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THIS IS NOT AMERICA: THE IMPACT OF THE NEW EU AUDIT REGULATION IN SLOVENIA

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ABSTRACT: *The article presents problems that could arise in a small European country with a modest number of public interest entities and weak market competition due to the new European audit legislation. In this framework, special attention is paid to the effects of the extended requirements to audit public interest entities, public oversight of the audit profession, and adoption of the international auditing standards. The author points out those fields where the European Commission's further action could make the legislation more proportionate in terms of the size of the country and its capital market development.*

Keywords: *European audit reform, directive, regulation, Slovenia, public oversight body, international auditing standards*

JEL Classification: K23, M42, M48

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INTRODUCTION

By publishing the Green Paper on the Audit Policy: Lessons from the Crisis, the European Commission (EC) started the discussion of what needs to be done to ensure that both audits of financial statements and auditor reports are “fit for purpose” (2010 p. 4). As stressed by Quick (2012, p. 18), the Commission recognised that the audit is a key contributor to financial stability and to re-establishing trust and market confidence. What emerged at the end of 2011 were the proposed Directive amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts and the proposed Regulation on specific requirements regarding the statutory audit of public interest entities (hereinafter: PIEs). Preparation of the proposed legislation presumed that having two separate legal acts makes sense since: a Regulation is a suitable and proportionate legal instrument to ensure high quality audits of PIEs; the direct applicability of a Regulation offers greater legal certainty; the legislation would become applicable on the same date across the European Union (hereinafter: the EU), thus avoiding problems associated with the late transposition of legislation by Member States; and a Regulation offers the highest degree of harmonisation since under its regime statutory audits would be carried out according to substantially identical rules in all Member States (EC, 2011b, p. 5).

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After a long and versatile discussion, final versions of Directive 2014/56/EU of the European Parliament and of the Council of 16 April 2014 amending Directive 2006/43/EC on statutory audits of annual accounts and consolidated accounts, and Regulation (EU) No 537/2014 of the European Parliament and of the Council of 16 April 2014 on specific requirements regarding the statutory audit of public interest entities and repealing Commission Decision 2005/909/EC (hereinafter: Regulation 2014), substantially different from the proposals of 2011 but still in two pieces, were accepted by the European Parliament and the Council at the end of May 2014. With Regulation 2014, additional requirements were introduced for audits of PIEs, while the Directive on statutory audits of annual accounts and consolidated accounts (2006, 2014) (hereinafter: Directive 2014) is still effective for all kinds of statutory audits.

This article will only cover a few aspects of audit quality exposed in Directive 2014 and Regulation 2014. It will concentrate on the effect of the additional requirements for audits of PIEs, on the definition of PIEs and on the way of enforcing the international auditing standards and the public oversight body in a small European country that joined the EU in 2004. These fields have not been as widely discussed as others (such as concentration of the audit market (cf. Velte and Stiglbauer, 2012), prohibited services (cf. Ratzinger-Sakel & Schönberger, 2015), joint audits (cf. André et al., 2016, Ratzinger-Sakel et al., 2013), mandatory rotation (cf. Ewelt-Knauer, Gold & Pott, 2013), audit fees (cf. André et al., 2011), the auditor's independence (cf. Evans & Nobes, 1998) etc.), yet can cause many substantial problems in a country within a different environment and with a short tradition of commercial auditing.

The article's principle aim is to identify problems that could arise as a consequence of the new audit legislation in the fields discussed. The identified problems might serve as a basis for furthering the debate about which measures the EC could take to ensure more proportionate implementation of the legislation.

The article consists of two major parts and concluding remarks. The first part presents a review of: the EU audit legislation literature regarding the additional requirements for auditing PIEs arising from a different legal form of the audit reform; the public oversight of statutory auditors; and the international auditing standards. In the second part, the same fields are discussed for the case of Slovenia as a small EU country with a modest number of PIEs and a less developed capital market. The concluding remarks summarise the main problems identified and indicate possible additional action the EC could take to make the legislation more proportionate regarding the country's size and the development stage of its capital market.

1. REVIEW OF THE EU AUDIT LEGISLATION LITERATURE

Some six years after Directive 2006/43/EC of the European Parliament and of the Council of 17 May 2006 on statutory audits of annual accounts and consolidated accounts (hereinafter: Directive 2006) as a successor of the Eighth Directive was supposed to have

been implemented by EU Member States, we have obtained new European legislation in the auditing field. As stressed by Humphrey et al. (2011, pp. 435–436), Directive 2006's overall objective “was stated as being to improve and harmonise the quality of audits and to support public confidence in the statutory audit function. This involved measures relating to the competence and independence of auditors, the potential acceptance of ISAs as EU standards for audit, third party public oversight and a range of other issues”.

