THE UNIVERSITY OF READING
DEPARTMENT OF ECONOMICS

Discussion Papers in Accounting

Series D

No. 56

Harmonisation relating to Auditor Independence: the Eighth Directive, the UK and Germany

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The authors are grateful for comments on an earlier version by Brenda Porter (Cranfield University) the participants of the EIASM Workshop on Auditor Regulation in Europe (Copenhagen, February 1997), and by two anonymous referees.

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Abstract

The European Union Eighth Directive on the approval of auditors covers auditor independence only to a very limited extent. The provisions in the five articles on this subject are far less detailed than they were in the drafts of the Directive, so that almost all specific regulation is left to the Member States. An examination of the development of the articles dealing with independence and integrity shows how the need to compromise, in order to reach an agreement, frustrated the intentions of the harmonisers. This paper traces the development of the independence rules in the Eighth Directive from the *avant projet* through the drafts to the final Directive. It assesses the extent to which pre-Eighth Directive regulation in the UK and Germany may have affected the Directive and then examines the implementation of the Directive in the two countries. It concludes that national culture and accounting traditions prevented harmonisation of independence rules through the Eighth Directive.

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Introduction

The Eighth EU Council Directive addresses the harmonisation of the conditions for the approval of auditors. A working party had prepared an *avant projet* of a Directive to deal with the minimum qualifications of auditors as early as May 1972, but the official Proposal for the Directive was not published until 1978; the Amended Proposal in 1979; and the Directive was finally adopted in April 1984. A chronology of the development of the Eighth Directive is given in Appendix 1.

Apart from the *avant projet* referred to above, other unpublished documents include a number of drafts developed in the early 1980s during the Directive's readings before a Council of Ministers working party. Instead of the usual maximum of three such readings, the Eighth Directive passed through six (*Accountancy*, 1983). One of the reasons for this delay appears to have been the Council's inability to come to an agreement on the Directive's rules on independence (see e.g. *Accountancy*, 1981b and *Accountancy*, 1981c).

In the final version of the Directive, independence is dealt with in five articles under the heading "Professional integrity and independence". These provisions are far less detailed than the coverage in the drafts, and almost all specific regulation is left to the Member States.

Van Hulle (1992:2228 translation) states:

> The principle of independence established in the Directive is not further elaborated. This was different in the original proposal by the Commission. However, a majority of the delegations could not agree to provisions going further in this area. At the passing of the Directive the Commission therefore

> had a declaration introduced into the Council minutes, according to which new initiatives in the area of auditor independence were planned.

Lück (1979) claims (even with reference to the 1978 Draft, which contained less flexibility than the final Directive) that the many options meant that individual national interests prevailed at the expense of a success in harmonisation. Similarly, Strobel (1984:955 translation) makes the following comment:

> The fact that the old Article 11 could not in the end gain acceptance in the Council of Ministers - with the governments of the EC States - makes ... clear how esoteric and powerless some ideas about reforms prove to be in the face of practice.

The purpose of this paper is to assess the influences on, and to trace the development of, the independence rules in the Eighth Directive and in German and UK law. These countries were chosen because they have been seen as representing opposing systems with regard to legal, accounting and auditing traditions (see Evans and Nobes, 1998). The strong accounting profession of the UK with its tradition of self-regulation would be expected to be more reluctant than the German accounting profession to embrace independence rules laid down in legislation, and would favour a minimum of statutory rules backed up by more detailed professional regulation; in Germany, one would expect more detailed statutory rules (but also further supplemented by professional rules).

Restriction of the investigation to German and UK law is not intended to imply that the laws of these two countries are the only possible influences on the development of the articles in the Directive. It is outside the scope of this paper to examine all these sources of influence in all the laws of the (then) Member States. However, wherever it is possible to infer a German or British influence, this will be indicated.

Regulation of independence before the Directive

UK

UK law before the Directive (the provisions of the Companies Act 1948 re-enacted as section 389 (6) Companies Act (CA) 1985) excluded a person[1] from being an auditor if he was an "officer or servant of the company", or a partner or employee of an officer or servant of the company, or a corporate entity. S. 389 (7) extended this prohibition also to the company's subsidiaries, holding company and fellow subsidiaries.

Germany

The German regulations before the Directive could be found in paragraph 164 of the 1965 Aktiengesetz (AktG - *Corporation Law*). This specified that a person could not be an auditor if he was, or had been within the last three years, a management or supervisory board member or an employee of the client, or if he was a legal representative, supervisory board member, owner of, partner in or employee of an enterprise connected with the client. A firm could not be an auditor if it was connected with the client, or if one of its legal representatives, partners or members of its supervisory board could not be auditor because he did not fulfil the above conditions.[2] (See the left hand column of Appendix 2 for these rules.)

In both countries, these laws were further supplemented by professional regulation, as noted below where relevant.

