have a technical department. Based upon our discussions with them, it appears that they tend to rely on their professional organizations and other service providers to supply them with information about the impact of new standards and to also supply them with implementation guidance, including manuals and audit software, training courses, etc. to help them apply new standards. It should be noted that generally, professional organizations and other service providers in Europe have only just begun assessing the impact of the clarified ISAs on audits of SMPs and have not yet begun the process of developing implementation guidance, training courses and other support for SMPs. It is expected that these materials and courses will not begin to be available to SMPs until the end of the third quarter or the beginning of the fourth quarter in 2009. This explains why SMPs appear to have felt that they are not able to respond to the questionnaires. SMPs do not appear to have the resources to deal with the quantitative cost-benefit questionnaires necessary to perform the quantitative cost-benefit analysis required by the invitation to tender. For these reasons, the results of the survey for the audit market covered by the FoF were extrapolated to the portion of the market covered by the firms not in the FoF using assumptions supported by other studies and discussions with professional bodies and standard setters. However, less reliance should be placed upon the quantitative results of the extrapolation than on the results of the survey, since the results of the extrapolation are not based upon data obtained directly by empirical means.

- International Audit Firm Networks: To obtain an understanding of the costs and cost savings that would be incurred or saved at an international audit firm network level and to avoid double-counting or neglecting potential cost effects beyond the audit firm level, a supplementary survey was sent to the big four firm networks and three mid-tier networks at international level. All of the surveyed networks, which are all members of the FoF, responded to all of the questions posed. 43

It should be noted that many cost and benefits effects cannot be quantified in monetary terms, but only be assessed in qualitative terms by ranking those effects. In addition, the survey of this Study required the participants to develop expectations about potential effects of the adoption of standards that are not yet effective 44 and have not yet been previously applied: the survey refers to the comparison of current audit methodologies with an audit methodology that is in compliance with ISAs *after* the completion of the IAASB clarity project. Naturally, this methodology has not been implemented yet, even if it may be conceded that parts of the clarified ISAs have been already considered by national professional bodies or auditors, some of which, such as audit firms with multinational clients, may have taken into account potential clarification effects in advance. As a consequence, the participants of the empirical part of the Study needed to design assessments that were not based on *evidence*, but rather on *extrapolations* of experience and expectations. Furthermore, audit clients vary widely in size and nature of business, which leads to greater variability in the answers. In order to account for these matters, quantitative answers were based on wide ranges, rather than exact figures. Consequently, the figures show a considerable variability. However, the information was summarised by deriving location parameters as point estimates. In summary, due to the limitations noted, the quantitative conclusions drawn in the Study only reflect best estimates and the ranking of effects represent indicators, rather than decisive evidence of potential cost and benefit effects.

We refer to appendices 4.1 to 4.6, which contain the survey questionnaires, including a description of the range of possible answers. 45

It should be noted that the responses in the survey on the costs and benefits of ISA adoption are based on the assumption that, if the ISAs were to be adopted, the introduction, objectives, definitions and requirements of the ISAs would be adopted by means of an EU regulation (see Section 1.3.3.). If these parts of the ISAs were to be adopted by a less binding legal instrument, then the survey responses, and hence the analysis of costs and benefits (and in particular, the analysis of the benefits arising from harmonisation) may change considerably, and in particular the benefits may decrease significantly. 46

The Study does not examine *recurring* translation costs and does not provide a treatment of transitional costs resulting from problems arising from legal implementation of the ISAs because the recurring translation costs would be replacing current costs of transposition, incorporation or consideration of ISAs in national standards, and transitional costs of legal implementation. As stipulated in the invitation to tender, reference to ISAs excludes the consideration of any “add-on” or “carve-out” resulting from the adoption process or from Member States exercising their power under the Statutory Audit Directive to “add-on” to, or “carve-out” from, adopted ISAs. 47

As stipulated in the invitation to tender, the Study is required to cover all statutory audits in accordance with the thresholds set forth in the Fourth EU Directive. Downward departures from these thresholds[20] by individual European member States in relation to small limited companies, and other statutory audits, lead to a large number of statutory audits in some jurisdictions that are not required by the Fourth and Seventh EU Directives. 48

[20] Statutory audits of the individual accounts of limited liability companies are mandated by Article 51 of 4th Directive 78/660/EEC. However the Member States are entitled to exempt small companies. Small companies are those that do not exceed the limits of two of the following thresholds: balance sheet total of €4.4 million, net turnover of €8.8 million, average number of employees of 50.

Voluntary audits beyond these, including those resulting from the voluntary appointment of "statutory" auditors, are also not covered by the Study. These issues are highly important, since the audit clients of these statutory audits and voluntary audits are much smaller and therefore not comparable to the audit clients as defined by the EU thresholds. Given the information provided by regulators, individual FEE members, FEE and official statistics, the overall number of statutory audits in accordance with the individual member state thresholds amount to 1.65 Mio. Based on the information from countries that follow the EU thresholds, only a fraction of these may be required by the EU thresholds to have statutory audits (the "relevant" audit market). Based upon discussions with the audit firms in a number of jurisdictions we further assume, that 50 % of the statutory audit engagements of medium-sized entities of this relevant audit market are audited by audit firms not in the FoF (the other part is assumed to be audit by big four firms or mid-tier firms); on this basis we also assume that the portion of firms not in the FoF in the relevant market of audits of large unlisted entities to be 33 %. It is recognized that the basis for these assumptions are not particularly reliable, but, based upon the discussions with audit firms, it appears that the market share for audit firms in the FoF for medium-sized clients may range between 40 % to 60 %. The Study uses the higher 60 % assumption for the market share of audit firms within the FoF because this would be conservative in terms of net benefits (i.e., the greater the proportion audited by the firms within the FoF, the higher the likely overall costs for the EU economy). However, the Study also provides a sensitivity analysis to demonstrate that changes in these assumptions would not change the overall conclusions of the Study. The assumptions used without the sensitivity analysis can be depicted in the following table:

Assumed market share	**Audit Firms in FoF**	**Audit Firms not in FoF**
Large unlisted audit clients	66 %	33 %
Medium-sized unlisted audit clients	50 %	50 %
Large and medium-sized unlisted audit clients	60 %	40 %

Table 2: Assumptions Underlying Alternative Audit Market Scenarios

It was stipulated in the invitation to tender that incremental costs should be distinguished between client 49
groups, i.e. medium-sized, large unlisted and publicly listed entities as well as banks and insurance companies and should be described in absolute as well as in relative terms (i.e. relative to sales or cost figures). As a consequence, all client-group specific questions in the survey were formulated to meet this objective. However, not all the participants were in the position to distinguish among client groups in the answers. Additionally, not enough respondents provided sales or cost figures that could serve as reference point for relative cost analyses. Therefore, client-group specific analyses are possible only for costs incurred by audit firms using absolute figures; relative terms could only be applied to the overall figures for all client groups. Group audits are not treated separately: they are treated as part of the audit of the parent company financial statement.

Given the caveats resulting from potential *survey participants´* incentives and information availability restrictions, the methodology of the empirical part of the Study needs to ensure adequate *data reliability* and *data validity*. Measures taken in this Study are described in Section 2.1. 50

2 Relevant Methodological Concepts

2.1 Surveys and Related Statistical Methods

In audit research, the collection or use of empirical evidence is quite common. One way to approach empirical research is to distinguish between studies using publicly available quantitative data sets and studies developing and implementing a survey instrument to collect data for the purpose of the Study. Usually the former allow for statistically more sophisticated analyses, since sample size is considerably larger and the data are often available on a discrete scale. However, the explanatory power usually depends on the selection or availability of proxies representing the underlying rationale or argument. In fact, data limitation is the primary constraint for the empirical investigation of auditing issues. 51

One way to address the problem of data availability is to generate original information about a subject matter by collecting the assessments from parties involved, i.e. carrying out a *survey*. Generally, a survey can comprise interviews or surveys in writing. Using appropriate *scales,* this information is transposed into data which is then described and analysed. In this Study, with reference to *qualitative* effects, the survey participants were asked to evaluate the perceived changes on a *Likert* Scale distinguishing between assertions such as “no change”, “slight”, “significant”, and “major” effects, where applicable; where relevant, the scale was two-sided with “no change” as the mid-point. In all other cases, the effects were assessed in a *binary* (yes/no) mode. In order to achieve maximum comparability of the answers, the questions were posed as *closed* questions. For *quantitative* effects, the survey participants were asked to quantify the implications, either indicating ranges, percentages, or stating concrete figures (in Euro or hours). Since the effects vary between audit firms, clients, stakeholders from capital markets and audit regulators, and because different stakeholders are privy to different information, four different questionnaires were developed. In order to account for additional remarks or information that could be relevant from the survey participants´ views, the final question was posed in an open manner. Apart from interpretation notes, we received no indication that the questionnaire had missed or biased any potential cost or benefit effects of an ISA adoption by the EC. 52

Empirical research usually involves problems concerning data reliability and data validity. Data *validity* describes whether the data collected (from interview or survey instruments) actually deliver the information for which the interview or survey instrument has been designed and conducted – that is, how effective an instrument is, given certain content requirements. Following the distinction of the American Psychological Association we can distinguish three types of validity: content validity, criterion validity (i.e. predictive validity and concurrent validity), and construct validity. *Content* validity implies that all relevant aspects of the investigated dimensions of a parameter are considered. *Criterion* validity is given if forecasts based on the outcome using one instrument are reconfirmed by the result of a second instrument. This second instrument may be applied later (*predictive* validity) or simultaneously (*concurrent* validity). *Construct* validity is given if hypotheses may be derived for the relations between the construct and other constructs and if these hypotheses can be empirically tested. In this Study, data validity is supported by setting up a consistent conceptual framework indicating all potential sources for cost benefit effects and by conducting extensive pretests, in which the clarity and 53 completeness of the questions were tested and proxy answers are analysed: Each questionnaire was tested with a pretest partner from the relevant stakeholder group. The guidelines or questionnaires were revised accordingly if needed. The proxy answers, however, were not used in the data pool for investigating cost benefit effects. In addition, every questionnaire contained detailed instructions containing definitions and explanations as well as background information.

Data *reliability* refers to the accuracy and precision of a measurement procedure[21] – that is, whether they are 54
free from bias due to the interview or survey setting so that they deliver the most *realistic* picture possible. General approaches to assess reliability are time stability measures and equivalent measures.[22] The former is based on the replication of the survey at a later point of time, the latter uses different items or control groups to measure the same dimension of a certain parameter. In this Study, due to time limitations time stability measures are not applicable. Data reliability is therefore enhanced by "cross checks" for issues that can be assessed by various groups of survey participants, e.g. auditors *and* clients or audit regulators *and* external users of financial statements. I.e., potential deviations from national auditing standards (referred to as auditing standard compliance effect) may not be reported from the respected audit firms. Hence, audit regulators were asked for an assessment of national audit standards compliance as well.

The data was analysed by calculating absolute and relative frequencies of the singular outcomes and averages. 55
With reference to the quantitative data, location parameters and extrapolations from the sample to the overall populations (e.g. for audit firms) were calculated.

2.2 The EU Administrative Cost Model

On 14 November 2006 the EC issued a communication on "A strategic review of Better Regulation in the Euro- 56
pean Union"[23] launching a strategy for reducing administrative burdens. To substantiate this strategy, the EC also published a working document "Measuring administrative costs and reducing administrative burdens in the European Union"[24], drawing a methodological framework for the qualification and quantification of administrative costs that should be subject to reduction.

Base line of the model is the distinction between administrative costs and administrative burdens. Following 57
the notion used by – among others – the OECD in its "International Standard Cost Model Manual[25]", *administrative costs* are defined as "... costs incurred by enterprises, the voluntary sector, public authorities and citizens in meeting legal obligations to provide information on their action or production, either to the public authorities or to private parties"[26]. Information that would not be collected without the legal provision, however,

21 FEE (2003): 180.

22 Feldt, L. S./Brennan, R. L. (1989): 109-116.

23 COM(2006) 689 final.

24 COM(2006) 691 final.

25 OECD (2005).

26 COM(2007) 23: 5. A comparison between the prototype Standard Cost Model developed in the Netherlands and the European approach as well as country case studies on the standard cost models applied in selected European member states can be found in

leads to *administrative burdens*. I.e. administration burdens are a part of administrative costs. In a second step it is conceded that even administrative burdens may be partially necessary to contribute to market transparency. The residual – the "unnecessary or unreasonably high" administrative burdens should be reduced.

From a methodological perspective, two steps are crucial: First, the distinction between administrative costs 58
and administrative burdens, i.e. the identification of information costs that are only incurred due to legal obligations – either because their benefits are underestimated (but actually significant) or because their benefits are negligible or unreasonable. Second, the distinction between the two categories of administrative burdens, i.e., the identification of unnecessary or unreasonably high administrative burdens. The second step, however, implicitly requires the consideration of benefits. Consequently, the qualification and assessment of benefits is necessary in any case – not only for the conduct of a cost benefit analysis, but also for the methodologically sound application of the EU administrative cost model. Therefore, this Study provides not only an explicit *investigation* of beneficiary effects of the adoption of ISAs by the European Commission, but also the necessary basis for the *evaluation* of potential costs incurred by ISA adoption in the course of future EU political decisions.[27]

With reference to this Study, the model is used to provide a methodological framework for the quantification 59
of identifiable and measurable cost effects.[28] The following steps can be identified:

(a) Identification of audit firm specific and stakeholder group specific activities related to cost benefit effects as a consequence of ISA adoption within the EU, covering the entire audit process, not just the audit report disclosed;

(b) Assessment of the hourly/daily rate for performing the activities identified;

(c) Assessment of the time necessary to perform these activities;

(d) Assessment of the number of activities;

(e) Assessment of the frequency of these activities.

The costs are then calculated as the product of number, frequency, time and hourly/daily rates. 60

2.3 The EU Impact Assessment Guidelines

EU institutions use the Commission´s integrated impact assessment system to design and communicate better, 61
i.e. more efficiently and more effectively, policies and laws.[29] This corresponds to the emphasis of the essential

WiFO/CEPS (2006): 105-119. An overview of the corresponding methodology applied in the USA is provided by The Interorganizational Committee on Principles and Guidelines for Social Impact Assessment (2003).

27 This is also the case for the the EU Net Administration Cost Model (COM(2005) 97 final). The amendment to the original approach is the recognition of costs that are avoided by a new regulation compared to the costs involved with the preceding regulation. The advantage of this method is that it can be used to counter allegations that new regulations only cause additional costs. However, the method provides no systematic guidance for the distinction between costs and burdens and it leaves the question unanswered why burdens should only be reduced but not eliminated. More insights can be expected from the programme to measure and reduce administrative costs in the EU that will be completed within the new framework contract with the EC (EC (2007)).

28 COM(2005) 518 final.

29 COM(2008) 32 final: 5.

role of evaluation as a necessary tool for political decision-making.[30] Starting with the introduction of the general evaluation framework in 1996, the number of evaluations carried out by the EC has been increasing continually. This increase has been accompanied by a shift from ex post evaluations to prospective evaluations – the latter particularly in the form of impact assessments.[31]

Recent examples are – among others – the impact assessments accompanying two regulation proposals of the European Parliament and of the Council on food hygiene[32] and on independent experts`' report on the occasion of a merger or a division[33]. Both – rather short (4 and 5 pages, respectively) – documents are structured along the EC´s guidelines. Both documents are designed to describe the consequences of two proposals following the overarching objective to positively influence EU competitiveness and hereby to contribute to the overall target of reducing administrative burdens and to ensure the availability of necessary and useful information to its current users. Whereas SEC(2007) 301 [Statement of the European Commission] delivers an estimate on expected cost reductions, SEC(2007) 298 [Statement of the European Commission] describes the potential beneficiaries in a qualitative manner. However, as both proposals explicitly imply the abolishment of information obligations, the assumption of cost reductions is not surprising. The crucial element is the justification with respect to the maintenance of the necessary information level. In the first case, it is simply stated that the same level of essential information will still be available; in the second case this problem is circumvented by introducing the option that the information may still be required by individual stakeholders. A much more sophisticated analysis is given in the impact assessment of the EC´s recommendation concerning the limitation of the civil liability of statutory auditors and audit firms.[34] The document gives a detailed analysis of general issues related to auditor liability and different liability regimes and defines six options, of which four are compared. 62

Also, with reference to the Endorsement of IFRS 8 Operating Segments, the EC has rendered an Analysis of Potential Effects[35] which has been prepared using various sources, ranging from comment letters, correspondence and public consultations, to interviews and results from academic research. The results once more show how difficult it is to quantify incremental costs or even incremental benefits of regulations requiring the submission of information. The extent of additional burdens is described as not significant or minor, whereas the benefits are linked to the expected increase of predictability and additional information. 63

In the case of ISA adoption in the European Union, cost benefit effects are comparably complex and intransparent, particularly since capital markets participants may not always be aware of auditing standards' impacts on audit quality. The aim of this Study therefore is to use the EU impact assessment guidelines and the EU administrative cost model where applicable and to clearly show what modifications have to be made. 64

[30] SEC(2007) 213 [Statement of the European Commission]: 3.
[31] SEC(2007) 213 [Statement of the European Commission]: 18.
[32] SEC(2007) 301 [Statement of the European Commission].
[33] SEC(2007) 298 [Statement of the European Commission].
[34] SEC(2008) 1975 [Statement of the European Commission].
[35] MARKT F3 D(2007).

With its Better Regulation Action Plan[36], the EC has launched an initiative to enhance competitiveness of European firms. One major approach is to provide considerable relief from administrative burdens that impair efficiency without contributing to the effectiveness of economic outcome. Future European regulation should therefore aim at the improvement of market conditions without neglecting the (information) needs of the public. As a result, regulatory initiatives need to be accompanied by an impact assessment. Following the Communication from the EC on impact assessment[37] in 2002, the EC published the Impact Assessment Guidelines in 2005 with an update on 15 March 2006 in order to provide a sound measurement methodology[38]. In its "Second strategic Review of Better Regulation in the European Union" the EC stressed the meaning and the usefulness of this instrument:[39] 65

> "Impact assessment identifies the likely positive and negative impacts of proposed policy actions, enabling informed political judgements to be made about the proposal and identify trade-offs in achieving competing objectives".[40] 66

The impact assessment reporting format recommended by the EC depicts the following major (methodological) steps:[41] 67

(a) Procedural issues and consultation of interested parties;

(b) Problem definition;

(c) Objectives;

(d) Policy Options;

(e) Analysis of impacts;

(f) Comparing the options;

(g) Monitoring and evaluation.

However, since this Study will only use the Impact Assessment Guidelines to assist the cost benefit analysis of one policy option (ISA adoption by the European Commission), only (e) above is relevant. 68

The analysis of impacts encompasses a thorough decomposition and evaluation of the effects and considers their causes, nature and extent. The European Commission Impact Assessment Guidelines suggest three steps for impact analysis:[42] 69

36 COM(2002) 278 final.

37 COM(2002) 276 final.

38 SEC(2005) 791 [Statement of the European Commission].

39 COM(2008) 32 final: 5.

40 COM(2002) 276 final: 2.

41 SEC(2005) 791 [Statement of the European Commission]: 14.

42 SEC(2005) 791 [Statement of the European Commission]: 27.

(a) Identification of impacts;

(b) Qualitative assessment of which impacts are the most significant;

(c) Advanced qualitative or quantitative analysis of impacts.

In order to identify all relevant parties affected by the regulations, it is recommended that a *causal model,* in which all relevant policy instruments are linked to their related objectives, be established. Using this procedure as a guideline for this Study, an ISA-related conceptual framework for financial statements quality and credibility that takes into account the role of audit quality, understandability and enforcement is developed in Section 3. This framework serves as a basis for the deduction and decomposition of effects of ISA adoption by the EU described in Section 4. 70

With reference to the impact assessment guidelines the following questions were used as guidance in scoping potential economic effects from ISA adoption: 71

(a) Competition in the internal market: Does ISA adoption affect the EU audit market and the EU capital market, i.e. the private and public market for capital (not only publicly listed entities, but the financial market for all entities subject to the Fourth and Seventh EU Directives)?

(b) Operating costs and conduct of business;

    a. Does ISA adoption impose additional adjustment, compliance or transaction costs for auditors?

    b. Does ISA adoption impose additional adjustment, compliance or transaction costs for preparers and users of financial statements?

    c. Does ISA adoption affect access to finance?

(c) Public authorities: Does ISA adoption have budgetary consequences for public authorities, i.e. audit regulators, both immediately and in the long run?

3 ISA-Related Conceptual Framework of Financial Statement Quality and Credibility

The following chapter is based on a general overview of relevant literature on potential effects of ISA adoption within Europe. A comprehensive review of academic articles and commentaries regarding the harmonisation of auditing practices by introducing ISAs identifies three core issues that focus on: audit quality, understandability, and enforcement of auditing standards from an economic as well as from a legal point of view. Nevertheless, the interrelationship between these three issues needs some elaboration: First, improving audit quality is the initial and paramount motive for adopting ISAs. Accordingly, developing and issuing high-quality auditing and assurance standards is identified as the main objective of the IAASB.[43] Second, understandability of auditing standards is a precondition to the improvement of the quality of those standards. This is particularly true in the light of the fact that international standards address a much wider public with a much broader cultural background than standards applicable in just one jurisdiction. Third, as emphasized by legal and economic academics,[44] enforcement of those standards is a precondition for improving auditing quality. In the words of the IAASB Terms of reference, to serve the public interest, strengthen the accountancy profession worldwide and contribute to the development of international economies, it is necessary not only to set but also to promote adherence to those standards furthering international convergence.[45] In this Study, the results of this scholarly debate is synthesised into an extended cost benefit conceptual framework that is used as basis for the empirical cost benefit analysis. 72

3.1 Audit Quality

Audits add credibility to, and thereby enhance, the quality of financial statements used in economic decisions. In fact, as recent accounting scandals worldwide have shown, credibility is a, if not the, most integral element of audit quality. There is a direct interrelation between audit quality and credibility. In other words, the increase in credibility is driven by the preparers' reactions to the threat of qualified audit opinions, i.e. when the auditor detects and reports material misstatements. The latter in general is referred to as audit quality. 73

3.1.1 Definition

Since audit quality is a matter of individual expectations and perceptions, for research purposes, audit quality needs to be *defined*. The notion has been defined in various ways. The definition still most widely used in empirical research is from DeAngelo (1981). She defines audit quality as the propensity of an auditor to *detect* that the financial statements are *materially misstated* and to *report* the material misstatement. The first component, the detection component, covers not only all resources like skills, knowledge, time and technological 74

[43] IAASB (2006). Note that on March 2, 2005, the International Accounting Standards Board (IASB) posted to its Web site a letter inviting comment on a "Draft Memorandum of Understanding (MOU) on the Role of Accounting Standard-Setters and their Relationship with the IASB" (the "draft MOU"). The letter, dated Feb. 18, 2005, states that the intent of the draft MOU is to provide "a shared vision of the respective roles of national and regional standard-setters and the IASB in working towards a **single set of high quality, understandable and enforceable** global accounting standards" (emphasis added).

[44] Pagano, M./Immordino, G. (2007).

[45] See id. (previous note).

infrastructure but also the mental attitude, personal capability and commitment necessary to identify misstatements that are material. The second component, the report component, again refers primarily to the competence as well as the willingness to communicate the findings in an appropriate way. Both components are covered by auditing standards, i.e. audit quality is affected by compliance with auditing standards, and both components enhance the quality of financial statements, too.

Depending on the measurement approaches used, the various interdependencies of the two explicit audit quality components as formulated by DeAngelo with their underlying variables led to several related audit quality approaches: for example, the consideration of audit quality as the *probability* that an auditor will not issue an unqualified report for statements containing material errors (Lee et al. (1999)) or the assumption of audit quality to be the accuracy of the information reported on by auditors (Titman and Trueman (1986)), the treatment of audit quality as a measure of the auditor's ability to reduce noise and bias in accounting data (Wallace (1980)) or as the degree to which the audit complies with relevant auditing standards (Krishnan and Schauer (2001), Tie (1999), McConnell and Banks (1998), Aldhizer, Miller and Moraglio (1995)) etc. 75

3.1.2 Measurement

In empirical audit quality research, the definition of audit quality corresponds to the *measurement* applied. One crucial issue, therefore, is the availability of appropriate measures for the investigation of the observable level of audit quality and its potential drivers. 76

In short, the measurement of audit quality may be directly attached to *proxies* 77

- relating to financial statement quality: discretionary accruals, bid-ask spreads in IPOs, restatements of financial statements, market response to quarterly earnings surprises, propensity to meet earnings benchmarks or (analyst) forecasts, bond ratings, earnings response coefficients;[46]
- relating to audit reports and effort: going-concern opinions (for financially distressed firms), auditor liability cases, investigations against the auditor by an oversight board, audit hours.[47]

Other studies investigate variables (and their corresponding proxies) as a *substitute* for audit quality: 78

- Auditor independence: Provision of non-audit services; earnings response coefficients to audit fee information, auditor tenure;[48]
- Auditor compensation: audit fees (also on different regional levels).[49]

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46 Feltham, G. A./Hughes, J. S./Simunic, D. A. (1991); Lee, P. J. et al. (2003); Mayhew, B. W./Schatzberg, J. W./ Sevcikand, G. (2004); Albring, S. M./Elder, R. J./Zhou, J. (2007).

47 Feroz, E. H./Park, K./Pastena, V. S.(1991); Dechow, P./Sloan, R./Sweeney, A. (1995).

48 DeFond, M. L./Raghunandan, K./Subramanyam, K. R. (2002); Ashbaugh, H./La Fond, R./Mayhew, B. W. (2003); Kinney, W. R./Palmrose, Z.-V./Scholz, S. (2004); Krishnan, J./Sami, H./Zhang, Y. (2005); Beck, P./Wu, M. (2006); Ruddock, C./Taylor, S./Taylor, S. (2006).

49 Simon, D. T./Francis, J. R. (1988); Craswell, A./Francis, J. (1999); Hoitash, R./Markelevic, A./Barragato, C. A. (2007); Srinidhi, B./Gul, F. A. (2007).

Using these proxies in multivariate regression analyses delivers insights into significant dependencies with audit firm characteristics, i.e. auditor size or auditor reputation[50]. However, since the data usually only delivers information on *correlations* but not on *causalities*, the models need to control for latent or intervening variables that may be misleading. Examples are other audit firm characteristics like audit firm specialisation[51], audit client characteristics like agency costs[52], or corporate governance characteristics like auditor liability regimes[53]. Given the complexity and extremely high interdependency of the underlying rationales it is not surprising that the literature about audit quality delivers mixed results. In particular, the studies vary in a way that proxies that may serve as control variables in one model serve as independent variables in another. However, the most important result from the observations is that they do *not* relate to auditing standards. All studies are based on a given set of ethical and educational requirements and a given audit methodology. Hence, no direct conclusions can be drawn from these studies with respect to the adoption of ISAs by the EU. 79

3.1.3 Relation between Audit Quality, and Credibility and Quality of Financial Statements

Since the European Commission shall only adopt the ISAs if the "contribute to a high level of credibility and quality to annual of consolidated accounts" as stipulated in Art. 26, 2b of the Statutory Audit Directive, the links between the three notions need further elaboration. Although there are no uniform definitions of the credibility of financial statements or the quality of financial statements there are some underlying rationales that show how audit quality enhancement eventually leads to an increase in credibility and quality of annual and consolidated accounts.[54] 80

First, it can be assumed, that *ceteris paribus*, a decrease in material misstatements in financial statements leads to an increase in financial statement quality and therefore credibility. This follows directly from the assumption that financial reporting standards are designed to support economic decision making and that, therefore, compliant financial statements *ceteris paribus* lead to higher economic benefits than non-compliant financial statements. Consequently, all measures enhancing the detection and reporting of material misstatements (audit quality) *ceteris paribus* enhance the quality and hence credibility of financial statements. 81

Following the notion of FEE, the link between the two concepts can also be visualised via the description of potential *benefits* of audits at the financial reporting level. In doing so, the effects "... can be divided into deter- 82

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50 Simunic, D. A. (1980); Francis, J. R. (1984); Francis, J. R./Simon, D. T. (1987); Palmrose, Z.-V. (1988); Davidson, R. A./Neu, D. (1993); Teoh, A. H./Wong, T. J. (1993); Ireland, J. C./Lennox, C. S. (2002); Krishnan, G. (2003); Bauwhede, H. V./Willekens, M. (2004); Jeong, S. W./Rho, J. (2004).

51 Palmrose, Z.-V. (1986); Ettredge, M./Greenberg, R. (1990); Craswell, A. T./Francis, J. R./Taylor, S. L. (1995); DeFond, M. L./Francis, J./Wong, T. J. (2000); Ferguson, A./Stokes, D. (2002); Balsam, S./Krishnan, J./Yang, J. (2003); Ferguson, A./Francis, J./Stokes, D. (2003); Krishnan, G. (2003); Lowensohn, S. et al. (2007); Knechel, W. R./Naiker, V./Pacheco, G. (2007); Behn, B. K./ Choi, J.-H./Kang, T. (2008); Lim, C-Y./Tan, H.-T. (2008).

52 Francis, J. R./Wilson, E. R. (1988); DeFond, M. (1992); Firth, M./Smith, A. M. C. (1992); Barton, J. (2005).

53 Nelson, M. W./Elliott, J./Tarpley, R. (2002); Lee, H. Y./Mande, V. (2003); Fuerman, R. D. (2006); Francis, J./D. Wang (2008).

54 As already pointed out, for the following analysis, the distinction between annual and consolidated accounts is irrelevant. They are hereinafter referred to as financial statements.

rence on the one hand, and detection and correction on the other hand".[55] The deterrence effect is twofold: First, those responsible for the preparation and disclosure of financial statements have an incentive to strengthen internal controls to detect fraud or error and to exercise greater diligence. Second, those with an opportunity and motivation to commit fraud face significant higher effort necessary to conceal their activities, which leads to a decrease in fraud. The detection (and reporting) of material misstatements follows directly from the objective of an audit, according to ISA 200. In the case of errors, the correction of material misstatements by those responsible for the preparation and disclosure follows their detection in order to avoid audit reports other than unqualified.

Credibility, however, is linked to the perception and cognitive processes of the users of the auditors´ opinions. 83
It is related to the assurance attributed by the user of a practitioner's opinion or conclusion on the subject matter. "In this sense, the reliability of information relates to its accuracy and precision, whereas the credibility of information relates to the degree to which the user perceives it likely that the information is as reliable as needed or as reliable as it purports to be."[56] Hence, *perceived* higher audit quality ceteris paribus results in an increase in financial statement credibility. This leads to the question if perceptions between users may differ and if measures designed to enhance audit quality (e.g. auditing standards) are *perceived* to be effective. However, assuming that the increase in detection of material misstatements is perceived as a means to increase financial statement quality, and given, that there are no distortions in the perception of changes in the detection of material misstatements, ceteris paribus, an increase in audit quality leads to an increase in perceived audit quality.

In 2008, the Financial Reporting Council (FRC) published an audit quality framework that identified four drivers 84
for audit quality:

- The culture within an audit firm (e.g. an environment where high quality is valued, invested in and rewarded or a monitoring system within firms and across countries);
- The skills and personal qualities of audit partners and staff (e.g. sufficient training or professional scepticism by partners and staff);
- The effectiveness of the audit process (e.g. well structured audit methodology and tools or high quality technical support);
- The reliability and usefulness of audit reporting (e.g. audit reports which are written clearly and unambiguously).

The four determinants of audit quality addressed by the FRC are related to those identified in literature; how- 85
ever, only the last two show a direct link to the design of auditing standards. However, this link leads to the role of ISAs.

[55] FEE (2007), p. 98.
[56] FEE (2003), p. 202.

ISAs touch upon the drivers of audit quality in a direct as well as indirect way. First, the IAASB explicitly addresses the understandability of auditing standards via the implementation of its clarity project (see Section 3.2). The higher the understandability of auditing standards, the easier should it be for the auditor to comprehend his or her tasks within the audit process, i.e. the higher is his or her capability to detect and report material misstatements. Second, audit methodology, i.e. the procedures to detect and report material misstatements are driven in part by the underlying auditing standards. Third, enforcement reinforces the effects of auditing standards on audit methodology. The drivers of audit and financial reporting quality in the context of ISAs can therefore be synthesised as shown in Figure 2 (Section 3.4). 86

Potential effects of ISA adoption on audit quality, financial statement quality and financial statement credibility are investigated in the empirical part of the Study. 87

3.2 Understandability

3.2.1 Definition

Following the notion that information is knowledge with the potential to influence decisions, in a decision theoretical context the value of information is related to the benefit of choosing one specific alternative given a setting of alternative environmental states and their corresponding outcomes. Implicitly, from a decision maker´s i.e. user´s perspective, information on the one hand has to relate to the decision context as far as its *content* is concerned. On the other hand information has to be *perceived* as relevant. Accounting theory refers to *decision usefulness* for the former and to understandability for the latter.[57] 88

The rationale underlying the perception of knowledge in a sense that it turns into information is linked to the user as well as to the information itself. With respect to the user´s profile FEE (2003) stresses the importance of diligence and the level of knowledge for the understandability of information. As far as the information profile is concerned, FEE (2003) elaborates a comprehensive list of potential determinants. This approach, together with the Financial Accounting Standards Board (FASB) view in Statement of Financial Accounting Concepts No. 2 (SFAC No. 2), provide a helpful information theory-based notion on qualitative characteristics of accounting information.[58] The approach considers decision makers and their characteristics, such as their level and nature of understanding or prior knowledge. The emphasis in this case is on the fact that information that is not understood by users because they lack the appropriate level or nature of understanding, either due to a lack of prior knowledge or otherwise, is not useful. In other words, information needs to be of a nature and form so that the characteristics of the user allow the information to be understood. Furthermore, the approach addresses the understandability of the information as a link between the characteristics of users and the inherent characteristics of the information, such as its intelligibility (more formally, understandability is defined as the quality of information that enables users to perceive its significance). 89

[57] FEE (2003), which is used as a reference for the following description.

[58] FASB (2001) p. 2.33 (2001).

As mentioned previously, one of the determinants of understandability are the characteristics of the user and the user profile – that is, the level and nature of user understanding or prior knowledge. Furthermore, there is an assumption that users are prepared to study the information with reasonable diligence and have a reasonable level of knowledge of the subject matter, criteria and the nature of the engagement. However, individuals may prefer limited rather than comprehensive information due to their threshold for information overload, which, if exceeded, may cause them to not perceive information as being significant even when it is so. In addition, individuals have different thresholds for ambiguity – sometimes information appropriately conveys ambiguity, but individuals may not feel comfortable with that level of ambiguity and hence attribute greater certainty to the information than is warranted. Studies have also shown that individuals are poor natural statisticians – that is, they tend to base estimates and predictions on recent or available observations even though these may neither be representative of long-run conditions nor reflect objective probabilities.[59] As in the case of IFRS [60], the individual user profile may turn out decisive with regard to the establishment of efficient standards of auditing. 90

In addition, it has been observed that user profile may vary not only from individual to individual but also from jurisdiction to jurisdiction.[61] This is of particular relevance in the light of the fact that ISAs, like IFRS, are drafted using English terminology from a common law context and are therefore more understandable to a common law audience rather than a reader with a continental (or civil law) law background. Cultures and traditions of statutory application and construction may vary remarkably between common law and civil law jurisdictions. To give an example, in accordance with common law principles of interpretation, there is very little room for the use of extrinsic aids to show legislative intention in the process of statutory construction,[62] whereas so-called “historical” or “teleological interpretation” by referring to extrinsic documents to identify legislative intent is a well recognised method of statutory interpretation in civil law jurisdictions.[63] On the other hand, ISAs (like IFRS) pose new problems and challenges for civil law jurisdictions. A continental European audience is still rather unfamiliar with “objectives”, “definitions”, and “application material” being inserted into a statute, i.e. forming part of the statutory regulation itself, and having the same binding force. From a theoretical perspective, it is difficult if not impossible to predict in what way and to what extent the outcome of the application of ISAs will be influenced after the adoption of ISAs by the EU. Unsurprisingly, there is virtually no academic literature existing on this issue. 91

In the light of this, one aim of this Study is to evaluate by means of empirical research the change in the understandability of auditing standards as a result of the adoption of ISAs by the EC. Assuming that auditing standards are information primarily for auditors, the crucial question will be if ISAs are more, equal or less under- 92

59 Hendriksen, E.S. (1982) pp. 106-107.

60 Paananen, M./Lin, C.. (2007).

61 Smith, M./Sagafi-Nejad, T./Wang, K. (2008); Glaum, M./Street, D.L. (2003).

62 Kernochan, J.M. (1976).

63 Henrich, D., Einführung in das Englische Privatrecht, 3rd ed., pp. 35-36 (2003). This is one of the main reasons for the European legislator to introduce European Directives and Regulations by numerous recitals forming part of the Directive or Regulation and setting out the relevant legislative motives.

standable than the auditing standards currently applied. Since the adoption of ISAs will lead to a change in the information profile, the analysis will focus on the impact of the shift from current auditing standards to ISAs on the determinants identified by FEE (2003). In a second step the question will be if these consequences vary between the applicants, i.e. the auditors, dependent on their diligence and knowledge.

Information profile related determinants of understandability relevant in the context of this Study are: 93

- Clarity (unambiguity);
- Conciseness (free from unimportant information elements);
- Comprehensiveness (all necessary information is included);
- Interpretability (the meaning can inherently be perceived).

3.2.2 Relation to the Clarity Project

"Clarification" of the meaning of the ISAs through the clarity project in essence involves the aim of improving users' understanding of the ISAs, including users understanding of the degree of obligation associated with different parts of the ISAs. As noted in Section 1.3.3 the ISAs as proposed in the clarity project include the following parts: 94

- Introduction;
- Objectives;
- Definitions;
- Requirements;
- Application and other explanatory material;
- Appendices.

Presumably, the division into these parts into this structure is supposed to increase users' understanding of the ISAs. An improved understanding ought to improve auditor application of the ISAs and oversight authority enforcement of them, and therefore improve the quality of audits. Although the delineation of the objectives, definitions and requirements plays a key role in improving such an understanding, there is a question as to the role of the other parts of the ISAs (introduction, application and other explanatory material, and appendices) in improving this understanding. 95

As noted in Section 1.3.3, ISA 200.19 states that the auditor shall have an understanding of the entire text of an ISA to understand its objectives and apply its requirements properly." This means that when applying the requirements of an ISA, the parts of the ISA other than the requirements (introduction, objectives, definitions, related guidance) must be taken into account by the auditor in interpreting the requirements, even though 96 these other parts do not lead to separate requirements. This issue is particularly important in the context of the fact that if the EU were to adopt the ISAs, the requirements of the ISAs would obtain direct legal sanction.