Even before the new audit legislation started to be enforced in 2014, many authors had critically assessed the extensive audit regulation. Arruñada (2004, pp. 635–636) established that the great changes made to auditing in recent decades were aggravating the difficulties legislators usually face when weighing up the costs and benefits of regulation. Instead of showing patience, they are keen to use audit and financial crises as excuses to introduce additional regulation into an industry that is already over-regulated. The findings of Posner and Véron (2010, pp. 400–401) suggest that European decision-makers have mainly tried to secure full market integration inside the EU rather than shape regulation to meet a common public purpose. They have also passed legislation that has harmonised rules largely in sync with the United States (US) and British approaches, which cannot be accurately described as aimed at managing globalisation. Critical views have also been expressed by Humphrey et al. (2011) and Öhman and Wallerstedt (2012). Last but not least, in 2013 Knechel (p. A13) reported that the auditing profession was more highly regulated than at any other time in its history.

The consequences of the recently enacted audit reform supposed to be demonstrated by higher audit quality cannot be predicted with a high degree of probability since practical experiences with Directive 2006 in different Member States were neither analysed nor taken into account as a basis for the audit reform in 2014. While higher audit quality is not certain, the additional administrative burden (at least in small Member States) is both certain and inevitable.

1.1 The Legal Form of the Audit Reform

Under the relatively strong influence of the American legislation, the European audit reform of 2014 brought extended additional requirements especially for audits of PIEs. Compared to the previous reforms, the primary feature of the last European audit reform was that Directive 2006 as a single legal act regulating the auditing field was replaced by two separate legal acts, Directive 2014 and Regulation 2014. While Directive 2014 retained its aim of harmonising the auditing legislation of European Member States, Regulation 2014 directly enforced additional requirements for the activities of auditors and audit firms that audit PIEs as well as for PIEs themselves. These extra requirements refer among others to audit fees in relation to prohibited services, mandatory rotations of an audit firm and audit partner, engagement quality control reviews, elements of the audit report, a special auditor's report to the audit committee, additional elements of the transparency report and public oversight. An additional speciality of Regulation 2014 is that in more than 20 cases options are given to Member States to not stick to the requirements of Regulation 2014

but to use allowed alternatives. The given options, which are not normally included in regulations, pose a serious danger of harming the initial intention of the unified European audit market for PIEs.

Following enforcement of the European audit reform effective from 17 June 2016, there are three main European legal acts dealing with statutory audits: Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC (hereinafter: Accounting Directive), Directive 2014 and Regulation 2014.

According to the Accounting Directive (Article 34), each Member State shall ensure that the financial statements of PIEs, medium-sized and large undertakings are audited. The Accounting Directive defines PIEs as undertakings whose transferable securities are admitted to trading on a regulated market of any Member State (hereinafter: listed companies), credit institutions, insurance undertakings, and undertakings designated by Member States as PIEs, for instance undertakings that are of significant public relevance by the nature of their business, their size or the number of their employees (Article 2). The same definition of PIEs can be found in Directive 2014.

As an outcome of the European legislation, two different classes of statutory audits inside Europe can be expected:

- statutory audits of PIEs; and
- all other statutory audits.

This distinction immediately raises the question: why should statutory audits be prescribed by the Accounting Directive also for non-PIEs if non-PIEs are not risky enough to require an independent and high quality audit as determined by Regulation 2014? Or, vice versa, why do we need special requirements for PIEs in Europe where micro, small and medium-sized enterprises make up 99% of all businesses² and where even listed companies in most European countries are confronted with relatively inefficient capital markets³?

Moreover, fears are growing that the legislative solution might adversely impact the concentration of the audit market. At once we will obtain a group of 'highly qualified' auditors, no doubt including auditors employed by the international audit networks – Deloitte, Ernst & Young, KPMG, Pricewaterhousecoopers (the 'Big Four' auditors) auditing PIEs, and other auditors auditing 'less important' entities.

From the auditing point of view, it seems logical that the proportionality of each individual audit is granted by the nature and size of the entity being audited because not

2 http://www.europarl.europa.eu/atyourservice/en/displayFtu.html?ftuId=FTU_5.9.2.html (accessed January 18, 2016).

3 For the definition, see Brigham and Daves, 2010, pp. 177-180.

all auditing rules apply to all kinds of entities. On the other hand, it is illogical why the audit (as 'an audit') of large and medium undertakings (although not PIEs) should be less independent and transparent than the audit of PIEs. Besides, similar to the auditing rules, the European legislation should enable Member States to take proportionality into account when implementing the legislation. This was possible under Directive 2006 but will be significantly limited by Directive 2014 and Regulation 2014. All of the fields specifically addressed by Regulation 2014, such as audit fees, prohibition on the provision of non-audit services, international auditing standards, report to the audit committee, report to supervisors, transparency report, information to the competent authority, the appointment, dismissal and resignation of statutory auditors and audit firms, duration of the audit engagement, hand-over files, competent authorities, quality assurance and cooperation between Member States, could be adequately dealt with in Directive 2014 as minimum harmonisation requirements. The details are already well determined by the international auditing standards as defined by Directive 2014 and there is no need to prescribe them again in a somewhat different manner but with more or less the same substance in Regulation 2014.