The development of the independence rules in the Directive

The *avant projet* (1972) identified ethical rules for auditing as one of four areas that needed to be addressed in the Eighth Directive. Existing rules of the Member States concerning auditor independence were summarised, for example those concerning incompatible activities, which was felt to be the main issue for the purpose of safeguarding the interests of shareholders and third parties.[3]

Article 4 of the *avant projet*'s total of five articles dealt with ethics. It required Member States to bind auditors by a code of ethics and to arrange for monitoring of compliance. Specifically, it provided that auditors should not be persons who were members of the client's management or supervisory board or staff, nor persons who had held any of these positions during the last three years. Further, auditors should not be audit firms whose shareholders or members of the supervisory or management board or other "authorised representatives" were holding or had held during the last three years any of the above positions in the client's company. While, on the one hand, these rules went further than the British law, they did not, on the other hand, prohibit auditors from being corporate entities. This matter is dealt with by Evans and Nobes (1998).

The *avant projet*'s proposals resembled strongly the provisions of German law (para. 164 (2)(1) and (3)(2) & (3) AktG 1965). The detailed provisions of the *avant projet* disappeared from the first officially published draft of the Eighth Directive (with similar content transferred to the draft Fifth Directive), although their spirit survives in the more general Art. 11 (1) of the first and second drafts of the Eighth. Table 1 summarises the development of the independence articles in the drafts of the Directive.

In the final version, the detailed rules of Article 11 (1) - (3) of the drafts have been dropped entirely, leaving the matter to the "law of the Member State which requires the audit". Similarly, the final Article 26, concerning sanctions, is far less detailed than Article 11 (4) of the drafts. Therefore, the enforcement of these issues is also left to the discretion of the Member States.[4]

Possible Influences on the Directive

British Views

As has been seen above, the law in the UK concerning auditor independence was very limited before the Directive (although the professional ethical guidelines covered much of the ground of the draft Directive). Consequently, the UK lobbied for the deletion of the

Table 1: Development of the 'Independence' Articles (summary only - emphases added)

Art.	1978	Art.	1979	Art.	1984
3	"The member states shall grant approval only to persons who are of good repute and independent."	**3**	"Member states shall grant approval only to persons who are of good repute and not carrying on any activity of such nature as to cast doubt on their independence."	**3**	"The authorities of a Member State shall grant approval only to persons of good repute who are not carrying on any activity which is incompatible, under the law of that Member State, with the statutory auditing of the documents referred to in Article 1 (1)."
-		-		**23**	"Member States shall prescribe that persons approved for the statutory auditing of the documents referred to in Article 1 (1) shall carry out such audits with professional integrity."
11 (1)	"An approved person whose independence does not appear sufficiently guaranteed in relation to the persons who are members of the body which represents, administers, directs or supervises a company, or its majority shareholders or members, shall not audit the accounts of that company."	**11 (1)**	unchanged	**24**	"Member States shall prescribe that such persons shall not carry out statutory audits which they have required if such persons are not independent in accordance with the law of the Member State which requires the audit."
11 (2)	auditor may not receive benefits and may not have interest in capital of company audited	**11 (2)**	'benefits' replaced by 'loans', both prohibitions extended to auditor's company or association		
11 (3)	not more than 10% of turnover to be derived from one client (company or group), unless disciplinary authorities consider that this does not limit auditor's independence	**11 (3)**	unchanged		
-		-		**25**	Articles 23 & 24 also to apply to natural persons auditing on behalf of firms of auditors

11 (4)	"Member States shall ensure that approved persons fulfil their obligations either through appropriate administrative measures or by making such person subject to professional discipline. In particular, approved persons shall, as a minimum, be liable to disciplinary sanctions if they fail to carry out their duties as auditors with all due professional care and complete moral and financial independence".	**11 (4)**	unchanged	**26**	"Member States shall ensure that approved persons are liable to appropriate sanctions when they do not carry out audits in accordance with Articles 23, 24 and 25."

detailed independence rules from the Directive.[5] It appears (see below) that both drafts of the Eighth Directive gave rise to considerable concern in the UK, and that the UK negotiators achieved significant changes in the final version, which led to, *inter alia*, the weakening of the independence provisions.

In a memorandum from the UK and Irish accountancy bodies to the Department of Trade (DoT) it is suggested that the detailed requirements of Article 11, with regard to independence, should not be prescribed by the Directive, but left to the individual Member States to regulate (Holmes, 1979:5). Bartholomew (1978), too, expresses concern with regard to the sections dealing with independence. He points out that the explanatory memorandum suggests, with reference to Article 3 (which requires that only persons who are of good repute and independent are to be approved), that "... a person seeking authorisation should not possess any characteristic incompatible with the role of an auditor" (Ibid.:335) and that this could mean he should not engage in any activity which might endanger his independence. Bartholomew shows concern that this, interpreted strictly, could ban auditors from providing other services to audit clients. His concern must have deepened with regard to the second draft's revised Article 3 (see Table 1), which now made clear what was formerly only implied: "Member States shall

grant approval only to persons who are of good repute and not carrying on any activity of such nature as to cast doubt on their independence."

