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The role of auditors in European Union Company Law

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A COMPARATIVE PERSPECTIVE THROUGHOUT THE EUROPEAN UNION

INTRODUZIONE

Questo elaborato si prefigge l'obiettivo di compiere una panoramica sul ruolo del revisore legale dei conti in vari contesti, come ad esempio il diritto dell'Unione Europea – attraverso i riferimenti alle varie Direttive e Regolamenti –, il diritto dei singoli Stati Membri – evoluto dapprima autonomamente e modificato successivamente dal recepimento delle Direttive – e il diritto degli Stati Uniti d'America – dove la figura del revisore legale dei conti è stata duramente messa in discussione all'inizio del secolo in corso.
In particolare, verrà posta particolare attenzione sull'importanza di una organica riforma della legislazione relativa alla responsabilità del revisore legale dei conti, che negli anni ha ricevuto notevoli ed importanti modifiche.

Brevemente, il primo capitolo si occuperà di analizzare la nascita e l'evoluzione dal punto di vista storico del revisore legale dei conti, e di come la professione in questione si sia diffusa dapprima nel Regno Unito e poi negli Stati Uniti d'America; del Paese in questione, successivamente, si analizzerà la disciplina in generale e di come abbia risentito degli scandali finanziari causati dal tracollo di società come Enron e WorldCom, ed infine, il capitolo si concluderà con la disamina circa l'evoluzione normativa della responsabilità del revisore legale dei conti.
Il secondo capitolo, invece, porrà la propria attenzione sull'avvicendarsi all'interno del panorama legislativo dell'Unione Europea di atti normativi, quali Direttive e Regolamenti, che molto hanno risentito dell'esperienza d'oltreoceano.
Infine, il terzo capitolo si concentrerà sulle influenze che le Direttive ed i Regolamenti analizzati nel capitolo precedente ed adottati a livello comunitario hanno avuto sulle esperienze legislative nazionali in materia, in particolare sulle tecniche attraverso le quali Italia, Francia e Germania hanno recepito gli atti legislativi in questione.

Innanzitutto, il revisore legale dei conti non è sempre stato caratterizzato da elevatissimi *standard* di onorabilità, professionalità ed indipendenza, bensì storicamente nasce come una figura che semplicemente affianca l'imprenditore nella tenuta dei registri contabili, registri attraverso i quali lo stesso annota i risultati dell'attività.
La sua evoluzione passa, come insegnano vari storici, attraverso la rivoluzione che ha caratterizzato il mondo delle società intorno al 1800, secolo in cui il concetto di "impresa" si muove dall'idea di una sola persona – l'imprenditore appunto – che porta avanti i propri affari da solo, a quella di "entità" formalmente separata dal suo proprietario.

Questa rivoluzione influisce sull'evoluzione del ruolo del revisore perché i soggetti terzi che vogliono investire nell'impresa vogliono ricevere una rassicurazione circa l'affidabilità e la serietà del modo in cui essa porta avanti i propri affari: questa garanzia viene appunto prestata da coloro i quali rappresentavano semplici contabili, ma che, appunto per questo, erano i soli in grado di poter delineare un quadro veritiero della situazione finanziaria dell'impresa di cui contribuivano a gestire la contabilità.

Questa incredibile ed ingente domanda di giudizi sul bilancio delle imprese contribuirà a creare una vera e propria professione, appunto quella del revisore legale dei conti, che si vedrà regolamentata proprio per la delicatezza del parere fornito al pubblico degli investitori.

Dal punto di vista normativo, la materia della revisione legale dei conti subisce una regolamentazione più organica quando gli investitori e gli azionisti delle società registrate negli Stati Uniti d'America, spinti dall'onda che ha colpito negli anni precedenti il Regno Unito, decidono di "importare" la figura del revisore.
Naturalmente, questa situazione crea una competizione tra professionisti britannici e professionisti americani che, appunto, contribuirà ad una maggiore regolamentazione della materia, come ad esempio l'introduzione anche gli Stati Uniti di un'associazione professionale ed un registro dove ogni professionista deve figurare per esercitare legalmente la professione.

Muovendo invece verso periodi più recenti, la professione del revisore legale dei conti ha goduto di una più ampia regolamentazione nel periodo immediatamente successivo la grande crisi finanziaria che ha colpito gli Stati Uniti verso le fine del 1920.
Infatti, il *Securities Act* del 1933 ed il *Securities Exchange Act* del 1934 hanno rivoluzionato il modo di intendere la revisione legale dei conti, prevedendo un obbligo per tutte le società che negoziano i propri strumenti finanziari presso la *New York Stock Exchange* di dotarsi di una revisione annuale obbligatoria, il cui parere finale è da trasmettere per l'approvazione finale alla *Securities and Exchange Commission*.

Inoltre, varie riforme si sono succedute negli anni seguenti, tra cui si ricordano il *Private Securities Litigation Reform Act* ed il *Securities Litigation Uniform Standard Act*, che hanno contribuito a limitare la responsabilità civile del revisore legale dei conti.

Infine, l'analisi di due dei più grandi ed emblematici scandali finanziari della storia delle società – ossia Enron e WorldCom – contribuiranno a fornire gli strumenti essenziali per carpire fino in fondo le sfumature della più organica riforma riguardante la revisione legale dei conti della storia degli Stati Uniti d'America, ovverosia il *Sarbanes-Oxley Act*, approvato nel 2002.

L'appena menzionato atto legislativo darà una spinta essenziale alla regolamentazione della revisione legale dei conti, tanto che l'Unione Europea, che nel frattempo aveva provveduto ad emanare vari atti, tra cui si ricordano la Direttiva 84/253/CEE – meglio nota come "Ottava Direttiva" – e le Raccomandazioni adottate a cavallo tra il 2000 ed il 2002 volte, appunto, ad emendare la Direttiva in parola, adotterà la Direttiva 2006/43/CE – come emendata dalla Direttiva 2014/56/UE – ed il Regolamento (UE) N° 537/2014, che regolamenteranno in maniera organica attraverso tutti gli allora ventotto Stati Membri dell'Unione Europea la materia della revisione legale dei conti.

Inoltre, nel 2008 l'Unione Europea adotta una Raccomandazione, la 2008/473/CE, gettando le basi di quello che sarebbe dovuto uno sforzo congiunto dei singoli Stati Membri per limitare la responsabilità civile del revisore legale dei conti che non derivi da dolo o colpa grave.
L'obiettivo primario della Raccomandazione, tra le altre cose, è quello di evitare il perpetrarsi di situazioni, come quelle accadute alcuni anni addietro negli Stati Uniti, nelle quali le previsioni di responsabilità solidali tra la società revisionata e la società di revisione legale dei conti facevano desistere molti potenziali concorrenti dall'entrare nel mercato.

Come si vedrà poi nel terzo capitolo, solo la Germania e pochi altri Stati Membri hanno recepito la Raccomandazione in parola – che giova ricordarlo, è un atto legislativo non vincolante dell'Unione Europea –, prevedendo metodi efficaci di limitazione della responsabilità civile del revisore legale dei conti, come ad esempio dei "tetti monetari" al di sopra dei quali il revisore non può essere più obbligato a corrispondere il relativo risarcimento.