The enacted legislation can hardly satisfy critical observers of the European audit environment. As pointed out by Humphrey et al. (2011, p. 450), it is crucial to ensure that practice and regulatory regimes allow adequate space to learn from difference. According to Cooper and Robson (2006, p. 430), "it is important to avoid adopting the myth (Hirst and Thompson, 1996) that national systems of regulation, or the nation state, are obsolete". On the other hand, as stressed by Arruñada (2004, p. 642), "the presence of externalities is even questionable for most quoted companies and, where external effects do seem to exist (e.g. when financial intermediaries are involved), specific mechanisms, including specialised impartial official auditing, are already in place to prevent them. When regulators of these industries demand omniscient external audits, they are just casting doubt on their own efficacy".

In the view of the Federation of European Accountants (FEE), it does not appear opportune to split the statutory audit legislation into two different instruments, a Directive and a Regulation, because this may increase barriers to entry to the PIEs audit market (FEE 2012b).

1.2 Public Oversight of Statutory Auditors

In line with Directive 2006, all 27 EU Member States have established a public oversight body (POB) (FEE 2012b, p. 1), confirming the statements by Humphrey et al. (2011, pp. 444–445) that "the decline in professional scepticism has potentially been happening on the watch of independent regulators" and "it would be useful to have a detailed analysis of achievements enacted by the Statutory Audit Directive and the impact to date – especially in terms of it having assisted in the stimulation and delivery of higher levels of audit quality".

With the final goal of higher audit quality, Directive 2014 and Regulation 2014 have imported into the European legislation extensive amendments and additional provisions regarding the public oversight system, which are supposed to be implemented by the POBs.

A comparison of the requirements of Directive 2014 and Regulation 2014 indicates that many provisions could be avoided if we had one document stressing special requirements connected with the audits of PIEs instead of two documents, namely, one requiring minimum harmonisation for all statutory audits and the other requiring maximum harmonisation for PIEs.

On the other hand, we can observe that a very small pool of knowledge is assigned to the extensive powers and responsibilities of the POBs. The legislative acts leave a lot of space for determining the appropriate professional education, relevant experience and specific training that can range from extensive theoretical and practical education to crash courses for public servants. Thus, it seems that 'professional competence' and 'due care' are much more relevant for the profession itself than for the employees at the POBs. Alternatively, observing the situation from the other side, contrary to the audit the regulation is supposed to be efficient by itself, which is difficult to expect. As stated by Humphrey et al. (2011, p. 449), "technologies of regulation should be subjected to the same sort of testing that regulators impose on auditors, but there is currently very little evidence on which to judge the quality of regulation or regulatory methodologies. ... Key questions include whether compliance with form is dominating matters of substance in audit practice? Are we getting better quality audits or better controlled audits? ...".

However, since "the role of the public regulation of auditing is widely recognized, the natural question arises of what is the optimal design of such regulation" (Pagano & Immordino, 2007, p. 364). Supported by a case study (Caramanis, Dedoulis, & Leventis, 2015, p. 12), "the formation and operation of the newly-established system of oversight is conditioned by local political and economic constraints and, thus, does not automatically translate into concrete benefits for the quality of financial reporting".

The quality of an audit depends a lot upon the proper exercise of professional judgement. This became even more important after the enactment of the International Financial Reporting Standards (IFRSs) (Regulation (EC) No 1606/2002), which leave significant space for accounting treatments of various kinds. "Elements such as accounting accruals (provisioning, fair value measurements) and the absence of a single set of rules, which serves as guidance for fair value measurements, contribute to the difficulty of ensuring consistent application, and hence comparability" (Ojo, 2010, p. 607). The research by André, Filip, and Paugam (2015, p. 510) indicates there is "a potential negative effect of the greater flexibility permitted by IFRS and/or lack of appropriate enforcement on a key dimension of accounting quality". Besides, they maintain (2015, p. 504) that the "decrease in conditional conservatism is lower for countries with high audit quality and strong enforcement of compliance with accounting standards". If IFRSs are accepted widely by an EU Member State with a less developed capital market, a short-term audit tradition and weak enforcement of compliance with accounting standards, the critical role of professional judgement becomes even greater.

According to Arruñada, auditing quality depends on technical competence, defined as the auditor's ability to carry out a thorough examination of the accounts and detect possible errors or anomalies, and his/her independence/willingness to provide an objective opinion. Technical competence can be hindered and independence trivialised if auditors are not allowed to exercise their professional judgement. Putting it even more precisely, he says:

Since they have to convey unverifiable information, it is not sufficient for auditors merely to be independent. What is required of them is that they exercise their professional judgement independently. It would be prejudicial if, in order to preserve their independence, auditors were obliged to refrain from making a professional judgement since the latter provides valuable information to those using the company's accounts (Arruñada, 2000, p. 206).

