

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

# **Executive Summary**

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# 1 Objectives 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). 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. In line with Article 26, ISAs should be adopted only if, among other conditions, they contribute to a high level of credibility and quality to audited financial statements. The Study evaluates whether the adoption of the ISAs by the European Union (EU) would achieve this condition and analyses the related costs and benefits of such an adoption. This analysis covers the costs and benefits arising at the audit engagement, audit firm and audit client levels, as well as those arising for audit regulators, audit markets, and capital markets.

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## 2 Methodology of the Study

### 2.1 Scope

The Study covers all statutory audits of financial statements required by the Fourth and Seventh EU Directives, which the Study estimates to be 224,000 audits in the EU. Some EU member states require statutory audits that are not required by these Directives, and in particular, for small limited companies<sup>1</sup>. These audits, which are estimated to be an additional 1.4 million audits, are not covered in this Study. Voluntary audits are also not covered.

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In assessing the costs and benefits of ISA adoption, the Study covers all of the ISAs issued by the IAASB in December 2008 (the so-called “clarified ISAs”) that are relevant to statutory audits required by the EU. The effect of an adoption of International Standard on Quality Control 1 (ISQC 1)<sup>2</sup> on the costs and benefits of ISA adoption is also considered.

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### 2.2 Design

The Study used a thorough literature search to synthesise a conceptual framework for conducting empirical research on potential cost and benefit effects of ISA adoption. The empirical research involved conducting a survey of stakeholders affected by ISA adoption (audit firms, audit clients, audit regulators, other capital market participants) and was supplemented by consultations with experts. The survey was designed to distinguish results between audits of financial statements of different client groups (medium-sized unlisted entities, large unlisted entities, publicly listed entities, banks, and insurance companies). The analysis of survey responses was

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<sup>1</sup> 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.

<sup>2</sup> ISQC 1 deals with an audit firm’s responsibilities for its system of quality control for audits of financial statements, as well as for other engagements.

used to estimate the economic impact of ISA adoption for the EU as a whole in both quantitative and qualitative terms.

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Many cost and benefit effects are qualitative assessments that cannot be quantified in monetary terms and can only be assessed by ranking those effects. In addition, since survey respondents have not had any direct experience in applying the clarified ISAs when responding to the survey, their responses are based upon expectations using their previous experience with auditing standards. Furthermore, because it is not possible to survey all EU member states and every audit firm or other stakeholder therein, a sample of audit firms within a selection of representative EU member states was drawn. Forty-four responses were received to the survey questionnaires, of which 32 were from audit firms in the Forum of Firms<sup>3</sup> (which provided considerable quantitative and qualitative data relating to a representative selection of nine member states), and an equal number of the remainder each from audit regulators and other capital market participants. For these reasons, 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.

The share of the audit market for statutory audits required by the EU covered by the firms in the Forum of Firms (FoF) is estimated at 60 % (estimated to comprise two-thirds of the large unlisted audit clients and half of the medium-sized unlisted clients). Since an inadequate number of responses was received to the survey from audit firms not in the FoF, 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.

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The responses to the survey are based upon the assumption that the introduction, objectives, definitions and requirements in the ISAs would be adopted by means of an EU regulation.

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### **3 Conclusions**

#### **3.1 Types of Cost and Benefit Effects**

The Study applies a novel approach to cost and benefit analyses by dividing cost and benefit effects into three separate kinds:

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1. Audit redesign effect (the cost and benefit effects of changing from current audit practices to clarified ISAs);

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<sup>3</sup> 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 IFAC to incorporate the ISAs into their firm audit methodologies and ISQC 1 into their firm quality control policies and procedures.

2. Audit harmonisation effect (the cost and benefit effects of using the same auditing standards in the same way throughout the EU);
3. Audit regulation effect (the cost and benefit effects of introducing auditing standards supported by direct legal sanction by means of EU adoption through a legal instrument).