In conclusione, ad oggi è facile poter dire che il panorama della revisione legale dei conti ha subito una vera e propria rivoluzione, sia culturale che normativa, a seguito dei ripetuti scandali finanziari che hanno colpito non solo gli Stati Uniti ma anche l'Unione Europea – come il caso Parmalat in Italia –, ma è altrettanto agevole capire che è importante continuare su questo impervio percorso di riforme strutturali della materia, per andare incontro ad un mercato che proprio in materia di revisione legale dei conti si mostra in evidente difficoltà.
L'accento qui è posto sulla morsa oligopolistica nella quale le cosiddette *Big-Four* tengono il mercato mondiale della revisione, per una serie di motivi tra i quali sono sicuramente

annoverabili: le elevatissime barriere in entrata – la continua formazione dei revisori, le entrate "modeste" rispetto ai cosiddetti servizi *non-audit* –, la preferenza da parte delle società da revisionare di un *equipe* di esperti del settore con molti anni di esperienza alle spalle, la presenza sul mercato di quattro colossi che si spartiscono la clientela più importante e la "Spada di Damocle" di eventuali richieste di ingenti risarcimenti nel caso di fallimento delle società revisionate.

Sono proprio questi i motivi che segnalano l'urgente bisogno di una serie di riforme strutturali in materia, riforme che saranno analizzate in parte nella sezione conclusiva dell'elaborato, dove verrà ponderata l'opportunità di effettuare alcune scelte legislative piuttosto di altre.

OVERVIEW

This dissertation aims at making an overview on the role of auditors in several contexts, such as the European Union law – through reference to the different Directives and Regulations –, Member States laws – which evolved first autonomously and then have been amended through the implementation of Directives – and the United States of America legislation – where the "auditor" figure has been under discussion at the beginning of this century.
In particular, more attention will be put on the importance of an organic reform of the legislation concerning auditors' liability, which received during the years considerable modifications.

Briefly, the first chapter will deal with a historical analysis of auditors' rise and evolution, and how the profession at hand spread first in the United Kingdom and then in the United States of America; then, an analysis on the overall discipline of the latter Country and on the way in which it has been affected by financial scandals of companies such as Enron and WorldCom will be performed. Finally, the chapter will be concluded with the examination of the auditors' liability.
The second chapter will put the attention on the way in which Union legislative acts, such as Directives and Regulations, came into succession, receiving the influence of the overseas experience.
Finally, the third chapter will concentrate on the influences Directives and Regulations analysed in the previous chapter had on the national legislative experiences, in particular on the techniques through which Italy, France and Germany implemented the legislative acts at hand.

First of all, auditors have not been always characterised by high standards in terms of good reputation, independence and professionality, rather they came out as figures who simply supported businessmen in the bookkeeping of records.
Many historians have taught that auditors' evolution passed through the revolution which characterised the corporate world around 1800, namely the century in which the concept of "business" shifted from the idea of a single businessman carrying out his business alone to that of an "entity" formally separated from its owner.
This revolution affected the evolution of the role of auditors because third parties who wanted to invest in the undertaking wanted to be reassured on the reliability and trustworthiness of the way in which it conducted its business: this assurance was given by those who represented only mere bookkeepers, but who, for this reason, were the only ones to be able to draft a

faithful picture of the financial statements of the undertaking which they contributed to keep records of.

This incredible and huge demand of reports concerning the financial statements of the undertaking will contribute to create a real profession, that of auditors, which will be regulated with a particular care because of the sensitiveness of the judgement given to investors.

From a regulatory point of view, statutory audit underwent a more organic regulation when investors and shareholders of companies incorporated in the United States, pushed by the wave which hit the United Kingdom during the previous years, decided to "import" the figure of auditor.
Of course, this situation created a competition between British and American auditors, which will contribute to a greater regulation of the subject matter at hand, such as the introduction also in the United States of professional associations and registers where each professional had to be registered in order to legally perform his activities.

Moving then to more recent periods, statutory audit has received a wider regulation in the aftermath of the huge financial crisis which hit the United States at the end of 1920s.
Indeed, the 1933 *Securities Act* and the 1934 *Securities Exchange Act* revolutionised the way of thinking at statutory audit, providing for an obligation for each company negotiating its financial instruments on the *New York Stock Exchange* to provide themselves with a mandatory annual statutory audit, whose final report had to be transmitted to the *Securities and Exchange Commission* for the final approval.

Moreover, several reforms kept replacing each other during the following years, amongst which there are the *Private Securities Litigation Reform Act* and the *Securities Litigation Uniform Standard Act*, which contributed to limit the auditors' liability.

Finally, the analysis of two of the hugest and most emblematic financial scandals in the corporate history – *i.e.*, Enron and WorldCom – will contribute to provide the reader with the necessary tools in order to fully understand the shades of the largest reform concerning statutory auditing in the history of United States of America, namely the 2002 *Sarbanes-Oxley Act*.

The aforementioned legislative act will give an essential push to the regulation of the statutory audit, through the adoption of many acts by the European Union, amongst which there are Directive 84/253/EEC – better known as the "Eighth Directive" – and the Recommendations adopted between 2000 and 2002, will adopt Directive 2006/43/EC – as amended by Directive 2014/56/EU – and the Regulation (EU) N° 537/2014, which will regulate the subject matter at hand in a more organic way through the then twenty-eight Member States of the European Union.

Moreover, in the 2008 the European Union adopted a Recommendation, 2008/473/EC, which laid the foundation for what should have been a joint Member States' effort aimed at limiting the auditors' civil liability not depending from *dolus* or *culpa lata*.
The Recommendation's main aim, *inter alia*, was that of avoiding the continuation of situations, such as those happened in the years before in the United States, for which joint and several liability between audited companies and audit firms led many potential competitors to waive the idea of entering into the market.

As will be seen in the third chapter, then, only Germany and few other Member States have implemented the Recommendation at hand – which is a non-binding legislative act –, providing for many effective methods of limitation of auditors' civil liability, such as "monetary caps" up to which auditors could not be held liable anymore.

In conclusion, today it is easy to say that the auditing panorama underwent a real revolution, both cultural and legislative, following many financial scandals which hit not only the United State but also the European Union – such as Parmalat case in Italy –, but it is equally easy to understand that it is really important to continue on this arduous path made of structural reforms, in order to restore a market which, concerning statutory audit itself, is in apparent difficulty.
Here the accent is put on the oligopolistic chokehold in which so-called *Big-Four* keep the global audit firms market, for several reasons, such as: the high barriers to entry – the auditors' continue formation, the "modest" incomes guaranteed by the statutory audit with respect to the provision of the so-called *non-audit services* –, the preference expressed by companies to be audited by an *equipe* of experts having many years of experience, the presence on the market of four giants dividing amongst them the most important clientele and the "Sword of Damocles" of any requests for huge compensations in cases of bankruptcies of audited entities.

These are the reasons making clear the urgent need for a series of structural reforms in the subject matter at hand, reforms which will be analysed in the conclusive section of this dissertation, where it will be weighed up the opportunity of making some legislative choices rather than others.

CHAPTER I
THE AUDIT IN THE UNITED STATES: HISTORY AND DEVELOPMENT

1.1 The origin of the audit: from bookkeepers to professional auditors

Before beginning with the analysis of the general role the auditor held until the modern age, it is necessary to make a reference to one of the most important accounting experts, FABIO BESTA:

> "*in the old days, people used to think at* oaths *as means of control, oaths which had to be sworn by each official at the moment they had to come into office. But those means cannot be considered useful with regards to the* audit*; because the oath has no effectiveness if the one who swears it is dishonest and it is superfluous in the opposite case*".[1]

This citation helps everyone understand the thousands shades the role of auditor has in the society nowadays and had in the old days, thanks to the mixed public and private tasks he or she performs.

But, considering the auditor as the only figure holding this public function – *i.e.*, that of the surveillance on States' economic entities, in particular on their compliance with the accounting rules –, it could be a terrible mistake.
Indeed, during the years, many professions entrusted with similar duties arose, completing a scheme which can be appreciated only by looking at it from a distance.