It is presumably mainly this Article which the Consultative Committee of Accounting Bodies (CCAB) allude to in a letter and memorandum to the DoT:

> 'First and foremost,' says the letter, 'the articles of the Directive dealing with the independence of statutory auditors, although vague, could be construed as denying the auditor the right to provide tax and other advisory services to audit clients. (*Accountancy*, 1981:6)

Other independence issues were also addressed in a report by the House of Lords select committee on the EC. In particular,

> ... the rigid requirement that an auditor shall have no interest in the capital of the company should be limited so as to apply only where the auditor is a sole trustee and has some beneficial interest in the trust - otherwise the requirement should be expressed in more general terms than a total prohibition. The committee also doubts whether the maximum percentage (set in the Directive at 10 per cent) of an accountant's turnover which he may derive from a particular audit should be fixed by law. (*Accountancy*, 1979:4)

This last point is also referred to by Radford (1980:56), who points out that the draft does not specify whether the 10% refers to an international firm's world-wide turnover, or to that in one country. If the latter were to be the case, this rule could cause difficulties for the firm's local offices in that country when they audit local subsidiaries of multi-national groups.

To summarise, the main points of UK criticism were: (i) the threat to non-audit services; (ii) the threat to trusteeships (as a result of the prohibition for the auditor to have an

interest in the client's capital); and (iii) the rule requiring that the maximum income from one client should not exceed 10%.

Later changes during the negotiations in the Council of Ministers intensified British concern over a possible prohibition of auditors from supplying consultation services to audit clients (*Accountancy*, 1981a and 1981b). It appears that towards the end of 1983 most of these issues had been resolved (*Accountancy*, 1984). In April 1984 the Directive was published in its final form. From the UK's point of view this much weakened compromise apparently represented a "the result of several years of hard and satisfactory bargaining" (Clayton, 1984:16) and "a victory for the UK accountancy profession" *(Accountancy*, 1984:7, November).

Considering the effort by the UK negotiators, it may appear surprising that stringent requirements regarding independence were included in a revision of the profession's ethical guidelines at the time of the first draft of the Directive.[6] However, it was to be expected that the UK profession with its approach to self-regulation would prefer such rules to be laid down in an "Ethical Guide", rather than in legislation, because the rules would be set and enforced by the profession rather than by the state.

German Views

Because there appear to have been mutual influences between the development of the German law and the Directive, this sub-section will begin by examining a number of issues regarding chronology. It will then summarise the main issues raised by the accounting profession and by accounting academics in Germany.

In Germany, a *Bilanzrichtlinie-Gesetz* (Accounting Directive Law) had been drafted to implement the Fourth Directive. Four main versions were drafted between 1980 and 1983, followed by a partial draft in 1985 and two further draft versions in 1985, which combined the draft *Bilanzrichtlinie-Gesetz* with the *Government Draft* for the

transformation of the Seventh and Eighth Directives to form the *Bilanzrichtliniengesetz* (see Gross and Schruff, 1986).

The original draft of the *Bilanzrichtlinie-Gesetz* did contain certain changes about audit and auditor authorisation which were felt to be necessary due to the extension of compulsory audit to a large number of German private companies. Para. 281 of the earliest (1980) draft which was not officially published, is set out - and contrasted with the old legislation of the AktG 1965 - in Appendix 2. The main proposed changes included the following:

(i) shareholdings in the audit client were outlawed;

(ii) participation in the book-keeping or preparation of accounts for audit clients was prohibited;

(iii) provision of consultancy and audit for the same client was prohibited where consultancy fees would be higher than audit fees for the year; and

(iv) the maximum fee income from one client was set at 25%.

The subsequent main changes to the independence paragraph happened between 1980 and 1981. While these reflected the German accounting profession's successful lobbying for a relaxation of some of the rules, in other instances the rules were tightened. The main changes in the unpublished 1981 draft were (for a detailed comparison see Appendix 2):

(i) the independence rules are extended in such a way that a WP may not act as auditor not only if he himself is ineligible under the rules of the independence paragraph, but also if this applied to "a person with whom he practices his profession jointly";

(ii) the section limiting the scope for provision of other services is eliminated;

(iii) the maximum fee income that may be received from one client is increased from 25% to 50% and the WPK is given the right to grant exemptions to avoid cases of hardship; and

(iv) restrictions where a WP firm could not act as auditor because a member of its supervisory board could not become auditor are relaxed.

The first officially published version of the *Bilanzrichtlinie-Gesetz* was the 1982 Government Draft, which came with an official explanation (BD 9/1878) for the changes from the AktG). These, in part, merely codified existing professional principles to ensure greater compliance. This explanation suggested that these changes would help to ensure the quality of the audit and the independence of the auditor to a greater degree than was previously the case.

It was pointed out that the independence paragraph (277 HGB in the 1982 and 1983[7] versions) adopts the provisions of Article 164 AktG, but tightens the rules on incompatibility of certain activities. It is also more detailed with respect to exclusion of auditors due to lack of independence, to ensure that an audit can only be carried out by those persons who have not contributed to the preparation of the documents and are not connected to the audited enterprise in other ways which might affect their independence. Paragraph 277 of this first Government Draft of the *Bilanzrichtlinie-Gesetz* is retained identically as paragraph 277 of the draft of 1983 (BD 10/317).