Although these three effects were separated to provide a basis for their analysis, they do interact. For example, the benefits of the harmonisation effect may be impaired if: 1. individual EU members states choose to implement differing auditing standards, or 2. auditing standards at European level are not clear enough about what is required and what is guidance to facilitate consistent application among different audit firms and jurisdictions. 9

In the first case above, the audit regulation effect resulting from the adoption of the ISAs by the EU by means of a 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 degree of compliance with the ISAs. 10

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), 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. 11

### 3.2 Combined Assessment of Costs Resulting From ISA Adoption

The responses to the survey (by firms in the FoF, capital market participants and audit regulators) and the extrapolation of results for the audit market covered by firms not in the FoF resulted in an assessment of the costs resulting 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. 12

The recurring costs affecting the audit market covered by the firms in the FoF are much more important than the one-off costs, which, although two and a half times as great as the recurring costs, have significantly less economic impact due to their being one-off. The survey shows that the recurring costs at audit firm, international audit firm (for firms in the FoF), and audit regulator level are less significant compared to the recurring costs that would be incurred at engagement level by audit firms and audit clients (engagement level cost increases represent about 85 % of all of the recurring cost increases). 13

The table below shows the expected recurring and one-off cost increases per audit at engagement level (that is, it does not include costs incurred at audit firm, international audit firm, or audit regulators level) that would be incurred by audit firms in the FoF and their audit clients. Overall across the EU, the big four firms appear to 14

expect an average 6 % increase in recurring costs, whereas the mid-tier firms expect an average increase of 10 % in recurring costs. Actual cost increases for particular clients in particular jurisdictions may vary considerably depending upon the individual audit firm, audit engagement (and in particular, by audit client type) and member state. Most of these cost increases result from the redesign effect and are attributable primarily to those ISAs that have been revised.<sup>4</sup> It is not possible to determine from the information obtained in the survey whether and to what extent audit firms or audit clients would bear the increased costs incurred by audit firms resulting from the adoption of ISAs through the audit firms.

in Euro	Medium-sized Entities	Large Unlisted Entities	Publicly Listed Entities	Banks	Insurance Companies	Weighted Average	Ratio
<b>Recurring cost increases at engagement level</b>							
Big Four	2,600	3,600	4,600	5,800	5,800	3,300	6%
Mid Tier	900	1,400				1,200	10%
Clients						2,200	
<b>One-off cost increases at engagement level</b>							
Big Four	4,100	6,900	13,600	20,500	20,500	7,700	14%
Mid Tier	1,400					1,600	13%
Clients						-500	

Table 1: Recurring and One-off Cost Increases at Engagement Level for Audit Firms in the FoF and Their Audit Clients

It should be noted that the results of the survey show that some four-fifths of the cost increases in the table above 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.

Based upon the extrapolation of costs for the audit market covered by the firms in the FoF (those audit firms that are required under their membership obligations to incorporate the ISAs in their audit methodologies) to the audit firms not in the FoF, for the EU as a whole there may be a recurring cost increase incurred by audit firms not in the FoF per audit at engagement level of about € 700 (which is estimated to represent a 10 % recurring cost increase for the audit firms) and recurring client cost increase of some € 1,300. Actual cost increases for particular clients in particular jurisdictions may vary considerably from these figures. In particular, the magnitude of the average cost increases depends considerably upon the extent to which national auditing standards are compliant with the ISAs that are currently effective.

### 3.3 Determination of Impact of EU Intervention

To determine the impact of EU intervention through EU adoption of the ISAs, it is necessary to first determine the impact on the EU of the actions of other parties in relation to the ISAs that would occur regardless of whether the EU adopts the ISAs. The audit firms that are members of the FoF are required under their membership obligations to incorporate the ISAs in their audit methodologies. In their survey responses, the responding audit firms (all of whom are members of audit firm networks or other forms of cooperation that are

<sup>4</sup> ISA 600 group audits, ISA 540 accounting estimates, ISA 260 communication with those charged with governance, ISA 265 reporting deficiencies in internal control to those charged with governance, ISA 550 auditing related parties, and ISA 620 the use of non-accounting and non-auditing experts by auditors.

members of the FoF) confirmed their intention to adopt the ISAs for audits of financial statements for periods beginning on or after 15 December 2009 regardless of whether the EU or their national jurisdiction within the EU adopts the ISAs. Furthermore, about half of audit regulators responding to the survey stated that they would be amending their national auditing standards to reflect all clarified ISAs. This is roughly consistent with the result in Section 3.1. above, that about 56 % of auditing standards in the EU reflect adopted ISAs. Consequently, for the firms in the FoF and for all audit firms in jurisdictions adopting the clarified ISAs, the impact of the adoption of ISAs through the EU would be different than for those firms not in the FoF in jurisdictions in the EU that will not adopt clarified ISAs.