This ensemble of professionals is called generally "gatekeepers".
Even though it has been used in many different contests, the definition of this term for the issue at stake in this dissertation is that for which a gatekeeper is a guardian which detects any flaws or defects in the company before it is made public. For instance, in the case of auditors, they are entrusted with the task of controlling the compliance of the entity's financial statement with the generally recognised accounting rules, reporting any material misstatement to the audited entity in order for it to make adjustments.

[1] "*La ragioneria*" (Besta, 1922, p. 186).

In general, the term “gatekeeper” refers to auditors, attorneys, securities analysts and credit-rating agencies, whose current role will be analysed in the following paragraphs.
In particular, this paragraph will focus on the origin and the development of the auditor – since it is the “paradigmatic gatekeeping profession”[2] –, together with the role it began to assume during the years.

So, beginning with the auditors’ origin, accounting historians, in particular LITTLETON attribute this event to the introduction of the double-entry bookkeeping, credited to Fra Luca Pacioli, an Italian monk who lived during the XV century and who in 1494 published a work aimed at summarising the practices the Italian merchant houses had probably used during the previous fifty years.
Hence, basically, the most paradigmatic gatekeeper was born as a bookkeeper who used to cooperate with the owner of a given business, in order to draft a systematic method to record exchanges and to help the former understand the implications of his or her conduct of business.[3]

The bookkeeper, then, began to gain more importance in the overall economic system also thanks to an important revolution blown up during the XIX century, when the concept of “business” shifted from the idea of a single person – the businessman – carrying out an activity on its own, in some cases with the help of another person, to the idea of an “entity” formally separated from its owner.

This revolution affected also the accounting dimension, because third parties who wanted to advance credit or capital to a business entity had to investigate on the entity’s solvency and reliability.
From this point of view, the best advice was that of the new figure outlined at the aftermath of the aforementioned revolution, namely the auditor.
Hence, the bookkeeper became auditor when there was the need felt from third parties to have a trustworthy and professional person upon whom to rely in order to evaluate the entity’s financial statements.

[2] “*Gatekeepers: The Professions and Corporate Governance*” (Coffee Jr., 2006, p.105).
[3] “*Accounting Evolution to 1900*” (Littleton, 1988, p.277).

Another revolution which contributed to shape the edges of the modern auditor has been that outlined by BERLE & MEANS (1932), according to which in the late 1930s a separation between the corporate's ownership and control occurred.[4]
If this discovery is put in connection with the XIX century's one, the outcome reveals that before shareholders became independent from corporate management, they first gained confidence in professional agents which could assure them the accuracy of financial statements issued by the corporate management itself, hence implying a relation of cause and effect between the two aforementioned revolution, where the accounting one paved the way to the formal separation between ownership and control.

The evolution of accounting profession spread largely in Great Britain, first, and then moved to the United States, as will be analysed further.

Great Britain was probably the centre of the world from an economic point of view during the XIX century, since it held mercantile power and the outbreak of the Industrial Revolution.

Before these occurrences, Great Britain in XIII century already experienced a figure named "*adwytour*", who was part of a close-knit community electing trusted persons to verify annually that public funds had been properly applied.
Although this figure clearly recalls the role of another auditor – what is represented in many Countries and in the European Union by a court, the Court of Auditors –, entrusted with public functions, it has been prodromal to the development of the professional at hand.

In the following period, Medieval great manors began to import that figure in order to control that no servant embezzled from any fund.
In the case in which this "rudimentary" auditor found any embezzlement, he or she had the power to testify against the delinquent servant and send him or her to prison, a power which nowadays is not recognised neither under the Sarbanes-Oxley Act nor under the European Union's set of Directives and Regulations.

A further development of the auditing profession is represented by the repealing of the so-called Bubble Act, a 1720 document in which the Great Britain stated that no corporation could have been created without the prior approval of the Parliament or of the Crown.
This repeal had the effect to liberalise the establishment of corporations, providing everyone with the possibility to carry out their own businesses in a more organised way.

[4] "*The Modern Corporation and Private Property*" (Berle and Means, 1932, p.314).

Of course, there were many burdens for the creation of a corporation, amongst which that of interest for this dissertation is for sure the mandatory use of an annual audit performed by an independent auditor being elected each year by the shareholders.
So, the foundations of the auditing profession may be found precisely in that, namely in the mandatory annual statutory audit with the auditor being elected by shareholders, provided for under 1844 Joint Stock Companies Act and the 1845 Companies Clause Consolidation Act.[5]

What will be criticised by American scholars about the British experience is the fact that the supply preceded the demand, forcing the market to adapt to a new "artificially implanted" phenomenon by the legislator, rather than leaving the market adapting on its own. Perhaps, the British choice had been the best one because there was the fear of another share market bubble, such as that which led to the issuance of the Bubble Act in 1720.

Indeed, few years after the introduction of the accounting profession in Great Britain, it developed in the sense of the spontaneous creation of auditing firms, which gathered within themselves many auditors who could carry out statutory audit of corporations.
Soon this phenomenon saw itself spreading in the United States, though with many differences with its British predecessor.

CAREY, one of the most eminent historians regarding accounting, stated that by 1850 there were more than two-hundred and ten public accountants in Great Britain and only nineteen between New York, Chicago and Philadelphia.[6]
This difference was to be attributed to the absence of a legislative constraint, such as that which pushed British corporations to provide themselves with certified auditors.

As already claimed, United States welcomed spontaneously the phenomenon at hand, but this early absence of any regulation of sort entailed the competitive disadvantage the American auditors had to face in the very first days.
Indeed, when American corporations, shareholders in particular, started to feel the necessity to provide their corporations with a professional figure who could assure them the compliance of financial statements, at first they relied upon American professionals, who trained mainly in the United States and, above all, were not certified since the absence of a uniform federal legislation. It is to say that before the first statutory auditors appeared on the American scene,

[5] "*Be Careful What You Wish For: How Accountants and Congress Created the Problem of Auditor Independence*" (O'Connor, 2004, p.749-751).
[6] "*The Rise of Accounting Profession: From Technician to Professional, 1896-1936*" (Carey, 1969, p.224).

shareholders used to check for themselves the compliance of financial statements with applicable accounting standards.

In this context, British chartered auditors started to cross the ocean in order to establish subsidiaries of their accounting firms in the growing market of the United States and of course American shareholders began to rely more upon certified accountants with more experience on their backs, rather than unexperienced American auditors.
Soon the competitive constraint pushed American auditors to join up in order to establish certified professional associations based on the British model.

Those professional orders were accompanied by new legislative provisions at single States level, such as the 1896 New York legislation, according to which, in order to perform statutory audits of any entity under New York legislature, it was mandatory to hold a "certification of public accountant". In addition, it was prohibited to carry out statutory audits without the aforementioned certification.
The impact of such legislation is appreciable when considering that by 1905, hence less than twenty years after, the aforementioned New York legislative provision affected seven more States in the United States.
Therefore, as stated before, American scholars used to criticise the British method, according to which the auditing profession had to be implemented in the system through a legislative implementation, hence creating the supply before the demand; but then the American experience has showed how, in order for competitive constraints to be effectively regulated, first the State of New York, then the others, started to put a check on the differences between British chartered accountants and American non-certified auditors.

But then a change occurred in the fragmented State-based legislation: indeed, a nationwide licensing examination developed in response to a need which was generally felt for which certified public accountants had to be evaluated according to the same criteria, so that also internally competition could work equally.
As a result, by 1950 every State but one adopted AICPA's (American Institute of Certified Public Accountants) Certified Public Accountants examination, as put forward by ZEFF.[7]

The expansion of the accounting profession produced many other phenomena as chain reaction, such as that for which by the beginning of the XX century American corporations began to disclose much more information about, *inter alia*, their accounts.