The requirement noted above has been introduced into ISA 200 under the assumption that auditors cannot understand the requirements without drawing upon the other parts of the ISAs. There are innumerable examples of requirements in the ISAs that cannot be understood without the other material in the ISAs. 97

For example, ISA 200.15 states: "The auditor shall plan and perform an audit with professional scepticism recognizing that circumstances may exist that cause the financial statements to be materially misleading." The term "professional scepticism" is a non-legal technical term ("term of art") of auditing whose broad meaning is not entirely clear on the face of it without drawing upon additional explanation in the ISAs, or expertise in auditing. The degree of "professional scepticism" exercised by an auditor is a key element in determining the work effort applied in an audit. This can be shown by examining two extreme examples: an auditor without any scepticism need not perform any work because the auditor would accept all assertions in the financial statements as true; on the other hand, an auditor that is completely sceptical would never be able to complete the audit, because the auditor would never have enough evidence to allay all (including unreasonable) doubts. Without drawing upon the related guidance in relation to the meaning of "professional scepticism" it is not possible to interpret the meaning of the requirement in ISA 200.15 and in particular, how it is supposed to impact an auditor's actions in an audit in a consistent manner that fulfils the requirements of legal certainty and predictability. 98

The related guidance in ISA 200.A17-.A19 clarifies that professional scepticism includes being alert to certain matters, and that it is necessary to reduce certain risks and for the critical assessment of audit evidence. ISA 200.A20 and .A21 contain further important clarification (e.g., "the auditor may accept records and documents as genuine unless the auditor has reason to believe the contrary"; "the auditor cannot be expected to disregard past experience of the honesty and integrity of the entity's management"). In the clarity project, there was some controversy as to the appropriate treatment of so-called "negative requirements" – that is, phrases such as those identified in ISA 200.A20 or .A21 above that serve to limit the application of a requirement, with some claiming that they ought to be in the "requirements section" of an ISA together with the requirements to which they relate, whereas other claimed that that moving these to the requirements section would "weaken" the authority of the other related guidance. 99

Another example is in ISA 200.16, which states that the auditor shall exercise professional judgment in planning and performing an audit of financial statements. Although the terms "judgment" and "profession" have legal significance, the term "professional judgment" is a non-legal technical term ("term of art") of accountancy and auditing whose broad meaning is not entirely clear on the face of it without drawing upon additional explanation in the ISAs, or expertise in accountancy and auditing. 100

The related guidance to ISA 200.16 in ISA 200.A22-.A26 clarifies the nature of professional judgment exercised by auditors by explaining why it is needed and for which areas of the audit in particular, its distinguishing feature, how it is exercised and evaluated, and that significant judgments need to be documented. In particular, ISA 200.A25 clarifies that judgment of auditors cannot be evaluated with hindsight by noting that such an evaluation must be made in light of the facts and circumstances known to the auditor at the date of the auditor's report. For these reasons, it is not possible to interpret the meaning of the requirement to exercise professional judgment in ISA 200.16 without drawing upon the related guidance. 101

3.3 Enforcement

WorldCom, Parmalat and other cases have offered a good opportunity to analyse failures of auditing and to demonstrate that auditors as gatekeepers are substantially undeterred because of poor enforcement rather than legislative black holes.[64] The issue of enforcement of internationally harmonised audit standards is threefold: First, quality control is a sort of preventive instrument that serves to detect deficiencies as early as possible. Second, public oversight combined with public enforcement (by criminal and administrative sanctions) is necessary to grant the public safeguards. Third, substantive (mainly liability) rules are required in order to prevent fraud by deterrence, but also as a most efficient means of private enforcement through private litigation in the aftermath of fraudulous conduct. The role of enforcement for audit quality has also been stressed in empirical research.[65] 102

3.3.1 Quality Control

The IAASB decided to clarify extant ISQC 1 "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements" at the same time as extant ISA 220 "Quality Control for Audits of Historical Financial Information" because the former deals with important quality control considerations at the firm level and the latter at the engagement level.ISA 220 is premised on the basis that the firm is subject to ISQC 1 (Redrafted) or to national requirements that are at least as demanding[66]. The standards are therefore closely linked, and the IAASB believes that their clarification at the same time makes sense to ensure consistency between them and in their application.[67] 103

3.3.2 Public Enforcement: Oversight

An analysis of the economics of public oversight of financial and corporate governance disclosures by issuers and of auditors in the context of an adoption of ISAs should take into account the framework of European law and institutional arrangements within which that system operates. It requires an examination of the role of the public bodies that are responsible for oversight and how they relate to each other. A closer look might reveal 104

64 Ferrarini, G./Guidici, P. (2005).

65 Willekens, M./Simunic D.A. (2007).

66 ISA 220.02 (Redrafted), December 2008

67 IFAC (2007).

that there is a more complex allocation of institutional power than the common impression created by the emphasis on having a single financial regulator per jurisdiction.[68] Having a detailed understanding of how public supervision is organised and actually works in individual countries might turn out to become a crucial first step towards being in a position to make reliable and defensible decisions in order to evaluate economic effects of the adoption of ISQC 1.

3.3.3 Private Enforcement: Auditors' Liability

Liability for auditing services and private litigation in order to enforce auditing standards is another issue of paramount importance in the context of internationalisation of auditing standards. It is important to note that the common law system of corporate governance in general and financial auditing in particular is characterised by a comparably strong system of private enforcement through liability actions brought by shareholders and investors which suffered loss caused by negligent or fraudulous managers and auditors. Hence, this type of "private party activism" is an integral part of the enforcement concept of those auditing regimes. In contrast, Continental Europe takes traditionally an unfriendly approach to private enforcement of collective interests. In most European jurisdictions, civil courts are ill-equipped to deal with complex litigation concerning capital market frauds and masses of claimants seeking to recover damages. As a result, global issuers and auditors are mainly exposed to the US private enforcement system with its plaintiff friendly weaponry: class actions and activist lawyers, notice pleading rules and aggressive pre-trial discovery rules. Commentators have suggested that Europe would have to upgrade and re-balance its public and private enforcement mechanisms in order to increase deterrence and weaken the role of secretive practices, political accountability, and social networks.[69] However, it is clear that private enforcement cannot be improved without fundamental changes to the whole civil procedure system including the creation of new formal and effective mechanisms for the coordinating of the roles of the two institutional frameworks (litigation and regulation). 105

A particular important question arises in the case of liability of several auditors when they conducted a "joint audit" (whether jointly auditing a single set of financial statements or auditing different financial statements of component enterprises within a corporate group). This problem is all the more important as joint audits are allowed in all the twenty seven Member States and even required in France in certain cases. In the *Parmalat* case, division of responsibility among those auditing firms that participated in the audit of the entire corporate group was permissible. Unsurprisingly, the revision of ISA 600 "Using the Work of Another Auditor" triggered a flood of Comment Letters. ISA 600 now provides for sole responsibility, whereas under US law division of responsibility is permitted. As a sort of counterbalance, US law, which from a European perspective is of relevance in the case of SEC registered European companies, prohibits limitation of auditor liability. 106

[68] For public oversight bodies within the UK Cearns, K./Ferran, E. (2008).

[69] Ferrarini, G./Guidici, P. (2005) with further references.

3.4 Conclusion

In the context of this Study, we investigate the question whether the mandatory application of clarified ISAs will lead to a change in audit quality due to a change in the audit methodology and due to changes in the institutional setting of audits – eventually resulting in higher financial statements quality and credibility. With reference to auditing standards driven modifications of the (business) risk-oriented audit approach and related consequences, findings from theoretical or empirical research are extremely rare. This is due to the mere fact that in the European Member States audit methodologies must be designed so as to obtain *reasonable assurance* about the subject matter; and material misstatements *must* affect the audit opinion. Hence, audit quality as defined above is *inherent* to all statutory audits as set forth by the Standard Setters. Based on the objectives of an audit pursuant to ISA 200.11, by definition, an audit performed in accordance with the ISAs would be a high quality audit. Generally, national standards include objectives or a general requirement similar to that in ISA 200.11. Consequently, it may be argued that the adoption of ISAs would not make a difference. 107

The problem is that the conditions for audit quality do not always hold. Pursuant to DeAngelo´s definition, the detection and reporting of material misstatements depends on the respective capability, willingness and infrastructure of the auditor. Capability is primarily related to an auditor´s skills and knowledge; willingness is primarily linked to an auditor´s commitment and attitude, and infrastructure relates to the organisational setting in which an audit (engagement) is carried out. Following this notion, the role of professional standards becomes evident: capability is particularly addressed by educational requirements, incentives to perform another than high quality audit are limited by ethical requirements and the organisation is determined by requirements concerning quality assurance on the firm and on the engagement level. 108

The rationale underlying audit quality has also been confirmed by professional bodies. E.g., Aldhizer, Miller and Moraglio (1995) present the findings of a survey of the American Institute of CPAs (AICPA) assessing – among – others the following common attributes positively associated with audit quality. 109

- Continuous professional education at the audit firm level;
- A relatively large portion of time spent on audits at the auditor level;
- Availability of all authoritative literature at the auditor level;
- An unqualified report from peer review.

The first three attributes relate to the notion of capability, the fourth to the organisation and incentive aspects.

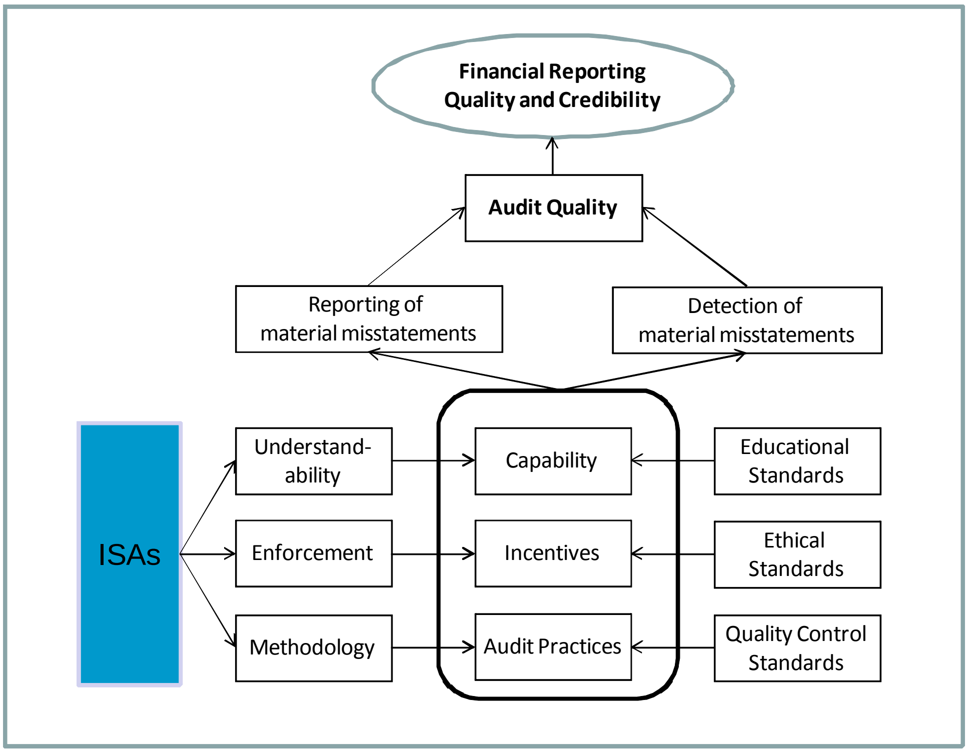

Figure 2: Conceptual Framework

4 Decomposition of Potential Effects of an ISA Adoption by the EU

4.1 Introduction

Based on the conceptual framework for potential effects of the adoption of ISAs by the EC in the light of audit quality, and the understandability and enforcement of auditing standards, the aim of the following Sections is to reconceptualise and frame the outline effects so that they can be analysed in a structured and empirical way. Core subject of the investigation is the *shift* from the various audit methodologies currently applied by auditors across Europe to a mandatory uniform audit methodology in compliance with clarified ISAs. 110

Given the current (as of mid 2008) audit methodology as it is reported by the auditors and accounting firms participating in this Study, audit procedures are based on the relevant *national* auditing standards. The national auditing standards may at least wholly or partly include ISAs in their current version, i.e. not in their final version after completion of the clarity project at the end of year 2008 (*ISAs pre clarity*). The adoption of the ISAs in their version after the completion of the clarity project (*ISAs post clarity*) would consequently have to lead to a redesign in audit methodology. This *redesign effect* would at the one hand come from the first-time application of ISAs instead of national auditing standards that do not (fully) comply with ISAs (*ISA compliance effect*). On the other hand, for those parts of audit methodology that already comply with ISAs, the clarity project will bring about modifications (*clarity project effect*), see Figure 3. 111

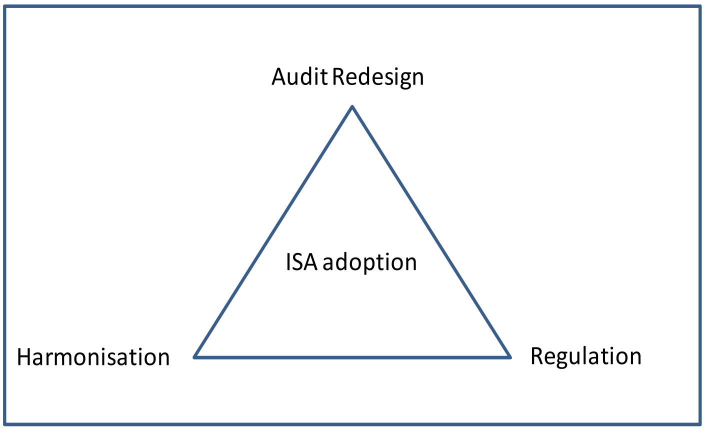

Figure 3: ISA Adoption Effects

The magnitude of the redesign effect is country-specific, as there are national differences between the compliance of national auditing standards with ISAs, and is ISA-specific, since the application of the clarity criteria to individual ISAs through the clarity project does not result in a uniform elevation of present tense sentences to requirements and also, in rare cases, introduces new requirements when obvious gaps are noted. The redesign effect may also be affected by the introduction of objectives into auditing standards by the clarified ISAs. In addition, the redesign effect will be auditor-specific, due to the fact that particularly auditors with multinational clients have adopted audit methodologies that may be compliant with existing ISAs, may even anticipate clarity project consequences, or refer to elements of other widely-used auditing standards, i.e. PCAOB auditing standards, whereas auditors without transnational audit clients may have audit practices that reflect only national standards. 112

The adoption of ISAs implies the substitution of *various* national auditing standards by a *uniform* set of auditing standards within the European Union and their consistent application. This *harmonisation effect* has internal as well as external implications. From an internal, i.e. EU perspective, harmonisation primarily leads to a higher comparability of audit methodologies and the audit report and to standardised audit procedures in auditing multinational clients. From an external perspective, the regional expansion of the area of application of ISAs may enhance their international acceptance – as long as necessary criteria regarding their content and their degree of obligation are met (see Section 4.4). 113

In addition, with the adoption of ISAs by the EC, the adopted parts gain *legal status*, i.e. they obtain legal sanction. This *regulation effect* leads to major changes in the degree of obligation of auditing standards in most European member states, but this does not imply that major changes in the degree of obligation would have a major impact on auditing or enforcement (see Section 4.5). All three effects may have some effects the understandability and the enforcement of auditing standards and may eventually affect audit and financial reporting quality. 114

Although these three effects (redesign, harmonisation, and regulation) are separated to provide a basis for their analysis, they do interact. For example, the benefits of the harmonisation effect, which are predicated upon the same auditing standards being used in the same way throughout the EU, may be impaired if: 1. individual EU members states choose to implement differing auditing standards, or 2. auditing standards at a European level are not clear enough about what is required and what is guidance to facilitate consistent application among different audit firms and jurisdictions. 115

In the first case above, the audit regulation effect resulting from the adoption of the ISAs in the EU by means of a European legal instrument serves to limit the proliferation of differing auditing standards within the EU and thereby secures any benefits arising from the harmonisation effect. Currently, only 56 % of EU member states use national standards that are adopted ISAs, whereas other member states use different national standards that vary widely in terms of their extent of compliance with the ISAs. 116

In the second case above , the audit redesign effect resulting from the adoption of clarified ISAs, which clearly delineate requirements from guidance (as opposed to the ISAs in previous form, which did not) would serve to harmonise the application of auditing standards among different firms and jurisdictions and thereby result in incremental benefits arising from the harmonisation effect. 117

The effects will likely depend on the size of the audit firm. To control this effect, the empirical part of this Study will distinguish between the big four (which are all in the FoF), the so-called mid-tier firms in the FoF, and firms that are not in the FoF, which are primarily SMP's. Finally, there is a possibility that not all audits are conducted in full compliance with the relevant national auditing standards (irrespective of the degree of compliance of these national auditing standards with ISAs). This *auditing standards compliance effect* is hard to measure 118 when addressing auditors. However, in order to assess the cost benefit effects from ISA adoption *excluding* the effects that may arise from (partial) first-time auditing standards compliance, representatives from national audit regulators will be asked to give an assessment of respective potential biases. Figure 4 summarises the decomposition of the effect from ISA adoption.

A list of potential costs and benefits from the adoption of ISAs by the EU is attached in Appendix 2. 119

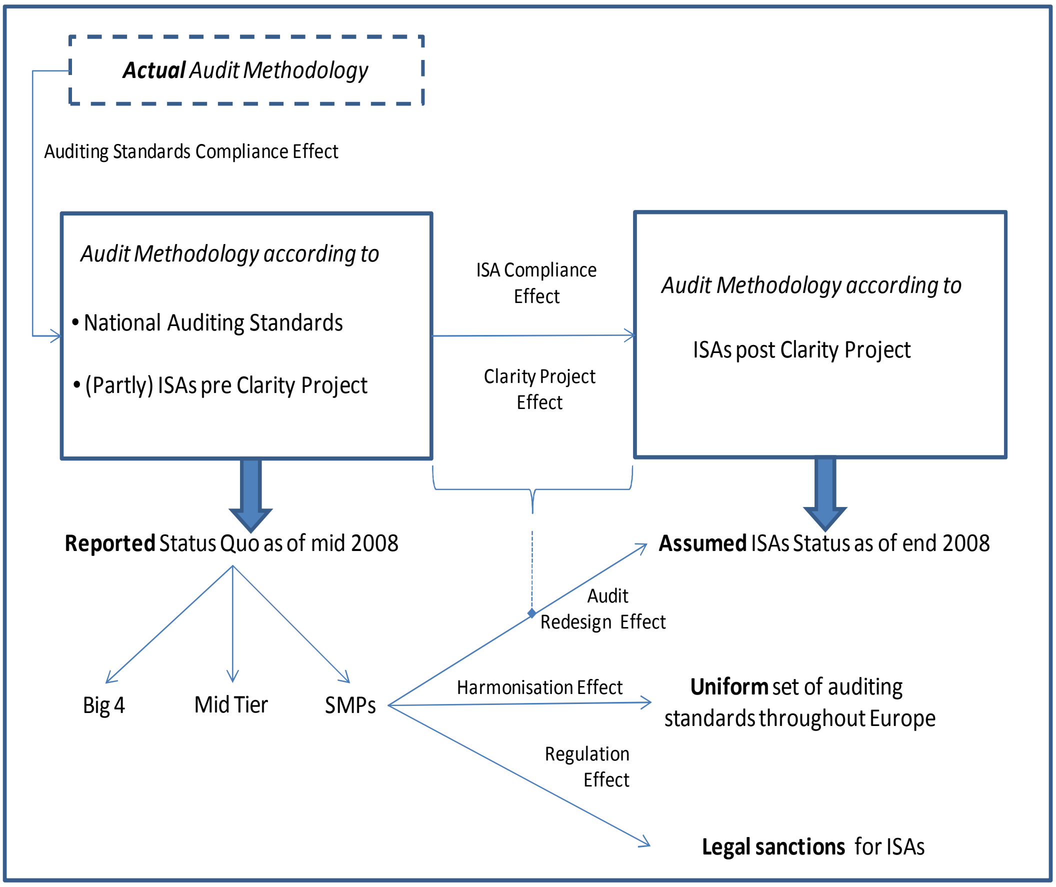

Figure 4: ISA Adoption Effect Decomposition

4.2 The Assessment of Current and Future Audit Practices

The costs and benefits for different jurisdictions and for different audit firms of the adoption of clarified ISAs in 120 the EU depends on the degree to which current audit practices in different jurisdictions and for different audit firms are in consonance with the clarified ISAs. For this reason, one major task of the survey is to determine the degree to which ISAs are reflected in national auditing standards and current firm audit practices. Furthermore, the degree to which national auditing standards setters and audit firms intend to amend their auditing standards and auditing practices, respectively, to reflect clarified ISAs when currently there are differences between those standards and practices, on the one hand, and the ISAs on the other hand, also determines the extent to which some of the identified costs and benefits of ISA adoption are relevant to EU decision-making on adoption.

4.2.1 Audit Regulators

One audit regulator asserts that in its jurisdiction, national auditing standards are adopted ISAs without translation. Four audit regulators assert that in their jurisdictions, national auditing standards represent transposed ISAs (minor differences). One audit regulator maintains that national auditing standards in its jurisdiction are based upon the ISAs (significant differences). Audit regulators did not provide any information as to how up-to-date their national standards are in relation to currently effective ISAs. Nevertheless, on this basis, four audit regulators state that firm practices in their jurisdictions are based upon national auditing standards, whereas two state that firm practices are based upon national auditing standards plus additional firm practices. It is important to note that two regulators state that their national auditing standards will be amended to partly reflect clarified ISAs even if the clarified ISAs are not adopted by the EU, whereas four state that their national auditing standards will be amended to reflect all clarified ISAs even if the clarified ISAs are not adopted by the EU. 121

4.2.2 Audit Firms

Twenty-five of the thirty-one firms responding to the question about the nature of national auditing standards in their jurisdiction assert that either their national standards are adopted ISAs with translation (five) or transposed ISAs with minor differences from the ISAs (twenty). An additional four firms assert that the national auditing standards in their jurisdiction are based upon the ISAs, but with significant differences. Hence, 80 % of the firms responding to this question claim that their national standards have a high degree of compliance with the ISAs, and another 13 % claim compliance with some significant differences. Only two firms (6 %) from the Southern/Eastern part of Europe claim that their national standards are not based upon the ISAs. Consequently, one can conclude that for most of Europe, the adoption of the clarified ISAs would result in changes to auditing standards that are limited to the changes between the existing (currently applicable) ISAs and the clarified ISAs. This is supported by the responses by the regulators above. 122

In relation to the question on audit practices, nineteen out of twenty-three big four firms state that audit practices reflect both national standards and ISAs and additional firm practices. The responses from the mid-tier firms are more heterogeneous, but only four of the nine thereof regard national auditing practices not to be based at least in part upon the ISAs. On this basis, it would be reasonable to conclude that generally, for the big four firms the adoption of clarified ISAs entails the change from currently applicable ISAs to clarified ISAs; for the mid-tier firms, there are differing views about this matter, but this may be the result of the national firms not being aware of the fact that their network methodologies incorporate existing ISAs (see the responses by the international networks below). 123

Twenty-seven (twenty-one big four and six mid-tier firms) firms out of the thirty one firms responding to this question state that their firms will amend their audit practices to reflect the clarified ISAs even if the clarified ISAs are not adopted by the EU or not incorporated into national auditing standards. Only two mid-tier firms claimed that their firm audit practices will be only partly amended to reflect the clarified ISAs even if the clari- 124 fied ISAs are not adopted in the EU or not incorporated into national auditing standards; one big four firm and one mid-tier firm claim that their firm audit practices will not be amended to reflect the clarified ISAs, even if the clarified ISAs are not adopted by the EU or not incorporated into national auditing standards. However, the latter responses are at variance with the responses provided by their international networks below. It is therefore reasonable to conclude that, on the whole, the clarified ISAs will be incorporated into big four and mid-tier firms regardless of whether or not the EU adopt the clarified ISAs or whether or not these are incorporated into national auditing standards.

Twelve big four firms also answered some supplementary questions in relation to ISQC 1. In relation to national standards for quality control in audit firms, three firms answered that the national standards in their jurisdiction are ISQC 1 without translations, for one firm the national quality control standards are ISQC 1 with translation, six answered that their national quality control standards are transposed ISQC 1 (minor differences) and two (from South-Eastern Europe) answered that in their jurisdiction the national quality control standards are not based upon ISQC 1. Based upon these answers, ten firms assert that their firm quality control standards are both national quality control standards and ISQC 1 as currently effective and additional firm quality control policies and procedures; one firm answered that its firm quality control standards are ISQC 1 (currently effective); one firm answered that its firm quality control standards are national standards plus firm quality control policies and procedures (it is possible, that this firm is not aware of the fact that the international network has incorporated ISQC 1 into the network quality control policies and procedures – see the responses by international network below). All twelve firms answered that their firm quality control policies and procedures will be amended to reflect the entire clarified ISQC 1 even if ISQC 1 is not adopted by the EU in future. 125

This suggests that existing ISQC 1 is largely incorporated in all big four firm quality control policies and procedures and will be incorporated into big four firm quality control policies and procedures throughout Europe, regardless of whether or not the EU adopts ISQC 1. 126

4.2.3 Audit Firm Networks

The international networks for the four big audit firms and for three mid-tier firms, all of whom are members of the FoF, were asked to provide some qualitative data on the nature of their audit practices and their policy with respect to clarified ISAs. All but one of these networks answered that the basis for their audit practices are both national auditing standards in different countries and ISAs currently effective and additional firm practices; one network (big four) answered that its auditing practices are the ISAs currently effective. Six out of the seven networks also answered that their network firm policy is that firm audit practices will be amended to reflect all clarified ISAs in future even if they are not adopted by the EU; one mid-tier firm network answered that its network firm policy is that firm audit practices will be amended to partly reflect clarified ISAs in future even if they are not adopted by the EU. 127

On this basis, for all big four networks and for most mid-tier networks, clarified ISAs will be incorporated into their network audit methodology without exception; there may be a few mid-tier networks that will incorporate the clarified ISAs into their network methodology, but with some exceptions. 128

4.3 Audit Redesign Effect

The redesign of audit methodology due to the mandatory application of ISAs – instead of the auditing standards as currently used within Europe is driven on one hand by the compliance with ISAs and on the other hand by the modifications of ISAs due to the IAASB clarity project. 129

4.3.1 ISA Compliance Effect

The cost benefit analysis of ISA adoption should encounter all potential effects from current audit methodology as applied currently in Europe to an audit methodology in compliance with ISAs after the completion of the IAASB clarity project. Obviously, these effects depend on the degree of alignment of national auditing standards with ISAs as stipulated by the national professional bodies. However, although the professional bodies of all of the European Member States are members of the International Federation of Accountants (IFAC) and therefore are subject to the IFAC Statements of Membership Obligation (SMO), the extent to which national auditing standards comply with ISAs varies considerably across countries. SMO 3 International Standards, related practice statements and other papers issued by the IAASB sets out the obligations of member bodies in relation to the ISAs and the other IAASB Pronouncements[70]. In particular, 130

(b) Member bodies should notify their members of all ISAs;

  a. Member bodies should use their best endeavours to incorporate the ISAs into their national standards or related other pronouncements; and

  b. To assist with the implementation of ISAs

(c) Member bodies should implement a process that provides for the timely, accurate and complete translation of ISAs, and for the timely dissemination of such translations where the ISAs are generally used by professional accountants in the jurisdictions.[71]

Substantiating these requirements the IFAC Board established a so-called Member Body Compliance Program as a means to evaluate the quality of members' and associates' endeavors to meet IFAC membership obligations. One part of that programme required members and associates to complete a self-assessment questionnaire about "... their best endeavors to promote and incorporate international standards issued by IFAC and the IASB, quality assurance and investigation and discipline programs to monitor compliance with applicable 131

[70] International Standards issued by the IAASB comprise International Standards on Quality Control (ISQCs), International Standards on Auditing (ISAs), International Standards on Review Engagements (ISREs), International Standards on Assurance Engagements (ISAEs), and International Standards on Related Services (ISRSs). The IAASB also issues related Practice Statements and other papers to provide interpretive guidance and practical assistance to professional accountants in implementing International Standards and to promote good practice, IFAC (2006): 22-25.

[71] IFAC (2006): 22-25.

professional standards"[72]. However, the responses by member bodies to IFAC under its compliance program are of limited use in relation to ISA-compliance of their national auditing standards. FEE has obtained information about the nature of national auditing standards in Europe that has been updated to the beginning of 2009. This can be depicted in the following diagram:

Adoption Status	**Countries**	**%**
Unamended ISAs (incl. ISA +): Bulgaria, Cyprus, Denmark, Finland, Hungary, Ireland, Italy*, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Romania, Slovak Republic, Slovenia, Sweden, United Kingdom	17 (1 for PIEs only)	59
Transposed ISAs (incl. ISA + and -): Austria, Belgium, Czech Republic, Estonia, France, Germany, Greece, Portugal, Spain	9	37
Principles-based national auditing standards: Poland	1	4
Total	27	100
*: For PIE (only recommended standards for other audits)		

Table 3: Current Adoption of (unclarified) ISAs for all Audits in the EU (early 2009) (Source: FEE (2009))

The terms used by FEE in the diagram above have the following explanations: 132

> "A similar table was initially prepared in early 2006 based on responses received to a joint European Commission / FEE questionnaire on the adoption and translation of the then current ISAs. The results of this questionnaire were presented to the European Auditing Standard Setters meeting facilitated by FEE on 10 May 2006.
>
> Subsequently, based on contributions made by national auditing standard setters at the half yearly European Auditing Standard Setters meetings in 2006, 2007 and 2008, the table was updated to reflect the status of national adoption of ISAs in the EU up to early 2009.
>
> The table includes three distinct categories as follows:
> - Countries having adopted unamended ISAs or ISA+. Unamended ISAs are the ISAs as issued by the IAASB. ISA+ are the ISAs as issued by the IAASB adapted for local (legal) circumstances with additional requirements and/or guidance material;
> - Transposed ISAs, including ISA + and ISA-. Transposition is the process whereby ISAs are translated to form the basis for local auditing standards. Further adaptations for local (legal) circumstances with certain additions (+) and deletions or carve-outs (-) are performed. The degree of adaptations varies from one EU member state to another;
> - Principles-based national auditing standards. Material extracted from the ISAs forms the basis to prepare the national auditing standards. In case a specific subject matter is not covered in the national auditing standards, the relevant ISA is to be used.
>
> It should be noted that different EU countries have adopted the ISAs included in different versions (dates) of the IFAC Handbook."

The analysis in the table suggests that for all audits required by the Fourth and Seventh EU Directives, only 15 out of 27 EU member states use the existing ISAs (56 %). Ten member states use transposed ISAs that include "ISA minuses". The degree to which these national standards comply with ISAs varies. One country has standards that are not based upon the ISAs at all. Since the degree of compliance for transposed standards is un- 133

[72] IFAC (2008).

clear, for the purposes if the Study it would be conservative to include these under the category "significant differences from the ISAs" together with the latter jurisdiction, thereby comprising 44 % of EU jurisdictions. Drawing on the results of the survey of audit regulators in Section 4.2.1, it appears that those jurisdictions that are currently complying with ISAs intend to also comply with the clarified ISAs, but it is unclear in what time-frame. Hence, the overall conclusion should be drawn that 56 % of jurisdictions within the EU would eventually comply with clarified ISAs.

4.3.2 Clarity Project Effect

As stipulated in the invitation to tender, the cost benefit analysis of ISA adoption should build upon a comparison of an audit methodology in compliance with ISAs with audit methodologies as currently practiced in Europe. Since ISA compliance varies within Europe, the amendments to current audit methodology on the audit firm level required by ISA adoption will vary as well. On the one hand, these amendments will come from ISA compliance *per se* (referred to as *ISA compliance effect*); on the other hand – for those who already comply with ISAs – such amendments will come from the consideration of the revision of ISAs due to the IAASB clarity project (referred to as c*larity effect*). Whereas the ISA compliance effect should only be relevant for some auditors, the clarity effect should apply to all audit firms in Europe. 134

Since the impact assessment guidelines published by the EC suggest conducting a qualitative assessment of which impacts from regulation are the most significant,[73] it appears to be appropriate to identify the most significant changes in ISAs due to the clarity project, because they will presumably affect all EU statutory auditors if the ISAs are adopted. 135

Consequently, it is important in the assessment of the changes to audit practices to identify the differences between current audit practices and the clarified ISAs: the survey applied in the Study examined these differences. However, since many audit methodologies and audit practices are already based upon the ISAs currently in effect, or are based upon national standards that represent adopted or transposed ISAs, it is also therefore important to identify the differences between the ISAs currently in effect and the clarified ISAs to assist respondents in their answers to the survey questionnaire. 136

As a quality control measure in the survey, all survey participants were provided with a detailed analysis of all changes in objectives, definitions, and requirements between the existing ISAs and the status of the clarity project in September. Audit firms were asked to rank the changes to assist them in developing their cost estimates. This quality control measure was supplemented in the second phase through the discussion with the EGAOB subgroup of the differences between the final clarified ISAs based upon the updated Agenda papers of the December 2008 IAASB meeting the status of the clarity project in September that formed the basis of the survey. These analyses are included in appendices 4.7 and 4.8. 137

[73] SEC(2005) 791 [Statement of the European Commission]: 27.

4.3.3 Survey Results for the Redesign Effect

4.3.3.1 Potential Cost Increases or Cost Reductions at Audit Engagement Level for Auditors

All four stakeholder groups (capital market participants, audit regulators, audit clients and audit firms) were asked to provide their estimates (whether quantitative or qualitative) of the potential cost increases or cost reductions at audit engagement level for auditors due to the potential effects of implementing clarified ISAs on current audit practices (redesign effect). A detailed overview of the responses given are compiled in Appendix 5 (qualitative questions) and Appendix 6 (quantitative questions). 138

4.3.3.1.1 Recurring Redesign Costs at Engagement Level Incurred by Audit Firms

When the clarified ISAs are adopted by the EU, audit firms would be required to change their existing audit practices in their engagements so that these practices are in compliance with the clarified ISAs. Some of the costs of this change would be one-off, but some of the additional or changed requirements in the ISAs may signify a continued greater or lesser audit effort for every year after implementation. These recurring costs and cost savings incurred or saved by audit firms at engagement level are important because they directly affect the long-term costs of performing audits for the firms and therefore are more likely to be passed on to clients than other costs. Consequently, these costs may have an impact on the resources used by the European economy for audits in the long run. 139

4.3.3.1.1.1 Capital Market Participants

Due to their very limited knowledge of the nature and magnitude of audit costs, capital market participants were asked to provide their answers on this issue using a double-sided ordinal scale (major decrease, significant decrease, slight decrease, no change, slight increase, significant increase, major increase). Two thirds of capital market participants that responded to the survey believe that recurring cost increases incurred at audit firms due to audit redesign would be slight. Overall, there appears to be an overall indication that capital market participants expect auditors to incur slight recurring cost increases for performing audits due to the redesign of audit practices. 140

4.3.3.1.1.2 Audit Clients

All six audit clients responding to the question of the size of any increase or decrease in audit costs incurred or saved on a recurring basis each year by the auditor subsequent to the first year of application of the clarified ISAs believe that there would be no change in audit costs. 141

4.3.3.1.1.3 Audit Regulators

Audit regulators did not respond in an adequate fashion to this question to allow an assessment of their views in this regard. 142

4.3.3.1.1.4 Audit Firms

Medium-sized Unlisted Audit Clients 143

For the big four firms, the potential recurring cost increases range between an increase of € 700 to € 8,600 per audit per year for a medium-sized unlisted audit client. The average recurring cost increase per medium-sized unlisted client per audit per year due to redesign effects is estimated at about € 2,600. Based upon the upper bound figures, a quarter of the potential cost increase for big four unlisted medium-sized audit clients results from ISA 600 in relation to group audits; furthermore, one-fifth of the cost increase is attributed to ISAS 260 (communication with those charged with governance) and 265 (communication of deficiencies in internal control) each. Another fifteen percent of the upper bound potential average cost increase for unlisted medium sized audit clients results from ISAs 540 (audit of accounting estimates including fair value estimates) and 550 (audit of related parties) each.

For the mid-tier firms, the potential recurring cost increases range between € 0 to € 4,100 per audit per year for a medium-sized unlisted audit client, which reflects a recurring average estimated cost increase per large unlisted client per audit per year of about € 970. Based upon the upper bound figures, about thirty five percent of the potential average cost increase for unlisted medium-sized audit clients results from ISA 600 in relation to group audits; furthermore, fifteen percent of the cost increase is attributed to ISA 315 (risk assessment). 144

Consequently, the cost increases for medium-sized unlisted clients audited by the big four firms and mid-tier firms are highly variable, but the absolute (but not relative) cost increases are significantly different, most likely because the mid-tier firms tend to audit the smaller as opposed to the larger mid-sized clients. For this reason, other than ISA 600 for group audits as defined in that standard, the cost drivers are somewhat different. 145

Large Unlisted Audit Clients 146

The range of potential cost increases and cost savings range between cost savings of € 500 and cost increases of € 15,500 per audit per year for a big four large unlisted audit client. It appears, therefore that the larger the client, the greater the variability in cost changes, but, based upon the response of the big four firms, the average cost increases for large unlisted companies may be about 30 % greater absolute terms than the average cost increases for medium-sized unlisted audit client, which reflects a recurring average estimated cost increase per large unlisted client per audit per year of about € 3,500. Over half of the upper bound cost increase for large unlisted audit clients is attributed to ISA 600, with ISAs 540, 260, 265 , 550 and 620 (using the work of an auditor’s expert) contributing 14 %, 13 %, 8 %, 8 % and 6 %, respectively.

With respect to mid-tier firms, the range of potential cost increases and cost savings range between cost savings of € 2,200 and cost increases of € 6,200 per audit per year for a large unlisted audit client, which reflects a recurring average estimated cost reduction per large unlisted client per audit per year of about € 100. It appears, therefore that the larger the client, the greater the variability in cost changes and that the redesign of audit standards may lead to no increase, or a slight reduction in recurring costs in some circumstances. The standards driving cost savings in this case based upon the lower bound figures include ISAs 510 (initial engagements), 530 (audit sampling) and 540 (accounting estimates), with the proportion of the overall cost savings per audit per year from these standards expected to range between 25 % to 30 % each. Thirty-two percent of the upper bound potential average cost increase for large unlisted audit clients is attributed to ISA 600, with ISA 315 contributing 13 % and 500 (audit evidence) contributing 11 %. However, the estimated average shows an overall expectation of slight cost savings. 147

Consequently, the variability of changes in cost is much greater for large unlisted clients compared to mid-sized unlisted audit clients. Furthermore, for the big four firms, there appears to be a significant absolute cost increase for large unlisted clients compared to medium-sized unlisted clients, whereas the estimate for mid-tier firms suggests that the average costs may not increase from medium-sized unlisted clients to large unlisted clients. ISA 600 appears to be the main cost driver for the big four firms and mid-tier firms in relation to their large unlisted clients, but there are some differences in the other standards considered to be cost drivers. 148

Publicly Listed Audit Clients 149

For a publicly listed audit client of the big four firms, the potential recurring cost savings or increases range between € 150 in cost savings to € 18,500 in cost increases per audit per year. Consequently, the variability for publicly listed audit clients is greater than for unlisted medium-sized or large audit clients: this makes sense because publicly listed audit clients range from small to very large. Based upon the responses from the big four firms, on average, however, it appears that in absolute terms the cost increases for publicly listed audit clients may be about 30 % higher than the average cost increases for large unlisted audit clients, which reflects a recurring average estimated cost increase per large unlisted client per audit per year of about € 4,500. For publicly listed entities of the big four firms, the main cost drivers with their contribution to the overall upper bound cost increase are as follows: ISA 600 (48 %), ISA 540 (16 %), ISA 260 (11 %), ISA 550 (10 %) and ISA 265 (7 %).

Very few mid-tier firms provided data on publicly listed companies. For this reason, it would be inappropriate to extrapolate assertions about cost saving and increases for the audits of publicly listed companies for mid-tier firms. 150

In conclusion, the big four firms expect a significant recurring cost increase for publicly listed clients compared to large unlisted clients. However, the variability of cost changes for publicly listed clients big four firms is greater than that for large unlisted entities. The main cost driver is ISA 600. 151

Banks and Insurance Companies 152

Because the data received for banks and insurance companies was virtually identical, these two kinds of audit client are dealt with together here. For banks and insurance companies audited by the big four firms, the variability and size of cost increases is expected to be greater than for publicly listed audit clients: for both, the estimated average potential cost increases range from € 600 to € 26,000. Based upon the response of the big four firms, in absolute terms, the big four firms expect the potential average cost increases for banks and insurance companies to be approximately 54 % greater than the potential average cost increase for publicly listed audit clients, which reflects a recurring average estimated cost increase per bank or insurance company per audit per year of about € 6,900. For banks and insurance companies the main cost drivers with their contribution to the overall upper bound cost increase are as follows: ISA 540 (41 %), ISA 600 (26 %), ISA 260 (8 %), ISA 550 (8 %) and ISA 265 (5 %).

Very few mid-tier firms provided data on banks and insurance companies. For this reason, it would be inappropriate to extrapolate assertions about cost saving and increases for the audits of banks and insurance companies for mid-tier firms. 153

Overall Conclusion on Audit Firm Views on Recurring Redesign Costs at Engagement Level 154

The recurring cost increases appear to be highly variable, with the variability increasing with audit client size, but also nature (i.e., the variability is greater for listed companies, banks and insurance companies). As is to be expected, for the big four firms the estimated absolute average recurring cost increases are significantly greater for larger unlisted companies compared to medium-sized companies and significantly greater for listed companies compared to larger unlisted companies; for the mid-tier firms, on average cost savings are expected for large unlisted companies. Furthermore, for the big four firms the estimated cost increases are significantly greater for banks and insurance companies compared to listed companies. The main cost driver appears to be ISA 600 and ISA 540 for the big firms, followed by ISA 260, 265 and 550; the mid-tier firms view ISA 600 and other standards to be the main cost drivers.