For these reasons, the analysis of costs and benefits of ISA adoption distinguishes the cost and benefit effects of ISA adoption by the actions of three parties: 18

1. adoption of ISAs by audit firms in the FoF;
2. adoption of ISAs by EU member states and the cost and benefit effects for audit firms not in the FoF in these jurisdictions;
3. adoption of ISAs through the EU and the cost and benefit effects for those firms in 1. and 2. above, and those firms not in the FoF in EU members states not adopting the ISAs.

This breakdown is necessary to enable the isolation of the cost and benefit effects of adoption through the EU as shown in Table 2 in Section 3.6. 19

In the estimation of costs and benefits, the calculation of benefits was performed on the basis of very conservative assumptions. Consequently, the net benefits are likely to be higher than estimated. 20

### **3.4 Expected Impact of ISA Adoption Through Firms in the Forum of Firms**

The results of the survey show that ISA adoption through the firms in the FoF will lead to a slight increase in audit quality, which would lead to a very slight decrease in the cost of capital for audit clients. Audit clients will incur some recurring costs arising from the redesign effect. Improvements in transnational audits resulting from such an adoption would lead to slightly reduced costs of capital and slightly better business opportunities for transnational audit clients. These benefits are recurring; furthermore, a decrease in a few basis points in the cost of capital for a transnational audit client translates into benefits that are considerable in relation to the increased costs. 21

It is therefore expected that the recurring costs incurred by the audit firms in the FoF by adopting the ISAs will amount to about € 500 million per year. On the other hand, the benefits from the expected reduction in the cost of capital *alone* for audit clients is expected to amount to about € 7,600 million per year, which yields a net expected recurring benefit of about € 7,100 million per year. The adoption of ISAs through the firms in the FoF 22

is expected to result in significant benefits for their audit clients, as well as for audit firms and auditors that perform transnational audits.

### 3.5 Expected Impact of ISA Adoption Through Jurisdictions in the EU Adopting ISAs

On the assumption that the 56 % of those jurisdictions that adopt ISAs as their national auditing standards would not do so directly by means of a binding legal instrument similar to an EU regulation, and by extrapolating the results from the survey to firms not in the FoF, it appears likely that the recurring benefits of adopting the clarified ISAs by these jurisdictions (regardless of EU adoption) would exceed the recurring costs. The recurring benefits are estimated at about € 100 million, whereas the recurring costs are estimated at about € 80 million, which results in an estimated recurring net benefit of about € 20 million. The quantification of benefits relates to the reduction in cost of capital for audit clients, whereas the costs relate primarily to those costs incurred by audit firms and audit clients resulting from the implementation of the clarified ISAs.

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### 3.6 Expected Impact of ISA Adoption Through the European Union

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.

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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
<b>Total</b>		<b>246</b>	<b>2,248</b>	<b>2,002</b>	<b>9:1</b>

Table 2: The Recurring Costs and Benefits of Adoption of the ISAs Through the EU (in million €)

The net benefits for firms in the FoF and their audit clients resulting from the adoption of the ISAs through the EU through an EU regulation are estimated to be considerable (see Table 2 above). The total recurring net benefits from the adoption of the clarified ISAs by the EU for the EU economy as a whole through lower costs of capital alone are estimated to likely exceed € 2,000 million.