[7] "*How the U.S. Accounting Profession Got Where It Is Today?*" (Zeff, 2003, p.189-205).

The pre-existing situation in the United States was characterised by a lot of secrecy on the corporates' information, especially the financial one, because of the possibility of alerting competitors which could take advantage of the disclosed information.

The accounting profession in the United States grew much slower than its correspondent in Great Britain for a series of reasons, such as that for which Great Britain had Industrial Revolution which produced its effects also in the United States, although limited, and the fact that, at least initially, U.S. stock market was much smaller than its British correspondent.
Notwithstanding these initial differences, even later on the American accounting profession did not grow as fast as the British one, also because of the different administrative structuring characterising the Countries at hand.
Indeed, while the European Country proved to be quicker in approving reforms concerning auditing, the United States encountered many difficulties, also due to their federal structure, with two opposing "factions", namely that for centralisation and that for de-centralisation.

After the so-called Progressive Era – *i.e.*, the period from 1890 to 1920 – when many reforms were on the table but none of them was actually approved – especially the one concerning the need for an independent audit of public listed corporations on the New York Stock Exchange –, the 1929 Crash changed everything.
Notwithstanding the financial crash, which invested United States, left almost nothing and nobody undamaged, accountants were probably the less harmed category.

Indeed, the most involved actors were the New York Stock Exchange – for the lack of control on public listed companies – and broker-dealers – for the flagitious financial advices given to their clients –, which came out from the breakout scaled down.
Auditors were affected "only" by the following 1933 Securities Act – which imposed on them the presumptive liability whether they had audited corporations engaged in a public offering – and by the 1934 Securities Exchange Act– under which the Securities and Exchange Commission (hereinafter, SEC) was given many powers in order to regulate auditing.
Amongst the mentioned powers there was one mandating auditors to be independent from their audited entities and another for which SEC had to draft generally recognised accounting standards.
The SEC, by the way, never used its power to draft accounting standards, at least at the very beginning of its mandate.
Indeed, generally recognised accounting standards were the biggest fear amongst auditors because they assumed that they were not mere technicians who had to mechanically apply

predetermined rules, instead they had to exercise discretion and judgement in order to better and fully accomplish their role; anyway, in the meantime – precisely in 1938 –, AICPA's Committee on Accounting Procedure (hereinafter, CAP) began to draft accounting standards which were more permissible and open with respect to any possible choice from the SEC.
Though, those accounting standards provided for by the CAP proved to be excessively permissible and open, thus laying itself open to criticism.

In 1959 AICPA welcomed the mentioned criticism by replacing CAP with the Accounting Principles Board (hereinafter, APB), which had to base its pronouncement on professional researches and simultaneously started an accounting research programme.

By the way, in 1963, a storm shook APB's accounting authority: indeed, SEC released a statement in which it claimed that auditors could follow indistinctly every accounting standard, endorsed or not by an APB's opinion.
This statement caused many problems to APB because of the reputational consequences it carried: APB's opinions started lacking credibility before auditors.

In response, AICPA's Council, in 1965, released a statement according to which APB's opinions had to be considered as "substantial authoritative support": it was perceived as the final blow for APB, indeed it caused the loss of credibility of this organ.

As a result, AICPA set up a special committee aimed at solving the APB's internal problems.
This committee – called Wheat Committee – recommended in 1972 the abolition of APB and its replacement with another organ.
AICPA, finally, decided to establish the Financial Accounting Standards Board (hereinafter, FASB), which differed from APB for many issues, amongst which, one worthy of being highlighted is the major independence of FASB's members from external pressures – from industries in particular – and the fact that these members must perform their activities on a full-time basis, with no possibility to carry out other working activities.

Although initial criticisms hit FASB for excessive slowness in releasing statements and opinions, it then sorted it out as the leading organ for authentic interpretation of Generally Accepted Accounting Principles (hereinafter, GAAP), as put forward by the SEC itself.

In conclusion, as will be analysed further, the 2002 Sarbanes-Oxley Act revolutionised the auditing subject matter, finally introducing strict regulations in order to avoid what will be highlighted in the following paragraphs, namely a series of financial scandals which undermined the gatekeepers' credibility – and not only gatekeepers' – before investors and stakeholders.

1.2 Arthur Andersen and the Enron case

The Enron scandal has been probably one of the most iconic failures by gatekeepers in history; with these regards, thinking that there is only one failure by gatekeepers – *i.e.*, auditors not performing properly their functions – could be a terrible mistake.

Indeed, gatekeepers – within the meaning explained in the previous paragraph – play a different role in each corporate governance system at stake, for example in the United States system, the focus is on directors, while in Europe there is more attention on the role of auditors – divergence which will be further analysed.

1.2.1 Enron Corp.: from origins to bankruptcy

Coming back to the Enron scandal, there are many peculiarities around this case.
First, it should be noted that the United States – and the world, more in general – has faced many other bankruptcies of these dimensions, similar also with regards to the global failure of gatekeepers, but this one is for sure the most emblematic.
More surprising has been the fact that, first, this financial scandal did not have a corresponding outbreak in Europe, and then that it symbolised the event uncovering Pandora's box.
To be honest, the "spiritual" corresponding financial scandal in Europe has been the Parmalat case, which has many similarities with the Enron case, but this will be better analysed further.

Enron, before becoming the then most successful company in the United States – and one of the most successful on a global basis –, began as Northern Natural Gas Company, registered in Nebraska, by the merger between three companies, North American Light & Power Company, United Light & Railways Company (holding each a 35% stake) and Lone Star Gas Corporation (holding the remaining 30%).
It was born as a natural gas company, as its name suggests, and owed its fortune to many factors related to the United States' 1929 financial crisis: natural gas was one of the less expensive heating fuels, a cheap workforce was readily available and new technologies were just being discovered.[8]

[8] New 24-inch steel pipe could transport six times the amount of gas carried by 12-inch cast iron pipe.

In 1938, the United States Congress passed the Natural Gas Act, which was aimed at regulating the interstate natural gas distribution, with a particular focus on the rates charged by the single companies. As a consequence, the sectorial regulation produced a minor – or more regulated – growth, which led in 1941 United Light & Railways to sell its shares to the public, in 1942 Lone Star Gas to distribute its shares to its shareholders and in 1947 North American Light & Power to sell its shares to underwriters who then offered the stock to the public. Northern Natural Gas was listed on the New York Stock Exchange that year.[9]
Since 1944, Northern Natural Gas began its expansion in many directions, such as that of covering other States, exploring other energetic sectors and expanding its assets.

After many mergers with both US and non-US-based companies, Northern Natural Gas changed its name into InterNorth, Inc.
In 1985, InterNorth merged with the – then – largest US-based natural gas company, Houston Natural Gas Corporation, entering into a $ 2.26 billion operation, creating the largest gas pipeline system in the United States – about 37,000 miles at the time. The resulting company, though being called in a first moment HNG/InterNorth, changed its name into Enron Corp.

One of the most important events in Enron's history was the deregulation process begun in 1994, according to which Central Government gave to Federal States the power to deregulate gas and electric utilities, which is also similar to the process the European Union went through few years ago.
Enron exploited this opportunity by expanding itself in States where the deregulation process was at a good point, offering attractive rates thanks to its dominant position.

In its expansion, Enron diversified its products, by penetrating into many different sectors, such as telecommunications, internet services, weather-depending sectors, renewable resources, and many others.
But, by doing so, the company faced many contrasting evaluations: Enron was either seen as a "shaky company", with not so solid foundations, or as a trustworthy energy trader, with a diversified energetic portfolio.
This contrast is, *inter alia*, at the basis of the company's hidden decline.