4.3.3.1.1.5 Overall Conclusion on the Recurring Redesign Costs at Engagement Level

The recurring redesign cost increases for the firms at engagement level posited by the firms range from no increase to slight or significant, depending upon the size of the firm and the nature and size of the audit client. This accords more or less with the views of the capital market participants. However, the view of the audit clients (no recurring cost increases incurred by audit firms) does not appear to be a reasonable proposition given the nature and extent of changes to the ISAs through their clarification: it appears to represent a political statement that industry does not desire audit cost increases. Hence, based upon our analysis of the changes to the ISAs compared to the existing ISAs in relation to the responses from the firms, we surmise that the cost increases expected by the firms are plausible in the circumstances. 155

4.3.3.1.2 First-time Redesign Costs at Engagement Level Incurred by Audit Firms

When the clarified ISAs are adopted by the EU, audit firms would be required to change their existing audit practices in their engagements so that they are in compliance with the clarified ISAs. Some of the costs of this change would be first-time costs – that is, they reflect the cost of implementing the clarified ISAs at engagement level in the first year of application of audit practices that are compliant with clarified ISAs;. The first-time costs include two components: the one-off costs that would not recur in subsequent years and the recurring cost component. In the later analysis, the overall one-off costs are extracted from the overall first-time costs. 156

4.3.3.1.2.1 Capital Market Participants

Due to their very limited knowledge of the nature and magnitude of audit costs, capital market participants were asked to provide their answers on this issue using a double-sided ordinal scale (major decrease, significant decrease, slight decrease, no change, slight increase, significant increase, major increase). Half of the capital market participants believe that the first-time cost increases in the first year of application would be major, but a third believes that these cost increases would be slight. Overall this suggests that capital market participants have different views about this issue, but tend on average to a significant increase in one-off costs at engagement level. 157

4.3.3.1.2.2 Audit Clients

With respect to the size of any increase or decrease in audit costs incurred or saved by the auditor at engagement level in the first year of application of the clarified ISAs, two audit clients expect a slight increase, whereas the rest expect no change. 158

4.3.3.1.2.3 Audit Regulators

Audit regulators did not respond in an adequate fashion to this question to allow an assessment of their views in this regard. 159

4.3.3.1.2.4 Audit Firms

Medium-sized Unlisted Audit Clients 160

The potential first-time cost increases at engagement level for big four firms range between an increase of € 1,800 to € 18,300 per audit for a medium-sized unlisted audit client, which reflects a first-time average estimated cost increase per medium-sized unlisted client per audit in the first year of about € 5,900. Based upon the upper bound figures, a quarter of the potential cost increase for unlisted medium-sized audit clients of big four firms results from ISA 600 in relation to group audits; furthermore, seventeen percent of the cost increase is attributed to ISA 550, fourteen percent to ISA 540, and ten percent to ISAs 260 (communication with those charged with governance) and 265 (communication of deficiencies in internal control) each.

For the mid-tier firms, the potential first-time cost increases range between an increase of € 180 to € 9,200 per audit for a medium-sized unlisted audit client, which reflects a first-time average estimated cost increase per medium-sized unlisted client per audit in the first year of about € 2,500. Based upon the upper bound figures, one-fifth of the potential cost increase for unlisted medium-sized audit clients results from ISA 600 in relation to group audits, with a broad spread of ISAs responsible for the remaining proportion of the cost increase. 161

There is a broad variability in first-time cost increases for medium-sized audit clients, with the absolute estimated increase for big four firms significantly greater than that for mid-tier firms, which may be in part due to the relative size of the medium-sized clients. ISA 600 is the main cost driver, but ISAs 550, 540, 260 and 265 also deserve mention. 162

Large Unlisted Audit Clients 163

The range of potential first-time cost increases for big four firms range between € 1,100 and € 30,600 per audit for a large unlisted audit client, which reflects a first-time average estimated cost increase per large unlisted client per audit in the first year of about € 8,500. It appears, therefore that the larger the client, the greater the variability in cost changes, but, based upon the responses of the big four firms, the average cost increases for large unlisted companies may be about 44 % greater absolute terms than the average cost increases for medium-sized unlisted audit client. About 40 % of the upper bound cost increase for large unlisted audit clients is attributed to ISA 600, with ISAs 540, 550, 402, 260, 265 and 620 contributing 16 %, 10 %, 8 %, 8 %, 5 % and 4 %, respectively.

Very few mid-tier firms provided data on first-time costs for large unlisted companies. For this reason, it would be inappropriate to extrapolate assertions about cost saving and increases for the audits of large unlisted companies for mid-tier firms. 164

The first-time main cost driver is ISA 600, with ISAs 540, 550, 402, 260, 265 and 620 deserving mention. 165

Publicly Listed Audit Clients 166

For a publicly listed audit client the potential first-time cost increases range between € 4,400 and € 62,000 in cost increases per audit, which reflects a first-time average estimated cost increase per listed client per audit in the first year of about € 18,800. Consequently, the variability for publicly listed audit clients is greater than for unlisted medium-sized or large audit clients: this makes sense because publicly listed audit clients range from small to very large. Based upon the responses of the big four firms of costs, on average, however, it appears that in absolute terms the first-time cost increases for publicly listed audit clients may be more than twice as high as the average cost increases for large unlisted audit clients. For publicly listed entities the main cost drivers with their contribution to the overall upper bound cost increase are as follows: ISA 600 (46 %), ISA 540 (20 %), ISA 260 (6 %), ISA 550 (6 %), ISA 620 (5 %), ISA 402 (4 %) and ISA 580 (4 %).

Very few mid-tier firms provided data on publicly listed companies. For this reason, it would be inappropriate to extrapolate assertions about cost saving and increases for the audits of publicly listed companies for mid-tier firms. 167

Overall the first-time cost increases at engagement level for the audit firms for publicly listed clients is highly variable; for big four firms, a significantly greater increase is expected on average for publicly listed clients than for large unlisted clients. The standards driving the costs are primarily ISA 600, ISA 260, ISA 540, ISA 550, ISA 620, and ISA 402. 168

Banks and Insurance Companies 169

Because the data received for banks and insurance companies was virtually identical, these two kinds of audit client are dealt with together here. For banks and insurance companies, the variability and size of cost increases is expected to be greater than for publicly listed audit clients: for both, the estimated average potential cost increases range from € 8,300 to € 101,700, which reflects a first-time average estimated cost increase per bank or insurance company per audit in the first year of about € 31,700. Based upon the responses, in absolute terms, the big four firms expect the potential first-time average cost increases for banks and insurance companies to be approximately 68 % greater than the potential first-time average cost increase for publicly listed audit clients. For banks and insurance companies the main cost drivers with their contribution to the overall upper bound cost increase are as follows: ISA 540 (37 %), ISA 600 (24 %), and ISA 620 (20 %).

Very few mid-tier firms provided data on banks and insurance companies. For this reason, it would be inappropriate to extrapolate assertions about cost saving and increases for the audits of banks and insurance companies for mid-tier firms. 170

Overall Conclusion on Audit Firm Views on First-time Redesign Costs at Engagement Level 171

The first-time cost increases appear to be highly variable, with the variability increasing with audit client size, but also nature (i.e., the variability is greater for listed companies, banks and insurance companies). As is to be expected, for the big four firms the estimated absolute average first-time cost increases are significantly greater for larger unlisted companies compared to medium-sized companies and significantly greater for listed companies compared to larger unlisted companies; for the mid-tier firms, on average smaller cost increases are expected for large unlisted companies and listed companies. Furthermore, for the big four firms the estimated cost increases are significantly greater for banks and insurance companies compared to listed companies. The main cost driver appears to be ISA 600 and ISA 540 for the big firms, followed by ISA 260, 265 and 550; the mid-tier firms view ISA 600 and other standards to be the main cost drivers.

4.3.3.1.2.5 *Overall Conclusion on the First-time Redesign Costs at Engagement Level*

The first-time redesign cost increases at engagement level for the audit firms as derived from estimates from the firms range from slight increases to significant increases, depending upon the size of the firm and the nature and size of the audit client. This accords more or less with the views of the capital market participants. However, the views of the audit clients (no recurring cost increases incurred by audit firms with two clients expecting only slight increases) does not appear to be a reasonable proposition given the nature and extent of changes to the ISAs through their clarification: it appears to represent a political statement that industry does not desire audit cost increases. Hence, based upon our analysis of the changes to the ISAs compared to the existing ISAs in relation to the responses from the firms, we surmise that the first-time cost increases expected by the firms are plausible in the circumstances. 172

4.3.3.1.3 Conclusion on Recurring and First-time Redesign Costs at Engagement Level Incurred by Audit Firms

As would be expected the expected, on average first-time redesign costs incurred at engagement level by the audit firms are significantly greater than the recurring ones, particularly since they include both a recurring and one-off portion. There is considerable variation in range based upon firm and client size and the nature of the client. 173

4.3.3.1.4 The Degree to which Redesign Costs at Engagement Level Incurred by Audit Firms are Charged to Audit Clients

An inadequate number of big four and mid-tier firms responded to the questions of the degree to which the recurring and first-time cost increases and savings will be passed on to audit clients. Furthermore, an insufficient number of capital market participants, audit regulators and audit clients expressed their views on this matter. Consequently, no conclusions can be drawn on this matter. 174

4.3.3.2 Potential Cost Increases or Cost Reductions at Audit Engagement Level for Audit Clients

When auditors redesign their audit practices, they change the nature, timing and extent of their audit procedures. These procedures then have an impact on the nature, timing and extent of information that auditors require from their audit clients. For this reason, when auditors redesign their audit practices at engagement level, audit clients will incur additional costs or gain cost savings from responding to the changed audit practices. The costs of such responses may be substantial. For this reason, the Study seeks to obtain information from audit clients about their understanding of the change in financial statement preparation effort resulting from the changed audit practices. 175

Unfortunately, due to the lack of an adequate number of responses from audit clients, the audit clients surveyed did not provide any useful data on costs that would be incurred at audit clients at engagement level in the financial statement preparation process. However, some audit firms did provide data on these matters, which reflect their expectations of the direct impact on the financial statement preparation costs of audit clients. 176

4.3.3.2.1 Recurring Costs at Engagement Level Incurred by Audit Clients In Responding to Redesigned Audit Practices

4.3.3.2.1.1 Capital Market Participants' Views

Two-thirds of capital market participants believe that the recurring increased costs incurred by the client due to the client's need to respond to their auditor's redesign of audit practices would be slight. 177

4.3.3.2.1.2 Audit Firm Views

With respect to medium-sized unlisted clients, the range of recurring cost increases incurred by clients due to impact of the use of the clarified ISAs rather than current audit practices on client financial statement preparation activities is estimated at between € 80 and € 4400 per audit per year for medium-sized unlisted audit clients, with a estimated average estimate of € 1,100 per audit per year. The variability of the range increases for large unlisted audit clients to between € 600 and € 9,600 per audit per year with an estimated average of € 2,800 per audit per year. Consequently, like for audit costs incurred at audit firms, variability tends to increase with client size. The expected range of recurring cost increases for listed clients for costs incurred at the client range between € 1,200 and € 16,000 per audit per year with an estimated average of € 4,900 per audit per year. The expected cost increase per audit per year for banks ranges from € 2,600 to € 29,500 with an estimated average of € 9,300 per audit per year. For insurance companies the range is from € 1,700 to € 21,900 per audit per year with an estimated average of € 6,800 per audit per year. 178

It is interesting to note which standards drive financial statement preparation costs. Based upon the upper bound figures, for medium-sized unlisted companies, the primary cost driver is ISA 260, which contributes 28 % to the preparation cost increase; the other major cost drivers include ISAs 580 and 600 (each with 19 %) and ISA 540 (15 %). For large unlisted companies the major cost drivers are ISA 600 (49 %), ISA 540 (14 %), ISA 260 (13 %) and ISA 580 (10 %). For publicly listed companies, the major cost drivers are ISA 260 (32 %), ISA 600 (32 %), ISA 540 (9 %), ISA 200 (6 %) and ISA 580 (6 %). For banks the major cost drivers are ISA 540 (25 %), ISA 600 (23 %), ISA 260 (20 %), ISAs 265, 402 and 620 (5 % each) and ISA 200 (4 %). For insurance companies the major cost drivers are ISA 540 (30 %), ISA 600 (27 %), ISA 260 (25 %), and ISA 580 (5 %). 179

4.3.3.2.1.3 *Conclusion on Recurring Costs Incurred by Audit Clients at Engagement Level*

Based upon the detailed views provided by the firms, it is likely that the views of capital market participants underestimate the extent of impact on recurring financial preparation costs at audit clients. The increases are approximately in line (i.e., not substantially at variance with) with the average increases for the recurring costs incurred by the auditor at engagement level. 180

4.3.3.2.2 First-time Costs at Engagement Level Incurred by Audit Clients in Responding to Redesigned Audit Practices

4.3.3.2.2.1 *Capital Market Participant Views*

Half of capital market participants believe that the first-time increased costs in the first year incurred by audit clients would be major, whereas one-third believes that these cost increases would be slight. 181

4.3.3.2.2.2 *Audit Firm Views*

With respect to medium-sized unlisted clients, the range of first-time cost increases incurred by clients due to impact of the implementation of the clarified ISAs rather than current audit practices on client financial statement preparation activities is estimated at between € 94 and € 5,600 per audit in the first year for medium-sized unlisted audit clients, with an estimated average estimate of € 1,500 per audit in the first year. The variability of the range increases for large unlisted audit clients to between 182

€ 1,100 and € 15,100 per audit with an estimated average estimate of € 4,600 per audit in the first year. Consequently, like for audit costs incurred at audit firms, variability tends to increase with client size. The expected range of first-time cost increases for listed clients for costs incurred at the client range between € 1,600 and € 20,400 per audit in the first year with an estimated average of € 6,300 per audit. The expected cost increase per audit in the first year for banks ranges from € 2,800 to € 31,900 with an estimated average of € 10,000 per audit. For insurance companies the range is from € 1,900 to € 23,300 per audit in the first year with an estimated average of € 7,300 per audit. 183

It is interesting to note which standards drive first-time financial statement preparation costs in the first year of application of the ISAs. Based upon the upper bound figures, for medium-sized unlisted companies, the primary cost driver is ISA 260, which contributes 22 % to the preparation cost increase; the other major cost drivers includes ISAs 600 (21 %), and ISA 580 (18 %). For large unlisted companies the major cost drivers are ISAs 580 and 600 (31 % each), ISA 540 (9 %), and ISA 260 (8 %). For banks the major cost drivers are ISA 540 (22 %), ISA 600 (20 %), ISA 260 (18 %), ISAs 265 and 402 (6 % each), and ISAs 200, 402, 315, 330, 550 and 580 (4 % each). For insurance companies the major cost drivers are ISA 540 (26 %), ISAs 260 and ISA 600 (24 % each) and ISA 580 (5 %). 184

4.3.3.2.2.3 Conclusion on First-time Costs Incurred by Audit Clients at Engagement Level

The firms expect the first-time costs incurred by audit clients at engagement level to be significantly greater than the recurring costs. This accords with the views expressed by the capital market participants. The cost drivers for the first-time costs are broadly the same as those for the recurring costs. 185

4.3.3.2.3 Conclusion on Costs at Engagement Level Incurred by Audit Clients in Responding to Redesigned Audit Practices

Depending upon their nature and size, audit clients will bear both first-time, and to a lesser extent, recurring costs at audit engagement level due to their need to respond to the redesigned audit practices of the audit firms when ISAs are adopted in the EU. 186

4.3.3.3 Other Potential Costs or Cost Savings at Audit Firm Level

Some costs will be incurred or saved at the national audit firm level as opposed to at engagement level. These are the costs incurred by the staff (as opposed to line) departments responsible for changing audit methodologies at a national level. 187

One-off costs would be incurred by the technical audit department in each national big four firm to amend the national firm’s audit practices (audit methodology, audit manuals, or audit programmes) so that the firm’s audit practices are compliant with the clarified ISAs. The extrapolated total such costs for all big four firms in Europe is estimated at about € 10 million and for the mid-tier firms at € 7.6 million. 188

One-off costs would also be incurred by the training departments of each the big four firms in each country (e.g., costs of trainers, facilities, materials, technology and travel) to train audit personnel (including partners) to use the new clarified ISA-compliant audit practices. Such costs extrapolated for all of Europe for all of the big four firms are estimated at about € 35 million and at € 23 million for the mid-tier firms. 189

Based upon the responses from the national big four firms, it appears that they expect to have their audit staff take part in training of about eight to sixteen hours per staff member so that they are trained to use the clarified ISA-compliant amended audit practices. Based on discussions with the firms, the limiting factor on earning fees is not the ability to obtain engagements, but having the trained staff to perform the engagements. Consequently, training time translates into opportunity costs for the firms in terms of lost revenue based upon the firms’ revenue per member of audit staff. This extrapolates into about € 19 million in costs borne by the big four firms and € 16 million for the mid-tier firms in Europe for training their audit staff. The question arises whether eight to sixteen hours per staff member is adequate time to convey a working knowledge of the clarified ISAs to audit staff. 190

Once the technical departments have developed their national firm audit practices to reflect clarified ISAs, these practices need to be implemented by means of new or amended audit tools that are used by audit personnel in the field when performing audits. For the big four and mid-tier firms, such audit tools are IT-driven, and are therefore implemented by the IT departments. It is estimated that these costs extrapolated for all big four firms in Europe are about € 8.4 million and € 5 million for the mid-tier firms. None of the big four firms expect any recurring IT costs saved or incurred for maintaining these audit tools; the costs expected by the mid-tier firms are minimal (less than € 200,000). 191

The firm quality control departments would also need to implement amended quality control policies and procedures over the new clarified ISA-compliant audit practices. It is estimated that these costs would be about € 2 million for the big four firms and € 2.4 million for the mid-tier firms, regardless of whether ISQC 1 is adopted or not because all of the big four firms have already incorporated ISQC 1 into their quality control policies and procedures. None of the big four firms expect any increases or decreases in costs to maintain the amended quality control policies and procedures; the mid-tier firms expect aggregate in increase in € 1.2 million in such recurring costs. 192

Additional costs may be faced, or cost savings gained, by the firms resulting from the use of clarified ISAs as the criteria rather than national auditing standards for external quality assurance (reviews or inspections). In part, these costs or cost savings would be external (i.e., additional or reduced review or inspection costs); and in part, these costs or cost savings would be internal (resulting from the need of the firm to prepare and respond to external quality assurance). Furthermore, some of these changes in cost would be first-time, and some would be recurring. An inadequate number of firms responded to the question on the extent of change in external costs of external quality assurance, and therefore no extrapolation of costs can be made in this regard. However, on the basis of the firm responses to the internal costs with ISQC 1, it is expected that the internal costs of external quality assurance in the first year of application of the ISAs would increase by about € 900,000 for the big four firms across Europe and € 1.6 million for the mid-tier firms. The additional recurring costs thereafter are estimated at about € 350,000 per year for the big four firms and € 1.7 million for the mid-tier firms. The difference in costs without adoption of ISQC 1 is considered to be immaterial to the overall determination of firm level costs across Europe. 193

Overall the additional audit firm level costs incurred by the audit firms for redesigning their audit practices, training their staff, and redesigning their quality control policies and procedures will be significant. 194

4.3.3.4 Other Potential Costs or Cost Savings at Audit Client Level

Some costs will be incurred or saved by the audit client at the client level as opposed to at engagement level. These are the costs incurred by the staff (as opposed to line) departments responsible for changing audit client preparation procedures and policies to respond to the changed audit methodologies of the audit firms. 195

Unfortunately, due to the lack of an adequate number of responses, the audit clients surveyed did not provide any useful data on costs that would be incurred at audit clients in the financial statement preparation process. However, some audit firms did provide data on these matters, which reflect their expectations of the direct impact on the financial statement preparation costs of audit clients. 196

The firms were asked to provide an estimate of the mean average one-off costs (e.g., costs of technical personnel, facilities, materials, technology, travel) per audit client incurred to respond to new audit practices based upon the clarified ISAs. Unfortunately, since only one big four network responded to this question, there is inadequate data to develop a reasonable estimate of these costs at client level. 197

Audit firms were also asked to provide an estimate of mean average one-off costs (e.g., costs of trainers, facilities, materials, technology, travel) per audit client incurred by the audit client's training department to train client staff to respond to new audit practices based upon clarified ISAs. The results of the responses suggests that the average such cost per client would be about € 1,400; extrapolated to all clients covered by the Study, the cost would be about € 189 million. 198

Furthermore, audit firms were asked to provide an estimate of the additional mean hours required per member of audit client personnel to be trained to respond to new audit practices based upon clarified ISAs. Based upon the responses, the average one-off training cost per client would be about € 2,100; extrapolated to all clients covered by the Study, the cost would be about € 283 million. 199

Based upon the responses of the audit firms to the question of the mean average one-off costs (e.g., costs for personnel and technology) per audit client incurred by their accounting and IT department to redesign their internal control over financial reporting, including their information systems, to respond to new audit practices based upon clarified ISAs, it is expected that this one-off cost per audit client would be about € 186 per client; this extrapolates into a one-off cost of € 27 million over all audit clients covered by the audit firms in the FoF. Based upon the responses from the audit firms, the increased recurring cost of maintaining these changed controls is immaterial (€ 12 per audit client and less than € 1.6 million over all audit clients). 200

In conclusion, in line with the costs at audit firm level, audit clients may also incur costs at audit client level to respond to audit firms changed audit practices. These costs are roughly in line with (i.e., not substantially at variance with) the costs incurred by the audit firms. 201

4.3.3.5 Potential Costs or Cost Savings at Audit Regulator Level

The audit regulators were asked to provide some estimates of the potential costs or cost savings at audit regulator level arising from the adoption of ISAs in the EU through the redesign effect. The responses were differentiated between the adoption of the ISAs under the assumption that ISQC 1 is also adopted and also under the assumption that ISQC 1 is not adopted. 202

Audit regulators were asked to provide an estimate of the increase or reduction in mean average hours incurred or saved per inspection or review on a recurring basis each year by an inspector or reviewer when performing inspections or reviews in the field due to the higher or lower inspection effort resulting from the need to examine the compliance of audit practices with the clarified ISAs. Overall, based on the responses of the audit regulators, an extrapolation of costs to all reviews and inspections of audit firms that perform statutory audits in the EU required by the Fourth and Seventh Directives suggests that the overall recurring increase in inspection or review costs per year with an adoption of ISQC 1 would be about € 1.7 million. Without an adoption of ISQC 1, these costs are estimated at € 1.4 million per year. It appears that this results from regulator views that the additional requirements in the ISAs would require the additional recurring work effort when performing inspections or reviews. 203

Audit regulators were also asked to provide an estimate of the one-off increase or reduction in the mean average hours incurred or saved per inspection or review in the first year in which ISAs are implemented when an inspector or reviewer performs inspections or reviews in the field due to the higher or lower inspection effort resulting from the need to examine the compliance of audit practices with the clarified ISAs. Overall, based on the responses of the audit regulators, an extrapolation of costs to all reviews and inspections of audit firms that perform statutory audits in the EU required by the Fourth and Seventh Directives suggests that the overall one-off increase in inspection or review costs with an adoption of ISQC 1 would be about € 5.7 million in the first year. Without an adoption of ISQC 1, these one-off costs are estimated at € 4.7 million in the first year. 204

Furthermore, audit regulators were asked to provide an estimate of the one-off costs (e.g., costs of technical personnel, facilities, materials, technology, travel) incurred by their technical department to amend their inspection or review practices to cover new requirements arising from the ISAs. Based on the estimates provided by the audit regulators, with ISQC 1 the total costs for audit regulators is estimated at about € 530,000; without ISQC 1 the costs are estimated at € 440,000. 205

One-off costs are also expected to be incurred in relation to the training department of audit regulators (e.g., costs of trainers, facilities, materials, technology, travel) to train inspection or review personnel in clarified ISAs. Based upon the estimates provided by the audit regulators, with ISQC 1 the total cost for audit regulators is estimated at about € 530,000; without ISQC 1 the costs are estimated at about € 370,000. 206

The audit regulators were asked to provide an estimate of the additional mean hours of training required per inspector or reviewer so that training costs can be estimated for all of Europe. However, because only two to three jurisdictions have inspectors and the other jurisdictions use reviewers from audit firms that perform the reviews on behalf of the audit regulators, it is not possible to estimate the costs for training inspectors and reviewers for all of Europe. 207

One-off costs are also expected to be incurred by the audit regulator IT departments to implement new or amended inspection or review tools based upon the clarified ISAs. Based upon the responses from the audit 208 regulators, the total one-off costs extrapolated to all audit regulators in Europe would be about € 18,000 with ISQC 1 and about € 12,000 without ISQC 1.

Recurring costs are expected to be incurred by the IT department of the audit regulators to maintain these to 209
inspection and review tools. Based upon the responses from the audit regulators, the total recurring costs per year in this respect extrapolated to all audit regulators in Europe would be about € 18,000; there would be no difference between these costs if ISQC 1 were or were not to be adopted.

Consequently, much like the costs for audit firms and audit clients, audit regulators will need to retool their 210
systems and train their staff to respond to changes in audit firm practices.

4.3.3.6 Other Potential Costs or Cost Savings at International Audit Firm Network Level

The international networks were asked to provide an indication of the costs and cost savings that would be 211
incurred or saved through implementing clarified ISAs on their current network audit practices.

In particular, the networks were asked what the one-off costs incurred by the technical department would be 212
to amend their network audit practices (audit methodology, audit manuals, or audit programmes) so that their network practices are in compliance with clarified ISAs. Based upon the responses provided by the big four firms, it is estimated that the four big international networks will be expending about € 2.9 million in one-off costs to implement the ISAs in their network methodology; based upon the responses by the mid-tier networks, it is estimated that the twelve mid-tier networks operating in Europe that are members of the FoF will expend about € 1.4 million in one-off costs to implement the ISAs in their network methodology.

Additional one-off costs will be incurred by the networks' training department to train their audit personnel to 213
use the clarified ISA-compliant audit practices. Based upon the responses provide by the big four networks, it is estimated that they will expend about € 2.9 million in their training department at an international level; based upon the responses provided by the three mid-tier networks, it is estimated that the twelve mid-tier networks operating in Europe that are members of the FoF will expend about € 1.4 million in such one-off costs.

The big four and the three mid-tier networks were also asked to provide an estimate of the one-off costs in- 214
curred by the international IT department to implement new or amended audit tools to reflect the clarified ISAs. For the big four networks, total costs are estimated at about € 2.1 million; for the twelve mid-tier networks, total costs are estimated at about € 1.4 million. The big four and mid-tier networks do not expect any additional recurring costs to maintain these tools once having implemented them.

However, the big four networks do expect some one-off costs to be incurred by their firm quality control de- 215
partment to implement amended network quality control policies and procedures over their clarified ISA-

compliant audit practices: it is estimated that the big four networks will be expending about € 1.5 million on such implementation, regardless of whether ISQC 1 is adopted by the EU or not. Strangely enough, the mid-tier firms do not expect major costs to result from implementing new network quality control policies procedures: the estimated cost for the twelve networks is about € 26,000 in total. Neither the big four nor the mid-tier networks expect any material recurring costs to arise from maintaining the new quality control policies and procedures.

Overall, the international networks will incur significant costs in changing their audit methodologies, training their staff and changing the quality control policies and procedures for the clarified ISAs and the clarified ISQC 1. However, these costs are incurred at an international level – not in Europe. Nevertheless, it is to be expected that a significant proportion of these costs is borne by the European member firms of the networks. On average, it is estimated that about 40 % of these costs would be borne by the European member firms. 216

4.3.3.7 Improvements or Impairments in Audit Quality at Audit Engagement Level

4.3.3.7.1 Improvements or Impairments in Audit Quality due to the Redesign of Auditing Practices

The introduction of the clarified ISAs is supposed to increase audit quality. The survey participants were asked whether this accords with their expectations. 217

4.3.3.7.1.1 Capital Market Participants

In relation to audit quality, on average capital market participants appear to believe that the introduction of the clarified ISAs would tend towards a slight improvement in the probability of detecting material misstatements in the financial statements, but tend to believe that either no improvement or a slight improvement would take place in forming an audit opinion and reporting material misstatements. On average they also appear to believe that the introduction of the clarified ISAs would tend towards a slight improvement in audit reporting and communication of audit findings. Overall, capital market participants appear to expect a slight improvement in audit quality. 218

4.3.3.7.1.2 Audit Regulators

Only four audit regulators responded to the questions on the potential effects of ISA adoption at audit engagement level on the sources of improvement in audit quality. On average, the responses ranged from just above no change to a slight improvement of audit quality 219

4.3.3.7.1.3 Audit Clients

Audit clients tend to believe that there will be between no change and a slight increase in audit quality due to the adoption of clarified ISAs, with the weighting clearly towards no change. 220

4.3.3.7.1.4 Audit Firms

A review of the average audit firm responses to the evaluation of the potential effects on audit quality arising from the application of clarified ISAs different from firm audit practices shows that the expected benefits for all of the stages of the audit process or aspects of the audit are no change to less than half way between no change and slight improvement. This applies regardless of whether the responses are from the big four firms, the mid-tier firms, from North-Western Europe, or from South-Eastern Europe. By standard, the clarified ISAs that are expected to yield the greatest benefits were ISA 600 for group audits, ISA 550 for related parties, ISA 540 for accounting estimates including fair values, ISA 265 on reporting control deficiencies, and ISA 700 on the auditor's report . It should be noted that all of these values are below a slight benefit on average. On the whole, the mid-tier firms are more conservative on the benefits expected than the big four firms, which also expect greater, if slight, benefits from ISAs 705 and 706. In addition, it appears that the firms from South-Eastern Europe are slightly more conservative than those from North-Western Europe. 221

4.3.3.7.1.5 Conclusion on Increase in Audit Quality

Overall, it appears that the consensus is that ISA adoption will lead to in between no change and slight improvement in audit quality. The possible reason is that the additional and changed procedures required by the clarified ISAs are beginning to reach the point of diminishing returns of quality in relation to audit effort. 222

4.3.3.7.2 Improvements or Impairments in Audit Quality Due to Adoption of ISQC 1

Half of the responding capital market participants believe that the adoption of ISQC 1 would not affect their views on the improvement in audit quality; the other half has varying views on this matter. Only one audit client respondent believes that the adoption of ISQC 1 would lead to a slight improvement in this assessment: the others believe that there would be no change. 223

Half of the five auditing regulator respondents to the question of whether the adoption of ISQC 1 would affect these changes in audit quality suggest that adoption of ISQC 1 would cause no change; one respondent believes that the adoption of ISQC 1 would cause a slight improvement; another posits a significant improvement. 224

Overall of the twenty-three firms that answered the question as to the effect of an adoption of ISQC 1 on audit quality, twenty (87 %) answered that it would not change audit quality: both big four firms and mid-tier firms had a similarly high percentage (over 75 %) taking this view. However, there is a dichotomy of views between the firms from North-Western Europe and those from South-Eastern Europe: 18 out of former 19 answering 225 the question assert that no change would occur, whereas for the latter half of those answering the question believe that adopting ISQC 1 would lead to a slight improvement in audit quality.

Overall it appears that the adoption of ISQC 1 would not lead to an increase in audit quality because it is generally recognised that the firms in the FoF have already largely adopted ISQC 1 in their firm quality control policies and procedures and that ISQC 1 was only redrafted and not revised, so the adoption of the clarified ISQC 1 would cause little change for these firms. Furthermore, many national standards setters have adopted, transposed, or otherwise based their national standards for firm quality control policies and procedures on ISQC 1. 226

4.3.3.7.3 Improvements or Impairments in Audit Quality Due to Introduction of Objectives

Half of the regulators believe that the introduction of objectives will not impact audit quality; one-third expect a significant improvement. Twenty-three firms answered the question as to the effect of the introduction of objectives into the ISAs on audit quality. Seventeen thereof believe that the introduction of objectives would lead to a slight increase in audit quality; six believe that there would be no change. The proportions here are similar for big four and mid-tier firms and by region. 227

The firms are slightly more optimistic than most of the regulators that the introduction of objectives will cause a slight increase in audit quality; some regulators take a more optimistic view than the firms. On balance, it appears that the objective may contribute to a slight increase in audit quality. 228

4.3.3.7.4 Improvements or Impairments in Audit Quality Due to Introduction of the Application Material

It is interesting to note that only one-third of regulators expect the application material to cause a significant improvement in audit quality; only one regulator expects a slight improvement. In contrast, one regulator expects a slight impairment to audit quality arising from the application material. Twenty-three firms also answered the question as to the effect of the application material in the ISAs on audit quality: twenty firms expect a slight improvement; two no change; and one a slight impairment. All of the big four firms responding believed that a slight improvement would take place, whereas six of the nine mid-tier firms did so. By region, all of the firms from South-Eastern Europe believed that a slight improvement would take place, whereas sixteen of the nineteen firms in North-Western Europe took this view. 229

On balance, it appears that the majority of regulators and firms take the view that the application material will contribute to a slight improvement in audit quality. 230

4.3.3.8 Other Potential Effects at Audit Firm Level

4.3.3.8.1 Capital Market Participants

On average, the responding participants appear to believe that the changed terms of engagement from introducing clarified ISAs would lead to a slight increase in the risk of professional sanctions, and to between no change and a slight increase in liability risk and reputational risk for auditors. In addition, on average, the responding participants appear to believe that the changed audit quality from introducing clarified ISAs would lead to a slight increase in the risk of professional sanctions and liability risk for auditors, but only to between no change and a slight increase in reputational risk for auditors. Half of the responding participants believed that the adoption of ISQC 1 would lead to no change to these responses, whereas the remaining participants took varying views. 231

4.3.3.8.2 Audit Regulators

On average, audit regulators appear to expect that the risk of professional sanctions, liability risk and reputational risk to essentially not change due to the application of clarified ISAs. Two-thirds of the regulators believe that the introduction of ISQC 1 would not change this assessment. 232

4.3.3.8.3 Audit Clients

Audit clients tend to believe that there will be between no change and a slight increase in the risk of professional sanctions, liability risk, and reputational risk due to changed terms of engagement or changed audit quality resulting from the adoption of the ISAs, with a clear weighting towards no change. Only one audit client believes that there would be a slight increase in risk due to the adoption of ISQC 1: the others believe that there would be no change in risk. 233

4.3.3.8.4 Audit Firms

On average audit firms appear to expect that the risk of professional sanctions, liability risk and reputational risk to essentially not change due to the application of clarified ISAs. The differences between the big firms and mid-tier firms and the regions do not appear to be significant. Twenty-two out of twenty three firms responding to the question of whether the adoption of ISQC 1 would change these assessments conclude that the adoption of ISQC 1 would not lead to any change in these assessments. 234

4.3.3.8.5 Overall Conclusion

Audit regulators and audit firms appear to agree that the effect of the introduction of the clarified ISAs on the changed terms of engagement, changed audit quality would essentially not have any impact on the firm's risk of professional sanctions, liability risk and reputational risk and that the introduction of ISQC 1 would not 235 change this assessment. Capital market participants tend to lean towards a slight increase in risk, along with audit clients, but neither group expects any significant change to this assessment from the adoption of ISQC 1.

4.3.3.9 Other Potential Effects at Audit Client Level

4.3.3.9.1 Capital Market Participants

The capital market participants were asked to provide their views on the potential effects of an ISA adoption on financial reporting quality for audit clients. On average, capital market participants believe that there will be between no change and a slight improvement in: the use by management and those charged with governance of audit reporting and the communication of audit findings; internal control relevant to financial reporting; accounting estimates within their reasonable range and their disclosure; management accounting and internal control; corporate governance; and access to capital and business opportunities. However the responding participants do tend to believe that the introduction of the clarified ISAs would lead to a slight improvement in the incidence of material misstatements in audited financial statements. Nevertheless, neither improvement nor impairment is expected for the choice and application of acceptable accounting policies, accounting estimates within their reasonable range and their disclosure, the quality of disclosures in the notes to the financial statements, and in other information containing financial statements. 236

4.3.3.9.2 Audit Regulators

Only four audit regulators responded to the question posed in the survey on potential effects on audit clients of ISA adoption. On average, it appears that they take the view that from an audit client perspective, ISA adoption would lead to no change to a very much less than a slight improvement in financial reporting quality. Half of the regulators believe that the adoption of ISQC 1 would not change this assessment; two expect the adoption of ISQC 1 to cause a slight improvement in financial reporting quality. 237

4.3.3.9.3 Audit Clients

With respect to the potential effects on financial reporting quality, audit clients appear to take a clear view that the adoption of ISAs would cause between no change and a slight increase in financial reporting quality with a clear tendency to no change. 238

4.3.3.9.4 Audit Firms

Eighteen firms responded to the questions on the impact of ISA adoption on financial reporting quality. On average these firms take the view that between no change and a slight improvement in financial reporting quality would occur due to ISA adoption. The average in relation to most aspects of financial reporting quality tended to no change, whereas the aspects “changed use by management and those charged with governance of audit reporting /communication of audit findings”, “changed internal control relevant to financial reporting” and “changed management accounting and internal control” tended towards half way between no change and 239 slight improvement. With the exception of "changed use by management and those charged with governance of audit reporting /communication of audit findings", and "changed choice and application of acceptable accounting policies" where the big four firms took a unanimous and strong view, respectively that there would be a slight improvement and the mid-tier firms believed that there would be none, the differences between the big four firms and the mid-tier firms do not appear to be significant. There were no significant differences between the regions.

4.3.3.9.5 Overall Conclusion

The general consensus appears to be that the introduction of the ISAs would lead to between no change and a slight improvement in financial reporting quality at the audit client level. 240

4.3.3.10 Other Potential Effects at Audit Regulator Level

There may be impacts of ISA adoption on the audit regulators other than cost increases or savings. This Section deals with these other potential effects. 241

4.3.3.10.1 Effect of ISA Adoption on Quality of Inspections or Reviews

Half of the audit regulators suggest that the adoption of the ISAs will not affect the quality of inspections or reviews; only one-third expect a slight improvement. Likewise, half of the regulators do not believe that the adoption of ISQC 1 would change this assessment; one-third expects a slight improvement in that assessment through the adoption of ISQC 1. 242

Only thirteen audit firms responded to the question on the effect on the quality or reviews of inspectors' or reviewers' changed understanding of the nature of an audit, of the ISAs and of their different levels of obligation resulting from the adoption of the ISAs. Six believe a slight improvement would ensue, whereas six others believe that no change would result (one believed that a slight impairment would result). Six out of nine mid-tier firms expect no change; two expect a slight improvement and one the slight impairment. All of the four big four firms answering expect a slight improvement. There is no significant difference in the proportions of answers between the regions. 243

Overall, based upon these views, ISA adoption is unlikely to affect the quality of inspections or reviews, and if it does, the improvement is likely to be slight. The adoption or non-adoption of ISQC 1 would not have any impact on this assessment. 244

4.3.3.10.2 Effect of ISA Adoption on Efficiency of Inspections or Reviews

Two-thirds of regulators expect ISA adoption not to have any effect on the efficiency of inspections or reviews; one-third expects a slight improvement in the efficiency of reviews. Half of the regulators do not expect the 245 adoption of ISQC 1 to change this assessment; one-third expects a slight improvement in that assessment through the adoption of ISQC 1.

With respect to the potential impact of ISA adoption on the efficiency of inspections or reviews, six firms expect no change and five a slight improvement; one firm expects a slight impairment and another a significant impairment. All four big four firms answering expect a slight improvement in efficiency; six of the nine mid-tier firms expect no change, whereas the rest have differing views. The answers from firms in the South-East vary; those from the North-West tend on average to either no change or slight improvement. 246

Overall, it appears unlikely that ISA adoption will have an impact on the efficiency of inspections or reviews, but if it does, the impact would be a slight improvement. The adoption or non-adoption of ISQC1 would have no impact on this assessment. 247

4.3.3.10.3 Effect of Adoption of ISQC1 on the Quality of Inspections or Reviews

Two-thirds of regulators expect the adoption of ISQC 1 to have no effect on the quality of inspections or reviews; one regulator expects a slight improvement. 248

Of the thirteen firms which responded to the question on the effect of the adoption of ISQC 1 on the quality of reviews or inspections, eleven suggest that the adoption of ISQC 1 would have no impact; one (mid-tier firm) expects a slight improvement and another (also a mid-tier firm) a significant improvement. 249

Consequently, the adoption of ISQC 1 will have no effect on the quality of inspections or reviews. 250

4.3.3.10.4 Effect of Introduction of Objectives in Auditing Standards on Quality of Inspections or Reviews

All but one of the regulators expect the introduction of objectives into the ISAs will not have any impact on the quality of inspections or reviews; the remaining regulator suggests that the introduction of objectives would result in a significant improvement to the quality of inspections or reviews. 251

Out of the thirteen firms that responded to the question on the effect of the introduction of objectives in to the ISAs on the quality of reviews or inspections, seven firms expected no change, five expected a slight improvement and one a slight impairment. The answers varied for both the big four firms and the mid-tier firms. 252
In conclusion, it is unlikely that the introduction of objectives would change the quality of inspections or reviews, but if it does, the change will likely be a slight improvement.