If we want to have efficient POBs, then their employees should comply with the same independence requirements as auditors. This means they should be independent not only in appearance⁴ but also in mind⁵ and, as such, able to exercise their own professional judgement. For this to be realisable, they would need appropriate skills and competencies. But “a professional skill is difficult for those outside the profession to duplicate, and this skill represents the profession's knowledge base” (Öhman & Wallerstedt, 2012, p. 252). Caramanis et al. (2015, p. 13) maintain that “global regulators should realize that independence from the profession, while simultaneously ignoring local institutional impediments, by no means guarantees the operation of effective national OBs across the globe”.

We have thus returned to the question posed by Humphrey et al. (2011, p. 444): “To what extent is regulatory oversight capable of being ‘independent’ of the profession?”

1.3 International Auditing Standards

The problem often exposed in Europe – that is, whether one set of auditing standards can fit all audit clients – seems to be overestimated and is not a real problem even for small emerging market economies.

The difference between accounting and auditing standards is very well illustrated by Knechel (2013, pp. A2–3):

A critical distinction is that ‘accounting standards’ define how to consistently measure and report an outcome across different companies, while ‘auditing standards’ define a process to verify the outcome.

⁴ The avoidance of facts and circumstances that are so significant that a reasonable and informed third party would be likely to conclude, weighing all the specific facts and circumstances, that a firm's, or a member of the audit or assurance team's, integrity, objectivity or professional scepticism has been compromised (IESBA, 2012, p. 150).

⁵ The state of mind that permits the expression of a conclusion without being affected by influences that compromise professional judgement, thereby allowing an individual to act with integrity, and exercise objectivity and professional scepticism (IESBA, 2012, pp. 149–150).

With the size of the entity and the complexity of its operations, the problem of the auditing standards' scalability in the audit procedure is resolved by itself as far as the volume of standards is reasonable.

It is interesting to observe how the attitude to use of international auditing standards changed from Directive 2006 to Directive 2014. Both of them required statutory auditors and audit firms to carry out statutory audits in compliance with international auditing standards adopted by the Commission. But without going into details, we can realise that there are two major differences between Directive 2006 and Directive 2014. While the first one includes no explicit definition of international auditing standards, the second one explicitly defines international auditing standards as International Standards on Auditing (ISAs), the International Standard on Quality Control (ISQC 1) and other related Standards issued by the International Federation of Accountants (IFAC) through the International Auditing and Assurance Standards Board (IAASB) in so far as they are relevant to statutory audits. In addition, by comparison with ISAs the first one allows add-ons and carve-outs regarding the national requirements connected with statutory auditing, in contrast with the second one which only allows add-ons.

The projected deadline for adopting the international auditing standards under Directive 2006 was 29 June 2010. Given that nothing has happened to date, we may still be afraid that something will go wrong before uniform auditing standards are finally adopted in Europe.

It is very likely that the reluctance to adopt international auditing standards is connected with doubts about the efficiency of the IFRSs' adoption. As pointed out by Ojo (2010, p. 616): "Difficulties in the implementation of rules are evidenced by the EC Regulation of 2002 and some other accounting Directives. It is argued that accounting Directives have achieved less harmonisation than was originally considered, whilst constituting 'an inflexible source of rules', which are 'difficult to change in a business world which is constantly changing'". Ojo also describes the lessons learned from the crisis, as stated at the Conference on Financial Reporting in a Changing World in Brussels (2009), as follows:

- the inter-connective and mobile nature of world capital markets;
- the inability of operators to comprehend the magnitude and impact of the risks they have undertaken and the need for greater transparency in financial reporting;
- the number of options presented by current rules, which have not only added to its complexity but also reduced comparability (Ojo, 2010, p. 610).

Nevertheless, irrespective of the political hesitation, a complete set of international auditing standards as defined by the Directive⁶ (ISAs) is widely supported by the profession and many European countries. Even before Directive 2006 was enacted, we could find statements identifying a vacuum that called for international auditing standards, such as:

It should be pointed out that the Eighth Directive defines the minimum training a statutory auditor should have, but does not establish auditing standards, and, accordingly, these standards have had to be drawn up by the governments of the

⁶ The International Standards on Auditing (ISAs), the International Standard on Quality Control (ISQC 1) and other related Standards issued by the International Federation of Accountants (IFAC) through the International Auditing and Assurance Standards Board (IAASB), in so far as they are relevant to the statutory audit.

Member States or regulated within the audit profession itself. This is evidently incompatible with the objective of attaining uniform quality and procedures (López Combarros, 2000, p. 649).

López Combarros also refers to the EC's Communication (1998) on the statutory audit in the EU and its conclusion:

The wide consultation which has taken place on the matter of the statutory audit has shown general agreement that the audit function is important, that the EU needs a framework of reference in the auditing field and that such a framework should be based as far as possible on existing international standards.