Apart from it, the real change in the corporate policy began with the management consulting carried out by Jeffrey Skilling, consultant for McKinsey & Company.

[9] "*Enron Corporation - Company Profile, Information, Business Description, History, Background Information on Enron Corporation*" (Reference for Business. Company History Index, 2018).

During his work with Enron, Skilling helped the company create a "forward market" in natural gas: in his idea, Enron had to create a natural gas bank that would intermediate between suppliers and buyers[10] and had to expand itself also in the sector of electronic trade, which would be realised in the following years by creating EnronOnline, an electronic trading platform for energy commodities. The latter was the first web-based transaction system allowing buyers and sellers to globally trade commodity products, such as natural gas, electricity, credit derivatives, bankruptcy swaps, pulp, gas, plastics, paper, steel, metals, freight, and TV commercial time.

Skilling's corporate advices casted him in a positive light in Kenneth Lay's eyes – Enron's founder, chairman and Chief Executive Officer until early 2001 – who hired him in a first moment as chairman and Chief Executive Officer of one of Enron's main subsidiaries – Enron Finance Corp. –, and then promoted him as Chief Operating Officer of Enron in 1997.

Skilling's policies showed the ability to work fast, making Enron the largest seller of natural gas in North America, while its trading activities were the second largest factor to its overall income.

Apart from the aforementioned corporate strategies, Skilling became famous for having proposed and enforced the so-called "asset-light business model".

Skilling, in his October 2000 speech before the Enron Finance Committee, started from the idea that Enron owned too many "heavy" assets, namely gas pipelines and production facilities, but that it had "limited cash flow to service additional debt and limited earnings to cover dilution of additional equity": indeed, a less leveraged balance sheet represented the only way to have access to more loans to pursue the new project in Enron corporate strategy, *i.e.*, EnronOnline.

In order for this strategy to be effectively enforced, though, there was an urgent need to sell those aforementioned heavy assets which could not generate any more useful information to the activity of trading facilities, but these assets were either overvalued or unattractive to strategic buyers, thus difficult to sell.

The solution to this conundrum represented the beginning of Enron tumble.

Indeed, Enron exploited – perhaps too much – the extensive interpretation – defined by COFFEE, JR. (2006) as "aggressive" – of some issues, such as the "mark-to-market" accounting rule and the regulation of the so-called "Special Purpose Entities" (hereinafter, SPE or SPEs).

[10] "*Gatekeepers: The Professions and Corporate Governance*" (Coffee, 2006, p.172).

This dissertation will briefly analyse the provisions and the interpretation concerning the aforementioned issues and then it will continue shedding light on the reasons behind Enron's downfall.

The "mark-to-market" accounting rule – or "fair value" accounting rule –, as defined under IFRS 13 and ASC 820, is "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date".
The opposite accounting rule is that of the "historical cost", for which the price of an asset on the balance sheet is based on its nominal or original cost when acquired by the entity at stake. Classical economists supported the idea for which the historical cost was a better accounting rule for many reasons, such as that, set forth by CECCHERELLI (1947), according to which "the original cost of a capital constituency, measuring a disbursement of funds remaining heavily at the undertaking service for different periods, purposes and modalities, expresses the functional value that the undertaking attributes in that precise moment to that precise investment".[11]
But the issue to highlight stands in the ontological difference between the two accounting rules, namely that for which the former is used for potential trades, while the latter for an effective one, or that the historical cost gives priority to the respect of the principle of prudence, while the fair value recognises predominance of the principle of competence on that of prudence.[12]
Having analysed these differences, the accounting rules at hand demonstrate to be alternative, with the implication that each undertaking carrying the obligation to draft the financial statement must choose between the two.

Moreover, a Special Purpose Entity (SPE) "is a legal entity usually a limited company of some type created to fulfil narrow, specific or temporary objectives. SPEs are typically used by companies to isolate the firm from financial risk. A company will transfer assets to the SPE for management or use the SPE to finance a large project thereby achieving a narrow set of goals without putting the entire firm at risk. SPEs are also commonly used in complex financings to separate different layers of equity infusion. In addition, they are commonly used to own a single asset and associated permits and contract rights to allow for easier transfer of that asset.
SPE may be owned by one or more other entities and certain jurisdictions may require ownership by certain parties in specific percentages. Often it is important that the SPE not to

[11] "*Il linguaggio dei bilanci*" (Ceccherelli, 1947, p.101).
[12] "*Il concetto di* fair value *e la valutazione degli strumenti finanziari*" (Rossi, 2003, p.88).

be owned by the entity on whose behalf the SPE is being set up. Therefore, many SPEs are set up as 'orphan' companies with their shares settled on charitable trust and with professional directors provided by an administration company to ensure that there is no connection with the sponsor".[13]

There are several advantages to using SPEs. One advantage is the ability to moderate risk by transferring the economic risks and rewards of assets to a non-consolidated third party, while retaining use of the assets.

An additional advantage of an SPE is that often it can create tax advantages for the transferor. As a "pass-through entity",[14] an SPE is typically not taxed at the entity level. Given the typical size of SPE transactions, the tax deductions are likely to outweigh any maintenance costs associated with the upkeep of the SPE.

Lastly, when properly structured, an SPE often reduces credit risk or other risks for lenders or investors and may lower financing costs.

In order for companies to enjoy the aforementioned advantages, in particular that of the absence of the consolidation of assets and liabilities of the SPE in the main company's financial statement, some conditions must be met. Firstly, a third-party owner independent of the sponsor has a sufficient equity investment in the SPE, secondly, the independent third-party owner investment is "substantive", namely the third-party owns at least 3 percent of the SPE'S total debt and equity or total assets), thirdly, the independent third-party owner has a controlling financial interest in the SPE, meaning that the owner holds more than 50 percent of the voting interests of the SPE, and lastly, the independent third-party owner possess substantive risks and rewards of its investments in the SPE, namely, the owner's investment and potential return are "at risk" and not guaranteed by the transferring organisation.

The Securities and Exchange Commission (hereinafter, SEC), the independent agency of the United States federal government with the task of vigilance on the Stock Exchange, dedicated much literature to the topic at hand during the first years of the last decade of the twentieth century, restating the aforementioned conditions for a company not to include a SPE in its consolidated financial statement.

Also FASB (Financial Accounting Standards Board), at the end of the previous century, tried to shed light over the issue at stake, but with no significant results, thanks both to pressures

[13] "*Special Purpose Entity (SPE) Law and Legal Definition*" (US Legal, 2016).

[14] A pass-through entity is a special business structure that is used to reduce the effects of double taxation. Pass-through entities don't pay income taxes at the corporate level. Instead, corporate income is allocated among the owners, and income taxes are only levied at the individual owners' level.

made by those big companies exploiting the role of the SPEs – amongst which there was also Enron – and to the technical difficulties surrounding the tool at hand.
Hence, Enron was able to take advantage of this interpretative uncertainty, by stretching the aforementioned notion to their limits, conducting a corporate policy which will reveal itself as criminal and unsustainable.[15]

But, specifically, how did Enron take advantage of the two aforementioned issues?
Firstly, in terms of the distort use of the "mark-to-market" accounting rule, Enron entered into long-term contracts – usually 20-years contracts – with large customers, according to which the company committed itself to supply energy at a fixed price, in return of which it received a considerable down payment.
The use of the abovementioned accounting rule stands in that Enron had to estimate the value of the contract at the moment in which the company entered into it with its counterparts, hence compelling the management to carry out a dangerous forecast on many issues whose value is barely predictable – such as energy prices or interest rates.
This issue caused a huge speculation, perfectly explained by the "Eli Lilly's case". Enron entered into a 15-years contract with Eli Lilly and Company, a pharmaceutical public company, for the electricity supply of its Indianapolis plant. Enron's management estimated that the contract would have generated more than $500 million only on the basis of rough prediction on the future energy price and, most of all, on the hope that Indiana would have deregulated electricity, with all the related consequences.