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Furthermore, the adoption of ISAs through the EU is a necessary condition for securing, in the long run, much of the recurring benefits of € 7,600 million per year (noted in Section 3.4) 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

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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:

- a) national regulators or auditing standard 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 standard 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;
- 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 adoption (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); and
- e) audit firms ceasing to use 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 by 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 that perform transnational audits, the long-run sustainability of much of these net benefits would depend upon adoption through the EU by means of a legal instrument at least as binding as an EU regulation.

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The net benefits for firms not in the FoF and their clients in both jurisdictions that adopt and do not adopt the ISAs are likely to exceed the costs of such an adoption (the expected benefits are shown in Table 2 above). For those firms and their audit clients in jurisdictions that adopt the ISAs, the quantification of benefits relates to the reduction in cost of capital for audit clients from the regulation effect (through a perception of increased audit quality among audit report users, which leads to increased audit and financial reporting credibility). The quantification of the costs for audit firms also arises from the regulation effect (primarily through auditors performing procedures to meet legal requirements even though such procedures may not be necessary from an audit quality perspective).

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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. 29

Table 2 demonstrates that the benefit-cost ratio of EU adoption for 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 the those participants in the audit market covered by firms in the FoF. 30

ISA adoption under Article 26 of the EU Statutory Audit Directive 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. 31

There are many short term qualitative benefits of a recurring nature not quantifiable that would result from ISA adoption. These, together with a narrative description of the identified quantified effects, are depicted in Table 3 below. Furthermore, in the long run, using a harmonised set of auditing standards in the EU would improve the efficiency of the internal market so that medium-sized unlisted and large unlisted audit clients and their capital providers would 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. 32

### **3.7 Overall Conclusions of the Study**

On balance, an adoption of the clarified ISAs through the EU would contribute to the credibility and quality of financial statements and to audit quality in the EU, and to a greater acceptance of audit reports outside of their home jurisdictions within and outside of the EU. There are significant net benefits expected from ISA adoption through the EU beyond any adoption through the FoF or EU member states. 33

<b>Potential Short and Medium-Term Costs and Benefits of ISA Adoption</b> (items in italics were quantified)	
<b>Costs</b>	<b>Benefits</b>
<b>Redesign Effect</b>	
<i>Significant recurring and one-off cost increases; these may be greater in relative terms for audits performed by firms not in the FoF in jurisdictions in the EU not using existing ISAs</i>	Slight increase in audit quality, including understandability for audits performed by firms in the FoF; greater increase in audit quality for firms not in the FoF in jurisdictions not using existing ISAs
Slight increase in audit concentration at the lower end of the audit market due to slight increase in audit firms joining networks or other cooperative arrangements	Very slight increase in financial reporting quality
	Very slight reduction in capital market transaction costs for audit clients
	<i>Very slight reduction in costs of capital for audit clients</i>
<b>Harmonisation Effect</b>	
Slight recurring and significant one-off cost increases and very slight decrease in audit quality due to ISAs not covering national particularities and understandability issues involving translations	Significant one-off returns for existing investors in the EU, but slight decrease in recurring returns for EU investors
	<i>Slight decrease in cost of capital for audit clients</i>
	Slight increase in earnings for financial intermediaries
	Slight improvement in quality of transnational audits
	Significant benefits for audit firms that perform transnational audits
	Slight improvement in transnational audit client access to capital and business opportunities
	Basis for harmonisation of audit oversight, including inspections and reviews, and collaboration among audit oversight authorities (effect enhanced by adoption of each of ISQC 1 and application material)
	Slight benefits for operation of market for transnational audits for firms not in the FoF
	Slight improvement in internal market in the EU for European audit professionals
	Greater acceptance of audit report outside home jurisdiction, within and outside of Europe
	Significant reduction in standards overload within Europe
	Significant reduction in contradictions between auditing standards, within and outside of Europe
	Slight improvement in operation of internal EU capital market
<b>Regulation effect</b>	
<i>Slight increase in recurring audit costs due to auditors performing more procedures than necessary</i>	<i>Perception by audit clients and capital market participants of slight improvement in audit quality leading to a very slight decrease in costs of capital for audit clients</i>

Table 3: Potential Short and Medium-Term Costs and Benefits of ISA Adoption