4.3.3.10.5 Effect of Introduction of Application Material in Auditing Standards on Quality of Inspections or Reviews

Two-thirds of regulators believe that the application material in the ISAs will have no effect on the quality of inspections or reviews; one-third of regulators expect a slight improvement. 253

Of the thirteen firms that answered the question on the effect of application material in the ISAs on the quality of reviews or inspections, eight firms expected no change and five a slight improvement. The answers varied for both the big four firms and the mid-tier firms. 254

Overall, the introduction of application material does not appear to have any material impact on the quality of inspections or reviews. 255

4.3.3.11 Other Potential Effects at European Audit Market Level

4.3.3.11.1 Audit Regulators

Half of the regulators expect no audit firms to leave the market for statutory audits in their jurisdiction because the introduction of clarified ISAs as required auditing standards would cause the costs of performing such statutory audits to exceed the benefits for those firms. On the other hand, one-third of regulators do expect audit firms in their jurisdiction to leave the statutory audit market. Only one audit regulator expects this to lead to a slight improvement in audit quality. 256

Two-thirds of regulators expect audit firms in their jurisdictions to join networks or other forms of cooperation due to the implementation of clarified ISAs. These audit regulators believe that between 3.5 % and 5.5 % of audit firms would join such networks or other forms of cooperation. However, regulator views on the impact thereof on audit quality are varied, with one third expecting a slight improvement in audit quality and one regulator each expecting no change or a significant improvement. 257

4.3.3.11.2 Audit Firms

Only twelve audit firms answered the question on whether they expect firms to enter or leave the audit market due to ISA adoption. The four responding big four firms and five mid-tier firms suggest there will be no change in the audit market; three mid-tier firms expect firms to leave the audit market. The three mid-tier firms that expect firms to leave the audit market expect a slight improvement in audit quality to result, but do not provide any data on the proportion of audit firms that they expect to leave the audit market. Twelve firms responded to the question of whether ISA adoption would cause audit firms to join or leave networks or other forms of cooperation: eight (four mid-tier firms and four big four firms) expect no change, whereas four (mid-tier firms) expect firms to join networks etc. These four mid-tier firms expect a slight improvement in audit quality to result, but do not provide any indication of the proportion of audit firms that may join networks, etc. 258

4.3.3.11.3 Conclusion

Only a minority of audit regulators and firms (mid-tier firms) expect ISA adoption to lead some audit firms to leave the market for statutory audit; only this minority of mid-tier firms expects this to increase audit quality in their audit market. However, a clear majority of regulators believe that ISA adoption would lead about 4 % of audit firms joining networks or other forms of cooperation; only half of the mid-tier firms share a similar view. The audit regulators take differing views of the impact of this on audit quality, whereas these mid-tier firms believe that audit quality would increase. 259

4.3.3.12 Other Potential Effects at European Capital Market Level

4.3.3.12.1 Correlation between Audit Quality and Financial Reporting Credibility

Four-fifths of the responding capital market participants believe that there is a significant correlation between audit quality and financial reporting credibility. One-third of regulators each believe that there is a slight, significant and major correlation between audit quality and financial reporting credibility. The audit clients responding take differing views on the correlation between audit quality and financial reporting credibility: one-third believes the correlation is slight, one-third believe it is significant, and one-third believes it is major. Fifteen (thirteen big four and two mid-tier firms) out of the twenty-seven audit firms responding believe that there is a slight correlation between audit quality and financial reporting credibility; seven (one big four and six mid-tier firms) expect a significant correlation and five (four big four and one mid-tier firm) a major correlation. The answers also vary by region: in the North-West, ten slight, six significant and four major correlation; in the South-East, five slight, one significant and one major correlation. Overall, on average the respondents appear to believe that there is a significant correlation between audit quality and financial reporting credibility. 260

4.3.3.12.2 Correlation between Financial Reporting Credibility and Financial Reporting Quality

Four-fifths of capital market participants believe that there is at least a significant correlation between financial reporting credibility and financial reporting quality. Half of the regulators expect a slight correlation between financial reporting credibility and financial reporting quality, one-third expects a significant correlation, and one regulator expects a major correlation. Two-thirds of audit clients responding believe that there is at least a significant (one audit client thereof believes a major) correlation between financial reporting credibility and financial reporting quality, whereas one audit client each believe that this correlation is slight or zero. With respect to the degree of correlation between financial reporting credibility and financial reporting quality, thirteen (big four firms) believe that the correlation is slight, seven (mid-tier firms) significant, and six (five big four firms and one mid-tier firm) major. The responses by region varied considerably. Overall, on average the respondents appear to believe that there is a significant correlation between financial reporting credibility and financial reporting quality. 261

4.3.3.12.3 Correlation between Financial Reporting Quality and the Ability of Investors to Assess Investment Risks

Four-fifths of capital market participants believe that there is at least a significant correlation between financial reporting quality and the ability of investors to assess investment risks. Two-thirds of regulators expect a slight degree of correlation between financial reporting credibility and the ability of investors to assess investment risks, whereas one regulator each expects a significant or major correlation. Half of the audit clients responding believe that the correlation between financial credibility and the ability of investors to assess investment risk is at least significant (one audit client, major), whereas two believe this correlation to be slight and one zero. In relation to the degree of correlation between financial reporting credibility and the ability of investors to assess investment risks, fourteen audit firms (thirteen big four firms and one mid-tier firm) expect a slight correlation, eleven (five big four firms and six mid-tier firms) a significant correlation, and one (mid-tier firms) each no or a major correlation. The proportions between the regions are roughly equivalent. Overall, on average the respondents appear to believe that there is a significant correlation between financial reporting quality and the ability of investors to assess investment risks. 262

4.3.3.12.4 Correlation the Ability of Investors to assess Investment Risks and Reduced Capital Market Transaction Costs

Half of the capital market participants believe that there is a significant correlation between the ability of investors to assess investment risks and reduced capital market transaction costs (costs of obtaining and interpreting capital market information used by capital market participants to make investment decisions); the other half believe that there is only a slight such correlation. Half of regulators expect a slight correlation between the ability of investors to assess investment risks and reduced capital market transaction costs; one each expects no correlation, significant correlation or major correlation. Half of the audit clients responding also believe that the correlation between the ability of investors to assess investment risk and reduced capital market transaction costs is significant; two believe that this correlation is slight and one believes it is zero. On the question in relation to the expectation of the degree of correlation between the ability of investors to assess investment risks and reduced capital market transaction costs, nineteen firms (thirteen big four and six mid-tier firms) expect a slight correlation, six (five big four and one mid-tier firm) a significant correlation and two (mid-tier firms) no correlation. In terms of region, fifteen in the Northwest and four in the South-East expect a slight correlation, three from each expect a significant correlation, and two from the Northwest no correlation. Overall, on average the respondents appear to believe that there is a between slight and significant correlation between the ability of investors to assess investment risk and reduced capital market transaction costs. 263

4.3.3.12.5 Correlation the Ability of Investors to Assess Investment Risks and Reduced Cost of Capital

There appear to be varying views among capital market participants on the degree of correlation between the ability of investors to assess investment risks and reduced costs of capital, with the responses ranging between 264 slight correlation and major correlation. Two-thirds of regulators believe that there is a slight correlation between the ability of investors to assess investment risks and reduced costs of capital, whereas one each believe that there is no correlation or a major correlation. Three audit clients believe in a slight correlation between costs of capital and the ability of investors to assess investment risks, whereas two believe that this correlation is significant and one believes that there is no correlation. Fourteen audit firms (thirteen big four and one mid-tier firm) expect a slight correlation between the ability of investors to assess investment risks and reduced costs of capital; ten (five big four and five mid-tier firms) expect a significant correlation and three (mid-tier firms) expect no correlation. The proportions by region are not significantly dissimilar. On average, the respondents appear to believe that there is a slight correlation between the ability of investors to assess investment risks and reduced costs of capital.

4.3.3.12.6 Examining the Chain of Correlations

The respondents overall had, on average, expectations of slight improvements in audit quality through ISA 265
adoption. Given the average expectation of a significant correlation between audit quality and financial reporting credibility (i.e., perceived financial reporting quality), such a slight increase in audit quality should translate into a very slight increase in financial reporting credibility. On average the respondents had also expected only a very slight improvement in financial reporting quality through ISA adoption. Given the average expectation of a significant correlation between financial reporting credibility (perceived financial reporting quality) and financial reporting quality, the increase in financial reporting credibility due to increased financial reporting quality from ISA adoption would be imperceptible. Aggregating these effects suggests that ISA adoption would lead to an at most slight improvement in financial reporting credibility.

On average the respondents appear to believe that there is a significant correlation between financial reporting 266
quality and the ability of investors to assess investment risks. However, even if the increase in actual financial reporting quality is, as expected, very slight, the concomitant slight increase in perceived financial reporting quality (financial reporting credibility) due to ISA adoption should lead to a very slight increase in investors' perceived ability to assess investment risk. Given the slight to significant correlation between the ability of investors to assess investment risk and reduced capital market transaction costs, adopting ISAs would lead to a very slight reduction in capital market transaction costs. Furthermore, given the slight correlation between investors' ability to assess investment risk and reduced costs of capital, adopting ISAs would lead to a very slight reduction in costs of capital.

Consequently, although ISA adoption has positive effects on capital markets, including reducing capital market 267
transaction costs and reduction in costs of capital, these effects are so small so as to be very slight.

4.4 Harmonisation Effect

The discussion relating to the harmonisation of auditing standards forms part of the general debate on the harmonisation of regulation.[74] Accordingly, harmonisation of auditing standards, like any regulatory harmonisation, requires a careful analysis of benefits and costs: Harmonisation in general may generate benefits on one side but, at the same time, may incur new costs, because it terminates competition among regulators as an inventive process to steadily improve regulation. Moreover, it is said that harmonisation in general bears the risk of suboptimal standards in the end. Harmonised standards, like harmonised regulations in general, tend to petrify and become resistant to reform. Experience shows that it usually turns out to be very difficult and complex to change harmonised regulation. Having gone through cumbersome and lengthy negotiations in order to reach harmonisation often means that the parties are not really prepared to reopen the negotiation process. 268

However, in order to analyse the impact of the adoption of ISAs by the EC due to the implicit harmonisation of the national sets of auditing standards currently in place, it is helpful to give an overview on the literature on regulatory harmonisation in general and auditing-related findings in particular. However, the vast majority of the studies deal with the harmonisation of accounting standards; there is hardly any evidence on the consequences or application of *clarified* ISAs available. Yet, the effective transposition of the results derived from accounting research is rather limited, since accounting standards are *result-oriented,* whereas auditing standards are *process-oriented*.[75] 269

4.4.1 Definition

Most of the literature dealing with the harmonisation of standards actually lacks a definition of the notion “harmonisation”. A helpful terminological approach is taken by Tay/Parker (1990) who in a first step defines the terms “harmonisation”, “standardisation”, “harmony” and “uniformity” and in a second step distinguishes between “de jure” and “de facto” harmonisation. Although they applied their approach to accounting standards, it appears to be suitable for auditing standards as well. According to their understanding 270

> “Harmonization (a process) is a movement away from total diversity of practice. Harmony (a state) is therefore indicated by a ´clustering´ of companies around one or a few of the available methods. Standardization (a process) is a movement towards uniformity (a state). It includes the clustering associated with harmony, and reduction in the number of available methods.”[76]

While “de jure” describes the situation where regulations are set by law or a profession, “de facto” implies the actual use of methods by practitioners. “De facto” situations do not necessarily imply a corresponding “de jure” status.[77] 271

[74] For a comprehensive overview of the subject see contributions in Schuppert, G. F. (ed.) (2006); Hertig, G./McCahery, J. A. (2006); Mattli, W./Büthe, T. (2005); Michaels, R./Jansen, N. (2006); Bamberger, K. A. (2007).

[75] Richter, T. (2003a): 78.

[76] Tay, J. S. Q./Parker, R. H. (1990): 73.

[77] Tay, J. S. Q./Parker, R. H. (1990): 73-74.

Gangolly et al. (2002) stress the relevance of enforcement systems for the convergence of "de jure" and "de 272
facto" situations.[78] They describe "de facto" harmonisation "as the result of global economic and competitive forces that lead to following [...] international standards in practice"[79]. They also note that the investigation of "de jure" harmonisation may provide some "insight into the political viability of the harmonization process"[80]. Obstacles to transform "de jure" harmonisation to "de facto" harmonisation may arise from cultural differences in the interpretation of auditing standards, translation problems and different enforcement systems.[81]

4.4.2 Measurement

Apparently harmonisation is regarded as a continual process. In order to assess the degree of harmonisation 273
measurement issues arise. For example, Jungen (1995) developed a measurement approach with regards to the harmonisation of Italian and German auditing standards. As one indicator for the harmonisation, he examined whether German auditors were allowed to use Italian audit opinions within their own statutory audits.[82] Ruhnke (2000) derived an own measure of the harmonisation of auditing standards, the "Harmonisation-Index" (HAI).[83] The assessment of the HAI is carried out in the following steps:

- Identification of significant aspects of ISAs,
- Weighting of these aspects,
- Measuring the extent of harmonisation by
  - A pairwise comparison of national auditing standards aspects with significant aspects of ISAs,
  - Assessing conformity between domestic auditing standards and ISAs,
  - Estimating the degree of divergence,
- Calculating a total score.[84]

Ruhnke (2000) conceded that his measure serves more as a methodological framework than a means for actual 274
application.[85] Remaining questions still are how to assess compliance in an objective manner and how to treat the differences between a "de jure" and a "de facto" harmonisation. The latter involves the problem of differences between the interpretation or application of "harmonised" standards. [86]

Two similar ways of substantiating the notion of harmonisation was developed by Hussein/Bavish/Gangolly 275
(1986) and Gangolly et al. (2002). They compared so-called "target states" with effective states as currently in place. The results of this comparison were measured using a binary code. The studies examined whether audi-

78 Gangolly, J. S. et al. (2002): 329.
79 Gangolly, J. S. et al. (2002): 332.
80 Gangolly, J. S. et al. (2002): 333.
81 Richter, T. (2003a): 80, Krommes, G. (2008): 718.
82 Jungen, D. (1995): 4.
83 Ruhnke, K. (2000): 179-183.
84 Ruhnke, K. (2000): 181-183; Richter, T. (2003b): 189.
85 Ruhnke, K. (2000): 183.
86 Ruhnke, K. (2000): 183; Richter, T. (2003a): 79; Richter, T. (2003b): 189.

tor reports actually available contained specific elements as required by the "target state" or not. The outcomes were attributed a "1" if a designated element existed, or a "0" otherwise. The degree of harmonisation was calculated as the total score, allowing for the clustering of the audit reports according to scores attained.[87] It was, by the way, interesting to see, that the clusters of jurisdictions according to the audit report scores corresponded to corporate governance systems' differences like differences in security markets activities, legal system differences, differences in accounting standards setting bodies and the level of codification of auditing standards.[88] Further comparisons were conducted for auditor reports in European member states in 1995,[89] in 2000[90].

In our Study, the measurement of a "degree of harmonisation" is no explicit issue. Instead, the adoption of ISAs by the EC is regarded as the implementation of a uniform set of auditing standards. However, as already mentioned, the exclusion of the application material from the adoption of ISAs may induce divergence in the application of "de jure" harmonised auditing standards. 276

4.4.3 General Legitimacy of Harmonising Regulation

First, the discussion of harmonising auditing standards forms part of the general debate on harmonisation of regulation.[91] Accordingly, harmonisation of auditing standards, like any regulatory harmonisation, requires a careful analysis of arguments in favour and against, which are only briefly summarised below as follows: 277

4.4.3.1 Benefits of Harmonisation

In general, globally accepted international standards are expected to have a number of benefits,[92] mainly in relation to audits where the audit reports are used by users across different jurisdictions or the audits relate to group financial statements with components from different jurisdictions (collectively referred to as "transnational audits" in this Study): 278

- reduction of the standards overload;
- strengthening quality of auditing;
- reduction of auditors' liability risk.

In addition to these major benefits, the introduction of globally accepted auditing standards is said 279

- to foster efficient designing of auditing manuals, checklists and auditing processes within auditing firms;

87 Gangolly, J. S. et al. (2002): 336.
88 Hussein, M. E. A./Bavishi, V. B./Gangolly, J. S. (1986): 131.
89 King, C. G. (1999).
90 Garcia-Benau, M. A,/Zorio, A. (2004).
91 For a comprehensive overview over the subject see the contributions in Schuppert, G. F. (ed.) (2006); Hertig, G./McCahery, J. A. (2006); Mattli, W./Büthe, T. (2005); Michaels, R./Jansen, N. (2006); Bamberger, K. A. (2007).
92 Brinkmann, R. (2006): 399.

- to permit the production of globally valid information about auditing standards in all countries of prospected investment and, thereby, fostering of the European capital market.

The number of audits that are conducted in accordance with ISAs is rapidly growing in recent years. Hence, adopting ISA for statutory audits in the EU simply corresponds to the path dependent development.[93]

Harmonisation in general contributes to cost reduction because it makes it easier in a global world to comply with law. Moreover, it becomes easier to check compliance and to enforce the law for transnational audits. The public is entitled to have confidence that, regardless of where a business activity occurs, the same high quality standards were applied. It is widely recognised that investors will be more willing to diversify their investments across borders if they are able to rely on financial information gathered and audited on a similar set of standards. Thus, adherence to international standards, such as those developed by the International Accounting Standards Board and the International Auditing and Assurance Standards Board, are said to lead to greater to greater economic expansion.[94] At the same time, harmonised standards are suggested to contribute to reducing vulnerability and strengthening the resilience of financial systems. The report on Rebuilding Public Confidence Financial Reporting issued in July 2003, provided further support for IFRS and ISA becoming the worldwide standards. It recommends that governance of national and international standards be achieved as soon as possible, viewing this as a significant public interest issue.[95] To sum up, adopting ISAs in the European Union, it is said, would clearly contribute to the stabilisation and expansion of European economy. 280

From a more general perspective, factors *in favour of* a harmonisation of auditing standards may referred to as information asymmetry, transaction costs from information search and standard-setting costs[96]: 281

- Information asymmetry: Addressees of financial information are usually familiar with their own national regulatory setting so as to be aware of the limitations of national regulation. For example, capital market participants may have obtained a certain understanding of auditing reports according to the auditing standards in their domestic market. However, they encounter a higher degree of uncertainty for audit reports from other jurisdictions. Therefore, harmonisation of auditing standards can reduce international information asymmetries between capital market participants.
- Transaction Costs: The comprehension and comparison of national auditing standards involves costs. In a harmonised auditing standard regime, the users of financial statements save the efforts necessary to compare audit reports.
- Standard-setting costs: The provision of one set of auditing standards decreases the total standard-setting costs from an overall perspective. Furthermore standard-setters save costs in informing the users and the public about auditing standards provided.

93 Roussey, R. S. (1999).
94 Wong, P. H. Y. (2004).
95 IFAC Task Force (2003).
96 Gangolly, J. S. et al. (2002): 330-331.

As expected, the argument most put forward is relates to comparability.[97] This is important to notice, since costs and benefits from *limited* comparability primarily are borne by capital market participants.[98] With a lack of harmonisation, capital market participants incur costs for the generation and processing of relevant information; the implementation of harmonised auditing standards, in turn, is costly at the audit firm level. The portion of costs that is refunded via higher audit fees again is compensated by capital markets.[99] The aim of the empirical part of the Study is to assess how this trade-off is perceived by capital market participants. 282

Other issues relating to the cost benefit effects perceived by the addressees of financial statements are the "overall harmonisation" with respect to financial statements, i.e. the harmonisation of accounting and auditing standards. For example, participants of a global roundtable with capital markets stakeholders underlined the need for "more consistent audit and independence standards, and to a certain extent regulatory oversight across borders"[100]. Obviously, the discussion about convergence of accounting standards is accompanied by the discussion about the necessity of convergence of auditing standards.[101] 283

Moreover, in addition to these general considerations on harmonisation of regulation, there are specific arguments in favour of harmonisation of auditing regulation through adoption of ISAs. 284

4.4.3.2 Costs of Harmonisation

On the downside, harmonisation may cause additional costs because it terminates competition among regulators as an inventive process to steadily improve regulation. Moreover, it is said that harmonisation in general bears the risk of ending up with standards that are not optimal due to the compromises that harmonisation involves. Harmonised standards, like harmonised regulations in general, tend to petrify and become resistant against reform. Experience shows that it usually turns out to be much more difficult to reform harmonised law than to achieve harmonisation in the first place. Having gone through cumbersome and lengthy negotiations in order to reach harmonisation, the parties are usually not really willing to reopen the negotiation process. Also, the role of interest groups in the process of harmonisation, like lawyers, the judiciary, members of involved professions, and politicians needs to be considered. All of these groups have individual interests that might be influential in the process of keeping traditional standards or adopting harmonised ones. 285

A substantial number of studies have examined both regulatory competition in corporate law and forum shopping in financial market regulation and have searched for alternatives to centralised harmonisation of regulation. Most of these studies are dealing with regulation in the US, while they are relatively new territory in the EU. 286

97 Rost, P. (1991): 27-35; Ruhnke, K. (2000): 151; Kampmann, H. (2003): 6-7; DiPiazza, S. A. Jr. et al. (2008): 4.
98 Richter, T. (2003a): 79-80.
99 Richter, T. (2003a): 80.
100 DiPiazza, S. A. Jr. et al. (2008): 3.
101 DiPiazza, S. A. Jr. et al. (2008): 5 and 16.

Based on a number of event studies, Romano (1998a, 1998b, 2001, 2005) advocates a market-oriented approach of competition among legislators that would expand the role of the states in regulation and would fundamentally reconceptualise the regulatory scheme. Under a system of competitive regulation, only one sovereign will have jurisdiction over all transactions that involve a corporation: the sovereign chosen by the corporation from among a number of foreign nations. The aim is to replicate for various contexts the benefits produced by state competition for corporate charters – a responsive legal regime that has tended to maximise share value. As a competitive legal market supplants a monopolist regulator in the fashioning of regulation, it will produce rules more aligned with the preferences of investors, whose decisions drive the capital market. 287

Enriques, L./Gelter, M. (2006) put forward another approach to the competition in the production of corporate law: although the shortcomings of state law have been widely recognised, there has been little support for centralised intervention because of the concern that such intervention might produce even worse arrangements. Their paper, however, identifies a form of centralised intervention in the regulation of corporations that would address these shortcomings without raising such a concern. "Choice-enhancing" intervention would consist of an optional body of substantive centralised law which shareholders (or corporations) would be able to opt into (or out of). An alternative version of choice-enhancing intervention would provide a centralised law requiring states to allow shareholders to initiate and approve opting out of corporate arrangements provided by the state's law. It is argued that such a centralised role in corporate law cannot harm and would likely improve the regulation of corporations. Moreover, by showing how federal law can be used to improve regulatory competition in the provision of corporation law rather than preempt it, the analysis lays the groundwork for a more general reconsideration of regulatory competition in corporate law. 288

Yet another concept has been suggested by Trombetta (2003). He finds that the market for audit services is modelled as a market with vertical product differentiation, rigid demand, third parties externalities and a liability rule. This framework is used to choose between full harmonisation and mutual recognition as possible international regulatory regimes for audit quality. He can show that if third parties externalities are zero, then full harmonisation is at least as good as mutual recognition. If, however, externalities are not zero, then mutual recognition can yield a higher level of social welfare than full harmonisation. He concludes that these results are relevant for the debate on the international regulation of the provision of audit services, especially within the EU, and shows that full harmonisation (by adopting ISAs for statutory audits) is not necessarily the best option. 289

Finally, it is contested that harmonisation of ISAs will ultimately end in truly uniform auditing regulation. First, it will hardly be possible to avoid regional or local deviations in the adoption of ISAs (the problem of "dialects") as long as the Statutory Audit Directive permits add-ons and carve-outs. Second, the transitional process will generate sets of ISAs that will differ in content and practical application. Third, the role of legal interpretation standards in the process of regulatory harmonisation should not be underestimated. Different rules and methods of statutory interpretation, which form an integral part of each member state jurisdiction and which are not accessible to regulatory harmonisation, are quite likely to provide for divergence in the application of "uni- 290 form" standards on auditing.[102] In that respect it appears particularly important that common law tradition and civil law (or codified law) tradition of statutory interpretation vary considerably. Hence, it is possible that one single ISA will work quite differently in a common law jurisdiction or in a civil law jurisdiction due to differing interpretation standards.[103] For these rather technical reasons, it is unlikely that adopting ISAs in the European Union will bring about complete harmonisation of auditing standards. However, complete harmonisation is not necessary to obtain substantial benefits from harmonisation, as long as the degree of harmonisation (or the perception of such harmonisation) is sufficient for such benefits to accrue.

4.4.4 Objectives of Harmonisation of Auditing Standards

4.4.4.1 Improving Legal Security and Public Trust in Auditing

A key issue in legal security and public trust in auditing is legal certainty. Auditors, audit oversight authorities 291
and users of audits seek legal certainty with respect to audit requirements. To this end, improved understanding of auditing standards through the clarity project is supposed to improve legal certainty and hence legal security and public trust in auditing. This is particularly important when auditing standards have legal sanction. As noted in Sections 3.3.1 and 1.3.3, the new structure of the ISAs, and in particular, the delineation of the objectives, requirements and definitions from the other material, is supposed to facilitate understanding and hence legal certainty. However, given the requirement to read the entire ISA when applying its requirements, the introduction and the related guidance also have an important role in enhancing legal certainty. The Study will therefore need to examine the impact on the costs of benefits of adoption of any departures, from the degree of obligation set forth in the ISAs, resulting from those means of adoption that result in a different understanding of the ISAs than that in the original ISAs. This would require an analysis of the degrees of obligation set forth in the ISAs, an analysis of the different understanding through the degrees of obligation resulting from the means as proposed, and a comparison of these.

4.4.4.2 Reduction of Civil Liability Risk

Third, harmonisation of auditing standards is supposed to reduce the risk of civil as well as criminal liability for 292
auditors for transnational audits. Hence, it would render auditing as a profession more attractive. Accordingly, it would become easier for auditing firms to recruit the personnel required to render in particular large scale or cross-border complex auditing services.

4.4.5 Survey Results for the Harmonisation Effect

Both costs and benefits result from the use of the same auditing standards in the same way across the EU. 293
However, the incurrence of costs and accrual of benefits resulting from the harmonisation is not necessarily symmetrical: some costs may be incurred in relation to audits generally, whereas some of the benefits may accrue only to those involved in, or affected by, transnational audits. The questions in the survey are posed in a

[102] Hertig, G./McCahery, J. A. (2003).

[103] Smith, M./Sagafi-Nejad, T./Wang, K. (2008).

manner to take this asymmetry into account. Furthermore, as noted in section 4.1 of the Study, some of the costs and benefits arising from the harmonisation effect not only depend upon the use of the same standards throughout the EU, but also on the degree to which the standards used are such that they facilitate consistent application. For these reasons, relevant questions are posed with reference to the clarified ISAs to take into account the effects resulting from the fact that the clarified ISAs (as opposed to other auditing standards) are the basis for the determination of the costs and benefits arising from the harmonisation effect. This allows the survey results to take into account the impact of the redesign effect on the harmonisation effect.

4.4.5.1 Potential Costs at Audit Engagement Level

In the survey, respondents were asked to include only those costs that would be incurred in an audit engagement in their country (that is, to exclude costs that would be incurred in auditing audit client's foreign subsidiaries. 294

4.4.5.1.1 Recurring Costs Resulting from ISAs not Covering National Particularities

Four fifths of the responding capital market participants believe that the adoption of ISAs will lead to a slight increase in costs that would be incurred on a recurring basis each year by the auditor when performing audits in the field due to clarified ISAs not taking into account national particularities (e.g., accounting, audit law, company law, securities law, insolvency law, contract and tort law, business practices). Of the five audit clients responding, four audit clients expect no change in audit cost and one expects a slight increase. 295

The audit firms were asked to estimate how many more mean average hours per statutory audit engagement would be incurred on a recurring basis by the auditor when performing audits in the field due to clarified ISAs not taking into account national particularities (e.g. accounting, audit law, company law, securities law, insolvency law, contract and tort law, business practices). The responses by the audit firms suggests that the question was misinterpreted because the size of the increased costs in the responses appears to reflect the overall cost of responding to national particularities rather than the incremental costs. For this reason, the responses to this question (and the question of what proportion of these costs is passed on to audit clients) were disregarded in the evaluation of the survey. 296

Overall, the incremental increase in costs due to ISAs not covering national particularities is likely to be slight. 297

4.4.5.1.2 One-off costs Resulting from Non-English Speakers Needing to Interpret Translations or Texts in Original English

Four fifths of the responding capital market participants expect a slight or significant increase (one-half of respondents) in one-off costs due to the additional effort required for auditors for whom English is not their mother tongue to understand the clarified ISAs in the original English or in translations thereof and any English 298 manual or implementation guidance. Of the five responding audit clients three expect no change and two a slight increase in audit costs therefrom.

The audit firms were asked to provide an estimate of the additional mean hours per audit engagement that would be incurred by the auditor in the first year of application of the clarified ISAs due to the additional audit effort required for auditors for whom English is not their mother tongue to understand the clarified ISAs in original English or the translations thereof and any English manual or implementation guidance. Based upon the responses the estimated costs of all of the big four firms in Europe for such one-off costs would be about € 88 million; for the mid-tier firms, the costs would be about € 13.3 million. An inadequate number of firms provided a response to the question on the proportion of such costs that would be charged to the audit clients to allow an estimate of such shifting of costs to audit clients. 299

Overall, the one-off costs of interpreting English-language documents on ISAs or translations thereof would be significant. 300

4.4.5.1.3 Impairment in Audit Quality due to ISAs not Covering National Particularities

One-third of capital market participants expect no change, half a slight impairment and one-sixth a significant impairment on the degree to which audit quality is impaired due to harmonised auditing standards not being specifically tailored to take into account national particularities. Of the five responding audit clients, three expect no change in audit quality and two expect a slight impairment of audit quality. Only three audit regulators responded to the question asking them to indicate the degree to which audit quality is impaired due to harmonised auditing standards not being specifically tailored to take into account national particularities. For audits of large unlisted clients, publicly listed clients, banks and insurance companies two out of these three regulators expect a slight impairment in audit quality; one regulator expects such no impairment. On average the firms essentially expect no change in audit quality. 301

On average, the respondents appear to expect no change to a slight impairment in audit quality. 302

4.4.5.2 Potential Costs at Audit Regulator Level

The audit regulators were asked to estimate the additional costs that would be incurred on a recurring basis each year by reviewers or inspectors when performing reviews or inspections due to clarified ISAs not taking into account national particularities (e.g., accounting, audit law, company law, securities law, insolvency law, contract and tort law, business practice). Based upon the responses from the audit regulators, the total costs for all inspections and reviews of audit firms that perform audits under the Fourth and Seventh EU Directives would be about € 148,000. 303

Because there is no information about the number of inspectors and reviewers in Europe, it is not possible to estimate the cost incurred by them to understand the clarified ISAs in original English or translation and any manuals or implementation guidance in English. 304

None of the five audit regulators responded to the question, asking them to indicate the degree to which the effectiveness or efficiency of oversight is impaired due to some loss in regulatory competition among audit regulators expect any impairment in oversight. 305

4.4.5.3 Potential Costs at European Capital Market Level

4.4.5.3.1 Capital Market Participants

As more non-EU investors enter the EU capital market, different capital market participants would benefit or bear costs: capital providers, such as investors would bear the cost because investment returns would be diminished, whereas those requiring capital, such as audit clients, would benefit from lower costs of capital and financial intermediaries would benefit from greater capital flows. The question posed to capital market participants in the survey is to provide an estimate of the extent to which they believe that an increase in acceptance by investors of audit and financial reports from non-EU countries due to the use of clarified ISAs by all audit firms in the EU and therefore the use of more comparable audit reports and auditing standards may lead to more non-EU investors entering the EU capital market. Responses to this question varied, with one-sixth expecting no change, one-half expecting a slight increase and one-sixth expecting a significant increase (there was one non-response). 306

4.4.5.3.2 Audit Clients

With respect to the extent to which an increase of acceptance by investors of audit and financial reports by non-EU countries due to the use of clarified ISAs by all audit firms in the EU may lead to more non-EU investors entering the EU capital market, three of the five responding audit clients believe there would be no change and one each believes there will be a slight increase and significant increase in non-EU investors entering the EU. 307

4.4.5.3.3 Conclusion

Overall, on average the respondents appear to believe that there would be a slight increase in non-EU investors entering the EU capital market due to the same auditing standards being used throughout that market and because these standards are international. This would necessarily cause, on the one hand, a slight decrease in returns for investors, but on the other hand, a slight decrease in the cost of capital to audit clients. 308

4.4.5.4 Potential Costs and Cost Savings at International Audit Firm Network Level

The big four international networks do not expect any material cost savings to result at international network level from using the same auditing standards throughout the EU: savings are obtained only at national firm level. In contrast, the mid-tier networks do expect some savings at international network level from the harmonisation of auditing standards in the EU. Based upon their responses, it is estimated that the twelve mid-tier networks operating in the EU that are members of the FoF will save about € 620,000 per year each from designing and maintaining their audit practices as well as from training costs due to economies of scale, and about € 310,000 per year each from using a uniform technology for auditors in the field as well as from using the same quality control if ISQC 1 is adopted by the EU. 309

4.4.5.5 Potential Benefits at Audit Engagement Level

4.4.5.5.1 Improved Audit Quality of Transnational Audits through ISAs throughout Europe

The question was posed whether adopting the ISAs so that the same auditing standards are used throughout Europe would have an impact on audit quality for transnational audits. 310

4.4.5.5.1.1 Capital Market Participants

The capital market participants expect the use of the same auditing standards in transnational audits in the EU to cause a significant improvement in audit quality including the probability of detecting material misstatements in the financial statements, the formation of the audit opinion (including better reporting of material misstatements) and harmonised audit reporting and communication of audit findings. 311

4.4.5.5.1.2 Audit Regulators

Only four audit regulators provided responses to the question on the potential improvement in audit quality, through the use of the same auditing standards, by source of potential improvement. All of these regulators agree that the use of the same auditing standards would lead to a slight improvement in audit quality due to an improvement in the consistent application of professional judgment due to the use of objectives and the consideration of application material. Three out of the four believe that the use of the same auditing standards would lead to a slight improvement in audit quality due to an improved consistency in: understanding the nature of an audit and the ISAs and their different levels of obligation; applying professional scepticism; and interpreting and applying the requirements through consideration of the application material. The remaining audit regulators believe there would be no change in audit quality from any changes in these due to using the same auditing standards. Half of the audit regulators responding suggest that there will be a slight improvement in audit quality when using the same auditing standards due to greater harmonisation of engagement quality control, better coordination and therefore improved audit responses to assessed risks to reduce detec- 312 tion risk, and greater consistency in: client acceptance procedures; understanding of the entity (including its internal control relevant to the audit); assessing business risks. The remaining two audit regulators believed that changes in these matters due to using the same auditing standards will not change audit quality. Only one audit regulator maintains that there will be a slight improvement in audit quality due to greater harmonisation of the engagement and clarification of management responsibilities; the others maintain that there will be no change in audit quality therefrom when using the same auditing standards.

Overall, three out of the four audit regulators believe that using the same auditing standards throughout Europe will lead to a slight improvement in the probability to detect material misstatements in transnational audits (audit quality); the remaining regulator believes there will be no change. It is interesting to note that only two out of four regulators believe that using the same auditing standards in transnational audits will lead to a slight improvement in forming an audit opinion, including better reporting of material misstatements and to harmonised audit reporting and communication of audit findings. The other two regulators believe that using the same auditing standards will not lead to any change in these matters. 313

Overall audit regulators appear to believe that having the same auditing standards (the ISAs) throughout Europe will lead to a slight improvement in the quality of transnational audits. 314

4.4.5.5.1.3 Audit Clients

Audit clients tend to believe that the use of the same auditing standards throughout the EU would result in between no change and a slight improvement in audit quality. 315

4.4.5.5.1.4 Audit Firms

On average, the audit firms tend towards expecting a slight improvement in audit quality from the use of the same auditing standards on transnational audits. The answers by firm type and by region are not significantly different. 316

4.4.5.5.1.5 Conclusion

Overall, on average it appears that the respondents believe that using the same auditing standards (the ISAs) throughout Europe will lead to a slight increase in quality in transnational audits. 317

4.4.5.5.2 Effect of the Adoption of ISQC 1 on the Audit Quality of Transnational Audits

Half of the capital market participants believe that the adoption of ISQC 1 would significantly improve the increase in audit quality, whereas one expected a slight improvement. Two-thirds of the audit regulators believe that adopting ISQC 1 would lead to at least a slight improvement in the changes noted above to audit quality in transnational audits (one of these regulators believes it would lead to a significant improvement). However, 318 the remaining regulator believes that the adoption of ISQC 1 would not lead to any change in audit quality in transnational audits due to using the same auditing standards. Four out of the five responding audit clients believe that adopting ISQC 1 would lead to no change in audit quality for transnational audits; one believes it would lead to a slight improvement. Twenty-five of the audit firms (twenty-three big four firms and two mid-tier firms) expect no change to result in this assessment due to the adoption of ISQC 1; four (mid-tier firms) expect a slight improvement and three (mid-tier firms) a significant improvement. In terms of region, the South-East expects the least change, whereas the mid-tier firms in the North-West appear to expect some improvements in harmonisation.

Overall, it appears that the audit firms believe that there would be no improvement in the quality of transnational audits because they already apply ISQC 1. On this basis, there would be no improvement in audit quality through the adoption of ISQC 1. 319

4.4.5.5.3 Effect of the Introduction of Objectives in the ISAs on the Audit Quality of Transnational Audits

Two audit regulators believe that the introduction of objectives in the ISAs would lead to a significant improvement in audit quality through harmonisation and one regulator believes that this improvement would be only slight; the remaining responding regulator believes that the objectives will lead to no change in audit quality for transnational audits due to improved harmonisation. 320

Seventeen firms (fourteen big four and three mid-tier firms) expect the introduction of objectives in the ISAs to slightly improve harmonisation of audit practices, but thirteen (nine big four and four mid-tier firms) expect no change and two (mid-tier firms) expect a significant improvement. In the Northwest, the split is about fifty-fifty between no change and slight improvement, whereas in the Southeast three-quarters of the firms believe the improvement would be slight. 321

Overall, the average view appears to be that the introduction of objectives into the ISAs such that these improve the harmonisation of auditing practice in Europe would cause a slight increase in audit quality for transnational audits 322

4.4.5.5.4 Effect of the Introduction of Application Material in the ISAs on the Audit Quality of Transnational Audits

Half of the audit regulators believe that the application material will lead to a slight improvement in audit quality due to improved harmonisation; one regulator believes that audit quality would improve significantly and another believes there will be no change in audit quality at all. In relation to the effect of the application material on the harmonisation of audit practices, seventeen (thirteen big four and seven mid-tier) firms believe that the application material would slightly improve such harmonisation, fourteen (ten big four and four mid-tier 323 firms) expect no change, and one (mid-tier firm) a significant improvement. The regional proportions are approximately the same as for the previous question.