The Federation of European Accountants (FEE) has always expressed very strong support for the international auditing standards and their improvements declaring: "Recognising that ISAs promote quality and enhance confidence in the internal market, FEE continues to call for their adoption for all statutory audits in the European Union" (FEE 2012a, p. 1). As the European professional organisation, the FEE also played an important role in the public debate on proposed Directive 2014. At the same time, the FEE confirms that "ISAs also address many issues arising from the financial crisis such as reinforcing professional scepticism, strengthening the requirements relating to group auditors and enhancing auditor's communication" (FEE 2012a, p. 1).

The adoption of international auditing standards as the driving gear of audit quality can also be supported by the indication of economic conditions that help justify the requirement to implement auditing standards, including: "(1) an unobservable outcome of the audit process (achieved level of assurance), (2) uncertainty surrounding penalties for inappropriate audit work (a negligence regime in law), (3) a fuzzy relationship between audit effort and assurance that is unknown to the client (credence good), and (4) an information advantage to the auditor (incentives)" (Knechel, 2013, p. A11). According to Knechel, taken together, these conditions may yield circumstances in which auditors are motivated to act strategically in their own self-interest. "At a minimum, auditing standards can serve the purpose of preventing auditors from taking a particularly dangerous path" (Knechel, 2013, p. A3).

2. CASE OF SLOVENIA

In line with the rationale of performing case studies (Meyer, 2001, p. 330), there are at least three reasons for choosing Slovenia as a relatively new EU country as a case.

The first reason is there are practically no articles in which newly joined EU countries are equally included in the research. As evidenced by the article of Brüggemann, Hitz, and Sellhorn (2013), the samples arising from these countries are extremely small, in some cases even 0. Another example is the book *Auditing, Trust and Governance: Developing Regulation in Europe* (Quick, Turley & Willekens, 2008) which includes case studies of nine EU countries (Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Spain and UK), Russia and the USA. The same applies to the survey⁷ performed by the IAASB at

⁷ Stakeholders in nine countries were included, as follows: Australia, Canada, Germany, Japan, Netherlands, New Zealand, South Africa, the UK, and the USA.

the IFAC in 2011 to assist in developing a framework for audit quality (2013, p. 69).

The second reason is that no research has been performed to prove or reject the contention that the attitude to audit regulation is different in countries with a short historical tradition of auditing.

The third reason is that the lessons learnt from Slovenia can send out an important message to international regulators and be useful for other similar economies that entered the EU in 2004 and later. These countries face the serious problem of adopting legislation “modelled on the external Anglo-American tradition” (Caramanis et al., 2015, p. 26), and the challenge of its (in)appropriate enforcement (compare André et al., 2015, p. 485). Since the importance of these countries is not negligible (look at Europa / How the EU works / Countries (2014) for details), it is of value analysing the audit reform’s possible effects regarding the mentioned fields in one of them.

As mentioned by The Economist (2013), Slovenia is “a text book case of the problem that has plagued other parts of the euro zone: the link between weak banks, which governments end up recapitalising at great expense, and weak government finance”. If we believe that extremes are the best illustrators of a situation, it is worthwhile taking a look at Slovenia as one of the smallest EU Member States.

As far as the auditing market is concerned, Slovenia has 56 audit firms and 195 registered certified auditors – of these, approximately 120 auditors are active, meaning they are employed by audit firms performing the audits of financial statements (as at the end of 2013).⁸ Currently, there are no solo practitioners in the Slovenian audit market.

On the side of audit clients, the number of entities listed on the Ljubljana Stock Exchange is 71 with a total market capitalisation of EUR 19,143,231,435 as follows:

Table 1: *Ljubljana Stock Exchange – Market Capitalisation*

	31 December 2012 (EUR)	31 December 2013 (EUR)	Market share (% in 2013)
EQUITY MARKET	4,911,166,381	5,173,109,323	27.02
Prime market	3,991,718,590	4,487,490,573	23.44
Standard market	317,840,563	234,913,579	1.23
Entry market	601,607,228	450,705,171	2.35
Banks	81,153,681	0	0.00
Companies	4,388,221,623	4,600,990,682	24.03

⁸ Slovenski inštitut za revizijo. Poročilo o delu za leto 2013. [Slovenian Institute of Auditors. Annual Report for 2013] http://www.si-revizija.si/sites/default/files/o_siru/porocilo-o-delu.pdf (accessed April 15, 2014).

	31 December 2012 (EUR)	31 December 2013 (EUR)	Market share (% in 2013)
Insurance companies	441,791,077	572,118,641	2.99
BOND MARKET	12,735,677,573	13,956,273,831	72.91
State	11,781,562,221	13,231,880,840	69.12
Banks	535,956,492	296,869,213	1.55
Companies	379,814,480	397,823,778	2.08
Insurance companies	38,344,380	29,700,000	0.16
FUND MARKET	16,848,376	13,848,281	0.07
TOTAL	17,663,692,330	19,143,231,435	100.00
SHARES	4,911,166,381	5,173,109,323	27.02
BONDS	12,735,677,573	13,956,273,831	72.91
FUNDS	16,848,376	13,848,281	0.07

Source: http://www.ljse.si/media/Attachments/English/Statistika/Letni/2013_01-12_statistics.pdf (accessed April 10, 2014).