Against this background, the following observations on the chronology (see Appendix 1) of the development of the Eighth Directive may be of interest:

1. Strobel (1984) quotes a version of the independence rules (then Article 11) which was apparently under discussion approximately six months before the publication of the Directive, i.e. late in 1983. This version contained provisions which go even beyond those of the earlier published drafts.[8] Strobel suggests that it was based on part of the draft *Bilanzrichtlinie-Gesetz*. Presumably he refers to the 1982 or 1983 versions. However, as will be seen later, Strobel's is by no means the only possible explanation for the development of the independence provisions in the Directive and in German law. As

mentioned above, some of the detailed rules of the draft could also be found in UK professional rules. Strobel himself (1984:955 translation) seems to qualify the claim:

> The consequence of these detailed provisions of the old Article 11 would have been an EC-wide prohibition of a combination of certain types of audit with consultation regarding the annual accounts or management consultation. This would have badly hit audit practice everywhere. It would have *inter alia* touched on the work of Treuarbeit AG, which is state-owned and audits chiefly state enterprises. Therefore also the German side of negotiations was moved to yield.

2. The paragraph in the 1980 Preliminary Draft of the *Bilanzrichtlinie-Gesetz* which prohibited the provision of audit services where the auditor's income from these would be exceeded by income from consulting services for the same client apparently preceded chronologically - by approximately 1 1/2 years - a new section in the 1981 unpublished draft of the Eighth Directive which prohibited the provision of other services by auditors (see *Accountancy*, 1981a and 1981b).

3. The 1980 Preliminary Draft limited the acceptable level of income from one client to 25%. It referred to the similar (10% limit) provision of the draft Directive (Article 11 (3)) but was critical of this stricter version. The reference to the draft Directive is interesting because it contradicts Strobel's (1984) suggestion that the Directive was influenced by German law, since it implies that the German legislator was considering the draft Directive's provisions when drafting the German law.

In summary, chronologically it is interesting to note that the independence provisions of the old para. 164 AktG were already being revised and introduced into the draft *Bilanzrichtlinie-Gesetz* (which, as pointed out above, intended only to implement the *Fourth* Directive into German law) before the Eighth Directive was finalised. Indeed, the German draft of August 1983 preceded the publication of the Eighth Directive by approximately eight months. Did the German law attempt to anticipate the rules of the Eighth Directive, or, as Strobel suggests, did the draft German law influence the

independence rules in the draft Eighth Directive?[9] It appears that mutual influences are most likely.

Regarding the views of the profession, the *Wirtschaftsprüferkammer* (WPK) and the *Institut der Wirtschaftsprüfer* (IdW) in a joint commentary (1979) - with reference to the early published drafts of the Eighth Directive - had expressed concern with respect to the 10% rule (Article 11 (3)). It was felt to be too rigid and of particular concern for those auditors at the start or at the end of their careers who may have only few clients. It would also cause problems where, due to additional contracts, the limit would be exceeded only temporarily, and the commentary therefore suggests that the situation ought to be considered over longer periods.

Lück (1979), also criticises the 10% rule in his analysis of the Directive's proposal, for reasons similar to those stated above. He also criticises the wording of the Proposal, which he considers not to be clear enough. With reference to Article 11, for example, he points out that in Article 11 (2) the reference to *Kredite*[10] is phrased too narrowly since it neglects other possible types of financial dependency[11] (see also Sieben and von Wysocki, 1979).

While, predictably, the professional bodies lobbied for a relaxation of the Directive and the national law, German academics argued for a tightening of the rules. Their views on the first draft of the Directive were expressed in the proposals made by a body representing university lecturers in *Betriebswirtschaftslehre* (von Wysocki, 1979). Its first suggestion with reference to Article 11 was the proposal that the principles of the paragraph should apply also to firms of auditors (rather than only to natural persons). It further suggested that Article 11 (2) should be extended to the effect that neither the auditee nor a company holding shares in the auditee should be allowed to hold shares (directly or indirectly) in the firm of auditors, unless the supervisory body would state explicitly that there was no cause for concern. Incidentally, the second Draft of the

Directive did indeed extend the prohibition of Article 11 (2) regarding share ownership to the auditor's firm.

While, with reference to Article 11 (3), a relaxation of the rules was suggested in that the percentage limit for fee income from one client should be increased from 10% to 15%, it was also suggested that a rule should require the auditor to inform the supervisory body if the limit was exceeded; further, these provisions, too, should be extended to firms of auditors. It was finally suggested that the requirements for confidentiality (mainly dealt with in Article 2 (2)(a)) should be extended.

In a further publication, the same body (Sieben and von Wysocki, 1979) made specific suggestions for a rephrasing of certain provisions of the draft Directive. Apart from the problem areas discussed in the earlier statement, these included the suggestion to extend the provisions of Article 11 (1) and (2) to firms of auditors. It suggested a very specific additional paragraph to Article 11 dealing with confidentiality, which would have effectively prohibited auditors (and persons being part of management, administration and supervisory bodies who were not themselves auditors) from taking advantage of or passing on information gained during the audit; confidentiality was even to be maintained towards members of the audit firm's supervisory board or partners/shareholders not taking part in the firm's management. It finally suggested additions of a similar content to Article 11 (4). The suggestions referring to confidentiality corresponded to the (then) German professional regulations.