Secondly, and probably with the major impact on the future Enron downfall, the aggressive use of SPEs.
Indeed, Enron began to transfer to its many new-established SPEs – more than one hundred by 2000 – most of what was indicated by Skilling as "heavy assets", such as pipelines or even whole production facilities.
These transactions produced two different outcomes, both in favour of Enron, namely, the enforcement of the aforementioned "asset-light" business model, producing a "slim" balance sheet, and the possibility to borrow more funds to lower interest rates, conserving the knowledge power deriving by the controlled infrastructures.
Notwithstanding any extensive interpretation of rules backing SPEs, there is the need that independent parties own at least 3 percent and control the SPE, and Enron, which demonstrated publicly several times to be in favour of this rule, infringed it in many ways.

[15] "*Through the SPE Looking Glass: Improving the Transparency of Special Purpose Entities*" (Deloitte & Touche, 2002).

One of the most surprising ways in which Enron used SPEs has been that of transactions with related parties, where related parties were represented by controlled SPEs themselves.

These transactions were known to Enron's audit committee and to Arthur Andersen (hereinafter, also "Andersen"), but neither one nor the other have expressed any serious concern before Enron's final days.

The beginning of the end for Enron can be traced to 16th October 2001, date in which the company announced the reduction of its incomes by $544 million, due to financial transactions with LJM2 Co-Investment, L.P. (hereinafter, LJM2), a company created and managed by Andrew Fastow, Chief Financial Officer of Enron itself. On the same occasion, Enron communicated a reduction of its net assets by $1.2 billion, due to the mentioned financial transactions.

Less than one month later, Enron announced the necessity to restate its balance sheets from 1997 to 2001, due to "accounting mistakes", with regards to many financial operations with several companies managed by Fastow, such as LJM Cayman, L.P. (hereinafter, LJM1) and another related party, namely Chewco Investments, L.P. (hereinafter, Chewco). This related party was managed by an Enron's employee, Kopper, who answered to the aforementioned Fastow.

The effects of those "corrections" brought to the following changes:

- The economic outturn for 1997 was reduced by $28 million (on an overall of $105 million, equal to its 27%), the economic outturn for 1998 was reduced by $133 million (on an overall of $703 million, equal to its 19%), the economic outturn for 1999 was reduced by $248 million (on an overall of $893 million, equal to its 28%), the economic outturn for 2000 was reduced by $99 million (on an overall of $979 million, equal to its 10%).
- Enron's net assets were reduced by $258 million in 1997, by $391 million in 1998, by $710 million in 1999 and by $754 million in 2000.

The disclosure to the public of those accounting "corrections" caused Enron breakdown, then, less than one month later – on 2nd December 2001 – forced it into bankruptcy.[16]

This downfall also represented an important lesson from the corporate governance point of view, as brilliantly analysed by MACEY (2008), according to which "it is unwise to place too much trust and reliance on a company's board of directors. Unfortunately, it appears that this lesson has not been learned. Commentators have been virtually unanimous in criticizing the

[16] "*Come si formano e si «eludono» le regole contabili. Il caso Enron e dintorni*" (Ianniello, 2003, p.92).

poor performance of the Enron board. Echoing the typical views expressed, one law professors observed that «as the Enron board starkly demonstrated, boards often fail to live up to our expectations, and ineffectual boards cast doubt on the entire corporate governance system»[17]".[18]

Before moving to the analysis of the gatekeepers' performances in the Enron affair, a question arises: how did the Enron scandal blow up? Something happened, and that *something* caused Enron to publicly release that it would have restated some of its financial statements.
Surprisingly, no gatekeeper was responsible for this disclosure, for the reasons explained in the next subparagraph; instead, paradoxically, short sellers were the "heroes" – as called by COFFEE, JR. (2006) – who opened the Pandora's box of the Enron case.

Short-selling is defined as a financial operation consisting in the sale of financial instruments that the seller does not own, with the subsequent re-purchase.
This financial operation is carried out when the short seller considers that the price at which he or she will re-purchase the financial instrument will be higher than that at which he or she sold the same financial instrument before.[19]

The whole affair began to be discovered with the analysis of Enron's public financial statements carried out by James "Jim" Chanos, a professional trader and president of a firm specialised in short-selling called Kynikos Associates.
As narrated by LAING (2002), Chanos affirmed that Enron had to be considered as a "hedge fund in disguise" and, as such, it had a very poor return for being a high-risk hedge fund.[20]
Moreover, considering the already existing perception of the several frauds committed by Enron and of its related parties' transactions, Chanos began to "short-sell" on Enron's shares on November 2000.
Chanos, started then his attempt of raising public opinion awareness on the fragility of Enron's investments: in particular, on February 2001, he attended the "Bears in Hibernation" national short sellers' conference, where he publicly expressed his opinions.

However, the issue which led public opinion to effectively think at Enron as a "fragile giant" has been the article appeared on March 2001 on FORTUNE, titled "Is Enron Overpriced?", wrote by BETHANY MCLEAN.[21]

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[17] "*Enron: Corporate Fiascos and Their Implications*" (Paredes, 2004, p.6).
[18] "*Corporate Governance: Promises Kept, Promises Broken*" (Macey, 2004, p.110).
[19] "*Sotto la lente: short selling*" (Borsa Italiana, 2008)
[20] "*The Bear that Roared: How short-sellers Jim Chanos helped expose Enron*" (Laing, 2002).

She had been convinced by Chanos himself that Enron had many "skeletons in its closet" and that the story was worthy of a deeper investigation, which was carried out and published in the said article, which finally changed the Enron's public stance.

As mentioned before, this was the beginning of the end for Enron, which led to Skilling's sudden resigning on August 2001 and to the following bankruptcy declaration.

Now this dissertation will explain the role that each gatekeeper had in the Enron affair.

1.2.2 Analysis of Arthur Andersen's fault: is it the only one to blame?

In order to fully understand the importance that Arthur Andersen had in the whole Enron scandal, a short digression about the history of the accounting firm must be outlined.

Arthur E. Andersen established the namesake firm in 1913, together with Clarence DeLany.
The founder had carefully cultivated a reputation for unbending integrity, which had been further fostered by his successor, Leonard Spacek. An example of such quality was given in 1986, when the firm dropped a major but excessively aggressive client, Lincoln Savings & Loan, because they lost confidence in its honesty. Lincoln Savings then hired another accounting firm, Arthur Young, which suffered many losses when the audited company failed.
Andersen has been the first major auditing firm to enter into the consulting business, activity begun in the mid-1950s. By the mid-1980s, the activity at hand was producing more revenues than auditing, hence producing a slight – but progressive – change in mentality.
Indeed, Andersen radically changed its business strategy, thinking at auditing as the *passe-partout* to a larger clientele, therefore turning their audit partner into a salesman incentivised through compensation formulas. These formulas allowed them to link their earnings to the outcomes of the consulting activity.

The transition at hand, despite having concerned every major auditing firm, overwhelmed Andersen, causing tensions in its management due to the greater and conflicting authority that consultants acquired during those years.
Consultants themselves started affirming that the auditing activities could not produce as much revenues as the consulting services, hence that they had to be separated. This division formally took place in 1989.

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[21] "*Is Enron Overpriced?*" (McLean, 2001).