2.1 Impact of the New EU Audit Policy in Slovenia

Returning to the definition of a PIE, Slovenia has 55 stock issuers, 22 bond issuers of which 6 have also issued stocks, one (the biggest) is the Republic of Slovenia and 5 are banks which means that (excluding banks and the Republic of Slovenia) there are 65 listed companies. In addition, there are 1 mutual fund, 20 banks (including 7 subsidiary banks and 3 savings banks)⁹ and 20 insurance companies (including 2 reinsurance companies and 3 pension companies)¹⁰. Altogether, Slovenia has 106 PIEs as defined by Directive 2014. We can conclude that the PIEs in Slovenia would scarcely meet the criteria for a PCAOB yearly inspection if the same audit firm were to audit all of them (Lennox & Pittman, 2010, p. 87)¹¹.

9 Bank of Slovenia. *Annual Report* (2012). http://www.bsi.si/iskalniki/letna_porocila_en.asp?MapaId=711 (accessed May 13, 2014).

10 Report on Business Performance of the Insurance Industry in 2012. http://www.a-zn.si/Documents/Porocila/annual_report-2012.pdf (accessed May 13, 2014).

11 PCAOB inspections are performed annually for firms that audit at least 100 public companies and triennially for smaller audit firms.

Taking account of the size of the Slovenian audit market with approximately 1,700 audited separate accounts and 500 audited consolidated accounts (AJPES, 2014)¹² and 120 active statutory auditors, of whom 70 statutory auditors are working in 52 Slovenian Small and Medium Practices (SMPs), it is very difficult to expect that SMPs would be prepared to cope with Regulation 2014's extensive requirements in order to be able to audit just one or two PIEs. Consequently, the PIEs' audit market is expected to become more concentrated after Regulation 2014 comes into effect.

On the other hand, PIEs will be faced with an extra administrative burden connected with the sources needed to ensure extended reporting by the auditors and the operating of audit committees or other appropriate bodies. While additional costs are inevitable, it is very difficult to imagine adequate benefits, especially in a PIE with extremely poor market capitalisation.

2.2 Public Oversight of Statutory Auditors

According to Caramanis et al. (2015, p. 16), "the proliferation of OBs in the early 2000s rests on the assumption that every country has the capability to successfully establish and operate accounting institutions molded on Anglo-American governance regimes". To better illustrate the situation in Slovenia, let us start with a short description of the situation in the 'source' country.

The American Congress passed the Sarbanes-Oxley Act (SOX) in 2002 in response to the Enron and WorldCom scandals. SOX terminated self-regulation for firms that audit public companies and the peer-review programme was replaced by independent Public Company Accounting and Oversight Board (PCAOB) inspections (Hilary & Lennox, 2005, p. 228). "The total compliance cost of the Sarbanes-Oxley Act has been estimated at \$7 billion a year for listed companies only. The cost of complying with one of its provisions, Section 404, which requires managers to organise and assess internal control systems and auditors to assess their effectiveness, has been estimated at 1 per cent of firms' earnings" (Arruñada, 2004, p. 637). Besides, according to Lennox and Pittman (2010, p. 84), audit clients do not perceive that the PCAOB's inspection reports are valuable for signalling audit quality, and less is known about audit firm quality under the new regulatory regime.

It is obvious that certain dilemmas emerge even in a large country with a well-developed capital market and enough clients to support the functioning of the PCAOB. One can imagine what the situation looks like in a small country with 65 listed companies.

12 AJPES – Agency of the Republic of Slovenia for Public Legal Records and Related Services (2014) *Objavljena letna poročila za leto 2013*. [Published Annual Reports for 2013]. http://www.ajpes.si/Letna_porocila/Druzbe_in_zadruge/Javna_objava/Koledar_JOLP/Arhiv_objavljenih LETNIH_POROCIL?id=1570 (accessed April 10, 2015).

According to the requirements of Directive 2006, Slovenia established a public oversight body in 2008 in the form of a state agency – the Agency for Public Oversight over Auditing (hereinafter: the Agency), financed by the state budget. Ultimate responsibility for all fields included in Directive 2006 has been assigned to the Agency. In fact, the Agency only took over part of the work hitherto performed by the professional institution – the Slovenian Institute of Auditors (the SIA) – in the field of the external quality control of audit firms and statutory auditors. The tasks transferred to the Agency mainly refer to sanctioning and issuing disciplinary measures based on the work still performed by the SIA¹³. For the purpose of external quality control procedures, the SIA has a monitoring unit with four experts who are not practising auditors. Recommendations for the Agency on the basis of the reviews performed are prepared by the Auditing Council as the professional body covering the auditing field at the SIA and consisting of seven members: the director of the SIA, four licensed statutory auditors and two “representatives of the interested public”, appointed by the Ministry of Finance. The Agency, on the other hand, has six employees, all engaged in the field of oversight. Since it is a public sector entity, it falls under the regime of public sector salaries and the limitations of state budget spending. A Director and Council of Experts, consisting of the Agency’s director and eight other members appointed by the Minister of Finance, govern the Agency. The Securities Market Agency, the Bank of Slovenia, the Insurance Supervision Agency, the SIA, the Ljubljana Stock Exchange, the Ministry of the Economy, the Ministry of Finance and the University shall propose eight members of the Council of Experts. All of them have to be non-practitioners.¹⁴