On balance, it appears that the application material will slightly improve audit quality for transnational audits by improving the harmonisation of audit practices. 324

4.4.5.5.5 Decrease in Cost of Transnational Audits through Better Coordination

Half of the capital market participants expect a slight decrease in transnational audit costs; the remainder expect no change or provided no response. In contrast, four out of the five audit clients responding believe that there will be no reduction in audit costs for transnational audits due to better audit coordination between group and subsidiary auditors when these use the same auditing standards; one believes there may be a slight decrease in cost. 325

The firms were asked to provide an estimate of the potential decrease in the mean average hours incurred by the group auditor (excluding subsidiary auditor time) per statutory transnational audit resulting from better coordination between group and subsidiary auditors from the use of the same auditing standards (the clarified ISAs). The cost savings extrapolated to all big firms in Europe are about € 15 million per year; the savings for mid-tier firms in Europe are estimated at about € 27.3 million per year. Due to the firms already applying ISQC 1, the firms responded that there would be no material change in their estimates due to the fact that they already apply ISQC 1. 326

Overall, the figures provided by the firms tend to support the view that the use of the same auditing standards throughout the EU (the ISAs) would result in a slight decrease in costs on transnational audits due to better coordination. 327

4.4.5.5.6 Greater Acceptance of Audit Reports outside of Home Jurisdiction

All of the capital market participants expected that the use of the same auditing standards within Europe would lead to a greater acceptance of audit reports on financial statements outside of home jurisdictions both within and outside of Europe. Three of the five responding audit regulators expect the use of the same auditing standards throughout Europe not to lead to any greater acceptance of audit reports outside of their home jurisdiction, whereas the remaining audit regulator believes that greater acceptance of audit reports will be achieved outside of their home jurisdiction in Europe, but also outside of Europe. Three audit clients believe that using the same auditing standards and audit report would lead to a greater acceptance of the audit reports on their financial statements outside of their home jurisdiction within Europe; two believe there would be no such effect. 328

It is of particular interest that twenty-five (eighteen big four and seven mid-tier firms) out of thirty-two firms expect the use of the same auditing standards in Europe to lead to a greater acceptance of their firm's audit report outside of their home jurisdiction even outside of Europe; five (four big four and one mid-tier firm) expect no change and two (one big four and one mid-tier firm) expect greater acceptance only within Europe. The proportions are approximately equal between the regions. 329

On the whole, the expectations of capital market participants, audit clients and audit firms appear to run counter to those of audit regulators, but for one. It appears that audit regulators (but for one) take an overly parochial view of their markets compared to the other respondents. For this reason, we can conclude that on the whole, the use of the same auditing standards (the clarified ISAs) throughout Europe will increase the acceptance of European audit reports outside of the firm's jurisdiction, both within and outside of Europe. 330

4.4.5.5.7 Reduction in Standards Overload

Two-thirds of those capital market participants responding believe that using the same auditing standards throughout Europe through ISA adoption would lead to a slight reduction in standards overload within Europe (the remaining respondent believed it would lead to a significant reduction), but half believe that it would lead to a significant reduction in standards overload outside of Europe. Audit regulators have varying views on the degree to which the use of the same auditing standards lead to a reduction in standards overload for transnational audits: the answers range from a major reduction to no change within Europe; they range from a significant reduction to no change outside of Europe. Three audit clients believe that the use of the same auditing standards within Europe would lead to a slight reduction in standards overload within and outside of Europe; one believes this reduction would be major within Europe; two believe there would be no change outside of Europe (and one no change within Europe). 331

It is also very interesting that eighteen audit firms (fourteen big four and four mid-tier firms) expect a significant reduction in standards overload within Europe, eight (five big four and three mid-tier firms) a slight reduction and six (four big four and two mid-tier) no change. The regional proportions are not significantly different from one another. The number of audit firms expecting a significant standards overload outside of Europe, however, falls to fifteen (fourteen big four and one mid-tier), with ten expecting a slight reduction (five big four and five mid-tier) and seven (four big four and three mid-tier) no change. Again, the proportions do not appear to vary significantly among regions. 332

It is clear that to auditors, having one set of standards within Europe (the clarified ISAs) would lead to a significant reduction of standards overload (too many standards leading to the inability of those applying the standards to cope with them) in Europe, and somewhat less so outside of Europe. The other respondents take a different view because auditing standards are not as relevant to them. 333

4.4.5.5.8 Reduction in Contradictions between Standards

Half of the capital market participants believe that using the ISAs throughout Europe would lead to a slight reduction in contradictions between standards in Europe, but the remaining two respondents believed either that this reduction would be significant or major. It is interesting to note that the proportion expecting a major or significant reduction outside of Europe represents half of the respondents; the rest either believe in no change or a slight reduction. On the degree to which the use of the same auditing standards leads to a reduction in contradictions between different sets of standards in transnational audits, half of the regulators maintain that there will be no change within Europe, whereas one claims a significant reduction will occur and another expects a slight reduction: the responses are similar for outside of Europe. On the question of the degree to which the use of the same auditing standards within Europe leads to a reduction in contradictions between auditing standards, three audit clients believe that there would be an at least slight reduction (one believes in a major reduction) within Europe, and two believe that there would be no change. With respect to the effect outside of Europe, two still believe in a slight reduction and three now believe there would be no change. 334

In terms of compliance with auditing standards due to a reduction in contradictions between them because of the use of the same auditing standards throughout the EU, eleven audit firms (nine big four and two mid-tier) expect a significant reduction, six (four big four and two mid-tier) a slight reduction and fifteen (ten big four and five mid-tier) no change. In this case, the proportion of firms from the Northwest claiming no change is somewhat higher than in the Southeast. It should be noted that these responses do not change significantly for reductions in contradictions in auditing standards outside of Europe. 335

On the whole, most audit firms, who deal with contradictions between standards on recurring basis appear to believe that having one set of auditing standards throughout Europe will lead to a significant reduction in contradictions between auditing standards – both within and outside of Europe. The capital market participants, who come into contact with differing audit reports are only somewhat more conservative. Audit regulators and audit clients, who have little or no contact with differing auditing standards, appear not to see a problem in this regard. 336

4.4.5.6 Potential Benefits at National Network Firm Level

The firms were asked to provide estimates of the recurring cost savings (costs of technical personnel, facilities, materials, technology, travel at technical department level) gained from designing and maintaining new audit practices due to less technical resources needed at national technical department level resulting from uniform rather than varying audit practices when ISAs are adopted in the EU. Based upon their responses, it is estimated that the big four firms will save about € 4.7 million per year throughout Europe, whereas the mid-tier firms would save about € 2.3 million per year. 337

The firms were also asked to indicate the recurring cost savings (costs of trainers, facilities, materials, technology, travel) gained from a reduction in costs due to economies of scale when ISAs are adopted in the EU. Based 338 upon the firms' responses, it is estimated that the big four firms would save about € 5.9 million per year throughout Europe, whereas the mid-tier firms would save about € 2.3 million per year.

Furthermore, a question was asked whether the firms would gain any recurring cost savings from a reduction in costs (cost of technology and personnel) to implement and maintain a uniform technology for auditors in the field when ISAs are adopted in the EU. Based upon the firms' responses, it is estimated that the big four firms would save about € 3.2 million per year, whereas the mid-tier firms would save about € 2.3 million per year. 339

Finally, the firms were asked whether there would be any recurring cost savings to be gained from a reduction in costs to implement and maintain network quality control if ISQC 1 is adopted by the EU. Based upon the firms' responses the big four firms would save about € 500,000 per year throughout Europe, whereas the mid-tier firms would save about € 2.3 million. 340

4.4.5.7 Potential Benefits at Transnational Audit Client Level

Unfortunately, due to the lack of an adequate number of responses, the audit clients surveyed did not provide any useful data on the monetary benefits that would be gained by audit clients in the financial statement preparation process. However, some audit firms did provide data on these matters, which reflect their expectations of the direct impact on the financial statement preparation costs of audit clients. 341

4.4.5.7.1 Cost Savings for Transnational Audit Clients through Reduction in Costs for Technical Department

The audit firms were asked to provide an estimate of the mean average recurring cost savings (cost of technology and technical personnel, facilities, materials, travel a technical department level) per audit client gained by audit clients from a reduction in costs for the technical department, incurred by transnational audit clients as preparers of financial statements, resulting from the need to respond to uniform rather than varying audit practices when the ISAs are adopted by the EU. The average cost savings per transnational audit client are estimated at about € 13,700 per client per year, which when extrapolated to all audit clients covered by the Study translates into cost savings of € 622 million per year. 342

4.4.5.7.2 Cost Savings for Transnational Audit Clients through Reduction in Costs for Training Department

The audit firms were also asked to estimate the recurring cost savings (cost of trainers, facilities, materials, technology, travel) per audit client gained by transnational audit clients through a reduction in costs in training resulting from increasing economies of scale for training due to needing to respond to uniform rather than varying audit practices when ISAs are adopted by the EU. The average recurring cost savings per transnational audit client are estimated at about € 1,400 per audit client per year, which when extrapolated to all audit clients covered by the Study translates into cost savings of € 63 million per year. 343

4.4.5.7.3 Cost Savings for Transnational Audit Clients through Reduction in Costs for Uniform Technology

Furthermore, audit firms were asked to estimate the recurring cost savings (cost of technology and technical personnel, facilities, materials, travel) gained by each transnational audit client from a reduction in costs for implementing and maintaining uniform technology resulting from increasing economies of scale due to needing to respond to uniform rather than varying audit practices when ISAs are adopted in the EU. The average recurring cost savings per transnational audit client are estimated at about € 130 per audit client per year, which when extrapolated to all audit clients covered by the Study translates into cost savings of € 5.8 million per year. 344

4.4.5.7.4 Cost Savings for Transnational Audit Clients through Reduction in Costs Uniform Internal Control

In answer to the question about the mean recurring cost savings (cost of technology and technical personnel) per transnational audit client per year from a reduction in costs for implementing and maintaining uniform internal control relevant to financial reporting resulting from increasing economies of scale due to needing to respond to uniform rather than varying audit practices when ISAs are adopted in the EU, the audit firms assert that the average recurring cost saving per transnational audit client per year would be € 500, which translates into € 66 million per year for all audit clients covered by the Study. 345

4.4.5.7.5 Benefit for Transnational Audit Clients through Reduction in Risk of Material Misstatements Prior to Audit

4.4.5.7.5.1 Capital Market Participants

Two-thirds of capital market participants believe that the use of the same auditing standards throughout Europe through ISA adoption would lead to a slight reduction in the risk of material misstatement in the financial statement prior to audit due to better coordination in the preparation process resulting from harmonised internal control relevant to financial reporting due to needing to respond to uniform rather than varying audit practices, and also believe it would lead to a slight increase in the recurring benefit to transnational audit clients through better use of audit reporting and communication of audit findings. 346

4.4.5.7.5.2 Audit Regulators

Only four audit regulators responded to the questions relating to the potential benefits at transnational audit client level. Two out of these regulators believe that the is a slight recurring benefit for all audit clients from a reduction in the risk of material misstatements in the financial statements prior to the audit due to better coordination in the preparation process resulting from harmonised internal control relevant to financial reporting needing to respond to the same audit practices; one regulator believes that there is such a slight benefit in the case of publicly listed audit clients, banks and insurance companies only. The other two regulators believe there is no such benefit for any transnational audit clients. 347

4.4.5.7.5.3 *Audit Clients*

Two audit clients believe that the is a slight recurring benefit for them from a reduction in the risk of material misstatements in the financial statements prior to the audit due to better coordination in the preparation process resulting from harmonised internal control relevant to financial reporting needing to respond to the same audit practices; three believes that there would be no change. 348

4.4.5.7.5.4 *Audit Firms*

Depending upon the type of audit client, between twelve to seventeen audit firms responded to the question on the extent of the recurring benefit gained by transnational audit clients as preparers from a reduction in the risk of material misstatement in the financial statements prior to the audit due to better coordination in the preparation process resulting from harmonised internal control relevant to financial reporting due to needing to respond to uniform rather than varying audit practices when ISAs are adopted by the EU. The average response was between no change and slight increase in benefits, and did not significantly vary by industry, size of firm or region. 349

4.4.5.7.5.5 *Overall Conclusion*

Overall, the views appear to be that there will be between no change and a slight reduction in the risk of material misstatement in the financial statements prior to the audit due to better coordination in the preparation process resulting from harmonised internal control relevant to financial reporting due to needing to respond to uniform rather than varying audit practices when ISAs are adopted by the EU. 350

4.4.5.7.6 Benefit for Transnational Audit Clients through Better Use of Audit Reporting or Communication of Audit Findings

4.4.5.7.6.1 *Audit Regulators*

Three regulators believe that there is a slight recurring benefit for all audit clients from better use of auditor reporting or communication of audit findings by management and those charged with governance within a group due to their needing to respond to the same audit practices; one regulator believes that there is no such benefit for any transnational audit clients. 351

4.4.5.7.6.2 *Audit Clients*

Two audit clients believe that there is a slight recurring benefit for them from better use of auditor reporting or communication of audit findings by management and those charged with governance within a group due to their needing to respond to the same audit practices; three believe that there will be no change. 352

4.4.5.7.6.3 Audit Firms

Depending upon the type of audit client, between twenty-two and twenty-seven audit firms responded to the question on the extent of the recurring benefit when ISAs are adopted in the EU gained by transnational audit clients as preparers from the better use of audit reporting or communication of audit findings by management and those charged with governance within a group due to their needing to respond to uniform rather than varying audit practices in relation to audit reporting or communications of audit findings. For publicly listed entities, banks and insurance companies, the average response conveyed a clear slight improvement in such benefit. Such benefit for large unlisted enterprises and unlisted medium-sized enterprises was estimated on average between no change and slight increase, with the weighting towards slight increase. The mid-tier firms took a more conservative view on this issue, tending more towards no change, whereas the big four firms tended more towards a slight increase. There was a clear view in the Southeast region that the increase in benefit would be at least slight for banks, insurance companies and publicly listed companies, whereas the views on the extent of the benefit were more conservative for unlisted companies (both medium-sized and large) and generally for the Northwest region. 353

4.4.5.7.6.4 Overall Conclusion

There appears to be between no benefit and a slight benefit from the better use of audit reporting or communications of audit findings for transnational audit clients. 354

4.4.5.7.7 Benefit for Transnational Audit Clients through better Access to Capital and Business Opportunities

4.4.5.7.7.1 Capital Market Participants

Two-thirds of the capital market participants expect at least a slight recurring benefit of better access to capital and business opportunities for transnational audit clients due to the greater acceptance of audit reporting and audit client financial statements resulting from applying the same auditing standards throughout the EU. 355

4.4.5.7.7.2 Audit Regulators

Three regulators believe that there is a slight recurring benefit for all transnational audit clients from better access to capital and business opportunities due to greater acceptance of audit reporting and therefore of their financial statements resulting from the same auditing standards; one regulator believes that there is no such benefit for any transnational audit clients. 356

4.4.5.7.7.3 *Audit Clients*

With respect to the recurring benefit resulting from better access to capital and business opportunities due to greater acceptance of audit reporting and therefore of their financial statements resulting from the same auditing standards, three transnational audit clients expect a slight increase, whereas two expect no change. 357

4.4.5.7.7.4 *Audit Firms*

Of particular interest are the views expressed by the twenty-two to twenty-seven audit firms (the number depending upon the industry in question) on the extent of recurring benefit gained by transnational audit clients as preparers from better access to capital and business opportunities due to greater acceptance of audit reporting and therefore their financial statements outside of their home jurisdiction resulting from uniform audit practices. The average response for all industries was an increase in benefit that is more than slight but less than significant, with the weighting towards slight. The mid-tier firms take a more conservative view on this issue, with their average response between no change and slight increase with the weighting towards slight increase, whereas the average response of the big four firms is between a slight and significant increase with the weighting towards a slight increase. The Northwest region takes a more conservative view than the Southeast, but the difference is slight. 358

4.4.5.7.7.5 *Overall Conclusion*

It appears that overall, the respondents believe that there will be a slight recurring benefit gained by transnational audit clients as preparers from better access to capital and business opportunities due to greater acceptance of audit reporting and therefore their financial statements outside of their home jurisdiction resulting from uniform audit practices. 359

4.4.5.8 Potential benefits at audit regulator level

All six audit regulators that responded to the audit regulator questionnaire responded to the questions on potential benefits at audit regulator level. 360

4.4.5.8.1 Benefit for Audit Regulators through better Collaboration with other Audit Regulators

4.4.5.8.1.1 *Audit Regulators*

Audit regulators appear to have different views on the potential improvement in communication, coordination and sharing of resources among audit regulators within and outside of Europe resulting from the user of the same auditing standards within the EU: with or without the adoption of ISQC 1, three regulators expect a slight improvement, two a significant improvement and one no improvement. 361

4.4.5.8.1.2 Audit Firms

It is to be noted that nine (big four firms) out of the twenty-five audit firms that responded to the question on the assessment of the extent of the potential improvement in communication, coordination and sharing of resources among audit regulators both within and outside of Europe resulting from the use of the same auditing standards (the clarified ISAs) together with ISQC 1 believe that a major improvement would result; another twelve audit firms (seven big four and five mid-tier) expect a significant improvement, three (one big four firma and three mid-tier) a slight improvement and only one (mid-tier) no change. The percentages by region varied. On average, it appears that the firms tend to believe that without ISQC 1 this benefit would decline somewhat: six (five big four and one mid-tier) expect a significant improvement, sixteen (twelve big four and four mid-tier) a slight improvement and three (mid-tier) no change. On this score, the firms from the Northwest region tended to be slightly more optimistic about the degree of improvement that those in the Southeast. 362

4.4.5.8.1.3 Overall Conclusion

Overall the firms tend to believe that adopting ISAs throughout Europe will lead to at least a significant improvement in communication, coordination and sharing of resources among audit regulators within and outside of Europe, whereas the audit regulators tend to believe in only a slight improvement. The firms also tend to believe that adopting ISQC 1 will tend to improve that collaboration, whereas the audit regulators tend to believe that there would be no difference. It appears that the firms believe that on the basis of the ISAs and ISQC 1 the audit regulators *ought to* improve their collaboration, whereas the audit regulators take the rather parochial view that they will determine whether or not they ought to collaborate more. However, it is clear that ISAs together with ISQC 1 form the basis for further collaboration. 363

4.4.5.8.2 Potential Improvement in Acceptance of Oversight Systems

4.4.5.8.2.1 Audit Regulators

Audit regulators also appear to have varying views on the extent of the potential improvement in acceptance of oversight systems, including review or inspection results, among audit regulators both within and outside of Europe resulting from the use of the same auditing standards within Europe: with ISQC 1, three regulators expect a significant improvement, one an slight improvement and two no change; without ISQC 1, three regulators expect only slight improvement, one a significant improvement, and two no change. 364

4.4.5.8.2.2 Audit Firms

In relation to the question on the extent of potential improvement in acceptance of oversight systems, including inspection results, both within and outside of Europe among audit regulators from the use of the same auditing standards with ISQC 1, twenty-five audit firms responded. Twelve (big four firms) believe that a major improvement would result, nine (five big four and four mid-tier) a significant improvement, and four (mid-tier) a slight improvement. The responses were roughly equivalent by region. However, on average, the same ques- 365 tion posed without ISQC 1 leads fourteen (big four) firms to expect a significant improvement, nine (three big four firms and six mid-tier) a slight improvement and two (mid-tier) no change. The responses by region varied.

4.4.5.8.2.3 Overall Conclusion

In relation to the question on the extent of potential improvement in acceptance of oversight systems, including inspection results, both within and outside of Europe among audit regulators from the use of the same auditing standards, it is apparent that again the firms take a more optimistic view than regulators; however, both firms and regulators believe that the adoption of ISQC 1 would make a significant difference in their assessments. Again, it appears that the firms hope for greater interjurisdictional acceptance of oversight systems, whereas the regulators apparently appear to believe that other factors are more important. In any case, ISAs together with ISQC 1 form a basis for the acceptance of oversight systems, including inspection results, both within and outside of Europe among audit regulators, but would not represent a sufficient condition for such acceptance on their own. 366

4.4.5.8.3 Benefit for Audit Regulators through Convergence of Oversight Systems

4.4.5.8.3.1 Audit Regulators

Varying views among audit regulators also exist with respect to the extent of potential convergence of oversight systems and bodies, including reviews or inspections, among audit regulators both within and outside of Europe resulting from the use of the same auditing standards with or without ISQC 1: three regulators expect no change, two expect a slight improvement and one expects significant improvement. 367

4.4.5.8.3.2 Audit Firms

Twenty-five audit firms answered the question of the extent of potential convergence of oversight systems and bodies, including inspections, both within and outside of Europe among audit regulators from using the same auditing standards with ISQC 1. Twenty-two (seventeen big four and five mid-tier) expect a significant improvement in convergence and three (mid-tier) expect a slight improvement. The responses by region were roughly equivalent. However, when the same question is asked without ISQC 1, only four firms (big four) still expect a significant improvement in convergence of oversight systems, but eighteen (thirteen big four and five mid-tier) a slight improvement and three (mid-tier) no change. Again, the responses by region were roughly equivalent. 368

4.4.5.8.3.3 Overall Conclusion

The firms take a very optimistic view that the use of the same auditing standards within the EU with ISQC 1 will lead to a significant improvement in convergence of oversight systems; again, the audit regulators take a rather conservative view. Furthermore, the firms take the view that ISQC 1 has a significant impact on such conver- 369 gence, whereas the regulators appear to believe that it doesn't have any impact. Once again, it appears that the firms hope for greater convergence of oversight systems, whereas the regulators apparently appear to believe that other factors are more important. In any case, ISAs together with ISQC 1 form the basis for the convergence of oversight systems, both within and outside of Europe among audit regulators.

4.4.5.8.4 Benefit for Audit Regulators through Harmonisation of Reviews and Inspections by Adopting ISQC 1

4.4.5.8.4.1 Audit Regulators

Varying views among audit regulators also exist with respect to the effect of the adoption of ISQC 1 on the harmonisation of reviews or inspections: three regulators expect no change, one slightly improved harmonisation, and one a major increase in harmonisation. 370

4.4.5.8.4.2 Audit Firms

Twenty-four audit firms responded to the question on the effect of the possible adoption of ISQC 1 on the harmonisation of reviews or inspections. Eleven audit firms (nine big four and two mid-tier) expect a significant improvement in such harmonisation, twelve (eight big four and four mid-tier) a slight improvement and one (mid-tier) no change. The responses by region were roughly equivalent. 371

4.4.5.8.4.3 Overall Conclusion

Audit firms and audit regulators (with two exceptions) generally appear to take opposed views on the effect of the adoption of ISQC 1 on harmonisation of inspections or reviews. Since standards for firm quality control policies and procedures forms the primary basis for conducting reviews or inspections, it is interesting to see that the audit regulators take such a conservative view, other than their apparent belief that other factors are more important for such a harmonisation. Audit firms, on the other hand, appear to believe that harmonising the basis for inspections and reviews ought to lead to their harmonisation, which may not take into account other institutional factors. 372

4.4.5.8.5 Benefit for Audit Regulators through Harmonisation of Reviews and Inspections through Objectives in ISAs

4.4.5.8.5.1 Audit Regulators

With respect to the effect of the introduction of objectives on the harmonisation of reviews or inspections, four regulators expect no change, one expects slightly improved harmonisation and one expects significantly improved harmonisation. 373

4.4.5.8.5.2 Audit Firms

Twenty-four audit firms also responded to the question on the effect of the introduction of objectives into the ISAs on the harmonisation of inspections or reviews. Seven audit firms (three big four and four mid-tier) expected a slight improvement in the harmonisation of inspections or reviews, but seventeen audit firms (fourteen big four and three mid-tier) expected no change. The responses by region were roughly equivalent. 374

4.4.5.8.5.3 Overall Conclusion

Audit regulators and audit firms appear to tend to agree that the introduction of objectives into auditing standards through the ISAs would not improve the harmonisation of reviews or inspections 375

4.4.5.8.6 Benefit for Audit Regulators through Harmonisation of Reviews and Inspections through Application Material in ISAs

4.4.5.8.6.1 Audit Regulators

Audit regulators hold different views on the effect of application material on the harmonisation of reviews or inspections: two expect no change, two expect slightly improved harmonisation, and two expect significantly improved harmonisation. 376

4.4.5.8.6.2 Audit Firms

Twenty-four audit firms responded to the question on the effect of the application material in the ISAs on the harmonisation of reviews or inspections. Eighteen audit firms (fourteen big four and four mid-tier) expect a slight improvement in harmonisation of reviews or inspections therefrom and six (three big four and three mid-tier) expect no change. The proportions are roughly equivalent for the regions. 377

4.4.5.8.6.3 Overall Conclusion

The audit regulators and audit firms generally appear to agree that the introduction of application material into auditing standards through the ISAs will improve the harmonisation of inspections or reviews, but on average the belief appears to be that this improvement would be slight. 378

4.4.5.9 Potential Benefits at European Audit Market Level

4.4.5.9.1 Improved Internal Market in Europe and Improved International Market for Audit Professionals

All thirty-two audit firms responded to the question on the extent to which their audit firm will be more likely to employ audit assistants, supervisors and managers from other EU member states because these employees would have been educated and trained to apply ISAs rather than national auditing standards. Nine audit firms 379 (seven big four and two mid-tier) expect a significant increase, fourteen (eleven big four and three mid-tier) a slight increase, and nine (five big four and four mid-tier) no change. In this respect, the Southeast region was significantly more positive about employing individuals from other EU member states than those in the North-west. The answers were precisely the same for the question on the extent to which such employees from out-side the EU would be employed. In conclusion, using the ISAs throughout Europe rather than national stan-dards will overall slightly improve the internal market in Europe and the international market for European audit professionals.

4.4.5.9.2 Reduced Barriers to Entry into Audit Market for Transnational Audits and Better Retention of Transnational Audit Clients

4.4.5.9.2.1 Capital Market Participants

Four-fifths of the capital market participants expect the use of clarified ISAs throughout the EU to lead to at least slightly (40 % thereof significantly) reduced barriers to entry into the audit market for transnational audits for audit firms that currently only use national standards; two-thirds believe that it would lead to a slightly (thereof 50 % significantly) better retention of transnational audit clients by audit firms that use only national standards. 380

4.4.5.9.2.2 Audit Regulators

In response to the question on the extent to which they believe that the use of clarified ISAs by all audit firms may lead to reduced barriers to entry into the audit market for transnational audit clients for audit firms that used to use only national standards, three out of five responding regulators suggest slightly reduced barriers to entry and two suggest no change. 381

In response to the question on the extent to which they believe that the use of clarified ISAs by all audit firms may lead to better retention of transnational audit clients by audit firms that used to use only national stan-dards, only one of the five regulators responding believes that it would lead to a slightly better retention; the others believe there would be no change. 382

4.4.5.9.2.3 Audit Clients

In response to the question on the extent to which they believe that the use of clarified ISAs by all audit firms may lead to reduced barriers to entry into the audit market for transnational audit clients for audit firms that used to use only national standards, three out of five audit clients expect a slight reduction in such a barrier to entry, whereas two expect no change. In response to the question on the extent to which they believe that the use of clarified ISAs by all audit firms may lead to better retention of transnational audit clients by audit firms that used to use only national standards, three audit clients expect a significant increase, one a major increase, and another no change. 383

4.4.5.9.2.4 Audit Firms

Twenty-seven audit firms responded to the question on the extent to which the use of clarified ISAs by all audit firms may lead to reduced barriers to entry into the audit market for transnational audit clients for audit firms the used to use only national standards. Seven (four big four and three mid-tier) audit firms expect a significant reduction in such barriers to entry, whereas seventeen (fourteen big four and three mid-tier) expect a slight reduction and three (mid-tier) no change. The responses by region were not significantly different. 384

Twenty-seven audit firms responded to the question on the extent to which the use of clarified ISAs by all audit firms may lead to better retention of transnational audit clients by audit firms that used to use only national standards. Three audit firms (mid-tier) expect a significant increase in such retention, ten (seven big four firms and three mid-tier) a slight increase and fourteen (eleven big four firms and three mid-tier) no change. The Southeast region appears to be more positive about such retention than the Northwest. 385

4.4.5.9.2.5 Overall Conclusion

On average, the respondents appear to believe that the use of clarified ISAs by all audit firms may lead to slightly reduced barriers to entry into the audit market for transnational audit clients for audit firms that used to use only national standards. All but the audit regulators apparently believe on average that the use of clarified ISAs by all audit firms may lead to at least a slightly better retention of transnational audit clients by audit firms that used to use only national standards 386

4.4.5.10 Potential Benefits at European Capital Market Level

4.4.5.10.1 Correlation between Use of Clarified ISAs by All Audit Firms and Increased Transparency

Two-thirds of capital market participants expect a significant correlation between the use of clarified ISAs throughout the EU and increased transparency resulting from the use of more comparable audit reports. All six audit regulators that responded to the survey responded to the questions posed about potential benefits at the European capital market level of using the same auditing standards throughout the EU. Three audit regulators expect a slight correlation between using the same auditing standards within the EU and increased transparency resulting from the use of more comparable audit reports; two regard this correlation as significant and one as major. Four out of five audit clients expect a slight correlation between the use of clarified ISAs by all audit firms in the EU and increased transparency resulting from the use of more comparable audit reports: one expects a significant correlation. Twenty-seven audit firms responded to the question on the expectation of the degree of correlation between the use of clarified ISAs by all audit firms in the EU and increased transparency resulting from the use of more comparable audit reports. Seventeen (thirteen big four and four mid-tier) audit firms expect a significant correlation, whereas eight (five big four and three mid-tier) a slight correlation and only two (mid-tier) a major correlation. There were no significant differences between the regions on this question. 387

The responses above should be understood in the context of the minimum requirements for audit reports in ISA 700, which do allow for some flexibility in content and structure. However, it appears that these minimum requirements do provide for increased transparency through more comparable audit reports. Overall, the average of the responses appear to suggest that there is a significant degree of correlation between using the same auditing standards within the EU and increased transparency resulting from the use of more comparable audit reports. 388

4.4.5.10.2 Correlation between Increased Transparency Resulting from the Use of More Comparable Audit Reports and Financial Reporting Credibility

Two-thirds of capital market participants expect a significant correlation between increased transparency resulting from the use of comparable audit reports and financial reporting credibility. Four audit regulators regard the degree of correlation between increased transparency resulting from the use of more comparable audit reports and financial reporting credibility to be slight; one believes this correlation to be major and another believes there is no correlation at all. With respect to the degree of correlation between increased transparency resulting from the use of more comparable audit reports by all audit firms in the EU and financial reporting credibility, four out of five audit clients expect a slight correlation; one expects a significant correlation. Sixteen (nine big four and seven mid-tier) audit firms expect a significant correlation, whereas eleven (nine big four and two mid-tier) expect a slight correlation. The results by region were not significantly different. 389

In conclusion, the average of the responses appears to suggest that there is at least a slight correlation between increased transparency resulting from the use of more comparable audit reports and financial reporting credibility. 390

4.4.5.10.3 Extent to which Clarified ISAs in the EU and Use of Comparable Audit Reports Reduce International Information Asymmetries

Of particular interest is the expectation by half of the capital market participants that the use of more comparable audit reports may lead to a significant reduction of international information asymmetries between capital market participants. The regulators have varying views on the extent to which the use of the same auditing standards and therefore the use of more comparable audit reports may lead to a reduction of international information asymmetries between capital market participants: two believe that there is no correlation, two believe that there would be a slight reduction in information asymmetries, one expects a significant reduction and one expects a major reduction. Three audit clients expect a slight reduction, one a significant reduction and one no change. Twenty-seven audit firms also responded to the question on the extent to which the use of more comparable audit reports in the EU through the use of clarified ISAs by all audit firms would lead to a reduction of international information asymmetries between capital market participants. Twenty-two (eighteen big four and four mid-tier) audit firms expect a slight reduction and five (mid-tier) expect a significant reduction. The expected reductions were not different between the regions. 391

In conclusion, the responses tend towards a slight reduction of international information asymmetries between capital market participants through the use of more comparable audit reports in the EU through the use of clarified ISAs by all audit firms. 392

4.4.5.10.4 Extent to which Clarified ISAs in the EU and Use of Comparable Audit Reports Reduce Costs to Comprehend Audits by Investors

Half of the capital market participants believe that the use of more comparable audit reports may lead to a significant reduction of costs to comprehend audits by investors (e.g., professional advice from auditors conversant with auditing standards in different countries, etc.) from different EU countries (another one-third believe that each of these reductions will only be slight or that there will be no reductions at all). Four regulators believe that the use of the same auditing standards and therefore comparable audit reports may lead to a slight reduction of costs to comprehend audits by investors from different EU countries; one regulator believes this reduction of costs to be significant, whereas another believes that there would be no change in costs. Four out of five responding audit clients believe that the use of clarified ISAs by all audit firms in the EU and therefore the use of more comparable audit reports and auditing standards may lead to a slight reduction of costs to comprehend audits by investors from different EU countries; one expects no change. Again, twenty-seven firms answered the question on the extent to which the use of comparable audit reports and auditing standards in the EU through the use of clarified ISAs by all audit firms will lead to a reduction in costs to comprehend audits by investors from different EU countries. Twenty-two (eighteen big four and four mid-tier) audit firms expect a slight reduction and five (mid-tier) a significant reduction. The expected reductions were not different between the regions. 393

In conclusion, the overall tendency among the responses is towards a slight reduction of costs to comprehend audits by investors from different EU countries through the use of the same auditing standards and therefore comparable audit reports. 394

4.4.5.10.5 Extent to which Clarified ISAs in the EU and Use of Comparable Audit Reports Leads to an Increase in Acceptance by Investors of Foreign EU Audit Reports within the EU

Four-fifths of capital market participants believe that the use of more comparable audit reports and auditing standards may lead to at least a slight increase (thereof 40 % significant increase) in acceptance by investors of audit and financial reports within the EU from other EU countries. Three regulators believe that the use of the same auditing standards and therefore the use of more comparable audit reports may lead to a significant increase in acceptance by investors of audit and financial reports within the EU; two expect a slight increase and one no change. Three audit clients expect a slight increase and two no change. Twenty-seven firms also answered the question on the extent to which the use of more comparable audit reports and auditing standards through the use of clarified ISAs in the EU may lead to an increase in acceptance by investors of audit and financial reports within the EU from other EU countries. No less than nineteen (thirteen big four and six mid- 395 tier) audit firms expect a significant increase in such acceptance and eight (five big four and three mid-tier) expect a slight increase. There were no differences between the regions

In conclusion, with the exception of audit clients, who appear to take a rather pessimistic view, it appears that the overall, the respondents believe that the use of the same auditing standards and therefore the use of more comparable audit reports may lead to a significant increase in acceptance by investors of audit and financial reports within the EU from other EU countries. 396

4.4.5.10.6 Extent to which Clarified ISAs in the EU and Use of Comparable Audit Reports Leads to an Increase in Acceptance by Investors of EU Audit Reports outside the EU

At least four-fifths of capital market participants expect at least a slight increase (thereof 60 % significant increase) in acceptance by investors from non-EU countries of audit and financial reports from the EU due to the use of comparable audit reports and auditing standards. Three regulators believe that the use of the same auditing standards and therefore the use of more comparable audit reports may lead to a significant increase in acceptance by investors outside of the EU of audit and financial reports from the EU; two expect a slight increase and one no change. With respect to such acceptance by investors from non-EU countries, four audit clients believe that there would be a slight increase in acceptance and one no change. Twenty-seven firms also answered the question on the extent to which the use of more comparable audit reports and auditing standards in the EU through the use of clarified ISAs by all audit firms in the EU may lead to an increase in acceptance by investors from non-EU countries of EU audit reports and financial reports. Eighteen (thirteen big four and five mid-tier) audit firms expect a significant increase and nine (five big four and nine mid-tier) a slight increase. There were no significant differences between the regions. 397

In conclusion, the overall average response suggests that there would be a significant increase in acceptance by investors from non-EU countries of audit and financial reports from the EU due to the use of comparable audit reports and auditing standards. 398

4.4.5.10.7 Increase in non-EU Investors Entering EU capital Markets due to Greater Acceptance of EU Audit Reports

Four fifths of capital market participants believe that an increase in acceptance by investors from non-EU countries of audit and financial reports due to the use of ISAs throughout the EU and therefore more comparable audit reports and auditing standards may lead to an at least slight increase in non-EU investors entering EU capital markets. Four regulators believe that an increase in acceptance by investors from non-EU countries of audit and financial reports due to the use of the same auditing standards would not lead to non-EU investors entering the EU capital market; two expect a significant increase in such non-EU investors entering the EU capital market in these circumstances. Three audit clients also believe that this would lead to a slight increase in non-EU investors entering the EU capital market; two believe there would be no change. Twenty-three audit 399 firms answered the question on the extent to which an increase in acceptance by investors from non-EU countries of audit and financial reports from the EU would lead to more non-EU investors entering the EU capital market. Nine (big four) audit firms expect a significant increase, twelve (five big four and seven mid-tier) a slight increase, and two (mid-tier) no change. In this respect, the Southeast region was more slightly more positive about an increase than the Northwest.

In conclusion, on average the respondents believe that an increase in acceptance by investors from non-EU countries of audit and financial reports due to the use of ISAs throughout the EU and therefore more comparable audit reports and auditing standards may lead to an at least slight increase in non-EU investors entering EU capital markets. 400

4.5 Regulation Effect

4.5.1 Adaptability of ISAs to European Financial Market Regulation

It is still an unsettled question whether and to what extent it will be possible to fit ISAs into the overall picture of European financial market regulation and investor protection law. Empirical research documents that common law countries have stronger investor protection laws and more developed financial markets than civil law countries.[104] This line of inquiry has been extended by Francis/Khurana/Pereira (2001) to examine if variations in legal systems also affect accounting and auditing, documenting that national accounting standards are more timely (accrual-based) and transparent in common law countries, which is said to be consistent with a greater role played by the public disclosure of accrual-based accounting information in corporate governance in these countries. It has also been examined if causality could run from high-quality accounting and auditing to the development of financial markets. La Porta et al. (1998) conjecture that high-quality accounting and auditing could mitigate the negative effect of weak investor protection on the development of financial markets. Francis/Khurana/Pereira (2001) examine if those civil law countries that have more timely and transparent accounting, and more auditing, also have more developed financial markets relative to other civil law countries. They find little support that this is the case, which raises questions about the rationale for the international harmonisation of accounting and the work of the International Accounting Standards Board, absent fundamental changes in investor protection laws of civil law countries. 401

As noted, the EU Commission proposes that this Study be performed on the basis that the introduction, objectives, definitions, and requirements of the ISAs be adopted by means of an EU regulation and that the related guidance (application and other explanatory material, including any appendices) in the ISAs be adopted by means of an EU recommendation. This means that the overall objective of the auditor, the introduction to each standard, the objectives of each standard, the definitions, and the requirements are in effect obtaining legal sanction through an EU regulation, which means that these are becoming legally required for statutory audits in the EU (i.e., they represent legal requirements). 402

[104] La Porta, R. F. et al. (1998); La Porta, R. F. et al. (1997).

However, the overall objective of the auditor is not a requirement, but an aim that an auditor seeks to achieve, but that may not be reached (and if not reached, will result in certain consequences for audit reporting). Furthermore, the objectives in the relevant ISAs do not represent legal requirements, but are aims that an auditor uses in planning and performing the audit to achieve the overall objective of the auditor and determine of further audit procedures are necessary, but which if not achieved, will result in the auditor determining whether the overall objective has been achieved. 403

It is therefore somewhat unclear how objectives in a regulation that, in principle, contains legal requirements, will be interpreted, and whether the courts would interpret the objectives as the IAASB intended as described in the requirements in ISA 200. Furthermore, the determination of costs and benefits of the objectives in ISAs adopted by means of an EU regulation would very much depend upon how the objectives are then interpreted. Much the same considerations apply to those parts of the introductory sections of the ISAs, that do not represent legal requirements (i.e., those parts dealing with the respective responsibilities of the auditor and others in relation to the subject matter and the context in which the ISA is set). 404

However, the issue in relation to objectives, and the parts of the introductory sections of the ISAs, that do not represent legal requirements is solely a “problem of the methodology of statutory interpretation” because the EU Commission is basing this Study on their inclusion in the EU Regulation. This issue cannot be solved beyond what the EU Commission already proposes, even if it may affect the costs and benefits of EU adoption. 405

The ISAs also require the auditor to have an understanding of the entire text of the ISAs (that is, including the related guidance) to understand its objectives and apply its requirements properly. Under the current EU Commission proposal, this related guidance would be included in an EU recommendation. However, EU recommendations need not be transposed into national law in the member states. Consequently, some member states may choose not to transpose the related guidance into national law. The question here is whether this would lead to differing interpretation of the ISAs adopted by means of an EU regulation in the different member states, and what affect this would have on the costs and benefits of ISA adoption, and in particular on the so-called “harmonisation effect” and on the “regulation effect”. In any case, the course of action proposed by the Commission would not be a faithful transposition of the status of the related guidance into the adopted ISAs. 406

First insights into potential cost benefit effects from a regulation effect perspective can be drawn from Australia, where a rather sophisticated – yet not quantified – investigation has been conducted by the Australian Government “Auditing and Assurance Standards Board”, when it presented a Regulation Impact Statement on Auditing Standards issued under section 336 of the Australian Corporations Act 2001 in April 2006. The reason for that assessment was that the Auditing and Assurance Standards Board (AUASB) was required to issue audit- 407 ing standards as legislative instruments using ISAs as a base where appropriate, but making amendments in order to incorporate the Australian setting.[105]

The AUASB (2006) distinguished six major groups that were affected by the *Corporate Economic Reform Program (Audit Reform and Corporate Disclosure) Act 2004:* 408

- Auditors;
- ASIC (Australian Securities and Investment Commission) and other regulators;
- Entities preparing financial reports under Corporations Act 2001;
- Other entities who are required to have their financial reports audited;
- Professional accounting bodies; and
- Users of financial reports.[106]

As far as the modification of current auditing standards was concerned, the four options considered were: 409

(a) Usage of ISAs as a base but amend where the AUASB considered necessary for the Australian regulatory environment;

(b) Minimal revision to Australian Standards (AUSs);

(c) Extensive revision to AUSs;

(d) ISAs as a base with few amendments.

Conceding that at that time no accepted method to quantify the cost benefit effects of auditing standard setting was available, the AUASB considered using the so-called Business Cost Calculator (BCC), an IT-based tool developed by the Australian Government to assist policy officers to estimate the business compliance costs of various policy options.[107] Since BCC provides an automated and standard process for quantifying compliance costs of regulation on business using an activity-based costing methodology, a wide range of detailed information is necessary. However, the AUASB found that the information required was not available and therefore resorted to a rather qualitative description of the expected consequences. 410

With respect to option (a), costs were assumed to arise from the revision of audit programs, although primarily restricted to auditors who are not members of the professional accounting bodies, and mostly related to only the first year of compliance. Benefits were appraised to be attributable to stronger consistency, lower uncertainty and international comparability. Costs and benefits for option (b) were regarded as insignificant. Costs of option (c) were expected to come from additional training and compliance costs – even if restricted to first time adoption - , and to higher risks for auditors who may have to use different systems in auditing multina- 411

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105 AUASB (2006): 1-2.

106 AUASB (2006): 3.

107 OBPR (2008).

tional clients. Benefits were primarily expected from the opportunity to incorporate global best practice requirements in advance of the IAASB´s clarity project. For option (d), (limited) costs were also expected from training, compliance and uncertainty. It was stated, however, that this option was consistent with the Fourth Directive as it places conformity with the ISAs above producing Auditing Standards of the highest quality. Benefits, in turn, were consistency, minimal changes and the conformity with ISAs. After the consultation of audit firms, professional bodies and regulators option (a) was chosen as it was stated that this option balanced the objectives with the costs and benefits.