In summary, the German professional bodies lobbied for a relaxation of the rules of national law and of the draft Directive, though apparently to a lesser extent than the UK profession. German accounting academics, on the other hand, argued for a tightening of the rules.

Implementation in Germany

To continue the examination of the chronological development of the German (draft) law, this part deals with the remaining development after the publication of the Directive and until the passing of the *Bilanzrichtliniengesetz*.

No new provisions concerning independence were introduced in the 1985 Government Draft for the Transformation of the Seventh and Eighth Directives (BD 10/3440),[12] and there were only minor changes from the 1982/83 drafts (discussed above) in the draft *Bilanzrichtliniengesetz* of November 1985 (BD 10/4268), which combined the transformation of the Fourth Directive with that of the Seventh and Eighth. Some changes had resulted from the decision to revive the lower qualification of *vereidigte Buchprüfer* (vBP). Apart from minor changes, i.e. the adding of words to clarify a meaning, the only other difference is an additional sub-paragraph, referring to the audit of consolidated accounts. There were no changes between the draft of November 1985 (Legal Committee) and the final law (which became paragraph 319 of the HGB).

A suggestion supported in particular by the opposition (SPD - the socialist party), namely that auditing and consulting services should be declared incompatible, was rejected by the Legal Committee on the grounds that the quality of the audit had not suffered through this in the past and because a separation of these services could mean increased costs for the enterprises to be audited. Further, reference was made to the professional guidance of the WPK, which requires an auditor, where he provides consulting services, to check in each case whether he should be excluded from the audit due to a risk of bias. Finally, it was felt that the suggested prohibition would be difficult to carry out and monitor in practice (BD 10/4268:118).

As to the final *Bilanzrichtliniengesetz*, Grewe (1986) comments that, although the incompatibility between preparation of financial statements and audit had previously been covered by professional regulations, it was now given a new relevance through: (i) its

legal codification; (ii) the extension of the rule with respect to existing company law connections between (legal and natural) persons who audit and (legal and natural) persons who are in charge of bookkeeping and preparation of annual accounts; (iii) the increase in the number of companies requiring an audit; (iv) the relevance of the provisions also for company and employment law relationships between the auditor and his assistant; and (v) the requirement for publication and audit of the notes to the accounts and other disclosures. Finally, it should be pointed out that the reasons for exclusion of the auditor covered in the legislation are not exclusive, but are supplemented by professional rules.

Implementation in the UK

The UK implemented the Eighth Directive through Part II of the Companies Act 1989. This resulted in few practical changes, and its main impact appears to have been that more rules were laid down in legislation, instead of, as previously, being left to the profession to regulate.

The 1989 Act (section 27) specifies cases in which a person would be ineligible to act as auditor, thus implementing Article 24 of the Directive, which gives scope to define lack of independence to the Member States. Included here is ineligibility if the auditor was also ineligible to audit an associated undertaking. Further, the Act requires auditors to be "fit and proper persons". This relates to Article. 3 of the Directive, which requires auditors to be "persons of good repute ...". The Act's wording was suggested by the DTI for the following reason:

> The Department considers that the 'good repute' criterion is equivalent to the 'fit and proper' test laid down for insolvency practitioners in the Insolvency Act 1985 and that the rules adopted in that context provide a model which might be followed in implementing this Article. This would mean that regard would be had to all aspects of a person's professional conduct both in considering whether he should be approved and in monitoring his continued suitability to

> retain that status. Regard would also be had to any matters which might cast doubt on a person's general probity and integrity.
>
> (DTI, 1986:9)

Schedule 11 of the Act has a sub-heading "Professional integrity and independence" equivalent to that of Section III (i.e. Articles 23 to 27) of the Directive. Here, the Act is little more specific than the Directive. It requires that the Recognised Supervisory Bodies (RSBs),[13] who are charged with the approval of auditors, should have rules ensuring that audit work is conducted properly and with integrity, that persons should not be appointed auditors where potential conflicts of interest may arise, and that persons who are not properly qualified or not a member of the firm may not influence the way the audit is conducted if this might influence the independence and integrity of the audit.

The remaining provisions of this Schedule relate to further requirements of the RSBs, for example concerning the maintenance of technical standards and standards of integrity, standards for monitoring and enforcing compliance with its rules, fair and reasonable rules regarding membership and discipline, arrangements to investigate complaints, ability to meet claims and rules regarding the keeping of a register of auditors.

A further change intended to strengthen auditor independence was the right for the Secretary of State to require the disclosure of fees earned by the auditor for the provision of non-audit services to audit clients.[14] This regulation, applying to large companies only, was introduced by the Corporate Affairs Minister. It was "... intended to buttress the independence of auditors" (*CA Magazine*, 1991:64). Its introduction was apparently the result of "... cross-party pressure in Parliament ... because of the popular perception that auditors cannot remain independent if they earn fees for non-audit work from the companies they audit." (*Accountancy*, 1990:10). It had been met

with strong resistance from the profession. The ICAEW had requested government not to implement the requirement or to delay it "... at least until such time as the relevance of the information and its value to shareholders can be demonstrated, and the new regulatory régime for auditors has had a chance to demonstrate its effectiveness". (Ibid.)