The additional pressure of regulation is gradually being reflected in ‘defensive auditing’. On one side, auditors are using more and more hard evidence to support their opinions, and audits are ‘becoming trivial’ (compare Arruñada, 2000, p. 218). Although the Agency is making a lot of efforts for the best possible results it cannot avoid the fact that (like in Greece) it is practically “impossible to attract suitably qualified staff at the very low public sector salary rates it legally has to follow” (as cited in Caramanis et al., 2015, p. 26). On the other side, foreign (mainly World Bank) experts are trying to help the Agency by proposing formal – quite ‘box-ticking’ – methodologies which are based on the form over substance principal, are easier to understand, and include very little professional judgement.

The problem is to be solved by striking an appropriate balance between independence from the audit profession and the competence required for the task of supervising the audit profession (FEE 2012b). Slovenia expects the EC to provide a more detailed explanation of the desired organisation and structure of the competent authorities, their skills and competencies, and their sources of financing to enable them to be efficient in its small market environment.

13 This is in line with the finding of Cooper and Robson: “Since the 1980, we have seen a shift in institutional justifications such that accounting regulatory institutions appear to have greater legitimacy if they facilitate and support capital markets rather than state agencies, who may be interested in supporting other social groups and institutions” (Cooper & Robson, 2006, p. 416).

14 The detailed structure of the Slovenian audit profession is evident from the Auditing Act (2008). http://www.si-revizija.si/sites/default/files/ZRev_2-EN.pdf (accessed December 23, 2015).

2.3 International Auditing Standards

Although we cannot deny some serious dilemmas connected with the ISAs, like for example the ‘expectations gap’¹⁵, we can claim that even small countries treat use of the ISAs as an optimal solution (compare Duhovnik, 2011). Let us consider an example of Slovenia as a member of the group of 25 EU Member States that currently fully comply with ISAs for all statutory audits in their national jurisdiction without modification or with a few national additions (FEE 2015).

The international auditing standards have been used in Slovenia for around 20 years (mandated by the Auditing Act 1993). In 2010, the SIA was invited by the IFAC to gather information from a sample of audits to help evaluate the impact of the clarified ISAs on audits undertaken by Small and Medium Practices (SMPs). The clarified ISAs were the result of the IFAC’s programme to enhance the clarity of its audit pronouncements. We can logically assume that this programme was also stimulated by Directive 2006 predicting ISAs to become part of EU legislation. As explained by IAASB (<http://www.iaasb.org/clarity-center>), the programme involved the application of new drafting conventions to all ISAs, either as part of a substantive revision or through a limited redrafting, to reflect the new conventions and matters of clarity. On 27 February 2009, the Clarity Project reached its completion when the Public Interest Oversight Board approved 36 newly updated and clarified ISAs and a clarified ISQC. The renewed-clarified ISAs were issued by the IAASB in March 2009. The SIA translated them into Slovenian with the financial help of the World Bank.

The IAASB believed it was especially important to obtain the views of SMPs as questions have been raised about whether the ISAs are proportional for smaller audits. A survey performed by the IAASB aimed to obtain information about the impact of the ISAs on a sample of SME audits carried out by SMPs over the three-year period 2009–2011 (hereinafter: the relevant period); where:

- 2009 is the year *prior* to the first use of the renewed ISAs (Year 0); and
- 2010 and 2011 are their *first and second years of use*, respectively (Years 1 and 2).

The SIA invited all 47 Slovenian SMPs (without the Slovenian Big Four and BDO) to take part in the project and throughout the relevant period the number of participating firms was 19 or 40% of Slovenian SMPs, employing 48.8% of SMPs’ practitioners (statutory auditors).

It is worthwhile to again stress that:

- in Slovenia use of the ISAs is mandatory in their current version; and
- implementation of the renewed ISAs in the initial years was not assisted by the use of audit software, although audit software is now available.

¹⁵ As defined by Ojo (2006, p. 2), the ‘expectations gap’ is the difference between what users of financial statements, the general public, perceive an audit to be and what the audit profession claim is expected of them when conducting an audit.

The information was gathered for the audit of one entity per SMP selected for the purpose of the survey, and included:

- information on the impact of the renewed ISAs on the audit time and thus the costs of the audit;
- views on the impact of the renewed ISAs on the quality of the audits selected for review and whether there were other benefits from using the renewed ISAs; and
- views on the challenges of using the ISAs.