4.5.2 Principles versus Rules-Based Approach

Under the new structure of the ISAs under the clarity project, the ISAs include the objective of an audit and an overall objective of the auditor.[108] Furthermore, each ISA will include an objective (hereinafter referred to as the "objective in the standard") and requirements, as well as application material and other explanatory material (hereinafter referred to as "application material").[109] By its nature, an objective cannot be expressed other than in a broad, principles-based manner. All ISAs include an introductory section, some of which that set the context for the standard and may provide a treatment of how the general inherent limitations of an audit may become specific ones in relation to the audit issues addressed in that standard.[110] 412

The purpose of the objective of an audit is to define, in broad principles-based terms, what an auditor of financial statements is aiming to achieve in an audit. If, in the professional judgment of the auditor, this objective has not been achieved, then this has consequences for the audit opinion. 413

It is important to recognise that the objectives expressed in the ISAs are not absolute – that is, they are subject to considerations of both reasonable assurance and materiality. Since reasonable assurance, by definition, expresses the assurance that ought to be achieved given the inherent limitations of an audit, the objectives are subject to the inherent limitations of an audit. Auditors must comply with the requirements of an ISA in all cases where such requirements are relevant[111]. Some requirements are expressed at a broad, principles-based level, whereas others are closer in nature to a rule, depending upon the degree to which the issue is susceptible to being resolved algorithmically. Nevertheless, since the wide range of circumstances and hence risks that may confront auditors cannot be foreseen, the ISAs allow auditors to depart from requirements when the requirement is not effective in meeting the objective of the requirement and the auditor documents how the aim of that requirement was achieved by means of alternative audit procedures[112]. The application guidance serves to help auditors by providing further explanation of, and guidance for carrying out (e.g., interpreting) the requirements[113] and provides additional guidance on the matters covered in the objectives. 414

108 FEE (2007); Proposed ISA 200.04-.06, .23-.25.

109 Proposed ISA 200.23-29.

110 Proposed ISA 200.A48. See for example ISA 240.5-.8 (Redrafted).

111 Proposed ISA 200.27.

112 Proposed ISA 200.28.

113 Proposed ISA 200.A49.

Moreover, most auditing regimes, such as the Dutch "Nadere Voorschriften Controle en Overige Standaarden",[114] the French "Normes d'exercice professionel" (NEP), the Belgium "Normes et Recommendations d'exercice professionel",[115] or the German "Prüfungsstandards" of the Institut der Wirtschaftsprüfer (IDW) pursue internal consistency. One central methodical and practical problem in all regimes is how the auditor shall develop and apply auditing policies when specific guidance relating to particular transactions and events does not exist. With regard to the so-called filling of gaps problem in the parallel case of accounting standards, it has been observed that in an internally consistent regime management is required to choose and apply consistent accounting policies to comparable accounting issues in the absence of specific guidance. According to Wüstemann, J./Kierzek, S. (2007), the present IFRS regime fails to ensure this because IFRS dealing with comparable issues are partly inconsistent. They also find that the complete elimination of rules and the reliance on principles only − as requested by many in accounting theory − is not an adequate solution since broad principles do not provide a sufficient structure to frame management's judgment in the choice of accounting policies. Accordingly, they propose that accounting regimes should consist of principles as well as of rules and that the rules shall be consistently derived from high-level principles. This is likewise true for ISAs. Due to the required consistency between standards addressing comparable issues, auditor's discretion in the choice of adequate auditing policies would be, from a normative perspective, ideally limited to one acceptable auditing treatment. 415

The relevance of the precision of auditing standards can also be shown from a theoretical perspective. E.g., 416
Nelson, Elliott and Tarpley (2002) analysed managers´ and auditors´ decisions about earnings management under different levels of precision in accounting standards gathering information from 253 auditors from one big five firm. They found that auditors are less likely to adjust earnings management facing accounting standards with high precision. With respect to auditing standards Willekens and Simunic (2007) analytically analysed the implications of a variation in the degree of precision in the standards. They showed that a relatively small degree of imprecision in auditing standards causes auditors to exert more effort and thereby increase the quality of audits[116]. If auditing standards become more imprecise, the auditor will exert less effort, although the risk for being held liable to third parties will increase. If auditing standards becomes extremely imprecise, the effort of the auditor converges to zero even if the auditor suffers legal consequences.[117] Using a different analytical framework Ewert (1999) analysed the efficacy of precise and vague auditing standards in a negligence liability system. He found that for each precise standard equilibrium there exists a vague standard equilibrium, which constitutes higher audit efforts than the precise standard pendant. Given the varying conclusions drawn by literature on these matters, the survey of the Study has also been used as an instrument to obtain further clarification of these matters.

114 Based on the "Wet Toezicht Accountantsorganisaties (WTA)": Act of 19 January 2006, Concerning the Supervision of Audit Firms (Act on the Supervision of Audit Firms).

115 Art. 44 of the Royal Decree of 21 April 2007: Arrêté Royal Portant Transposition de Dispositions de la Directive 2006/43/CE du Parlement Européen et du Conseil du 17 Mai 2006 Concernant les Contrôles Légaux des Comptes Annuels et des Comptes Consolidés et Modifiant les Directives 78/660/CEE et 83/349/CEE du Conseil, et Abrogeant la Directive 84/253/CEE du Conseil: 22932.

116 Willekens, M./Simunic, D. A. (2007).

117 Willekens, M./Simunic, D. A. (2007): 230-231.

4.5.3 Survey Results for the Regulation Effect

4.5.3.1 Potential Costs at Audit Engagement Level

4.5.3.1.1 Provision of Legal Sanction to Auditing Standards and Unnecessary Procedures

Half of the capital market participants believe that the provision of legal sanction for auditing standards would cause a significant increase, and one third a slight increase, in auditors generally treating ISAs as legal rules as well as principles and therefore to perform procedures required by the ISAs even when these procedures are not necessary under these circumstances to avoid having to justify (to audit regulators) and document exceptional departures from the ISAs. Two-thirds of the audit regulators believe that the provision of legal sanctions for auditing standards would cause a slight increase in auditors generally treating ISAs as legal rules as well as principles and therefore to perform procedures required by the ISAs even when these procedures are not necessary under these circumstances to avoid having to justify (to audit regulators) and document exceptional departures from the ISAs; one regulator expects no change. Half of the audit clients responding believe that the provision of legal sanctions for auditing standards would cause a slight increase in auditors generally treating ISAs as legal rules as well as principles and therefore to perform procedures required by the ISAs even when these procedures are not necessary under these circumstances to avoid having to justify (to audit regulators) and document exceptional departures from the ISAs; one audit client expects a significant increase and two no change. All thirty-two audit firms responded to the question on the extent to which the provision of legal sanction for auditing standards would cause auditors in the field to treat ISAs as legal rules as well as principles and therefore perform procedures required by the ISAs even when these procedures are not necessary under these circumstances to avoid having to justify (to audit regulators) and document exceptional departures from the ISAs. Twenty-one (eighteen big four and three mid-tier) audit firms expect no change, ten (five big four and five mid-tier) a slight increase and one (mid-tier) a significant increase. In this respect, the Northwest region believes more strongly in the increase than the Southeast. 417

In conclusion, based upon the overall respondents, it appears that the provision of legal sanction to auditing standards will cause in between no change and a slight increase in auditors generally treating ISAs as legal rules as well as principles and therefore to perform procedures required by the ISAs even when these procedures are not necessary under these circumstances to avoid having to justify (to audit regulators) and document exceptional departures from the ISAs. 418

4.5.3.1.2 Provision of Legal Sanction to Auditing Standards and Audit Methodology

Only one-third of the capital market participants expect such provision of legal sanction to cause a slight increase in auditors generally treating ISAs as legal rules rather than principles and to disregard the audit objectives, the requirement for additional procedures in ISA 200 and the application material such that the auditors only perform procedures required by the ISAs even though additional procedures would be necessary for an 419 audit of adequate quality. Half of audit regulators also believe that the provision of legal sanctions for auditing standards would cause a slight increase in auditors generally treating ISAS as legal rules rather than principles and to disregard the audit objectives, the requirement for additional procedures in ISA 200 and the application material such that the auditors only perform procedures required by the ISAs even though additional procedures would be necessary for an audit of adequate quality; one audit regulator believes it would cause no change. Two audit clients believe that the provision of legal sanctions for auditing standards would cause a slight increase in auditors generally treating ISAs as legal rules rather than principles and to disregard the audit objectives, the requirement for additional procedures in ISA 200 and the application material such that the auditors only perform procedures required by the ISAs even though additional procedures would be necessary for an audit of adequate quality; four audit clients believe there would be no change.

All thirty-two audit firms also responded to the question on the extent to which the provision of legal sanction 420
to auditing standards would cause auditors in the field to treat ISAs as legal rules rather than principles and therefore disregard the audit objectives, the requirement for additional procedures in ISA 200 and the application material such that the auditors only perform procedures required by the ISAs, even though additional procedures would be necessary for an audit of adequate quality. Remarkable is, that thirty-one audit firms expect no change, but one (mid-tier) firm expects a significant increase. There were no significant differences between the regions on this matter.

In conclusion, the responses taken as whole seem to suggest the provision of legal sanctions for auditing stan- 421
dards would be no increase in the number of auditors generally treating ISAs as legal rules rather than principles and to disregard the audit objectives, the requirement for additional procedures in ISA 200 and the application material such that the auditors only perform procedures required by the ISAs even though additional procedures would be necessary for an audit of adequate quality.

4.5.3.1.3 Change in Audit Quality due to Auditors Treating ISAs as Rules rather than Principles or as Rules and Principles

Four-fifths of the capital market participants expect the auditors treating ISAs as rules and principles to result in 422
at least a slight increase in audit quality, but only one respondent expects a decrease in audit quality due to ISAs being treated as rules rather than principles. However, two regulators each expect a slight increase or no change, whereas one expects a slight decrease in quality. Five audit clients believe that these behaviours by auditors will cause no change in audit quality; one expects a slight increase in audit quality. Twenty-seven (twenty-two big four and five mid-tier) audit firms expect no change in audit quality, four (one big four and three mid-tier) expect a slight increase in audit quality and one (mid-tier) expects a slight decrease in audit quality. There is no significant difference between the regions on this matter.

In conclusion, overall it appears that there would be countervailing effects leading to no change in audit quali- 423
ty.

4.5.3.2 Potential Costs at Audit Firm Level

The firms were asked to provide an estimate of any increase in recurring compliance management costs (e.g., costs of legal department or consultation with legal advisors) that would be incurred through provision of legal sanction for auditing standards when ISAs are adopted by the EU. Based upon the firms' responses, the total costs for the big four firms throughout Europe are estimate at about € 275,000 per year, whereas these costs are estimated at € 4.4 million per year by the mid-tier firms. 424

The big four firms do not expect any change in recurring annual external quality assurance (review or inspection) costs due to the provision of legal sanction to auditing standards. Based upon the responses of the mid-tier firms, it is estimated that their external quality assurance costs therefrom would increase by about € 340,000 per year. 425

4.5.3.3 Potential Costs at Audit Regulator Level

4.5.3.3.1 Capital Market Participants

Half of the capital market participants believed that legal sanction for auditing standards would result in audit regulators being more concerned about compliance with ISAs as rules when performing or monitoring external quality assurance, whereas only one participant each believed that audit regulators would be either more concerned about audit quality or equally concerned about compliance with ISAs as rules and about audit quality. 426

4.5.3.3.2 Audit Regulators

All of the audit regulators believe that legal sanction for auditing standards would result in audit regulators being equally concerned about compliance with ISAs as rules and about audit quality. Furthermore, the audit regulators appear to believe that there would be no recurring additional annual external quality assurance costs (inspections or reviews) that arise from this stance. 427

4.5.3.3.3 Audit Clients

Five out of six audit clients believe that audit regulators will be equally concerned about compliance with the ISAs as rules and about audit quality; one believes that the audit regulator will be more concerned about audit quality. 428

4.5.3.3.4 Audit Firms

Seventeen firms of the eighteen responding to the question on whether the provision of legal sanctions for auditing standards would cause audit regulators to be more concerned about compliance with ISAs as rules, more concerned about audit quality, or equally concerned about compliance with the ISAs as rules and about 429 audit quality, believe that audit regulators would be equally concerned about compliance with the ISAs as rules and about audit quality.

4.5.3.3.5 Overall Conclusion

The provision of legal sanction for auditing standards would cause regulators to be equally concerned about compliance with the ISAs as rules as well as with audit quality; audit regulators expect no change in audit quality to result. 430

4.5.3.4 Potential Costs at European Audit Market Level

The big four firms tend to believe that if auditing standards are given legal sanction and as a consequence audit regulators are equally concerned about audit quality and compliance with the ISAs as rules, about 26 to 40 percent of auditors generally (i.e., not in their firm) would cause auditors in the field to treat ISAs as legal rules rather than principles and therefore only perform procedures required by the ISAs even though additional procedures would be necessary for an audit of adequate quality. The mid-tier firms tend to believe that 21 % to 32 % of auditors would engage in such behaviour. 431

4.5.3.5 Potential Costs and Cost Savings at International Network Firm Level

The big four firm networks and mid-tier networks were asked at an international level whether there would be an increase in recurring compliance management costs due to the fact that the adoption of the ISAs in the EU would provide auditing standards legal sanction. The mid-tier networks expect no such increase in costs, whereas, based upon the responses by the big four networks, it is estimated that they will incur about € 43,000 per year in extra compliance management costs. 432

4.5.3.6 Potential Benefits at Audit Engagement Level

4.5.3.6.1 Legal Sanction for Auditing Standards causes Procedures to be Performed that would not have otherwise been Performed Due to Greater Authority of Auditors

Two thirds of capital market participants expect at least a slight increase (one respondent thereof a significant increase) in the extent to which the provision of legal sanction for auditing standards through the adoption of ISA in the EU would cause auditors generally to perform needed procedures required by the ISAs that would not have otherwise been performed because of the greater authority of auditors vs. clients when referring to standards with legal sanction. Half of the audit regulators expect no change in the extent to which the provision of legal sanction for auditing standards through the adoption of ISA in the EU would cause auditors generally to perform needed procedures required by the ISAs that would not have otherwise been performed because of the greater authority of auditors vs. clients when referring to standards with legal sanction; one-third 433 of audit regulators expect a slight increase. Two-thirds of audit clients believe that the provision of legal sanctions for auditing standards would cause a slight increase in auditors in the field to perform needed procedures required by the ISAs that would not have otherwise been performed because of the greater authority of auditors vs. audit clients when referring to standards with legal sanction; two expect no change. All thirty-two audit firms answered the question on the extent to which the provision of legal sanctions for auditing standards would cause auditors in the field to perform needed procedures required by the ISAs that would not have otherwise been performed because of the greater authority of auditors vs. audit clients when referring to standards with legal sanction. Twenty-eight (twenty-three big four and five mid-tier) audit firms expect no change, three (mid-tier) a slight increase and one (mid-tier) a significant increase. There were no differences by region.

In conclusion, there appears to be a difference of opinion between the audit firms and audit regulators, on the one hand, and the capital market participants and audit clients on the other hand. The former generally expect no change, whereas the latter generally expect a slight increase in procedures that would not otherwise have been performed. The difference appears to be that the latter have perceptions about auditor behaviour in relation to the law vs. auditing standards that neither auditors nor regulators appear to note in their work (internal quality reviews and external inspections, respectively). Consequently, the conclusion is no change in the procedures that would not have otherwise been performed. 434

4.5.3.6.2 Legal Sanction for Auditing Standards Causes Procedures to be Performed that would not have otherwise been Performed Due to Greater Legal Certainty

Four-fifths of capital market participants expect at least a slight increase (one respondent thereof a significant increase) in auditors performing needed procedures required by the ISAs that would not have otherwise been performed due to greater legal certainty about what audit regulators and the courts will enforce. Half of the audit regulators expect no change in auditors performing needed procedures required by the ISAs that would not have otherwise been performed due to greater legal certainty about what audit regulators and the courts will enforce; one-third expect a slight increase. Half of audit clients also believe that the provision of legal sanction for auditing standards would cause a slight increase in auditors in the field to have a greater incentive to perform needed procedures required by the ISAs that would not have otherwise been performed due to greater legal certainty about what audit regulators and the courts will enforce would; the other half believe there would be no change. 435

All thirty-two audit firms also answered the question on the extent to which the provision of legal sanction for auditing standards would cause auditors in the field to have a greater incentive to perform needed procedures required by the ISAs that would not have otherwise been performed due to greater legal certainty about what audit regulators and the courts will enforce. Twenty-five (twenty-one big four and one mid-tier) audit firms expect no change, five (one big four and four mid-tier) a slight increase and two (one big four and one mid-tier) 436 a significant increase. In this respect, the Southeast region was somewhat more inclined towards between no and a slight increase, whereas the Northwest was more clearly inclined towards no change.

In conclusion, the responses seem to indicate that there would be between no change and a slight increase in the extent to which the provision of legal sanction for auditing standards would cause auditors in the field to have a greater incentive to perform needed procedures required by the ISAs that would not have otherwise been performed due to greater legal certainty about what audit regulators and the courts will enforce. 437

4.5.3.6.3 Legal Sanction for Objectives in Auditing Standards

Two out of the four audit regulators responding to the question of whether the introduction of objectives, with legal sanction, into auditing standards believe that this would have no impact on the legal certainty of required audit practices; one each expect a slight improvement or a significant improvement. All thirty-two audit firms responded to the question on the effect of providing legal sanction for objectives on the legal certainty of required audit practices. It is significant to see that fourteen (nine big four and five mid-tier) audit firms expect no change, fourteen (thirteen big four and one mid-tier) expect a significant improvement in legal certainty and four (one-big four and three mid-tier) a slight improvement. It is remarkable that the differentiation among firms appears to be between those from the Southeast and the Northwest: the Southeast had a significantly higher proportion of firms that expect a significant increase in legal certainty than the Northwest. 438

In conclusion, it appears that whether the introduction of objectives into auditing standards that have legal sanction would increase legal certainty of required audit practice depends upon the jurisdiction. 439

4.5.3.6.4 Legal Sanction for Application Material in Auditing Standards

Three out of the four audit regulators responding to the question of the effect on the legal certainty of required audit practices of not adopting the application material in the ISAs such that the application material has the same degree of legal sanction as the degree of obligation for application material in the ISAs believe that such non-adoption would have no effect on legal certainty; one regulator expects a significant impairment of legal certainty. Twenty-eight audit firms answered the question on the effect on legal certainty of not adopting the application material such that it has the same degree of legal sanction as the degree of obligation for application material in the ISAs. Eight (big four) audit firms regard the non-adoption of the application material as leading to a significant impairment of legal certainty, two (one big four and one mid-tier) to a slight impairment, ten (four big four and six mid-tier) to no change, seven (five big four and two mid-tier) to a slight improvement, and one (mid-tier firm) to a significant improvement. The firms from the Southeast region are significantly more inclined to expect an impairment through non-adoption than those in the Northwest. 440

In conclusion, the audit regulators believe that the non-adoption of application material has no impact on legal sanction, whereas the views of the firms are mixed. 441

4.5.3.7 Potential Benefits at Audit Firm Level

4.5.3.7.1 Capital Market Participants

On average, capital market participants believe that both increased audit quality and greater compliance with auditing standards that have legal sanction slightly reduce that risk of professional sanctions, liability risk and reputational risk for auditors. 442

4.5.3.7.2 Audit Regulators

On average, audit regulators believe that increase audit quality would cause between no change and a slight reduction in the risk of professional sanctions, liability risk and reputational risk for audit firms. Audit regulators also appear to believe that greater compliance with auditing standards that have legal sanction through the adoption of ISAs by the EU would not cause any change in these risks to the firms. 443

4.5.3.7.3 Audit Clients

On the extent to which increased audit quality would reduce the risk of professional sanctions, liability risk and reputational risk, audit clients believe that there would be between no reduction and a slight reduction across the board, with a slight tendency towards a slight reduction. With respect to the extent to which greater compliance with auditing standards that have legal sanction would reduce the risk of professional sanctions, liability risk and reputational risk, audit clients also believe that these risks would only be reduced between not at all and slightly, with a tendency towards not at all. 444

4.5.3.7.4 Audit Firms

On average, the audit firms tend to view that greater compliance with auditing standards that have legal sanction would not, or only slightly, reduce the risk of professional sanctions, liability risk and reputational risk for audit firms. 445

4.5.3.7.5 Overall Conclusion

Overall increased audit quality and greater compliance with auditing standards would either not change the risk of professional sanctions, liability risk and reputational risk for audit firms or just slightly reduce them. 446

4.5.3.8 Potential Benefits at Audit Client Level

4.5.3.8.1 Improved Basis for Legal Claims against Audit Firms through Legally Sanctioned Auditing Standards

Four-fifths of capital market participants believe that auditing standards that have legal sanction through the adoption of the ISAs by the EU would provide at least a slightly improved (thereof two participants, a signifi- 447 cantly improved) basis for legal claims against auditors by audit clients when auditors have not complied with those auditing standards. Two-thirds of audit regulators believe that auditing standards that have legal sanction through the adoption of the ISAs by the EU would cause no change in the basis for legal claims against auditors by audit clients when auditors have not complied with those auditing standards; one regulator expects a significant improvement in that basis. Half of audit clients believe that auditing standards that have legal sanction through the adoption of the ISAs by the EU would cause a slight improvement in the basis for legal claims against auditors by audit clients when auditors have not complied with those auditing standards; the other half believes there would be no change.

Twenty-eight audit firms responded to the question on the extent to which auditing standards that have legal 448
sanction would provide an improved basis for legal claims against auditors by audit clients when auditors have not complied with such auditing standards. Twenty-one (fifteen big four and six mid-tier firm) audit firms believe that the basis for legal claims would not change therefrom, four (big four) expect a slight improvement for the basis for claims against audit firms by audit clients, and three (mid-tier firm) would expect a significant improvement for the basis for claims against audit firms by audit clients. There are no significant differences between the regions on this matter.

In conclusion, overall, there does not appear to be any change in the basis for legal claims against auditors by 449
audit clients when auditors have not complied with such auditing standards that have legal sanction.

4.5.3.8.2 Improved Access to Capital and Business Opportunities through Legally Sanctioned Auditing Standards

Four-fifths of capital market participants believe that auditing standards that have such legal sanction would at 450
least slightly improve (one participant thereof, significantly improve) access of audit clients to capital and business opportunities due to perceived better audit quality audits because of such legal sanction. All audit regulators believe that auditing standards that have such legal sanction would not change access of audit clients to capital and business opportunities due to perceived better audit quality audits because of such legal sanction. Five out of six audit clients believe that auditing standards that have such legal sanction would slightly increase access of audit clients to capital and business opportunities due to perceived better audit quality audits because of such legal sanction; one believes that there would be no change. Twenty-eight audit firms also responded to the question on the extent to which auditing standards that have legal sanction would improve access to capital and business opportunities due to perceived better quality audits because of the legal sanction for auditing standards. Fifteen (thirteen big four and two mid-tier firm) audit firms expect a slight improvement in such access and thirteen (six big four and seven mid-tier firms) expect no change. The firms from the Southeast region were slightly more positive on improved access than the firms from the Northwest.

In this case, the perceptions of audit clients and capital market participants (the providers of business oppor- 451
tunities and capital) matters more than those of audit regulators and audit firms. On this basis, having auditing

standards with legal sanctions appears to provide a perception of quality that gives an impetus to a slight improvement to business opportunities and access to capital.

4.5.3.9 Potential Benefits at Audit Regulator Level

4.5.3.9.1 Capital Market Participants

Capital market participants have differing views on the extent to which auditing standards that have legal sanction through the adoption of ISAs by the EU would improve audit quality due to the ability of audit regulators to apply legally supported sanctions when auditors have not complied with auditing standards with such legal sanctions because legally supported sanctions have greater deterrent effect. About one third of the participants believe that there would be no increase in audit quality; one-sixth believes it would be slight; and one third believes it would be significant. 452

4.5.3.9.2 Audit Regulators

Two-thirds of audit regulators believe that the extent to which auditing standards that have legal sanction through the adoption of ISAs by the EU would not improve audit quality due to the ability of audit regulators to apply legally supported sanctions when auditors have not complied with auditing standards with such legal sanctions because legally supported sanctions have greater deterrent effect; one regulator believes this would cause a slight improvement in audit quality. 453

4.5.3.9.3 Audit Clients

Five out of six audit clients believe that the extent to which auditing standards that have legal sanction through the adoption of ISAs by the EU would slightly improve audit quality due to the ability of audit regulators to apply legally supported sanctions when auditors have not complied with auditing standards with such legal sanctions because legally supported sanctions have greater deterrent effect; one believes there would be no change. 454

4.5.3.9.4 Audit Firms

Twenty-eight audit firms responded to the question on the extent to which auditing standards that have legal sanction would improve audit quality due to the ability of audit regulators to apply legally supported sanctions when auditors have not complied with auditing standards that have legal support because legally supported sanctions have a greater deterrent effect. Fifteen (ten big four and five mid-tier firm) audit firms that there would be no such increase in audit quality; four (one big four and three mid-tier firms) believed there would be a slight improvement, eight (big four firms) a significant improvement, and one (mid-tier firm) a major improvement. There is a stark difference between the regions on this issue: on average the firms from the Northwest region tend to answer in between no change and a slight increase, whereas on average the firms from the Southeast region tend to answer in between a slight increase and a significant increase. 455

4.5.3.9.5 Overall Conclusion

There appear to be differing views among the stakeholders: audit firms and audit regulators generally expect no improvement in audit quality due to legally supported sanctions for auditing standards; audit clients believe that there would be a slight improvement in audit quality; capital market participants have varying views. 456

All of the regulators but one expect the quality of inspections or reviews not to change from the effect of the introduction of objectives, with legal sanction, into auditing standards on the legal certainty of required audit practices; one regulator expects a slight improvement in audit quality therefrom. Audit regulators have differing views about the impact on the quality of reviews or inspections resulting from the effect on the legal certainty of required audit practices of not adopting the application material in the ISAs such that the application material has the same degree of legal sanction as the degree of obligation for application material in the ISAs: two expect a slight improvement in audit quality, two no change, and one a slight impairment in audit quality. 457

4.5.3.10 Potential Benefits at Audit Market Level

On average, audit regulators believe that 18 % to 31 % of auditors in their jurisdiction would treat the ISAs as legal rules as well as principles and therefore perform procedures required by the ISAs even when these procedures are not necessary under these circumstances to avoid having to justify (to audit regulators) and document exceptional departures from the ISAs. 458

The big four firms tend to believe that if auditing standards are given legal sanction and as a consequence audit regulators are equally concerned about audit quality and compliance with the ISAs as rules, about 29 to 45 percent of auditors generally (i.e., not in their firm) would cause auditors in the field to treat the ISAs as legal rules as well as principles and therefore perform procedures required by the ISAs, even when these procedures are not necessary under these circumstances, to avoid having to justify (to audit regulators) and document exceptional departures from the ISAs. The mid-tier firms tend to believe that 25 % to 38 % of auditors would engage in such behaviour. 459

Overall then, a significant proportion of auditors would perform more work on an audit than strictly necessary due to their treatment of the ISAs as principles and rules. 460

4.5.3.11 Potential Benefits at Capital Market Level

One-third of capital market participants believe that auditing standards that have legal sanction through the adoption of the ISAs by the EU would improve audit quality only slightly, whereas half believe it would improve audit quality significantly. 461

Half of the audit regulators believe that auditing standards that have legal sanction through the adoption of the ISAs by the EU would slightly improve audit quality; one regulator expects a significant improvement, whereas one expects no change. 462

Two-thirds of the audit clients believe that auditing standards that have legal sanction through the adoption of the ISAs by the EU would slightly improve audit quality; two expect no change. 463

All thirty-two firms answered the question on the extent to which auditing standards that have legal sanction would improve audit quality. Eight (four big four and four mid-tier firm) audit firms expect no change in audit quality, nineteen (fifteen big four and four mid-tier firms) expect a slight improvement, and five (four big four firms and one mid-tier firm) a significant improvement. There were no major differences between the regions on this issue. 464

In conclusion, overall there appears to be an average view that the provision of legal sanction for auditing standards will slightly improve audit quality. 465

5 Overall Conclusions Reached by Survey Respondents

5.1 Capital Market Participants

Overall, one-third of capital market participants believe that the costs and benefits of ISA adoption by the EU are equally balanced, one-third believes that the benefits slightly outweigh the costs, and one-sixth believe that the benefits significantly outweigh the costs. 466

5.2 Audit Regulators

Overall, one-third of audit regulators believe that the benefits of ISA adoption through the EU would significantly outweigh the costs; one third believes that such benefits would slightly outweigh the costs, and one regulator believes that such costs and benefits are balanced. 467

5.3 Audit Clients

Overall, half of audit clients believe that the benefits of ISA adoption through the EU would slightly outweigh the costs; the other half believes that such costs and benefits are balanced. 468

5.4 Audit Firms

All thirty-two audit firms responded to the question on the overall relation of costs and benefits of adoption of ISAs by the EU. Twenty-five (twenty-one big four and one mid-tier firm) audit firms expect the benefits to significantly outweigh the costs, five (two big four and three mid-tier firms) expect the benefits to slightly outweigh the costs, one (mid-tier firm) expects the costs to slightly outweigh the benefits, and one (mid-tier firm) expects the costs to significantly outweigh the benefits. The responses were not significantly different by region. 469

5.5 Overall Conclusion

Overall, the balance of opinion appears to be that the benefits at least slightly outweigh the costs. It appears that the big four firms' views are largely a consideration of their decision to adopt clarified ISAs for their methodologies, regardless of whether or not the EU adopts the ISAs. 470

6 Synthesis of Survey Results

6.1 Synthesis of Survey Results on Quantitative Costs and Cost Savings

6.1.1 General Considerations

The quantitative costs and costs savings estimated from the data provided from the survey respondents can be analysed from the following perspectives: 1. the cause of the cost or cost saving (redesign effect, harmonisation effect, regulation effect), 2. who incurs or gains the costs or cost savings (audit firms, audit clients, audit regulators, other capital market participants), 3. at what level the costs or cost savings are incurred or gained (engagement level vs. firm level, client level, or international network firm level), 4. whether the costs or cost savings or recurring or one-off, and 5. who ultimately bears or obtains the costs or cost savings (i.e., the "incidence" of costs and cost savings). If enough data were available from the survey respondents, an analysis of costs and cost savings by country or region would also be possible and useful. Unfortunately, survey respondents did not provide enough data to permit reasonable conclusions to be drawn by country or region. 471

It is not possible to analyse all aspects of the different perspectives for all costs and cost savings: it would require a multidimensional matrix that would not necessarily enlighten. However, it is important to focus on certain perspectives in relation to key issues for certain costs and cost savings so that decision-makers at the European Commission and elsewhere gain an understanding of the nature, timing and extent of the costs and cost savings and how these ought to affect their decision-making. 472

Since the data provided by the audit firms indicates no material difference between the costs and cost savings for audit firms and audit clients with or without the adoption of ISQC 1, with the exception of the figures for audit regulators, which are differentiated by adoption and non-adoption of ISQC 1, the figures for audit firms and audit clients are given on the basis that ISQC 1 is adopted. 473

The responses to the survey (by firms in the FoF, capital market participants and audit regulators) resulted in an assessment of the costs and cost savings from ISA adoption that combines the costs arising from adoption through the firms in the FoF, adoption by certain jurisdictions in the EU, and adoption by means of an EU regulation. 474

6.1.2 The Incidence of Costs and Cost Savings

From an economic point of view, one of the key issues is who ultimately bears the costs and gains the costs savings (the "incidence" of costs and cost savings) incurred or saved by a particular party. Unfortunately, not enough data was received on this issue from any of the respondent groups to allow the Study to draw any definitive conclusions in this matter. From discussions and supplementary correspondence received from the audit firms and international audit firm networks, it is apparent that at least for the costs incurred and cost savings gained by the audit firms, whether at engagement or audit firm level, or by the international audit firm 475 networks, this issue is very complex. The shifting of costs and cost savings to audit clients and audit staff depends very much upon a number of factors including overall economic conditions, audit market conditions, the economic conditions of particular types of audit client and of particular audit clients, the labour market for audit staff, etc.

For example, when audit firms incur additional engagement level costs due to new audit practices prescribed by new auditing standards, the costs can either be: 1. passed on to the audit client or 2. absorbed by the audit firm. If absorbed by the audit firm, these costs can be: 1. absorbed by the partners of the firm through lower profits, 2. absorbed by audit staff through lower remuneration (or smaller increases in annual remuneration) or increased work for the same remuneration, 3. compensated for through greater audit efficiency, which translates into less demand for audit staff than would otherwise been the case and possibly into lower remuneration for new audit staff. Of course, any combination of these possibilities can occur with variations in individual extent. Furthermore, how each of these effects actually flows through to the overall economy depends upon how those who bear the increased costs deal with the reduced economic resources at their disposal, which is beyond the scope of this Study. 476

However, even if the Study is not able to conclude on the incidence of costs and cost savings, the additional costs and cost savings identified do provide an indication to decision-makers at the European Commission and elsewhere about the effect of new auditing practices on the change in the share of economic resources of the overall economy being allocated to statutory audits of financial statements as required by the Fourth and Seventh EU Directives, both in the short term and in the long run, which would assist these decision-makers in drawing conclusions on the overall relationship between the costs and benefits of ISA adoption. 477

6.1.3 Recurring vs. One-off Costs and Cost Savings

The narrative on the incidence of costs and cost savings above closed with a reference to the economic resources being used for audits in *both the short term and in the long run*. This is a key issue, because even if a change in audit practices incurs significant short-term or “one-off” costs, in the long run there may be recurring cost savings and other benefits that are worth these one-off costs. In this sense, major changes in audit practices represent a “capital budgeting” exercise for decision-makers at the European level. Consequently, while one-off costs and cost savings are important – particularly if they are very large in relation to the recurring costs and cost savings – the recurring costs and cost savings are more important because they reflect a permanent change in the proportion of economic resources in the European economy dedicated to audits required by the Fourth and Seventh EU Directives. Consequently, the primary focus of the synthesis of costs and cost savings in this Study will be on recurring costs and cost savings. These estimates of recurring costs and cost savings are based upon the assumption that they will not change over time due to learning effects beyond the initial year of implementation or other long-run efficiency gains. Consequently, the recurring costs are somewhat overstated and the cost savings somewhat understated, which is a conservative approach in relation to net benefits. 478

6.1.3.1 Recurring Costs and Cost Savings at Audit Firms and Audit Clients

It was not possible for the survey to obtain quantitative data on the costs and cost savings incurred or saved by capital market participants: the data provided by them was qualitative in nature. Although costs and cost savings are incurred or saved by audit regulators, because these costs and cost savings relate to the oversight of audits and audit firms, including inspections and reviews, rather than the performance of audits or the preparation of the financial statements to be audited, it is clear that the costs incurred and cost savings gained by audit regulators would reflect only a small fraction of the costs and cost savings incurred or gained by audit firms and audit clients. For this reason, the recurring costs incurred and cost savings gained by audit firms and audit clients need to be brought into sharper focus. 479

6.1.3.1.1 Recurring Costs and Cost Savings at Audit Firms and Audit Clients at Engagement Level

Some recurring costs and cost savings would be incurred or saved at the level of the audit firm, international audit firm network, or audit client – that is, they would be incurred or saved to some degree independent of the nature, timing and extent of the changes to the costs and cost savings incurred or saved at audit engagement level, whether at the audit firm through the performance of the audit or at the audit client in response to the performance of the audit. Since these latter costs and cost savings would be "multiplied" by the number of engagements performed, the recurring engagement level costs and cost savings tend to be of an order of magnitude greater than those at the audit firm level. For this reason, the engagement level costs and cost savings deserve significantly greater attention in the Study than the costs at audit firm and audit client level. 480

6.1.3.1.1.1 Recurring Costs Incurred and Cost Savings Gained by Audit Firms at Engagement Level

The recurring costs incurred or cost savings gained by audit firms at engagement level are the primary source of costs and cost savings resulting from a change in audit practices to those that are compliant with the clarified ISAs. Furthermore, they are the cost increases and savings that are most likely to be passed on by audit firms to their audit clients. For this reason, they are given the greatest attention in this Study. 481

Based upon the data provided from the big four firms, there will be significant variation in the recurring total cost increase per engagement per year by audit client. The primary cost driver are the recurring redesign costs at engagement level with a small contribution to the overall cost increase provided by the regulation effect. However, some countervailing recurring cost savings are expected from the harmonisation effect. Overall, it is estimated that the estimated recurring cost increase per audit would be € 2,600 for medium-sized unlisted audit clients, € 3,600 for large unlisted audit clients, € 4,600 for publicly listed audit clients, and € 5,800 for banks and insurance companies each. Based upon the cost data provided by the big four audit firms, on a weighted average basis, this represents an overall estimated average increase of € 3,300 per audit client of all 482 kinds and translates into a cost increase of about 6 %. For the entire audit market of the big four firms, this represents a recurring cost increase at engagement and transnational audit engagement level (including recurring regulation effect costs at engagement level) of about € 245 million each year.

Based upon the data provided by the mid-tier firms, there will be even greater variation in the recurring total cost increases or savings per engagement per year by audit client. Furthermore, the cost and cost savings drivers also vary by type of audit client. Overall, it is estimated that the average recurring cost increase per audit would be € 900 for medium-sized unlisted audit clients and € 1,400 for large unlisted audit clients. Based upon the cost data provided by the mid-tier firms, on a weighted average basis, the represents an overall average increase of € 1,200 per audit client of all kinds and translates into a cost increase of 10 %. The higher percentage cost increase than for the big four firms results from the fact that the audit clients, and hence total audit costs, are significantly smaller on average for the mid-tier firms compared to the big four firms and therefore a smaller absolute increase still translates into a greater relative increase. For the entire audit market for the mid-tier firms, this represents a recurring cost increase at engagement and transnational audit level (including recurring regulation effect costs at engagement level) of about € 71 million. 483

It must be emphasized that these are average estimates of data that showed a great variability. The variability of the data for the mid-tier firms in this respect was considerably greater than that for the big four firms. Consequently, the cost increases or savings that would occur in any one case for a particular audit client could be an order of magnitude greater or smaller than the estimates noted, depending upon the size and nature of the engagement, the nature of the audit client, the firm, the jurisdiction in which the audit is performed, and other factors. Consequently, while these results may differ from those obtained by studies performed in any one jurisdiction, (e.g., the U.K.), they do not contradict those results because the results by jurisdiction would vary. 484

In any case the combined total recurring engagement level cost for both the big four and mid-tier firms in the FoF is estimated at about € 316 million. It should be noted that the results of the survey show that some four-fifths of these cost increases would be incurred even if the EU were not to adopt the ISAs because the firms in the FoF will be applying ISAs pursuant to their FoF obligations. 485

The breakdown of the recurring costs by standard vary between the big four firms by audit client category and the mid-tier firms by audit client category. It is not possible to average these costs across all audit firm and audit client categories. However, it is possible to provide the breakdown of the ranges of cost increases included in the categories by standard. Over all firms and audit client categories, the breakdown of the ranges of cost increases caused by each of the primary cost driving standards is as follows in descending order: 486

- ISA 600 25 % to 50 %
- ISA 540 15 % to 41 %
- ISA 260 8 % to 32 %
- ISA 265 5 % to 20 %
- ISA 550 8 % to 15 %

- ISA 620 6 %
- ISA 580 6 %

6.1.3.1.1.2 Recurring Costs Incurred and Cost Savings Gained by Clients at Engagement Level

The recurring costs incurred or cost savings gained by audit clients at engagement level are a major source of costs and cost savings resulting from a change in audit practices to those that are compliant with the clarified ISAs. These costs result from audit clients needing to respond to the changed audit practices of their auditors in their financial statement preparation process and in supporting their auditor in the audit. In a sense, there is no difference between the engagement level and the client level for audit clients because each audit client only represents one audit engagement. 487

Because audit clients did not respond to the quantitative questions on the questionnaire, the survey cannot draw upon client views on the quantitative effects of ISA adoption on their costs and cost savings. However, an adequate number of audit firms did provide their views on the recurring costs and cost savings that may occur at engagement level at clients to allow the Study to develop estimates in this regard. 488

It must be emphasized that these are average estimates of data that showed a great variability. The variability of the data for the clients of the mid-tier firms in this respect was considerably greater than that for the clients of the big four firms. Consequently, the cost increases or savings that would occur in any one case for a particular audit client could be an order of magnitude greater or smaller than the estimates noted. 489

Overall, for all of the audit clients of both big four and mid-tier firms in the FoF, the average recurring costs at engagement level are estimated to be about € 2,200 per audit client. This translates into total recurring costs at engagement level for all audit clients of big four and mid-tier firms in Europe of an estimated € 298 million. 490

6.1.3.1.2 Recurring Costs and Cost Savings at Audit Firms and Network Level

6.1.3.1.2.1 Recurring Costs Incurred and Cost Savings Gained at Audit Firm Level

Some recurring increased redesign costs, such as maintaining new audit tools, maintaining new quality control policies and procedures, and responding to changed external quality assurance result at firm, rather than engagement, level. Other recurring costs and cost savings at audit firm level occur through the harmonisation effect. This include cost savings from less need for technical resources at national level, from economies of scale for training, from applying uniform technology, and from not needing to maintain network quality control policies and procedures at national level. Increased recurring regulation costs at firm level may result from the need to increase compliance management costs. 491

Based upon the data received from the big four firms, the total recurring cost savings gained at firm level would be estimated to amount to € 13.7 million. Based upon the data received from the mid-tier firms, their analogous savings would amount to € 1.4 million. Together, the big four and mid-tier audit firms expect to save about € 15.1 million at national firm level by adopting the ISAs. 492

6.1.3.1.2.2 Recurring Costs Incurred and Cost Savings Gained at International Audit Firm Network Level

Some recurring costs and cost savings would be incurred or saved at the international audit firm network level. 493
In this respect, it is interesting to note that the international networks of the big four firms essentially expect no material costs or cost savings from ISA adoption: this is because these networks already use the ISAs at the international network level as a basis for their audit methodologies. Based upon the responses from the international mid-tier firms, however it is estimated that they will gain cost savings of some € 4.8 million collectively, of which € 1.9 million would be passed on to the national firms in Europe.