In 1998, Andersen released a guideline claiming the necessity to wrap up audit and non-audit services in order to double revenues. This was the clear sign of a corporate policy oriented in an opposite direction with respect to the original spirit which characterised the firm for a long time.

However, the most resounding symbol of a deviated mentality was represented by the "Professional Standards Group", an "internal watchdog body"[22] with the task of keeping centralised control over accounting policies and practices.
Under Arthur E. Andersen and its immediate successors, this body was one of the most powerful, invested with the task of assuring a certain degree of reliability to the firm by detecting and contrasting potential conflicts, such as the risk of "capture" of the whole firm or of a local office by a powerful partner.
Nevertheless, as the firm began to develop a more business-oriented mentality, the Professional Standards Group lost most of its power, remaining their recommendations unheard.

Returning to the main issue of this paragraph, *i.e.*, Andersen's role in the Enron affair, the competent office which dealt with the firm was the Houston one.
There are evidences that in at least four occasions the Houston office did not follow the accounting recommendations issued by the Professional Standards Group concerning Enron.
In addition, the local Professional Standards Group representative, Carl Bass, who also monitored the Enron account, was re-assigned upon request of Enron's Chief Accounting Officer, Rick Causey, who claimed that Bass's actions could hinder Enron's use of Special Purpose Entities.
Rick Causey himself was a former Andersen's partner, issue which can perfectly explain the organic relations existing between the two firms.

But attributing Enron downfall only to Andersen's greed could be a terrible mistake. Indeed, the latter had other conflicts as well.
Examples could be found in all the financial scandals blown up during the 1990s, such as the Sunbeam case in 1997, the Waste Management case in 1999, the WorldCom scandal – which will be analysed in the following paragraph by this dissertation – and, of course, Enron.
Also other major audit firms were involved in these kinds of scandals – demonstrating a trend which will be inverted only with the issuance of the Sarbanes-Oxley Act in 2002 – but the difference between them and Andersen stands in two linked factors: first, comparing the

[22] "*Gatekeepers: The Professions and Corporate Governance*" (Coffee Jr., 2006, p.185).

auditees of Andersen and the ones of the surviving Big Four, it is clear how Andersen's audit clients experienced a significantly higher rate of both private and public securities litigation,[23] hence meaning that perhaps Andersen assisted clients more incline to commit crimes, secondly, assistant U.S. Attorney General Michael Certoff described Andersen as "recidivist", assuming that the criminal inclination is one of its peculiar attitudes.

But, how highlighted in the heading of this subparagraph, a deep analysis must be carried out in order to assess whether Enron breakdown's responsibility can be saddled only upon Andersen.

Of course, there are other actors in the whole system surrounding Enron – those described generally under the first paragraph of this chapter as "gatekeepers" –, and the objective of this subparagraph is exactly that of determining the degree of fault attributable to each of them.

Starting from the Enron's internal audit committee, it should have watched over its firm's compliance with financial obligations, and according to the immediate outcomes, it did well.

Indeed, as emerged from several documents, Enron's audit committee was one of the best of its time, according to single members' wages, specific competences and backgrounds. For instance, in the body at hand, personnel could count individuals like the former CEO of Rio de Janeiro's State Bank, the former U.K. Secretary of State of Energy and the former Chair of the U.S. Commodities Futures Trading Commission.

Moreover, the audit committee met regularly, proved by every meeting's documentation stored in the firm.

However, to a closer inspection, there were many unreported – or covered – conflicts of interests, such those involving Dr John H. Mendelsohn, President of the University of Texas's Medical Division Andersen Cancer Center, which received many financial aids from Enron itself.

A more cautious analysis would have also brought out other weird situations. For instance, in a February 2001 meeting, which lasted only ninety minutes, Enron's audit committee had on the table several serious issues, such as the Andersen's report about Enron's compliance with GAAP and internal controls, a report on the adequacy of related party transactions carried out, *inter alia*, by Ken Fastow, a review of the 2001 Internal Control Audit Plan, which included a review of key business trends and risks, and many other questions.

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[23] "*Differentiating Between Arthur Andersen and the Surviving Big Four on the Basis of Auditor Quality: An Empirical Examination of the Decision to Criminally Prosecute Arthur Andersen*" (Fuerman, 2015, p.8).

It is unlikely that the audit committee could have adequately discussed about all these issues in so little time. A strong clue fostered by another scandal broke in the late 1980s involving two "rogue employees" exceeding their trading limits: Enron's internal audit committee prepared a detailed report addressed to the Enron board, which allegedly never received it.
Then, Andersen prepared a "whitewashed version" of the story, informing the audit committee that every issued raised by them had been solved.

This is to say that generally the internal audit committee was regularly blinded by its professional advisers which only passed information the senior management wanted to receive.

Furthermore, other key actors in Enron downfall were securities analysts, which can be defined as the professionals which carry out studies on various industries and companies, providing for evaluation concerning their reliability and recommending to investors whether buying, selling or holding their securities.
On the basis of their role, securities analysts had to be the first gatekeepers to report the "opaque" condition in which Enron's shares lied, but they did not. Why?
This question has different, but complementary, answers.

First of all, securities analysts, as well as Andersen and Enron's internal audit committee, had clear conditions of conflicts of interests, highlighted by a thorough 2005 study.[24]
This study showed that investment banks earned more than $125 million in underwriting fees on Enron offerings over the period from 1998 to 2000. Analysts working at investment banking firms that engaged in underwriting had significantly higher estimates for Enron's likely share price appreciation compared to analysts who did not work at investment banks.[25]
But there is an incoherence in this story: analysts who worked for investment banks without current business with Enron had even higher price estimates than the analysts who worked for banks with ongoing investments with Enron.[26]

This anomaly can be explained only with reference to the other conditions which led securities analysts not to release the Enron scandal.

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[24] "*Conspiracy of Fools*" (Eichenwald, 2005, p. 430).

[25] Between January and October 2001, analysts who worked for investment banks expected a 54% 12-month appreciation in Enron's stock price, while analysts who did not estimated only a 24% appreciation.

[26] The analysts who worked for investment banks that had no current banking relations with Enron actually had higher estimates of its likely 12-month share price appreciation compared to the analysts who worked for its current investment banks.

The second answer lies in the fear of retaliation.
It is perfectly explained by the "Merrill Lynch case", when Enron refused to allow Merrill Lynch, its long-time investment bank, to participate in a major and highly lucrative public offering of its shares unless the bank fired its energy market securities analyst, who had downgraded Enron's shares. As imaginable, Merrill Lynch fired the analyst.
The result of this affair was that securities analysts were scared of giving bad ratings to Enron, hence producing the aforementioned "anomalies".

Finally, another oddity stands in that analysts hired by equity funds - such as mutual and pension funds - did not report Enron's anomalies, despite being analysts with no concrete fear of retaliation.
Amongst the possible answers, there is the one set out by SHERMAN, according to which someone on the "buy-side" did detect irregularities at Enron and dumped their shares, but because buy-side research is proprietary and rarely released publicly, the analysts' discovery of a fraud at Enron would not alert others. Indeed, a major institution seeking to liquidate a large and illiquid block of stock in Enron would be very careful not to set off alarm bells that would create panic among other investors.
In any case, it is clear that most fund managers did not dump Enron shares until the penultimate moment. As late October 2001, 60% of Enron's shares was held by the major mutual funds, including those managed by Fidelity, Vanguard, Merrill Lynch, Morgan Stanley, and Goldman Sachs. Those firms certainly knew that the "sell-side" research was conflicted and should have recognised that Enron's financial statements were opaque and its portfolio of businesses very risky.
The answer to this behaviour stands in the fact that "fund managers tend to herd"[27]: the latter and the analysts find it more damaging to their careers to be individually wrong than collectively wrong.[28]

Moreover, other gatekeepers are to blame, such as attorneys, both corporate's and external, who for definition are those responsible for the firm's compliance with federal securities laws.
At the dawn of Enron's breakdown, its board of directors set up a Special Investigative Committee[29] – informally called "Powers Committee", by the name of its Chair – with the task of shedding light over the related parties' transactions with Andrew Fastow and other Enron's employees.