Based on the survey results¹⁶, SMPs in Slovenia consider implementation of the renewed ISAs has had a fairly large impact. In terms of the different phases of the audit, views on the impacts were as follows:

Table 2: Impact assessment of the ISAs in Slovenia

	Number of audits included in the sample		
	High	Medium	Low
Agreeing the terms of engagement	4	11	4
Quality control	9	10	-
Audit planning	7	11	1
Audit performance	6	13	-
Communications	4	10	5
Forming the audit opinion	7	6	6

Source: Survey results.

On the basis of the survey the cost of implementing the ISAs does not seem to have been significant. When compared to the base Year 0, total audit hours increased by 6% (165 hours in aggregate) in Year 1 and by 0.4% (12 hours in aggregate) in Year 2 due to the renewed ISAs. Between Year 1 and Year 2, audit hours fell by 5%, suggesting there was a small 'year one cost' in implementing the renewed ISAs (in 6 of the 19 audits there was a time reduction in Year 2 compared to Year 1). Implementation costs might have been lower if Slovenia had had access to the ISA-compliant audit software.

The survey results are even more encouraging regarding benefits; five audits were more effective in identifying misstatements and nine produced an improved management letter. Other benefits were also identified for audit firms and engagement teams.

Indeed, implementation of the renewed ISAs in Slovenia was not without its challenges and, although 12 (63%) of the firms reported the challenges were reduced in the second year of implementation, seven of them (37%) reported that they were not reduced.

¹⁶ In June 2012, the author was given approval by the IFAC to use the detailed data she had collected for Slovenia in her article.

While additional training and guidance would probably reduce some of the challenges, a minority of firms (7) believe that changes to the ISAs themselves are needed in the following directions:

- The guidance needs to be simplified.
- More examples need to be included in the ISAs.
- A unique set of standards with differentiated guidance for SMEs' audits is needed.
- Too much repetition in the ISAs 'befogs' the essentials.

It is evident that even those who thought the changes would be necessary did not criticise the requirements in the ISAs but focused more on the Application and Other Explanatory Material as the mandatory part of each ISA.

Regarding the fact that "at this moment in time the clarified ISAs are the best instrument available to unify the auditing approach in the European environment and to take the necessary second step after the endorsement of the IFRSs" (Duhovnik, 2011, p. 138), the EU should make its best to legally enforce ISAs just after the application of the new audit legislation in June 2016.

3. DISCUSSION AND CONCLUSION

Based on the Slovenian case, we can argue that the main problems that could arise in the fields discussed as a consequence of the new audit legislation in a small EU country with a less developed capital market are as follows.

It is very difficult to expect that SMPs in small EU countries will be prepared to cope with Regulation 2014's extensive requirements in order to be able to audit just one or two PIEs. Consequently, the PIEs' audit market is expected to become more concentrated after Regulation 2014. At the same time, relatively small PIEs will be faced with an extra administrative burden connected with the sources needed to ensure extended reporting by the auditors and the operating of audit committees or other appropriate bodies. While additional costs are inevitable, it is very difficult to imagine adequate benefits, especially in a PIE with extremely poor market capitalisation.

Since according to the European legislation a very small portion of knowledge is assigned to the extensive powers and responsibilities of the POBs, it can happen that, although independent from the profession, employees in the POB will not be qualified enough to exercise their own professional judgement independently.

The possible delay in enforcing the ISAs inside the EU will cause disproportionate costs of translating the ISAs in small EU countries which do not have enough financial and human resources to develop their own auditing standards.

The identified problems might serve as a basis for further debate about the measures the EC could take to ensure more proportionate implementation of the audit legislation.

While nothing can be done regarding the additional requirements for audits of PIEs, the EC could provide a more detailed explanation of the desired organisation and structure of the POBs, their skills and competencies, and their sources of financing to enable them to be efficient in a small market environment. Besides, enforcement of the ISAs inside the EU would enable the EC to better communicate with the international auditing standard setter (currently the IAASB at the IFAC) whether it consistently follows the principles set up by the clarified ISAs and does not exaggerate by pursuing the currently increasing ideas to have each detail defined in the ISAs, which would likely destroy the positive attitude of SMPs regarding their usefulness.

Although we have to be aware that the distinctive characteristics of a small and less developed market economy would need to be proved by analysing the effects of legislation in the longer time period, the main contribution of the article should be perceived in the recognition that the group of small EU countries with a less developed capital market deserves special attention to be kept in mind when drawing up European legislation.

We may conclude that a lot of room remains for tracing and further investigating how the legal form of the audit reform, the legally prescribed structure of public oversight, and the implementation of the ISAs will influence those EU countries with a small number of PIEs and weak market competition. Among others, special attention should be paid to:

- the effect of the audit regulation on concentration of the audit market;
- whether employees of the competent authorities comply with the same independence and professional requirements as auditors and are thus able to exercise an independent professional judgement; and
- whether the European Commission will be able to adopt the ISAs in due course and without hesitation.

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