6.1.3.1.3 Total Recurring Costs and Cost Savings Arising at the Audit Firms, Networks and Audit Clients

Based on the figures noted above, the total recurring additional costs for the big four and mid-tier firms in the 494
FoF are estimated at about € 316 million in engagement costs and cost savings of € 15.1 million at national firm level, as well as cost savings at international network level of 1.9 million, which leads to total recurring costs of € 299 million for the audit firms and mid-tier firms in Europe collectively.

For the audit clients of firms in the FoF, the total recurring additional costs are estimated at € 298 million. This 495
suggests that the total additional recurring costs for ISA adoption incurred by the big four and mid-tier firms collectively and their audit clients will amount to about € 597 million.

6.1.3.2 Recurring Costs and Cost Savings at Audit Regulators

Some costs incurred by regulators occur only once due to the implementation issues surrounding the adoption 496
of clarified ISAs, whereas other costs to deal with oversight, including reviews and inspections, resulting from ISA adoption would be incurred on a recurring basis. However, some costs and cost savings at audit regulators would be incurred or saved at the level of individual inspections or reviews, whereas other would be incurred or save at the organizational level of the audit regulator (the institutional level).

6.1.3.2.1 Recurring Costs and Cost Savings of Audit Regulators at Inspection or Review Level

The total cost to audit regulators or reviewers in this case depends upon the total number of inspections or 497
reviews carried out. Based upon the data provided by the auditor regulators, it is estimated that on average the additional recurring cost per review per year would amount to about € 240. This amounts to an estimated € 1.7

million in additional recurring review costs per year. This numbers change to € 200 per inspection or review and to a total of € 1.4 million if ISQC 1 were not to be adopted. Audit regulators appear to believe that ISQC 1 is more stringent on average than their national standards for firm quality control policies and procedures and that therefore their recurring costs on inspections and reviews would rise if ISQC 1 were to be adopted.

6.1.3.2.2 Recurring Costs and Cost Savings of Audit Regulators at Institutional Level

Based upon the data provided by the audit regulators, it is estimated that the recurring additional costs resulting from ISA adoption together with the adoption of ISQC 1 would be about € 166,000 per year, regardless of whether ISQC 1 is adopted or not. 498

6.1.3.2.3 Recurring Costs and Cost Savings of Audit Regulators in Total

Based upon the figures above, the total recurring additional costs per year incurred by audit regulators in Europe due to the adoption of ISAs would amount to € 1.9 million with ISQC 1 and € 1.6 million without ISQC 1. 499

6.1.3.3 Total Recurring Costs and Cost Savings

Based upon the figures above, the total additional recurring costs arising from ISA adoption for the big four firms, mid-tier firms, their audit clients, and audit regulators in Europe would be estimated at about € 599 million per year. Consequently, the value of the other costs and benefits arising from ISA adoption must not only outweigh these additional recurring costs, but also, in the long run, at least the cost of capital of the one-off costs incurred, which are substantial. 500

6.1.4 One-off Costs and Cost Savings

One-off costs are those costs that arise from ISA adoption but do not recur every year. In a sense, these costs represent an "investment in the future". From an economic point of view, they do not result in a permanent reallocation of economic resources in the economy, other than the opportunity costs of capital incurred resulting from the expenditure of those one-off costs. 501

6.1.4.1 One-off Costs and Cost Savings at Audit Firms and Audit Clients at Engagement Level

Some one-off costs and cost savings would be incurred or saved at the level of the audit firm, international audit firm network, or audit client – that is, they would be incurred or saved to some degree independent of the nature, timing and extent of the changes to the costs and cost savings incurred or saved at audit engagement level, whether at the audit firm through the performance of the audit or at the audit client in response to the performance of the audit. Since these latter costs and cost savings would be "multiplied" by the number of engagements performed, the engagement level costs and cost savings tend to be of an order of magnitude 502 greater than those at the audit firm level. For this reason, the one-off engagement level costs and cost savings deserve significantly greater attention in the Study than the one-off costs at audit firm level.

6.1.4.1.1 *One-off Costs Incurred and Cost Savings Gained by Audit Firms at Engagement Level*

The one-off costs incurred or cost savings gained by audit firms at engagement level are the primary source of one-off costs and cost savings resulting from a change in audit practices to those that are compliant with the clarified ISAs. 503

Based upon the data provided from the big four firms, there will be significant variation in the one-off total cost increase per engagement by audit client in the first year in which the ISAs are applied. Overall, it is estimated that the average one-off cost increase per audit would be € 4,100 for medium-sized unlisted audit clients, € 6,900 for large unlisted audit clients, € 13,600 for publicly listed audit clients, and € 20,500 for banks and insurance companies each. Based upon the cost data provided by the big four audit firms, on a weighted average basis, this represents an overall average increase of € 7,700 per audit client of all kinds. For the entire audit market of the big four firms, this represents an additional one-off cost at engagement level of about € 565 million in the first year of the application of the clarified ISAs in addition to the recurring costs incurred in that year. 504

Based upon the data provided by the mid-tier firms, there will be even greater variation in the one-off total cost increases or savings per engagement by audit client. Overall, it is estimated that the average one-off cost increase per audit would be € 1,400 for medium-sized unlisted audit clients; not enough data was provided by the mid-tier firms to provide an estimate of one-off costs for large unlisted and publicly listed audit clients, banks and insurance companies separately. Based upon the cost data provided by the mid-tier firms, on a weighted average basis, this represents an overall average increase of € 1,600 per audit client of all kinds. For the entire audit market for the mid-tier firms, this represents a one-off cost increase at engagement level of about € 95 million. 505

It must be emphasized that these are average estimates of data that showed a great variability. The variability of the data for the mid-tier firms in this respect was considerably greater than that for the big four firms. Consequently, the cost increases or savings that would occur in any one case for a particular audit client could be an order of magnitude greater or smaller than the estimates noted and may also depend upon other factors, such as the audit firm and the jurisdiction in which the audit is performed. 506

In any case, the combined total one-off engagement level cost for both the big four and mid-tier firms in the FoF is estimated at about € 660 million. 507

6.1.4.1.2 *One-off Costs Incurred and Cost Savings Gained by Clients at Engagement Level*

The one-off costs incurred or cost savings gained by audit clients at engagement level are a major source of costs and cost savings resulting from a change in audit practices to those that are compliant with the clarified ISAs. These costs result from audit clients needing to respond for the first time to the changed audit practices of their auditors in their financial statement preparation process and in supporting their auditor in the audit. 508

Because audit clients did not respond to the quantitative questions on the questionnaire, the survey cannot draw upon client views on the quantitative effects of ISA adoption on their costs and cost savings. However, an adequate number of audit firms did provide their views on the one-off costs and cost savings that may occur at engagement level at clients to allow the Study to develop estimates in this regard. 509

It must be emphasized that these are average estimates of data that showed a great variability. The variability of the data for the clients of the mid-tier firms in this respect was considerably greater than that for the clients of the big four firms. Consequently, the cost increases or savings that would occur in any one case for a particular audit client could be an order of magnitude greater or smaller than the estimates noted. 510

Overall, for all of the audit clients of both big four and mid-tier firms, the average one-off cost savings at engagement level are estimated to be about € 500 per audit client. This translates into total one-off cost savings at engagement level for all audit clients of big four and mid-tier firms in Europe of an estimated € 69 million. 511

6.1.4.1.3 One-off Costs and Cost Savings at Audit Firm and Network Level

6.1.4.1.3.1 One-off Costs Incurred and Cost Savings Gained at Audit Firm Level

Some one-off increased redesign costs, such as to amend audit methodologies or practices (big four: € 10 million; mid-tier: € 7.6 million), training department costs (big four: € 35 million; mid-tier: € 23 million), training audit staff (big four: € 19 million; mid-tier: € 16 million), developing new audit tools (big four: € 8.4 million; mid-tier: € 5 million), developing new quality control policies and procedures (big four: € 2 million; mid-tier: € 2.4 million), and responding to changed external quality assurance for the first time (big four: € 550,000; mid-tier: € 0), result at firm, rather than engagement, level. The total of such one-off costs would therefore be estimated at € 129 million. 512

6.1.4.1.3.2 One-off Costs Incurred and Cost Savings Gained at International Audit Firm Network Level

Some one-off costs and cost savings would be incurred or saved at the international audit firm network level. The international big four firm networks expect about € 9.4 million one-off on in redesign costs to be incurred for amending their methodologies, their training department, the IT department (to develop tools), and their 513 quality control department due to the adoption of clarified ISAs. The mid-tier firms expect costs of € 4.3 million for these matters. It is expected that the European firms would bear about 40 % of these costs, which would then be estimated at € 5.5 million.

6.1.4.1.4 Total One-off Costs and Cost Savings Arising at the Audit Firms, Networks and Audit Clients

Based upon the figures above, the total one-off cost increases from audit firms, networks and audit clients can be summed up as follows: 514

Audit engagements	€ 660 million
Audit clients	€ -69 million
Audit firms	€ 129 million
International networks	€ 6 million
Total	€ 726 million

6.1.4.2 One-off Costs and Cost Savings at Audit Regulators

Some costs incurred by regulators occur only once due to the implementation issues surrounding the adoption of clarified ISAs, However, some one-off costs and cost savings at audit regulators would be incurred or saved at the level of individual inspections or reviews, whereas other would be incurred or save at the organizational level of the audit regulator (the institutional level). 515

6.1.4.2.1 One-off Costs and Cost Savings of Audit Regulators at Inspection or Review Level

The total cost to audit regulators or reviewers in this case depends upon the total number of inspections or reviews carried out. Based upon the data provided by the auditor regulators, it is estimated that on average the additional one-off cost per review in the first year would amount to about € 1,100. This amounts to an estimated € 5.7 million in additional one-off review costs in the first year. This number changes to € 690 per inspection or review and to a total of € 4.7 million if ISQC 1 were not to be adopted. Audit regulators appear to believe that ISQC 1 is more stringent on average than their national standards for firm quality control policies and procedures and that therefore their one-off costs on inspections and reviews would rise if ISQC 1 were to be adopted. 516

6.1.4.2.2 One-off Costs and Cost Savings of Audit Regulators at Institutional Level

Based upon the data provided by the audit regulators, it is estimated that the one-off additional costs resulting from ISA adoption together with the adoption of ISQC 1 would be about € 1.1 million in the first year if ISQC 1 is adopted and € 822,000 if ISQC 1 is not adopted. 517

6.1.4.2.3 One-off Costs and Cost Savings of Audit Regulators in Total

Based upon the figures above, the total one-off additional costs in the first year incurred by audit regulators in Europe due to the adoption of ISAs would amount to € 6.8 million with ISQC 1 and € 5.5 million without ISQC 1. 518

6.1.4.3 Total One-off Costs

Based upon the figures above, the total additional one-off costs arising from ISA adoption for the big four firms, mid-tier firms, their audit clients, and audit regulators in Europe would be estimated at about € 731 million in the first year; the one-off costs for regulators associated with ISQC 1 are immaterial to the total. 519

6.1.5 Overall Conclusions on Synthesis of Quantitative Costs and Cost Savings

The calculations above show recurring costs for Europe for audit firms, audit firm networks, audit clients and audit regulators of € 599 million per year. This compares with one-off costs in the first year of € 731 million. On this basis the one-off costs are higher than the recurring ones. However, given the generally applicable costs of capital, which can range anywhere from 4 percent to 8 percent per year, it is apparent that the recurring costs are the more serious costs. The qualitative analysis of other costs and benefits would therefore need to demonstrate a net benefit of somewhere between € 630 million and € 660 million per year for the benefits of the adoption of ISAs to be worth their costs. The potential cost effects are summarized in Table 4. 520

in Euro		medium-sized	large unlisted	publicly listed	banks	insurance companies	Weighted Average	Relative	Sum (Mio.)	Subtotal (Mio.)	Total (Mio.)
Recurring costs increases at engagement level											
	Big Four	2,600	3,600	4,600	5,800	5,800	3,300	6%	245		
	Mid Tier	900	1,400				1,200	10%	71		
	Clients						2,200		298	614	
Recurring savings at firm or network level											
	Big Four								-13.7		
	Mid Tier								-1.4		
	International networks								-1.9	-17	
Recurring cost increases, audit regulators											
	at inspection or review level								1.4		
	at institutional level								0.2	1.6	
Sum of recurring costs											599
One-off cost increases at engagement level											
	Big Four	4,100	6,900	13,600	20,500	20,500	7,700		565		
	Mid Tier	1,400					1,600		95		
	Clients						-500		-69	591	
One-off cost increases at firm or network level											
	firm level								129		
	network level								5.5	134.5	
One-off cost increases, audit regulators											
	at inspection or review level								4.7		
	at institutional level								0.8	5.5	
Sum of one-off costs											731

Table 4: Summary of Recurring and One-off Cost Changes

6.2 Synthesis of Survey Results on Other Costs and Benefits

6.2.1 General Considerations

The “other costs and benefits” related to those for which qualitative data was provided by the survey respondents, rather than quantitative data about costs incurred and cost savings. The other costs and benefits evaluated from the qualitative data provided by survey respondents can be analysed from the same perspectives as the quantitative cost and cost savings, such as: 1. the cause of the other costs or benefits (redesign effect, harmonisation effect, regulation effect), 2. who incurs or gains the costs or benefits (audit firms, audit clients, audit regulators, other capital market participants), 3. at what level the costs or benefits are incurred or gained (engagement level vs. firm level, client level, or international network firm level), 4. whether the costs or benefits are recurring or one-off, and 5. who ultimately bears or obtains the costs or benefits (i.e., the “incidence” of costs and benefits). 521

It is not possible to analyse all aspects of the different perspectives for all costs and benefits. However, it is important to focus on certain perspectives in relation to key issues for certain costs and benefits so that decision-makers at the European Commission and elsewhere gain an understanding of the nature, timing and extent of the costs and benefits and how these ought to affect their decision-making. Furthermore, the qualitative nature of the responses makes the aggregation of responses difficult and subject to judgmental evaluations. 522

6.2.2 Other Costs and Benefits Arising from the Redesign Effect

The conclusions drawn from the analysis of the other costs and benefits arising from the redesign effect are:

Effects on audit quality 523

- Adoption of clarified ISAs will lead to between no change and a slight improvement in audit quality, regardless of the adoption or non-adoption of ISQC 1, including understandability
- The incorporation of objectives contributes to a slight increase in audit quality
- The application material contributes to a slight increase in audit quality

Conclusion: adoption of ISAs will lead to a slight increase in audit quality, including understandability

Effects on audit firms 524

- Adoption of clarified ISAs will not have any appreciable impact on the risk of professional sanctions, liability risk or reputational risk for audit firms; the adoption of ISQC 1 would not change this assessment

Conclusion: adoption of ISAs has no impact on the audit firms in relation to risks

Effects on financial reporting quality at audit client 525

- Adoption of ISAs will lead to between no change and a slight improvement in financial reporting quality at the audit client level

Conclusion: adoption of ISAs is likely to have in imperceptible positive effect on financial reporting quality at client level

Effects on the quality of inspections or reviews 526

- ISA adoption is unlikely to affect the quality of inspections or reviews; adoption of ISQC 1 will not have any impact on this assessment
- ISA adoption is unlikely to affect the efficiency of inspections or reviews; adoption of ISQC 1 will not have any impact on this assessment
- The adoption of ISQC 1 will have no effect on the quality of inspections or reviews
- It is unlikely that the introduction of objectives into auditing standards would improve inspections or reviews
- The introduction of application will not have any material impact on the quality of inspections or reviews

Conclusion: Adoption of ISAs or ISQC 1 will not have any effect on the quality of inspections or reviews and therefore will not impair enforcement over audits

Effects on audit market 527

- The adoption of ISAs will not cause audit firms to leave the audit market
- The adoption of ISAs may cause a low percentage of audit firms to join networks or other forms of cooperation.
- There are differing views as to whether audit quality would increase from the circumstances noted in the first two bullet points.

Conclusion: Adoption of ISAs will not have any impact on the audit market with the possible exception of a low percentage of audit firms joining networks or other forms of cooperation. The impact on audit quality is unclear.

Effects on capital market 528

- ISA adoption reduces capital market transaction costs and costs of capital very slightly

Conclusion: the adoption of ISAs will have a very slight positive effect on capital markets

Overall conclusion: 529

The only material redesign effect through ISA adoption is a slight increase in audit quality, including understandability, which leads to a very slight reduction in capital market transaction costs and costs of capital. This effect is a recurring effect, rather than one-off. Nevertheless, other net benefits of the ISAs do not appear to arise from the redesign effect (effect of change from current audit practices to clarified ISAs). No impairment will result to enforcement of audits.

6.2.3 Other Costs and Benefits Arising from the Harmonisation Effect

The conclusions drawn from the analysis of the other costs and benefits arising from the harmonisation effect are:

Engagement level costs 530

- The incremental increase in costs due to ISAs not covering national particularities is slight
- There would be no change to a slight impairment in audit quality due to ISAs not covering national particularities
- The *one-off* costs of interpreting English-language documents on ISAs or translations thereof would be significant

Conclusion: The fact that ISAs do not cover national particularities would lead to a slight recurring increased cost and an imperceptible decrease in audit quality. The *one-off* costs of understandability are significant.

Costs/Benefits to European capital market 531

- Slight increase in non-EU investors entering the EU capital market which implies significantly higher one-off returns for existing EU investors, but slightly lower recurring returns for EU investors thereafter, a slight decrease in costs of capital for audit clients and a slight increase in earnings by financial intermediaries

Conclusion: cost – significant increase one-off returns for existing EU investors, but a slight decrease in recurring returns for EU investors; benefits – slight decrease in costs of capital for audit clients and slight increase in earnings for financial intermediaries

Improved quality of transnational audits 532

- Slight increase in quality of transnational audits through ISA adoption
- No improvement in quality of transnational audits through adoption of ISQC 1
- Slight improvement in quality for transnational audits through objectives in standards
- Slight improvement in quality for transnational audit through application material

Conclusion: slight improvement in quality for transnational audits

Benefits for audit firms 533

- Greater acceptance of audit reports outside home jurisdiction, within and outside of Europe
- Significant reduction in standards overload within Europe, somewhat less outside of Europe
- Significant reduction in contradictions between auditing standards, within and outside of Europe

Conclusion: significant benefits for audit firms that perform transnational audits

Benefits for transnational audit clients 534

- No perceptible reduction in risk of material misstatement prior to audit
- No perceptible improvement from better use of audit reporting or communication of audit findings
- Slight improvement in audit client access to capital and business opportunities

Conclusion: slight improvement in transnational audit client access to capital and business opportunities

Benefits for audit regulators 535

- ISA adoption forms the basis for improved collaboration between audit regulators
- ISA adoption forms the basis for acceptance of oversight systems within and outside of Europe
- ISA adoption forms the basis for convergence of oversight systems within and outside of Europe
- Adoption of ISQC 1 enhances the effect of ISA adoption of improved collaboration, acceptance of oversight systems and convergence of oversight systems
- Adoption of ISQC 1 forms a basis for harmonisation of reviews and inspections
- No harmonisation of inspections or reviews achieved through objectives in auditing standards
- Slight improvement of harmonisation of reviews and inspections through application material in ISAs

Conclusion: ISA adoption forms a basis for acceptance and convergence of oversight systems within and outside of Europe and for improved collaboration among audit regulators; this effect would be enhanced through the adoption of ISQC 1, which also forms a basis for harmonisation of inspections or reviews; slight improvement in inspections or reviews through application material

Benefits at audit market level 536

- Slight improvement in internal market in Europe and internationally for European audit professionals
- Slightly reduced barriers to entry for market for transnational audits by firms not in the FoF
- Slightly improved retention of transnational audits by firms not in the FoF

Conclusion: slight benefits in market for transnational audits for firms not in the FoF and slight improvement in market for European audit professionals

Benefits for European capital market 537

- Slight reduction of international information asymmetries between capital market participants
- Slight reduction in costs of investors to understand audits from other European jurisdictions
- Slight increase in acceptance of investors from other EU countries of audit reports
- Significant increase in acceptance of EU audit reports by investors from outside EU
- Slight increase in non-EU investors entering EU capital markets, which leads to a slight one-off increase in EU investor returns, and thereafter to slightly lower but slightly more reliable recurring returns for EU investors

Conclusion: slight improvement in internal EU capital market; slight one-off increase in EU investor returns and thereafter slightly lower but slightly more reliable recurring returns for investors, but slightly lower costs of capital for transnational audit clients and slight improvement in earnings for financial intermediaries.

Overall Conclusion: 538
There is a significant one-off cost to understandability because of the need to understand translations or the original English. Furthermore, there is a slight increase in cost and decrease in quality due to ISAs not covering national particularities; however, this is a gap that can continue to be filled by national standards setters providing additional guidance on national matters.

It should be noted that the following benefits are all of a recurring nature, which increases their weight vs. the one-off costs. 539

There are significant benefits for audit firms that perform, or wish to perform, transnational audits. The quality of transnational audits will improve slightly. Other than a slight improvement in inspections and reviews of transnational audits, institutional barriers will likely prevent potential benefits from accruing to audit regulators and audit firms from a potential improvement in audit regulator collaboration, acceptance of oversight systems and harmonisation of inspections or reviews; ISQC 1 enhances these potential improvements. No impairment in enforcement over audits will ensue from ISA adoption. A slight improvement in the internal and international market for EU audit professionals should ensue. 540

The key benefits, however, are at transnational audit client and capital market level. Although improved efficiency of capital markets leads to one-off slightly higher returns to EU investors and thereafter to slightly lower but slightly more reliable recurring EU investor returns, and more investors in the market to slightly better returns for financial intermediaries, it does lead to slightly lower costs of capital for transnational audit clients and slightly better access to business opportunities. Although these benefits are termed “slight”, small decreases in cost of capital and small increases in business opportunities have a very large impact at a macroeconomic level (e.g., a decrease in a few tens of basis points for the cost of capital per transnational audit client could have a very large financial impact when extrapolated to all transnational audit clients in the EU; the same argument applies to business opportunities). For this reason, the macroeconomic benefits of these changes could be considerable. Moreover, these benefits would be recurring. 541

6.2.4 Other Costs and Benefits Arising from the Regulation Effect

The conclusions drawn from the analysis of the other costs and benefits arising from the regulation effect are:

Costs and benefits at engagement level 542

- Provision of legal sanctions causes about one-third of auditors would perform more procedures than necessary
- Provision of legal sanctions will not increase the incidence of auditors only following the rules rather than performing an adequate audit
- Provision of legal sanction will not change audit quality
- Legal sanction for objectives in auditing standards will not change audit quality in all jurisdictions

- Non-adoption of the application material has no impact on the legal certainty of requirements
- Legal sanction for auditing standards will not change the quality of reviews or inspections

Conclusion: provision of legal sanctions for auditing standards will not cause any perceptible change at the engagement level other than causing a significant proportion of auditors to perform some more procedures than necessary

Costs and benefits at firm and audit client level – conclusion: Legal sanction will result in no change to the risk 543 of professional sanctions, liability risk or reputational risk of the audit firms, nor improve the basis for legal claims against auditors by audit clients for noncompliance with auditing standards

Costs at audit regulator level – conclusion: legal sanction for auditing standards will cause regulators to be 544 equally concerned about audit quality and the standards as rules – no change in audit quality

Capital market benefit – conclusion: audit clients and capital market participants believe that the provision of 545 legal sanctions will slightly improve audit quality; in this case, for the capital market, perceptions may be more important than reality.

Overall Conclusion: Among the primary recurring costs is the cost of a significant proportion of auditors per- 546 forming some procedures that are not necessary in the circumstances. There is a perception among users of audit reports that audit quality increases slightly when standards have legal sanction. This in turn may increase audit and financial reporting credibility, with the concomitant very slight capital market effects on costs of capital, etc., as described in the harmonisation effect above.

6.2.5 Summary Synthesis of Other Costs and Benefits and Overall Survey Conclusions on Costs and Benefits

The redesign and regulation effects appear to be positive overall, but slight – they relate primarily to a slight 547 increase in actual audit quality, including understandability, plus a slight increase in the perception of increased audit quality by audit report users. These would both translate into slightly greater audit and financial reporting credibility, which result slight effects on capital market transactions costs and costs of capital. As noted above, even slight effects on these matters can have a significant macroeconomic impact. In part, the benefits of the redesign effect appear to be muted because auditing standards may have reached the point of diminishing returns in terms of the incremental benefit of additional requirements and because the big four firms and mid-tier firms already have more than the existing ISAs incorporated in their audit methodologies. The regulation effect appears generally to be overrated and actually causes some unnecessary procedures to be performed by some auditors generally

With the exception of the one-off understandability costs, where the benefits of the ISAs come to force is in 548 the harmonisation effect. There are significant benefits for audit firms performing or seeking to perform transnational audits, for the quality of transnational audits and for the quality of reviews and inspections of firms performing transnational audits. The internal and international market for European audit professionals would become more efficient. Other than a slight improvement in inspections and reviews of transnational audits, institutional barriers will likely prevent potential benefits from accruing to audit regulators and audit firms from a potential improvement in audit regulator collaboration, acceptance of oversight systems and harmonisation of inspections or reviews; ISQC 1 enhances these potential improvements. No impairment in enforcement over audits will ensue from ISA adoption.

As mentioned the most important benefits are at transnational audit client and capital market level. Although improved efficiency of capital markets leads to a one-off slight increase in EU investor returns and thereafter to slightly lower but slightly more reliable EU investor returns, and more investors in the market to slightly better returns for financial intermediaries, it does lead to slightly lower costs of capital for transnational audit clients and slightly better access to business opportunities. Although these benefits are termed “slight”, small decreases in cost of capital and small increases in business opportunities have a very large impact at a macroeconomic level (e.g., a decrease in a few tens of basis points for the cost of capital per transnational audit client could have a very large financial impact when extrapolated to all transnational audit clients in the EU; the same argument applies to business opportunities). For this reason, the macroeconomic benefits of these changes could be considerable. Moreover, these benefits would be recurring. 549

It is for the aggregation of these reasons that the overall conclusion of the survey participants, that the benefits at least slightly outweigh the costs needs to be seen. Based on their responses, for the big four and mid-tier audit firms the benefits are significant, which is why they are applying the ISAs in their audit methodologies on a voluntary basis. 550

6.2.6 Overall Conclusions on Synthesis of Survey Results on Costs and Benefits

The survey results show that for the big four and mid-tier audit firms, despite significant cost, there are overriding benefits to incorporating the ISAs and ISQC 1 into their audit methodologies and firm quality control policies and procedures, respectively. However, there are also significant benefits for capital market participants, including for transnational audit clients. The audit firms voluntarily provided considerable cost and other monetary data so that the costs and cost savings of adopting ISAs could be estimated. Despite these costs, the general consensus among the participants is that the benefits of adoption are worth the costs. We have no reason to question these results, since they accord with the commercial reality that transnational audit clients choose audit firms that operate transnationally that apply transnational auditing and quality control standards, regardless of whether or not these are legally sanctioned. 551

Based upon the results of the survey, we reach the conclusion that at least for the audit firms and audit clients covered by the survey (i.e. audit firms in the FoF and their audit clients), which represent 60 % of the audit 552 market for audits that are required by the Fourth and Seventh EU Directives, the benefits of ISA adoption, including the adoption of ISQC 1, are worth the cost.

6.3 Synthesis of Survey Results on Coverage of European Audit Market

6.3.1 Size of Audit Market Covered by the Study

Data of varying reliability about the number of audits by type of audit client was received from audit regulators, professional bodies, data bases, and other sources. The data obtained for the number of listed companies, banks and insurance companies by jurisdiction is generally reliable. However, when comparing data from different sources for the number of large unlisted and medium-sized unlisted companies, it is apparent that the data received for only a small number of major jurisdictions and for a few smaller jurisdictions is of sufficient reliability to form a basis for the extrapolation of results for the other jurisdictions, for which the data obtained is not sufficiently reliable. Consequently, the Study uses the reliable data received for the small number of major jurisdictions and for a few smaller jurisdictions together with GDP as a basis for extrapolating the number of medium-sized and large unlisted audit clients by country. This appears to give fairly reliable numbers. 553

As discussed in Section 1.3.4, there are approximately 1.6 million statutory audits in the EU. Furthermore, of these 1.6 million audits, on the basis of the extrapolation, the Study estimates that only about 224,000 of these audits are required by the EU Fourth and Seventh Directives – that is, are audits that are required by the thresholds set forth in the EU Fourth Directive given the options to exempt small companies from such audits in that Directive. There are, of course, many other audits of financial statements performed by auditors in the EU that are not required by either the EU or by law in the EU member states, some of which involve the appointment of an auditor as if that auditor were a "statutory" auditor: this Study does not cover these audits nor has the Study attempted to estimate the number of these kinds of audits. 554

This means that about 1.4 million audits are required by EU member states even though there is no concomitant requirement therefore at EU level. It is not possible to obtain comparable information about the nature and extent of these audits because the thresholds applied vary among EU member states, which hinders the acquisition of comparable data and its evaluation for the purposes of a study on cost and benefit effects. However, decision makers at a European level need to be aware of the fact that the costs of auditing these 1.4 million companies are not directly relevant to EU decision making because the EU member states are in a position to change the number and kinds of entities subject to such audits without reference to the EU. If the costs of auditing the financial statements of these 1.4 million companies are made an issue in relation to the reduction or elimination of administrative costs and burdens at an EU level, then decision makers at an EU level may need to intimate to EU member states that such administrative costs and burdens arising from their national law need to be addressed at a national, rather than EU, level. Hence, only the 224,000 audits required by the EU represent the "relevant audit market" for the purposes of the Study. 555

However, there are different estimates of how many of the 1.6 million statutory audits are actually required by the EU. For example, the DG Internal Market and Services estimates that there may be 310,000 statutory audits required by the EU.[118] The question arises what the impact on the conclusions of the Study would be, if this higher estimate were to be applied. 556

6.3.2 Size of Audit Market Covered by the Survey

The survey covered only statutory audits in the "relevant audit market" (see above) performed by audit firms in the FoF but, due to a lack of data, did not cover audits performed by audit firms not in the FoF. The Study estimates that the audits performed by audit firms in the FoF cover about 60 % of the 224,000 audits required by the EU (about 50 % of the medium-sized unlisted audit clients and about 66 % of the large unlisted audit clients, and almost all of the publicly listed audit clients, banks and insurance companies). Hence, due to the lack of responses from SMPs and other firms not in the FoF, and their audit clients, the remaining 40 % of relevant audits (one-third of audits of large unlisted enterprises and half of the audits of medium-sized unlisted companies) performed by firms not in the FoF are not covered by the survey. However, the actual percentages by jurisdiction may vary widely. Some commentators have suggested that the percentages ought to be reversed (i.e., audits performed by the audit firms in the FoF ought to cover 40 %, rather than 60 % of the 224,000 audits required by the EU). The questions arises what the impact on the conclusions of the Study would be if the percentages were to be so reversed. 557

6.3.3 Sensitivity Analysis of Costs for Audit Market Covered by the Study and Survey

To determine whether imprecision in the number of statutory audits required in the EU and in the percentage of those audits performed by audit firms in the FoF have an impact on the conclusions of the survey, the Study includes a sensitivity analysis of the possible impacts by calculating the following additional scenarios on the survey results: 558

1. 310,000 audits required by EU and FoF market share of 60 %
2. 310,000 audits required by EU and FoF market share of 40 %

As Table 1 in Appendix 7 shows, the alternative scenarios show total increased recurring costs per year of € 832 million and € 548 million, respectively. The latter shows an 8 % reduction in total increased recurring costs, whereas the former a 39 % increase, compared to the figures used in the survey analysis. The scenario 224,000 audits required by the EU and an FoF market share of 40 % was not explicitly calculated because it would simply lead to an approximate reduction of about 33 % in total increasing recurring costs per year compared to the figure used in the survey analysis. On this basis the total increasing recurring costs per year for audits performed by firms in the FoF for all of Europe range from about € 400 million to about € 830 million. The estimated € 599 million resulting from the scenario applied in the survey is comfortably in the middle of the noted 559

[118] Consultation Paper on Review of the Accounting Directives, European Commission Directorate General Internal Market, page 10 - http://ec.europa.eu/internal_market/consultations/2009/company_law_dir_en.htm.

range. Consequently, it would be fair to conclude that the estimate generated by the survey of € 599 million is plausible in the circumstances, but that the range of reasonably possible estimates lies between € 400 million to € 830 million. The following analysis is based on the plausible estimate of € 599 million.

Because the one-off costs only affect future years through their opportunity cost, wide ranges are less critical. As Table 1 in Appendix 7 shows, the alternative scenarios show total one-off costs of € 968 million and € 692 million, respectively. The latter shows a 5 % reduction in total one-off costs, whereas the former a 32 % increase, compared to the figures used in the survey analysis. The scenario 224,000 audits required by the EU and a FoF market share of 40 % was not explicitly calculated because it would simply lead to an approximate reduction of about 33 % in total one-off costs compared to the figure used in the survey analysis. On this basis the total one-off costs for audits performed by firms in the FoF for all of Europe range from about € 490 million to about € 970 million. The estimated € 731 million resulting from the scenario applied in the survey is comfortably in the middle of the noted range. Consequently, it would be fair to conclude that the estimate generated by the survey of € 731 million is plausible in the circumstances, but that the range of reasonably possible estimates lies between € 490 million to € 970 million. The following analysis is based on the plausible estimate of € 731 million. The reasonable range of recurring opportunity costs, for that "one-off investment" at between 4 % to 8 % would lie between € 29 million to € 58 million per year with a plausible average estimate of about € 44 million. 560

By adding the plausible estimate of the recurring opportunity costs of the one-off costs to the plausible estimate of the recurring costs, this suggests that for the portion of the relevant audit market serviced by audit firms in the FoF, the recurring benefits would need to exceed between € 628 million and € 657 million per year, with an average estimate of about € 643 million per year. 561

6.4 Quantification of Selected Benefits and Comparison to Results of Sensitivity Analysis of Costs

The estimates of recurring costs above provide an indication of how high the monetary benefits need to be for the benefits to exceed the costs. The question arises whether it would be possible to translate into quantitative monetary estimates some of the benefits that were measured using a Likert scale. Prime candidate for such a translation would be the benefit in relation to reduction in costs of capital for audit clients. 562

As noted in Section 6.2.2 above, the redesign effect leads to a very slight decrease in the cost of capital for all audit clients. Likewise, as noted in Section 6.2.4 above, the regulation effect also leads to a very slight decrease in the cost of capital for those audit clients in jurisdictions in which auditing standards are not enshrined in law. More importantly, Section 6.2.3 describes how the harmonisation effect would lead to a slight decrease in costs of capital for transnational audit clients. 563

To translate these qualitative results into a monetary estimate, it would be necessary to determine what would commonly be understood as "very slight decreases in costs of capital" and "slight decreases in cost of capital". Based upon discussions with representatives of an international publicly-owned institutional bank, when interest rates are at about 1 % per annum, banks would appear to regard a reduction of 5 to 10 basis points as slight; very slight would therefore range from 1 to 4 basis points. Furthermore, some accumulation of the different sources of decreases in cost of capital appears to be needed. On this basis, the redesign, harmonisation, and regulation effects would cause an aggregate reduction of between 7 to 18 basis points for transnational audit clients. Since the cost of capital for equity and corporate bonds are significantly greater than 1 % at the present time, using these figures the Study would be very conservative on the benefits side. Furthermore, one study in the U.S. does show that increases in cost of capital resulting from changes in market perceptions about the decline in the quality of an audit shows a mean average of 101 basis points increase in cost of capital, and a median increase of 48 basis points.[119] There are a number of further studies in the U.S. that provide similar and related conclusions.[120] While the results of these studies may not be directly transferable to Europe, they do provide a strong indication that a 7 to 18 basis point decrease in cost of capital for increased (perceived) audit quality is very conservative. 564

The other basis for a cost of capital calculation is the capital, which comprises two components: debt and equity. Reliable data is available from Eurostat on the estimated market capitalization of stock markets (equity) in the EU as at December 31, 2008. While such figures would include listings of enterprises from outside the EU, this would be offset by listings outside the EU by enterprises based in the EU. The net difference is likely to be immaterial for the overall stock market capitalization of enterprises in the EU. Pursuant to Eurostat, the stock market capitalization of stock markets in Europe as at December 31, 2008 is estimated at about € 5.5 trillion (which, due to the financial crisis, is about half of what it was at the end of 2007)[121]. 565

Eurostat also has data on the estimated debt securities of euro area residents at the amount outstanding for non-financial corporations and financial intermediaries, financial auxiliaries, insurance corporations and pension funds. As at December 31, 2007 (the latest data available at the time the final report of the Study was written) the amount outstanding for these entities is estimated at about € 2.1 trillion.[122] This compares with the value of bond markets that are members of the World Federation of Exchanges as at that date (which does not include the total value of the European bond market for those exchanges not members of the World Federation of Exchanges), which is € 3.1 trillion.[123] Therefore, using the € 2.1 trillion figure for debt capital is extremely conservative on the benefit side: it excludes debt securities issued by enterprises in the EU outside of the Eurozone (e.g., U.K., Sweden and Denmark) and excludes those of banks in the Eurozone. Hence the total 566

119 See Botosan, C. A./Kinney, W./Palmrose, Z.-V. (2007). The authors of the Study would like to thank Messrs. Botosan, Kinney, and Palmrose for their permission to cite their study. The Study is indebted to Prof. Kinney for having made its authors aware of this research.

120 See for example Blackwell, D. W./Noland, T. R./Winters, D. B. (1998); Fortin/Pittman (2007); Hribar, P./Jenkins, N. T. (2004) and Ashbaugh-Skaife, H. et al. (2006).

121 Eurostat (2009a).

122 Eurostat (2009b).

123 World Federation of Exchanges (2009).

capital used as a basis for calculating cost of capital for entities that have listed debt or equity securities on European exchanges is estimated very conservatively at € 7.6 trillion.