Further, s. 123 of the 1989 Act[15] requires an auditor who ceases to hold office to make a statement concerning any circumstances which he feels shareholders or creditors should be made aware of, or a statement to the effect that there are no such circumstances. These requirements extend similar ones of the CA 1985 s.390 which referred only to the resignation of the auditor. The reason for the extension of the provision is to cover situations where the auditor would prefer not to apply for reappointment because he felt pressures imposed by the client were endangering his independence (DTI, 1986).

Other independence issues had been addressed in a 1986 Consultative Document by the Department of Trade and Industry (DTI). For example, it was noted that there where no restrictions on other activities under UK regulation, and that the Directive did not require Member States to pass any such restrictions. On independence and integrity, the main concern seemed to be the perception that the Directive required these areas to be dealt with in legislation, and that they therefore could no longer be left entirely to the profession's self-regulation. It was felt that:

> The ethical rules of the various bodies would seem to be sufficient to satisfy the spirit of the Directive. The critical question is whether the Directive can be properly implemented within the terms of Community law if those rules are not written into public law or the Secretary of State at least has the capacity to exercise control over them. (Ibid.:28)

As to the requirement for auditors to be independent, the DTI made reference to the current regulation. Further, reference was made to the profession's specific ethical rules[16], i.e. those prohibiting business relationships with clients, restricting the provision of other services to clients, financial interests in client companies and restrictions on maximum fee income from one client. The DTI addressed the issue of whether the (then) current rules were considered sufficient and whether the balance between legislation and professional rules should be changed. The DTI suggested that a total prohibition of the provision of other services (as exists in some member states) might lead to a situation where "... the cure might be thought to be worse than the disease" (Ibid.:31) and that it might be difficult to enforce.

Other issues briefly addressed in this context were: lowballing, financial interests in an audit client, personal relationships, extension of restrictions on one auditor's ability to audit to the entire firm, and rules stating positively what is expected of an auditor to ensure independence. Further, consideration was given to extending the rules protecting auditors from pressures exercised on them by clients (see above). In this context suggestions such as appointing auditors for a fixed term were considered.

The issues addressed in the DTI document went considerably further than the requirements of the Eighth Directive. Cooper *et al*. (1996:602-3) comment as follows:

> The points raised by the ROA [the DTI document] in relation to Article 24 of the Directive concerning independence cannot be attributed solely to the requirements identified by the Directive. ... The additional points raised by the ROA make sense only in terms of the changing political context in the UK, particularly the significance of new Right philosophies that stressed free markets and the concern of the State with the efficiency of the adult [*sic*] profession. ... Such issues went far beyond what the Directive required; that such proposals were raised at all again startled and alarmed the professional accounting and audit bodies.

As can be seen from the limited changes actually implemented, the traditional UK preference for self-regulation (versus legislation) prevailed.

Summary

The *avant projet* for the Eight Directive was prepared in 1972 before the UK became a member of the then Common Market. Its provisions on independence were close to earlier German law. However, the detail was replaced by other detailed provisions in the first published draft (1978) of the Directive. Certain elements of that draft bore resemblance to UK professional guidance but the issue was not covered in law. The influence of the UK can most obviously be inferred from the disappearance of the detail from the drafts, (compared to the 1972 *avant projet*), and from the delegation of several matters to member states, which enabled the UK to further delegate to professional bodies.

For the content of the Directive from 1978 onwards, once again it is relevant to look at German legal developments. Here, the direction of influence is difficult to establish. Two opposing hypotheses can be suggested:

1. The Directive's independence rules had little or no impact on German law but were influenced by German proposals; or
2. The Directive's independence rules did at some stage of their development influence German law.

The first hypothesis is possibly supported by Strobel's claim that the draft German law was at one stage the source for the draft Directive's Article 11, and by the fact that the revision of the German law with respect to independence had largely been drafted by the time the Eighth Directive was published. The second hypothesis is supported by the chronology of the development of the drafts of the EC and German law, as well as the fact that the *Begründung* to the Preliminary Draft actually refers to the Draft Directive.

On consideration of the evidence presented here a mutual influence appears the most likely.

The above discussion also confirms the expectations stated in the introduction, i.e. that the strong UK accounting profession with its tradition of self-regulation would be more reluctant than the German profession to embrace independence rules laid down in legislation. This explains the UK lobbying against the inclusion of detailed rules in the Directive against the background of the simultaneous inclusion of similar rules in the British professional ethical code. This is not surprising if one considers the cultural, historical and legal background, in particular the common law system which places more emphasis on general principles than on detailed rules, and the tradition of professional self-regulation. Germany on the other hand, and in line with prior expectations, included more detailed independence rules in legislation, rather than leaving them to be covered by professional regulation. It appears that accounting rule making was indeed much more driven by the profession in the UK, but by government (and legislation) in Germany.[17]

An examination of the development of the articles dealing with independence and integrity shows clearly how the need to compromise, in order to reach an agreement, frustrated the intentions of harmonisers.

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Footnotes

[1] UK legislation also required an auditor to be a member of a recognised professional body. This would make him subject to this body's rules, which included ethical guidelines dealing with, *inter alia*, independence.

[2] For supervisory board members not all of these restrictions applied.

[3] "Consultant" and "assessor" were given as examples for potentially incompatible activities.

[4] A further condition concerning independence not detailed in the Table 1 is the requirement that those shareholders or members of the administrative, management or supervisory bodies of the firm not themselves fulfilling the conditions of the Directive must not be allowed to interfere with the audit process in a manner which might endanger the independence of the auditors. This condition is found in Article 27 of the final version. It had been included, in slightly more detailed form, in Article 2 of the drafts.

[5] See for example Cooper *et al*. (1996), where UK reaction to and lobbying against the independence provisions of the (draft) Directive are examined against the background of other simultaneous political processes and the shifting interrelationship between the UK profession and government.

[6] *Statement 1 of the Ethical Guide - proposed revision* addresses maximum fee income from one client, shareholdings in clients, trustee shareholdings, and provision of accounting assistance to audit clients (*Accountancy*, 1978:78-80)! It is conceivable even that some of the detail of the drafts had been influenced by UK professional rules (which were undergoing a revision at the time).

[7] BD 10/317

[8] For example, it prohibited a person from being an auditor if: he was not independent with regard to members of the (legal) representative, administrative, management or supervisory bodies of the company to be audited (- this prohibition extended also to persons who were members of the above bodies of a company, or employees.); he benefited from the client directly or indirectly in any way except for the receipt of the audit fees or other professional fees; he accepted loans or securities from the company to be audited or provided loans or securities to clients; he owned shares or had a share in the client's profits.

[9] As pointed out above, there was also a strong similarity between the independence provisions of the *avant projet* of 1972 and the AktG 1965. However, the *avant projet's* detailed rules were not retained in the first published draft of the Directive.

[10] Literally 'credit(s)'; the English version uses the wider 'benefits'; incidentally, the second draft uses *Darlehen*, lit. 'loans', and the English also uses 'loans'.

[11] The Explanatory Memorandum to the second Draft comments as follows: "At the request of the Parliament and the Economic and Social Committee the word "loans" has replaced the word "benefits" the translation of which was delicate in certain languages." (Commission of the European Communities, 1979:3)

[12] Changes to other parts of the legislation, especially those introducing the requirements of the Seventh Directive (in the Government Draft referred to above) led to a renumbering of the paragraphs. Paragraph 277 Draft HGB becomes paragraph 303 in the Government Draft for the Transformation of the Seventh and Eighth Directive and finally paragraph 319 in the HGB.

[13] The RSBs are effectively the same professional bodies whose members were previously authorised to audit. The government therefore took advantage of the Directive's provision permitting it to delegate the approval of auditors to professional associations.

[14] S. 121 CA 1989 introducing, *inter alia*, s.390B into the 1985 Act.

[15] Introducing s.394 and 394A into the 1985 Act.

[16] It is again interesting that the possibility to include the rules of the Directive's drafts into legislation was once again raised.

[17] Cooper *et al*. (1996) compare accounting rule making to a game not played out on the international level alone, but also in the process of the implementation of directives on the national level, and the interchange between the profession and the State in this process. This may well involve issues not directly arising from the directives.

Appendix 1: Chronology of the Development of the Eighth Directive	
(unpublished) draft prepared by working party of Commission	30.05.72
Proposal for Eighth Directive (No C 112/6)	13.05.78
Amendments proposed by European Parliament (No C 140/154)	05.06.79
Opinion of the Economic and Social Committee (No C 171/30)	09.07.79
Amended Proposal for Eighth Directive (No C 317/6)	18.12.79
Council of Ministers/Working Party: revised (unpublished) drafts	1980-84
Eighth Council Directive (No L 126/20)	10.04.84
(The items in bold print are publications in the Official Journal of the European Communities. For the Proposal and the Amended Proposal the actual issue dates were somewhat earlier, i.e. the Proposal dates from 24.4.1978 and the Amended Proposal from 5.12.1979.)	

Appendix 2: Comparison of the Independence Paragraphs in the AktG and HGB (translation)