An extremely conservative one basis point decrease in cost of capital due to the adoption of ISAs by the firms in the FoF for only enterprises in the EU that have debt or equity securities listed on exchanges would therefore amount to a € 760 million reduction in costs of capital per year for these audit clients. On this basis, even a one basis point decrease in the cost of capital would lead to more than break-even versus the estimated average costs of € 643 million per year for all audit clients audited by the firms within the FoF without even including the reduction in cost of capital benefits for other transnational audit clients audited by the firms in the FoF. 567

If the Study were to apply the conservative 7 to 18 basis point decrease of cost of capital estimated above, the benefits resulting from the reduction in cost of capital for listed entities alone vs. the costs for all of the audit clients audited by the firms in the FoF would exceed the costs by a factor ranging between 8 to 1 (7 basis points times € 7.6 trillion divided by the upper bound of costs of € 657 million as noted in Section 6.3.3) and 22 to 1 (18 basis points time € 7.6 trillion divided by the lower bound of costs of € 628 million as noted in Section 6.3.3) with a conservative mid-point estimated factor of about 15 to 1. 568

It should be pointed out that the actual factors of benefit to cost would be much higher if the benefits resulting from reduced cost of capital from transnational audit clients and other audit clients audited by the firms in the FoF were to be included, i.e., it is to be expected that the reductions in cost of capital are likely to be similar for unlisted companies. Furthermore, benefits other than reduced costs of capital noted in Sections 6.2.2 to 6.2.4 above, such as increased business opportunities or reduced capital market transaction costs, etc. have not been included in this quantitative analysis because measurement thereof is rather difficult. 569

Consequently, there is little doubt that for the audit firms in the FoF, their audit clients, and capital market participants, the benefits of adopting clarified ISAs outweigh the costs considerably. This accords with the overall assertions made by audit firms, audit regulators and capital market participants, that the benefits of ISA adoption would significantly outweigh the costs. However, as noted in Section 4.1, the maintenance of these benefits into the future is predicated upon adoption of the ISAs by the EU through a binding legal instrument (in particular, by limiting firms and member states from future departures from ISAs that would impair the recurring harmonisation benefits). 570

However, an outstanding question would be the costs and benefits of ISA adoption for audit firms not in the FoF (primarily SMPs) and their audit clients (primarily SMEs). 571

6.5 Extrapolation of Survey Results from the Firms in the FoF to the Other Firms

In this section, the quantitative analyses are based upon the assumption that the relevant market for statutory audits required by the EU numbers 224,000 audits and that firms not in the Forum of Firms service 40 % of that market (one-third of the large unlisted entities and half of the medium-sized unlisted entities). 572

6.5.1 Extrapolation of Survey Results for Costs from the Firms in the FoF to the Other Firms

The survey obtained insufficient data from firms not in the FoF to be able to draw direct conclusions on the impact of ISA adoption on these firms, their audit clients, and other stakeholders. However, it may be possible to extrapolate some of the survey results to firms not in the FoF and their audit clients. Such an extrapolation would need to be based upon reasonable assumptions. Nevertheless, the quality of the results would not be as persuasive as those obtained by means of the survey. 573

A useful starting point is the estimated recurring cost increase per medium-sized unlisted audit client per year resulting from the redesign effect for audits performed by mid-tier firms in the FoF: € 970 (see Section 4.3.3.1.1.4). Generally speaking, firms not in the FoF would tend to audit those medium-sized audit clients that are less complex, not transnational and of lesser size than those audited by the mid-tier firms in the FoF. Using the results of the APB Consultation Paper from October 2008[124], certain ISAs had only limited relevance to audits of small and mid-sized entities. ISA 600 (group audits) has only very limited relevance, as does ISA 620 (using the work of an auditor's expert). One standard not covered in the U.K. study also very likely to be of limited relevance to audits of medium-sized unlisted audit clients is ISA 402 (service organizations). The estimated impact of the adoption of these ISAs on medium-sized unlisted audit clients audited by mid-tier firms in the FoF has therefore been partially removed to extrapolate the impact of adopting clarified ISAs on medium-sized unlisted audit clients audited by audit firms not in the FoF. This approach was discussed with a few professional bodies and standard setters. To take into account the fact that for audits performed by firms in the FoF in jurisdictions that do not use the existing ISAs as national standards, additional costs would be incurred in moving from national standards to existing ISAs (before addressing the impact of moving from existing ISAs to clarified ISAs), the Study assumes an average 30 % cost increase for such audits beyond the adjustment from existing ISAs to clarified ISAs (see Appendix 7 Table 2). 574

The results are that the recurring cost increase per year incurred by audit firms not in the FoF at an engagement level due to the redesign effect would be about € 450. After adjusting for the regulation effect, these recurring costs per year would be estimated at a total of € 710, which in absolute terms is 30 % less than the recurring costs per year incurred for mid-tier firms in the FoF. However, after adjusting to the fact that on average these audits would be much smaller in terms of audit time (less than 50 %), it is estimated that this recur- 575

[124] APB (2008).

ring cost increase would represent about a 10 % increase over current audit costs. Since the current average total audit cost for such clients is estimated at less than 50 % of that for medium-sized unlisted audit clients audited by audit firms in the FoF, which would be a conservative estimate of current average audit cost medium-sized unlisted audit clients audited by audit firms not in the FoF, the actual percentage increase may be lower than the estimated 10 % relative cost increase.

By assuming that the other recurring costs and audit client level and one-off costs at audit engagement level would behave proportionately, the recurring cost increase per year incurred by audit clients is estimated at € 1,300 (Appendix 7 Table 2) whereas the one-off costs incurred by the audit firms are estimated at € 1,400 (Appendix 7 Table 2). 576

It should be noted that the actual average cost increases described in the previous two paragraphs may vary considerably from the figures shown. In particular, the magnitude of the average cost increases depends considerably upon the extent to which national auditing standards are compliant with ISAs that are currently effective. 577

Unlike the firms in the FoF, because the other firms are less likely to have in-house technical and training departments, they are also less likely to incur audit methodology change costs or internal training costs on a large scale. Rather, these firms tend to purchase updates of audit methodology and implementation guidance, including software, or updates thereof, on an annual basis from professional bodies or other service providers (see Section 1.3.4). Discussions with a few professional bodies that are also such service providers lead to two different scenarios, which are provided as a sensitivity analysis on the assumptions made and to allow greater transparency as to the effects of the assumptions in the scenarios. In the first scenario, one could assume that each member of audit personnel requires 3 training days in addition to those already required for other matters (one day more than the incremental training days proposed by the firms in the FoF), that the firm suffers opportunity costs when staff are training rather than auditing for this period (at € 800 per day per staff member), and that the firm needs to purchase the materials, implementation guidance and software at an out of pocket cost of € 1,000. In the second scenario, one could assume that only two additional training days are required, but that this does not lead to any opportunity costs and that the cost of the materials, implementation guidance and software is included in the normal cost of annual updates. In both scenarios the out of pocket training cost per day per staff member for the courses taken would amount to € 400. 578

On the assumption that the audit per staff ratios are the same for the firms in the FoF and for those that are not (this is supported somewhat by the equivalent ratios between the big four firms and the mid-tier firms in the FoF), the same sensitivity analysis can be applied for the portion of the audit market serviced by the firms not in the FoF as is applied in Section 6.3.3 above. The total estimated average recurring costs incurred by audit firms and audit clients extrapolated to the entire audit market in the EU serviced by the firms not in the FoF would be about € 180 million. The estimated average one-off costs would be about € 144 million. Hence, applying the procedure used in Section 6.3.3 above, the reasonable range of recurring opportunity costs at between 579

4 % to 8 % would lie between € 6 million to € 12 million per year with a plausible mid-point estimate of about € 9 million.

By adding the recurring opportunity costs of the one-off costs to the recurring costs, this suggests that for the portion of the relevant audit market serviced by audit firms not in the FoF, the recurring benefits would need to exceed between € 186 million and € 192 million per year, with a mid-point estimate of about € 189 million per year. This means that the benefits of ISA adoption to audit firm not in the FoF, their audit clients, and capital providers to these audit clients must exceed these costs. 580

6.5.2 Analogous Application of Survey Results for Benefits from the Firms in the FoF to the Other Firms and Cost-Benefit Conclusion

There is very little data available on the total capital (debt and equity) of European business enterprises that do not have their shares or debt securities listed on European exchanges. This applies not only to those audit clients whose financial statements are audited by firms in the FoF, but also to those whose financial statements are audited by firms not in the FoF. It is therefore very difficult to quantify the benefits resulting from an adoption of ISAs for this portion of the audit market. The primary difference between those audit clients whose financial statements are audited by firms in the FoF and those who are not is that the former includes audit firms with transnational audit clients and their capital providers that benefit immediately, directly and on a recurring basis from the harmonisation effect. There is no such immediate and direct effect for audit clients whose financial statements are audited by firms not in the FoF and their capital providers because these are local, rather than transnational in nature. 581

However, this analysis applies only in the short-term. The purpose of harmonisation through the EU is for local markets – in particular for those enterprises whose business activities and capital providers that are currently local rather than transnational – to become more European. That is, in the long run, locally oriented medium and large unlisted enterprises in particular member states in Europe would become more European in both business activities and sources of capital: this market would become more efficient as a result and medium-sized enterprises in the EU would benefit from the increased business opportunities. This is the very purpose of the internal market activities of the European Commission. This would therefore also be a major long run benefit, even if it cannot be quantified. 582

To the extent that local auditing standards are not codified in law in a particular member state, these audit clients (that is, those whose financial statements are audited by firms not in the FoF) would also benefit from the regulation effect (due to capital market participant perception of slightly improved audit quality due to having auditing standards in law), which would lead to a very slight reduction in cost of capital (at between 1 to 4 basis points as noted in Section 6.4). Furthermore, the positive audit redesign effects would also lead to at least slightly better audit quality and a further slight reduction in cost of capital (1 to 4 basis points), which implies a likely benefit of reduced cost of capital for these audit clients of between 2 to 8 basis points. Using 583 the recurring engagement level audit firm (€ 700 – rounded downwards from € 710 – as shown in Appendix 7 Table 2) and recurring proportional audit client incremental cost increases (i.e., € 1,300 as shown in Appendix 7 Table 2) as a basis, which would lead to an average total recurring cost increase of € 2,000 per year (i.e., € 1,300 plus € 700), this implies that these audit clients with total capital (debt and equity) exceeding only € 2.5 million to € 10 million would benefit from such reduced costs of capital, depending upon how large the reduction ranges between 8 basis points and 2 basis points, respectively; if the cost of capital were reduced by only 1 basis point (which would be a very conservative benefit estimate), breakeven would be reached for an audit client with total capital exceeding € 20 million.

Under the thresholds for statutory audits required by the EU Fourth and Seventh Directives, medium-sized unlisted entities are required to exceed two of the following thresholds two years in a row: net turnover of € 8.8 million, balance sheet total of € 4.4 million, and 50 employees. In the vast majority of cases, entities exceed the first two thresholds two years in a row rather than any combination of one of these and the third. The balance sheet total is equal to the total debt plus equity of an entity (which is equal to the total assets of an entity). This implies that total capital (debt and equity) of medium-sized unlisted entities in the EU is almost always greater than € 4.4 million. The upper bound of the balance sheet total for medium-sized unlisted entities is at € 17.5 million. On this basis, the benefits from the reduction in cost of capital alone will exceed the increased recurring audit costs for many, if not the majority of, medium-sized unlisted entities whose financial statements are audited by firms not in the FoF. However, the other potential benefits still apply, which suggests that overall, the benefits of ISA adoption are likely to exceed the costs for most such audit clients. 584

To extrapolate the benefits from the reduced cost of capital alone to the entire audit market of medium-sized unlisted audit clients serviced by firms not in the FoF (which is estimated at about 70,000 medium-sized unlisted entities), one can assume that such audit clients would be in the 25th percentile of the bounds of the balance sheet total threshold (i.e., on average firms not in the FoF would tend to audit the smaller entities within this range: this would lead to a conservative estimate of benefits), and therefore the capital of such entities would amount on average to € 7.6 million. This would lead to extrapolated benefits from the reduced cost of capital of between € 106 million and € 425 million, with a mid-point estimate of € 266 million. 585

Using the same analysis for large unlisted audit clients audited by firm not in the FoF under the assumption that these are no different in size or complexity than those audited by the mid-tier firms in the FoF, the recurring engagement level audit firm and audit client incremental cost increases (based upon the weighted average for all clients audited by mid-tier firms in the FoF would represent an average total recurring cost increase of € 3,600 per year (i.e. 1,400 as shown in Table 4 and 2,200 as shown in Appendix 6.2, Table 1), this implies that these audit clients with total capital (debt and equity) exceeding only € 4.5 million to € 18 million would benefit from such reduced costs of capital, depending upon how large the reduction ranges between 8 basis points and 2 basis points, respectively,: if the cost of capital were reduced by only 1 basis point (which would be a very conservative benefit estimate), break-even would be reached for audit client with total capital exceeding € 36 million. 586

Under the thresholds for statutory audits required by the EU Fourth and Seventh Directives, large unlisted entities are required to exceed two of the following thresholds two years in a row: net turnover of € 35 million, balance sheet total of € 17.5 million, and 250 employees. In the vast majority of cases, entities exceed the first two thresholds two years in a row rather than any combination of one of these and the third. This implies that total capital (debt and equity) of large unlisted entities in the EU is almost always greater than € 17.5 million, without any upper bound. On this basis, the benefits from the reduction in cost of capital alone will exceed the increased recurring audit costs for virtually all of large unlisted entities whose financial statements are audited by firms not in the FoF. However, the other potential benefits still apply, which suggests that overall, the benefits of ISA adoption will exceed the costs for all such audit clients. 587

To extrapolate the benefits from the reduced cost of capital alone to the entire audit market of large unlisted audit clients serviced by firms not in the FoF (which is estimated at about 21,000 large unlisted entities), a very conservative assumption would be that all of these entities are at the lower bound of the balance sheet total threshold, and therefore the capital of such entities would amount on average to € 17.5 million. This would lead to extrapolated benefits from the reduced cost of capital of between € 74 million and € 294 million, with a mid-point estimate of € 184 million. 588

Hence the total benefit for reduced cost of capital for medium-sized and large unlisted entities audited by firms not in the FoF would range between € 180 million and € 719 million, with a mid-point estimate of € 450 million. 589

On this basis the net benefit (that is benefits, minus costs calculated in Section 6.5.1 above) of ISA adoption for the entire audit market in the EU for medium and large unlisted audit clients audited by audit firms not in the FoF due to reduced costs of capital alone could range between at net cost of € 8 million (€ 192 million costs minus € 180 million benefits) and a net benefit of € 533 million (€ 719 million benefits minus € 186 million costs) with a mid-point estimate of a net benefit of about € 261 million. These estimates, of course, do not include the other benefits that are difficult to quantify, which may be substantial. 590

However, it should be recognised that for audits performed, by firms not in the FoF, in EU jurisdictions in which national auditing standards and firm quality control standards that are significantly different than the current ISAs and ISQC 1, respectively, both the benefits and costs arising from the redesign effect may be greater than those extrapolated from the survey results. Consequently, this issue requires further analysis as described below. 591

6.6 Synthesis of Survey and Study Results on the Basis for Firm Audit Practices and National Standards Setting in Europe

It was concluded in Section 4.2.2 on the assessment of current and future audit practices that, on the whole, the clarified ISAs will be incorporated into big four and mid-tier firm auditing practices that are members of the FoF, regardless of whether or not the EU adopts the clarified ISAs or whether or not these are adopted into 592 national auditing standards. Furthermore, it was also concluded that existing ISQC 1 is largely already incorporated into all big four firm quality control policies and procedures and that the clarified ISQC 1 will be incorporated into these quality control policies and procedures regardless of whether or not ISQC 1 is adopted by the EU. The fact that ISQC 1 is already incorporated into firm quality control policies and procedures is precisely the reason why the quantitative differentiation of audit costs and cost savings lead to the conclusion that the differences in costs and cost savings for audit firm and audit clients are immaterial. Only the audit regulators appear to perceive a significant effect resulting from the difference between the adoption and non-adoption of ISQC 1.

Consequently, the entire audit market covered by the big four firms and the mid-tier firms (60 % of the relevant audit market as suggested in this Study) will be using clarified ISAs and ISQC 1 when they become effective regardless of EU adoption. This means that, from an economic point of view, all of the redesign and most of the harmonisation costs and benefits identified in the previous synthesis for costs and benefits for audits performed by firms in the FoF are not relevant for decision making by the EU Commission and others. Only some of the harmonisation benefits, and the regulation costs and benefits, which reflect the differences between those jurisdictions that already have their auditing standards incorporated into law and those that do not, will continue to be relevant for EU decision-making. These costs and benefits are a small fraction of the total costs and benefits identified for audits performed by firms in the FoF. The firms in the FoF intend to adopt the clarified ISAs and ISQC 1 when these become effective pursuant to the effective dates in those standards as issued by the IAASB – that is, for audits of financial statements for periods beginning on or after December 31, 2009. If the EU Commission were to adopt the ISAs (with or without ISQC 1), due to the EU consultation process and due process involving the member states and the European Parliament, such adoption is not likely to take place before late 2010 at the earliest. For this reason, the previous synthesis and analysis needs to be split in two parts: those costs and benefits arising from the voluntary adoption of the clarified ISAs and ISQC 1 by the firms in the FoF, and those costs and benefits arising from the adoption of the clarified ISAs (with or without ISQC 1) thereafter through the EU Commission. 593

However, as noted in Section 4.3.1 on the assessment of future auditing standards in the jurisdictions of audit regulators, in about 56 % of jurisdictions in the EU, national auditing standards are very close to the existing ISAs. Furthermore, a clear majority of audit regulators or the standards setters in their jurisdictions will amend their national auditing standards to reflect all clarified ISAs, even if clarified ISAs are not adopted by the EU. This means that about 56 % of all jurisdictions will eventually be applying standards that are equivalent, or very close, to the clarified ISAs for all audits required by the Fourth and Seventh EU Directive regardless of whether or not the EU adopts them. For this reason, other than for issues of timing (i.e., if the EU were to adopt the clarified ISAs before national auditing standards setters that intend to do so have done so), in 56 % of EU jurisdictions, the decision by the EU Commission whether to adopt clarified ISAs is not relevant to the assessment of the costs and benefits of ISA adoption through the EU. This would have no impact on those audits performed by audit firms in the FoF, their audit clients, and their capital providers, but it would have a direct impact on those audits performed by audit firms not in the FoF, their audit clients, and their providers of capital, because 594 in the 56 % of jurisdictions that would be adopting the clarified ISAs anyways, the performance of audits by audit firms not in the FoF would be directly affected.

For these reasons, the Study analyses the effects of ISA adoption identified in the previous syntheses by examining the impact of the actions by three parties: 595

1. Adoption of clarified ISAs through the audit firms in the FoF,
2. Adoption of clarified ISAs by 56 % of jurisdictions in the EU already using the existing ISAs for all audits required by the Fourth and Seventh EU Directives and the concomitant impact on audits performed by firms not in the FoF in those jurisdictions and other effects, and
3. Adoption of ISAs by the EU with the impact on the 44 % of jurisdictions not using the existing ISAs and not intending to adopt the clarified ISAs on their own, with the concomitant effect on audits performed by firms not in the Forum of Firms in those jurisdictions, and other effects.

This breakdown (and in particular, the determination of the impact on the EU of the actions of the first two parties in relation to ISAs that would occur regardless of whether the EU adopts the ISAs) is necessary to enable the isolation of the cost and benefit effects of EU adoption.

6.7 Expected Costs and Benefits of Adoption of Clarified ISAs by Adopting Party

6.7.1 Expected Costs and Benefits of Adoption of Clarified ISAs by Audit Firms in the FoF

Pursuant to Section 6.3.3 above, the recurring costs resulting from ISA adoption in the EU for the audits performed by audit firms in the FoF are estimated at € 643 million. Because the transnational audits performed by the firms in the FoF would not be affected by ISA minuses in national standards (the firms would simply perform the procedures required by the ISAs as a “national standards plus” and then claim compliance with both ISAs and national standards), there would be no reduction in the harmonisation effect for audits of transnational audit clients. The fact that the EU has not adopted the ISAs would require the following adjustments for costs that would not be incurred at this stage: 596

1. The recurring costs incurred by audit firms due to regulation effect € 71 million
2. The recurring costs incurred by audit clients due to regulation effect € 66 million

Therefore, the recurring costs arising from adoption of clarified ISAs through the FoF would be € 506 million. 597

The benefits would also require adjustment for the regulation effect: the reduction in the cost of capital resulting from the regulation effect would need to be removed. 598

Based upon Section 6.4 above, the benefits resulting from the reduction in cost of capital from the regulation effect would range between 1 to 4 basis points, whereas the total reduction calculated ranged between 7 and 18 basis points, then the total benefit calculated without the benefits of the regulation effect would range between 6 and 14 basis points on a total capital for listed enterprises in the EU of € 7.6 trillion. 599

If the Study were to apply the conservative 6 to 14 basis point decrease of cost of capital estimated above, the benefits resulting from the reduction in cost of capital for listed entities alone vs. the costs for all of the audit clients audited by the firms in the FoF would exceed the costs by a factor ranging between 9 to 1 (€ 7.6 trillion times 6 basis points divided by costs of € 506 million) and 21 to 1 (€ 7.6 trillion times 14 basis points divided by costs of € 506 million), with a mid-point estimate of 15 to 1 (that is, total benefit: € 7.6 trillion times the mid-point of ten basis points = € 7.6 billion, of which € 1.9 billion arise from the redesign effect and € 5,7 billion arise from the harmonization effect). Clearly, the benefits of the FoF adopting ISAs outweigh the costs for their audit clients. 600

6.7.2 Expected Costs and Benefits of Adoption of Clarified ISAs by Jurisdictions in the EU Adopting Clarified ISAs Regardless of EU Adoption

This stage involves the determination of the costs and benefits of the adoption of clarified ISAs by 56 % of jurisdictions in the EU already using the existing ISAs for all audits required by the Fourth and Seventh EU Directives and the concomitant impact on audits performed by firms not in the FoF in those jurisdictions. Based upon the extrapolation of the number of audits in each jurisdiction in the EU, the Study estimates that these jurisdictions represent approximately 45 % of the audits of medium-sized unlisted entities and large unlisted entities in Europe audited by audit firms not in the FoF. 601

Using the same procedure and results as in Section 6.5.2 above, the total estimated recurring costs incurred by audit firms and audit clients extrapolated to the entire audit market in the EU serviced by the firms not in the FoF for jurisdictions in the EU that will adopt the clarified ISAs would be about € 76 million (these costs are calculated from the figures in Section 6.5.1 above, by applying 45 %, and deducting the costs per audit resulting from the regulation effect in Table 1 of Appendix 7 multiplied by the number of audits – 41,000 – covered by firms not in the FoF in the jurisdictions that will adopt the ISAs: € 180 million times 0.45 minus 41,000 times € 123). The estimated one-off costs would be about € 65 million (these are 45 % of the one-off costs of € 144 million in Table 1 of Appendix 7). Hence, applying the procedure used in Section 6.3.3 above, the reasonable range of recurring opportunity costs at between 4 % to 8 % would lie between € 3 million to € 5million per year with a plausible mid-point estimate of about € 4 million. 602

By adding the recurring opportunity costs of the one-off costs to the recurring costs, this suggests that for the portion of the relevant audit market serviced by audit firms not in the FoF for jurisdictions in the EU that will adopt the clarified ISAs, the recurring benefits would need to exceed between € 79 million and € 91 million per 603 year, with a midpoint estimate of about € 80 million per year. This means that the benefits of ISA adoption to audit firm not in the FoF, their audit clients, and capital providers to these audit clients, in jurisdictions in the EU that will adopt the clarified ISAs regardless of EU adoption, must exceed these costs.

Using the procedures in Section 6.5.2 above and assuming that the jurisdictions in question adopt the ISAs as their national standards would not do so directly by means of a binding legal instrument similar to an EU regulation, by applying 45 % to the share of the market, and deducting the benefits from the regulation effect due to reduced cost of capital, it is possible to extrapolate the benefits arising from the audit redesign effect alone (since the regulation effect through ISA adoption by means of EU adoption does not apply). Consequently, the benefit resulting from reduced cost of capital would range between 1 basis point to 4 basis points. On this basis the total range of benefits resulting from reduced cost of capital would be calculated as follows: 604

For medium-sized unlisted entities:

Lower bound	€ 7.6 million x 70,000 x 45 % x 1 basis point	= € 24 million
Upper bound	€ 7.6 million x 70,000 x 45 % x 4 basis points	= € 96 million
Mid-point	€ 7.6 million x 70,000 x 45 % x 2.5 basis points	= € 60 million

For large unlisted entities:

Lower bound	€ 17.5 million x 21,000 x 45 % x 1 basis point	= € 17 million
Upper bound	€ 17.5 million x 21,000 x 45 % x 4 basis points	= € 66 million
Mid-point	€ 17.5 million x 21,000 x 45 % x 2.5 basis points	= € 41 million

The total benefits resulting from the reduction in cost of capital from the adoption of clarified ISAs through member states currently applying existing ISAs for medium-sized and large unlisted audit clients audited by audit firms not in the FoF is estimated to range between € 41 million and € 162 million with a mid-point estimate of € 101 million. Consequently, the net benefit would range between a net cost of € 50 million (€ 91 million costs minus € 41 million benefits) and a net benefit of € 83 million (€ 162 million benefits minus € 79 million costs) with a mid-point estimate of a net benefit of about € 21 million. It should be remembered that this does not include a quantification of all of the other recurring benefits resulting from ISA adoption in these jurisdictions. 605

Consequently, although the case for individual member states currently using existing ISAs to adopt clarified ISAs for all entities requiring audits under the EU Fourth and Seventh Directive is not as necessarily clear cut as for adoption by the firms in the FoF (unless such standards are adopted by means of legislation to benefit from the regulation effect) it appears likely that the benefits would exceed the costs for the majority of enterprises audited by firms not in the FoF. 606

6.7.3 Expected Costs and Benefits of Adoption of Clarified ISAs by the EU

This stage involves the determination of the costs and benefits of the adoption of clarified ISAs by the EU Commission and, in particular, its immediate effects on: 607

1. the audits performed by the firms in the FoF;
2. the audits performed by firms not in the FoF in the 56 % of jurisdictions currently using existing ISAs and intending to adopt clarified ISAs
3. the 44 % of jurisdictions not using the existing ISAs and not intending to adopt the clarified ISAs on their own, with the concomitant effect on audits performed by firms not in the FoF in those jurisdictions

Furthermore, there are long-term effects that cannot be quantified that need to be considered.

6.7.3.1 Effects on Audits Performed By Firms in the FoF

The adoption of ISAs by the EU Commission will not have any impact on audit quality or on the harmonisation of audit practices of the audit firms in the FoF: the costs and benefits of these have already been addressed in Section 6.7.1 above. However, there are costs and benefits arising from the regulation effect for those jurisdictions in which auditing standards are not directly enshrined in law or statute if the EU Commission were to adopt the ISAs by means of an EU regulation (as is the desired assumption in this Study as requested by the Commission and was surveyed from the respondents – see Section 1.3.3). The average effects on recurring costs from the regulation effect for audits performed by firms in the FoF as noted in Section 6.7.1 would be: 608

1.	The recurring costs incurred by audit firms due to regulation effect	€ 71 million
2.	The recurring costs incurred by audit clients due to regulation effect	€ 66 million
	Total	€ 137 million

Pursuant to Section 6.7.1, the average benefits resulting from the reduction in the cost of capital due to the regulation effect would range between 1 to 4 basis points. On a total capital for listed enterprises alone in the EU of € 7.6 trillion, the benefit from the regulation effect would therefore range between € 760 million and € 3 billion, with a mid-point of about € 1.9 billion. 609

Consequently, the net recurring benefit from reduced cost of capital alone for audits performed by firms in the FoF would range between € 623 million and € 2.8 billion, with a mid-point estimated at € 1.8 billion. Since the benefit is calculated only for listed enterprises audited by firms in the FoF and the medium-sized unlisted and large unlisted audit clients audited by these firms also have considerable capital, the benefits far exceed these numbers, even without considering any other recurring benefits of EU adoption. 610

6.7.3.2 Effects on Audits, in Jurisdictions Currently Using Existing ISAs and Intending to Adopt Clarified ISAs, not Performed By Firms in the FoF

Since the harmonisation effect in the short run primarily has an impact on transnational audit clients, it would be unlikely that there would be short-term harmonisation costs or benefits for most medium-sized unlisted and large unlisted audit clients whose financial statements are audited by audit firms not in the FoF. Since these audit clients in jurisdictions using the existing ISAs and intending to adopt the clarified ISAs would already be audited using the existing ISAs by audit firms not in the FoF, there would be only a very slight increase in audit quality through the use of clarified ISAs, which has been taken into account in Section 6.7.2. 611

However, using the methodology in Section 6.7.2 and the results of the survey, there would be recurring regulation effects through the adoption of the ISAs in the EU by means of an EU Regulation as noted in the previous Section. These recurring regulation effects include both costs and benefits and can be calculated as follows: 612

Costs: 41,000 audits x € 123/audit = € 5 million 613

Benefits: For medium-sized unlisted entities: 614

Lower bound	€ 7.6 million x 70,000 x 45 % x 1 basis point	= € 24 million
Upper bound	€ 7.6 million x 70,000 x 45 % x 4 basis points	= € 96 million
Mid-point	€ 7.6 million x 70,000 x 45 % x 2.5 basis points	= € 60 million

For large unlisted entities:

Lower bound	€ 17.5 million x 21,000 x 45 % x 1 basis point	= € 17 million
Upper bound	€ 17.5 million x 21,000 x 45 % x 4 basis points	= € 66 million
Mid-point	€ 17.5 million x 21,000 x 45 % x 2.5 basis points	= € 41 million

Hence, the total benefits resulting from the reduction in cost of capital from the adoption of clarified ISAs through the EU for audits of medium-sized and large unlisted audit clients audited by audit firms not in the FoF in member states currently applying existing ISAs is estimated to range between € 41 million and € 162 million with a mid-point estimate of € 101 million. Consequently, the net benefit would range between € 36 million and € 157 million with a mid-point of about € 96 million. 615

6.7.3.3 Effects on Audits, in Jurisdictions Not Using Existing ISAs and not Intending to Adopt Clarified ISAs, not Performed By Firms in the FoF

The jurisdictions not using existing ISAs and not intending to adopt the clarified ISAs have very heterogeneous standard setting. Some jurisdictions such as Germany, have standards that are almost completely in compliance with the existing ISAs but for a handful of add-ons and carve-outs due to national law. Some such as France, have standards very close to most of the existing ISAs, but do not have a corresponding standard for 616 every ISA. Italy recommends the use of the existing ISAs for audits of non-public interest entities, but these are not mandatory. Poland has principles based standards not in line with the ISAs. It is therefore very difficult to determine what the effects in all of these jurisdictions on audits performed by firms not in the FoF would be when ISAs are adopted in the EU. A useful simplifying assumption is that these jurisdictions are on a continuum of compliance with existing ISAs so that on average, the redesign effect would be slight (as opposed to very slight – both in terms of costs and benefits. Of course, in some countries the effect would be significant, in others slight, in some very slight, etc. However, an overall slight redesign effect appears to be a reasonable assumption for the purposes of this Study.

As noted in 6.7.3.2, for these kinds of audit clients, there would be no immediate harmonisation effect. Consequently, the primary costs and benefits other than in relation to audit quality would arise from the regulation effect. Essentially the same procedures will be applied as in Sections 6.4 and 6.7.3.2 to calculate the benefits and costs of the redesign effect and the regulation effect, respectively. 617

Pursuant to Section 6.7.2, the audits performed by audit firms not in the FoF in jurisdictions not using existing ISAs and not intending to adopt clarified ISAs represent about 55 % of all audits performed by firms not in the FoF in the EU. Hence, the total recurring costs for these audits incurred by audit firms and audit clients would be 55 % of the costs calculated in Section 6.5.1 above. Consequently, the recurring costs (including the recurring opportunity costs of the one-off costs) would range between 55 % of € 186 million and € 192 million per year with a mid-point estimate of 55 % of € 189 million – that is, between € 102 million and € 106 million with a mid-point estimate of € 104 million. 618

Pursuant to Section 6.5.2, the slight reduction in cost of capital from the regulation effect would be between 1 to 4 basis points, as would a slight reduction in the cost of capital due to better audit quality through the redesign effect. This implies a total benefit of reduced cost of capital for these audit clients of between 2 to 8 basis points. 619

The benefits are calculated as follows: 620

For medium-sized unlisted entities:

Lower bound	€ 7.6 million x 70,000 x 55 % x 2 basis point	= € 58 million
Upper bound	€ 7.6 million x 70,000 x 55 % x 8 basis points	= € 234 million
Mid-point	€ 7.6 million x 70,000 x 55 % x 5 basis points	= € 146 million

For large unlisted entities:

Lower bound	€ 17.5 million x 21,000 x 55 % x 2 basis point	= € 40 million
Upper bound	€ 17.5 million x 21,000 x 55 % x 8 basis points	= € 162 million
Mid-point	€ 17.5 million x 21,000 x 55 % x 5 basis points	= € 101 million

On this basis the total recurring benefits from a reduced cost of capital range from € 98 million to € 396 million with a mid-point estimate of € 247 million. 621

Consequently, the immediate net recurring benefits of adoption of ISAs in the EU from a reduction in the cost of capital alone range between a net cost of € 8 million (€ 106 million costs minus € 98 million benefits) to a net benefit of € 294 million (€ 396 million benefits minus € 102 million costs) and a mid-point net benefit € 143 million. 622

6.7.3.4 Total Recurring Net Benefits from ISA adoption by the EU

From an economic point of view an adoption of the ISAs by the EU can be treated as an investment – that is, the total recurring net benefits can be regarded as a return on the adoption of ISAs by the EU. Such recurring benefit effects cannot be substituted by any action taken by other parties, including audit firms. 623

The total recurring net benefits from the adoption of the clarified ISAs by the EU Commission for the EU economy as a whole through lower costs of capital alone would range between € 651 million (€ 623 million benefits plus € 36 million benefits plus a cost of € 8 million) and € 3,200 million (€ 2,800 million plus € 157 million plus € 294 million), with a mid-point estimate of about € 2,000 million. It should be noted that these are very conservative estimates: the actual benefits from lower costs of capital may be much higher. There are many short term qualitative benefits of a recurring nature not quantifiable that would result from ISA adoption. 624

Furthermore, the adoption of ISAs through the EU is a necessary condition for securing, in the long run, the recurring benefits of € 7,600 million per year (noted in Section 6.7.1.) resulting from the adoption of ISAs through the firms in the FoF. In particular, EU adoption would secure the decisive portion of the benefits from the harmonisation effect of €5,700 million per year. The adoption of ISAs through the EU by means of an EU regulation would secure these benefits by limiting the following: 625

a) national regulators or auditing standards setters subsequently carving out, in their auditing standards, particular provisions in the ISAs and thereby forcing firms in the FoF not to apply the carved out ISA requirements (it would be much easier to carve-out ISA requirements without an EU requirement that limits the ability of member states to introduce such carve outs)
b) national regulators or auditing standards setters subsequently introducing additional requirements (add-ons) in their auditing standards that affect the ISA audit opinion on the financial statements over above what is required in the ISAs and thereby forcing firms in the FoF to apply these additional requirements (it would be much easier to add on requirements without an EU requirement that limits the ability of member states to introduce such add-ons);
c) conditions similar to (a) and (b) above taking effect due to an EU adoption using a less binding instrument than an EU regulation for other than the application material, which would allow member states to subsequently (i) not transpose the ISAs at the same time or not transpose them or (ii) transpose the ISAs in different ways through the use of different wording than that which would be used in a translation of an EU regulation; and
d) audit regulators in different EU member states interpreting the ISAs adopted nationally differently and therefore causing differences in application across the EU due to the lack of an EU adop-

tion (EU adoption means that audit regulators will need to cooperate on interpreting the ISAs for transnational audits, and hence harmonise interpretation for all statutory audits).

e) audit firms ceasing using the entire ISAs due to their subsequently leaving the FoF (if the EU were not to adopt the ISAs, some firms in the FoF could decide to leave the FoF and would no longer be required to apply the ISAs unless bound be an EU requirement to do so);

Hence, even though the adoption of ISAs through the firms in the FoF is expected to result in significant net benefits for their audit clients, as well as for audit firms and auditors the perform transnational audits, the long-run sustainability of much of these benefits would depend upon adoption through the EU by means of legal instrument at least as binding as an EU regulation. 626

In the long run, using the same auditing standards in the EU would improve the efficiency of the internal market such that medium-sized unlisted and large unlisted audit clients and their capital providers also benefit from the harmonisation effect. In this respect, the EU would be helping to facilitate the operation of the internal market for capital and business opportunities with lower capital market transaction costs for these kinds of entities in the long run. 627

A summary presentation of the quantitative conclusions on the effects of the adoption of clarified ISAs by all parties based upon the synthesis in Sections 6.1 to 6.5.2 is provided in the following Table 5. 628

Auditor	Client Group	Total Capital	Cost of Capital Reduction (Mid-point estimate)	Sum of Recurring Costs	Total Opportunity Costs	Total Recurring Costs	Recurring Net Benefit
FoF	all client groups	€ 7.6 trillion*	€ 9,500 million	€ 599 million	€ 44 million	€ 643 million	€ 8,857 million
Non FoF	large unlisted entities	€ 532 billion	€ 184 million	€ 180 million	€ 9 million	€ 189 million	€ 261 million
	medium sized unlisted entities	€ 350 billion	€ 266 million				
* this is the total capital (debt and equity) for listed entities alone							

Table 5: Quantitative Conclusions on Overall Costs and Benefits of ISA Adoption by All Parties

Table 6 below shows how how EU adoption directly affects audit clients based upon the analysis in Section 6.7.3 It demonstrates that the benefit-cost ratio of EU adoption for 629
participants in the audit market covered by audit firms not in the FoF in jurisdictions that currently apply ISAs is likely to exceed that for those participants in the audit market covered by firms in the FoF. For firms not in the FoF, the quantification of the costs relates primarily to those costs incurred by audit firms and audit clients resulting from the implementation of the clarified ISAs (redesign and regulation effect), whereas the quantification of the benefits arises from the reduction in cost of capital for audit clients from the regulation effect. The actual costs and benefits of ISA adoption through the EU in this case in each member state would vary very much dependent upon the extent to which the national auditing standards in a particular EU member state comply with the ISAs currently effective.

Affected Participants	Short and Medium-Term Recurring Effects	Recurring Costs	Recurring Benefits	Recurring Net Benefits	Benefit-Cost Ratio
Participants in audit market covered by firms in FOF	regulation effect	137	1,900	1,763	14:1
Participants in audit market covered by firms not in FOF in jurisdictions with ISA compliant auditing standards	regulation effect; no harmonisation effect, since audits are assumed not to be transnational	5	101	96	20:1
Participants in audit market covered by firms not in FOF in jurisdictions without ISA-compliant auditing standards	regulation effect, redesign effect; no harmonisation effect, since audits are assumed not to be transnational	104	247	143	2.4:1
Total		**246**	**2,248**	**2,002**	**9:1**

Table 6: The Costs and Benefits of Adoption of ISAs through the EU (in million €)

7 Overall Conclusions of the Study

As noted in the purpose of the Study at the beginning of this Study, the main purpose of the Study is to determine whether the adoption of ISAs contributes to a high level of credibility and quality of financial statements in the EU for those companies that are required by the Fourth and Seventh EU Directives to have their financial statements audited. Concomitant objectives noted are to describe, analyse and – if possible – quantify the effects of the adoption of ISAs by the EU with special consideration given to understandability and enforcement of auditing standards and audit quality. Furthermore, under the invitation to tender, the Study should analyse the benefits of ISA adoption for EU stakeholders and assess the incremental direct and indirect costs of adoption by company (e.g., listed companies, banks, medium-sized companies, etc.), source (changes to audit firm methodologies, etc.) and timing (i.e., one-off vs. recurring). 630

The synthesis of the benefits of adoption of ISAs shows that, on balance the ISAs are viewed as contributing to the credibility and quality of financial statements and to audit quality. Audit regulators, as a whole, have concluded that ISAs would not impair enforceability. Some one-off costs will be incurred in transition by auditors whose mother tongue is not English to understand translations of the standards or the original English, but the survey results show that this is not a serious problem in the long run and that the ISAs are understandable. The one-off costs of adoption are much less significant than the recurring ones, which have greater permanent impact on the economy of the EU. 631

However, in drawing on this information, the EU needs to be aware of the fact that from an economic point of view, all of the big four firms and all of the mid-tier firms in Europe that are members in the FoF have already made their decision on this matter on a commercial basis without adoption through any legal instruments, which implies that for them, the benefits of ISA adoption must be worth the costs because the ISAs provide significant net benefits to them and their clients and relevant capital market participants. Furthermore, a majority of auditing standards setters in Europe have either adopted the ISAs or issued standards that are close to the ISAs and are prepared to further adopt or transpose the ISAs even if no adoption takes place through the EU. Consequently, a significant portion of firms not in the FoF will also need to adjust their audit practices to make them close to the ISAs without ISA adoption through the EU. 632

However, there are significant net benefits to be obtained from ISA adoption through the EU beyond any adoption through the FoF or national jurisdictions. These net benefits appear to apply generally to most audit firms that perform statutory audits required by the Fourth and Seventh EU Directives and their audit clients of all categories, as well as to their capital providers. 633

In conclusion, it is apparent that the benefits of the adoption of ISAs are worth the costs for big four and mid-tier firms that are members of the FoF, for their audit clients, for European audit professionals working or seeking to work on transnational audits, and for other relevant capital market participants. It is likely that the benefits of ISA adoption are worth the costs for audit firms not in the FoF (primarily SMP's) and their audit clients 634 for audits required by the EU. However, the lack of data obtained directly from these firms and the consequent extrapolation of the costs and benefits for audits performed by firms not in the FoF signifies that further consultation on this matter may be useful. ISA adoption would also bind audit oversight authorities within the European Union and would form a foundation for improving cooperation amongst them. This regulation effect would be enhanced through the adoption of ISQC 1, which would also form the basis for the harmonisation of the methodology for inspections or external quality reviews of audit firms.

Whether the benefits are worth the costs for the many audits not required by the EU, but that are required by 635
EU member states, is not an issue within the scope of the Study, but remains an issue that may need to be addressed by the EU member states that require such audits.

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