Aktiengesetz para. 164	**draft Handelsgesetzbuch para. 281** (1980 version)	**draft Handelsgesetz 277** (1982 version)
(1) Only *Wirtschaftsprüfer* and firms of *Wirtschaftsprüfer* may be auditors.	(1) Only *Wirtschaftsprüfer* and firms of *Wirtschaftsprüfer* may be auditors.	(1) Only *Wirtschaftsprüfe* *Wirtschaftsprüfer* may be
(2) A *Wirtschaftsprüfer* may not be auditor if he	(2) A *Wirtschaftsprüfer* may not be auditor if he	(2) A *Wirtschaftsprüfer* m auditor if he or a person v practises his profession jo
	1. owns shares in the enterprise to be audited;	1. owns shares in the ent audited;
1. is or was in the last three years before his appointment a member of the board of management or of the supervisory board or an employee of the *Gesellschaft* to be audited;	2. is or was in the last three years before his appointment a legal representative or member of the supervisory board or an employee[ii] of the enterprise to be audited;	2. is or was in the last thr before his appointment a representative or membe supervisory board or an e the enterprise to be audite
2. is a legal representative or member of the supervisory board of a legal person, partner of a partnership or owner of an enterprise where the legal person, the partnership or the sole proprietorship is connected with the *Gesellschaft* to be audited;	3. is a legal representative or member of the supervisory board of a legal entity, partner of a partnership or owner of an enterprise, where the legal entity, the partnership or the sole proprietorship is connected with the enterprise to be audited or owns more than twenty per cent of its shares;	3. is a legal representativ of the supervisory board entity, partner of a partne of an enterprise, where th the partnership or the sole proprietorship is connecte enterprise to be audited o than twenty per cent of its
3. is an employee of an enterprise which is connected with the *Gesellschaft* to be audited.	4. is an employee of an enterprise which is connected with the enterprise to be audited or which owns more than twenty per cent of its shares;	4. is an employee of an e which is connected with th to be audited or which ow twenty per cent of its shar employee of a natural per owns more than twenty pe shares of the enterprise to
	5. has participated in the bookkeeping or preparation of the annual accounts or of another document to be audited over and above the auditing activity;	5. has participated in the or preparation of the annu over and above the auditi

[i] Here the term for 'may' has changed from *kann* to *darf*.

[ii] Ther term for 'employee' has changed from *Angestellter* to *Arbeitnehmer*.

	6. is a legal representative, member of the supervisory board or *Gesellschafter* of a legal person or of a partnership or owner of an enterprise where the legal person, the partnership or one of its *Gesellschafter* or the sole proprietorship could not be auditor pursuant to number 5;	6. is a legal representativ member of the supervisor *Gesellschafter* of a legal person or of a partnership of an enterprise where the natural person, the partne of its *Gesellschafter* or the proprietorship may not be pursuant to number 5;
	7. employs an employee in the audit who could not be auditor pursuant to numbers 1 to 6;	7. employs a person in th may not be auditor pursua numbers 1 to 6;
	8. carries out consultancy for the enterprise to be audited and the consideration for this activity is higher in the financial year to be audited than the consideration for the audit of the annual accounts; included in these are, respectively, considerations which the auditor receives from enterprises of which the enterprise to be audited owns more than twenty percent of the shares; or	
	9. has in each of the last five years received more than twenty-five percent of his total income from his professional activity from the audit and consultancy of the enterprise to be audited and of enterprises, of which the enterprise to be audited owns more than twenty per cent of the shares.	8. has in each of the last fiv received more than half of h from his professional activit audit and consultancy of the be audited and of enterprise enterprise to be audited own twenty per cent of the share this is to be expected also current financial year; to a hardship, the *Wirtschaftsp* can grant exemptions sub limits.
(3) A firm of *Wirtschaftsprüfer* may not be auditor	(3) A firm of *Wirtschaftsprüfer* may not be auditor, if	(3) A firm of *Wirtschaftspr* be auditor, if
1. if it, or an enterprise connected with it, is connected with the *Gesellschaft* to be audited;	1. it owns shares in the enterprise to be audited or is connected with it or if an enterprise connected with it [the firm of WP/vBP] owns more than twenty per cent of the enterprise to be audited or is connected with it;	1. it owns shares in the e be audited or is connecte an enterprise connected v of WP/vBP] owns more th cent of the enterprise to b is connected with it;
	2. it could not be the auditor pursuant to section 2, no. 6 as *Gesellschafter* of a partnerhsip or pursuant to section 2, nos. 5, 7 to 9;	2. it may not be the audit section 2, no. 6 as *Gesell* legal person or a partnerh pursuant to section 2, nos

2. in the case of firms of *Wirtschaftsprüfer* that are legal persons, a legal representative, in the case of other firms of *Wirtschaftsprüfer* a *Gesellschafter* could not be auditor pursuant to section 2, nos. 1 to 4;	3. in the case of a firm of *Wirtschaftsprüfer* that is a legal person, a legal representative or a *Gesellschafter* who owns fifty percent or more of the voting rights the *Gesellschafter* are entitled to, or in the case of other firms of *Wirtschaftsprüfer* a *Gesellschafter* could not be auditor pursuant to section 2, nos. 1 to 4;	3. in the case of a firm of *Wirtschaftsprüfer* that is a a legal representative or a *Gesellschafter* who owns or more of the voting righ *Gesellschafter* are entitle case of other firms of *Wir* a *Gesellschafter* may not pursuant to section 2, nos
	4. one of its legal representatives or one of its *Gesellschafter* could not be auditor pursuant to section 2, no. 5 or 6, or	4. one of its legal represe one of its *Gesellschafter* auditor pursuant to sectio 6, or
3. if a member of the supervisory board of the firm of *Wirtschaftsprüfer* could not be auditor pursuant to section 2 no. 1.	5. a member of its supervisory board could not be auditor pursuant to section 2 no. 1 to 6.	5. a member of its super may not be auditor pursu 2, no. 2 or 5.

(The German term 'Gesellschafter', which can mean either a shareholder in a body corporate, or a partner in a partnership, has been retained.)