[27] "*Herd Behavior and Investment*" (Scharfstein and Stein, 1990, p.465-479).
[28] "*Enron: Uncovering the Uncovered Story*" (Sherman, 2002).
[29] "*Report of Investigation*" (Special Investigative Committee of the Board of Directors of Enron Corp., 2002)

In particular, they underlined that "we were not asked, and we have not attempted, to investigate the causes of Enron's bankruptcy or the numerous business judgments and external factors that contributed it", in order to emphasise the fact that they were been set up only for an internal investigation on precise matters and not to provide the Board of Directors with the reasons behind Enron's downfall.
Let's remember that the Commission had been set up in the aftermath of Enron's financial restatement, so few months before the following bankruptcy request.

The Commission was formed by POWERS, JR., TROUBH & WINOKUR, JR., who basically, in the very beginning of their Report, described the disclosure process carried out by Enron's attorneys as "fundamentally dysfunctional".

As mentioned before, not only corporate attorneys are responsible for all the affair at stake, but also external attorneys, among which the main counsel was Vinson & Elkins.
At a certain point of the Powers Report, it is claimed that James Derrick, Enron's general counsel, recommended Vinson & Elkins, indicating it as "the logical choice because, among other things, it was familiar with Enron and LJM matters".
This exact issue – *i.e.*, that of familiarity – periodically returns in the whole discussion about the reasons behind the reforms in the auditing field, because it usually leads to an inadequate control over the entity under surveillance.
Notwithstanding the fact that this situation concerns attorneys, the issue is almost the same.

By the way, corporate's and external attorneys have been considered as minor actors in the whole issue because they relied mainly upon the outcomes provided by accountants.
This lack of transparency has been considered by COFFEE, JR. (2006) as "attributable less to a gatekeeper that failed and more to the absence of any true gatekeeper in the disclosure process with real responsibility or authority".

Finally, other actors upon which attributing a certain degree of responsibility have been credit-rating agencies.
These have been defined as independent companies evaluating the financial condition of issuers of debt instruments and then assigning a rating that reflects their assessment of the issuer's ability to make the debt payments. Potential investors, customers, employees and business partners rely upon the data and objective analysis of credit rating agencies in determining the overall strength and stability of a company.[30]

[30] "*Credit-Rating Agencies*" (Business Dictionary, 2018).

A general problem arisen also with regards to the WorldCom scandal – as will be analysed in the next paragraph – and the Parmalat case has been that of the slowness in changing their Enron's credit-rating, index which will be revised only when the Enron's corporate situation was in the public eye.
The slowness, also in this case, could be explained through the reference to conflicts of interests, which involved credit-rating agencies too.
Though, this situation cannot be compared to those highlighted before because credit-rating agencies have so many clients that no one is really essential for their survival, hence avoiding any fear of retaliation.

Rather than conflicts of interests, a better explanation can be provided for by the devastating consequences of a rating downgrading. Indeed, as analysed, Enron was one of the most important U.S.-based companies – and generally one of the most important on a global basis – and the first energy company in the United States.
The consequences of a rating downgrading, considering also the stakes held in Enron by the United States itself, would have been catastrophic.

The last factor to be considered in order to explain the aforementioned slowness can be represented by the lack of competition in the market for credit-rating agencies, problem discovered also with regards to the major auditing firms.
The major credit-rating agencies – *i.e.*, Moody's and Standard & Poor's – effectively hold a monopoly, considering that the existence of many minor competitor cannot represent a threat to their business.
This absence of competitive constraints may bring – as in the case at stake – to a lack of incentives for investing into the improvement of their services.

In conclusion, the Enron case highlighted several problems affecting gatekeepers in general through those years, primarily that of conflicts of interests and of familiarity.
This subparagraph highlighted also another issue, namely that for which the literature which came right after the Enron case had been too severe with Andersen, barely not considering the implication of the other gatekeepers which had, as analysed, a role almost comparable to that of the auditing firm at stake.

The outcomes of this study made clear that gatekeepers needed a huge, radical and organic reform, which arrived, as will be seen in the following paragraphs, with the issuance of the so-called “Sarbanes-Oxley Act” in 2002.

1.3 The WorldCom Scandal

The WorldCom case is worthy of being mentioned because, until the Madoff scandal, it was the largest accounting scandal in the United States history – even larger than Enron.
Indeed, the size of a corporate bankruptcy is measured in terms of the company’s pre-bankruptcy assets, and WorldCom’s was $107 billion, while Enron’s was “just” $63 billion.

WorldCom, unlike Enron, was not a long-established firm which tried to mutate into something new – in the case analysed in the previous subparagraph, into a trading company. WorldCom had quite a short history, and it is mentioned right after the Enron case for the involvement Andersen had in both firms, notwithstanding the different degree of responsibility.
In order to better understand Andersen’s implications and degree of fault, it is advisable to introduce WorldCom’s background.

Long Distance Discount Service (hereinafter, LDDS) – this was its original denomination – was created in 1983 by Murray Waldron and William Rector, who wanted to establish a discount long-distance provider.
LDDS entered into many mergers agreement, thanks to which it became one of the largest telephone companies in the United States and, more in general, in the world.
In 1995, LDDS acquired voice and data transmission company Williams Telecommunications Group Inc. (WilTel) for $2.5 billion and changed its name to WorldCom Inc.
In 1998, WorldCom successfully completed three mergers with MCI Communications Corp. ($40 billion) – the largest in corporate history at the time –, Brooks Fiber Properties Inc. ($1.2 billion) and CompuServe Corp. ($1.3 billion).
In 1999, WorldCom ended under the U.S. Securities and Exchange Commission’s limelight for the attempted merger with Sprint Corp., another huge U.S. based telecommunication company – nowadays the largest, together with AT&T. After much strain by both the United States’ and Europe’s antitrust authorities (the latter worried about the possible competitive implications such a deal would have brought), the deal was blocked for the fear that the limitation of the competitive constraints on the U.S. telecommunication market would have been lethal for both consumers and AT&T. This attempt of merger caught many attentions because it would have been the largest telecommunication merger operation since then.

Apart from these considerations, WorldCom impressed its main rivals for its efficiency, in

particular for the reported lower "line-costs" compared to AT&T and Sprint.
Line-costs are transmission costs paid to other services providers for the use or the right to use their lines.[31]
These costs amounted almost to half of its overall expenses,[32] and the fact that WorldCom reported lower line-costs – compared to its main rivals – kept its shares' price high and led it to acquire its – just apparently – less efficient rivals.
However, these costs were kept fraudulently low through the decision taken by Scott Sullivan, WorldCom's Chief Financial Officer, to cease expensing line costs and instead capitalise them.
As stated by COFFEE, JR. (2006), "to capitalise a payment made to rival companies for use of their lines and facilities amounts to a mortal sin for accountants. When one capitalises a payment, one is in effect creating an asset (which will be depreciated at a much lower rate, thereby reducing the current charge to earnings). But no legitimate asset arises out of the payment of such an expense.
To see this, imagine an ordinary tenant making a monthly lease payment and seeking to capitalise this payment as if the tenant had acquired an asset by virtue of the payment. In fact, the tenant has acquired nothing and will be forced to move out at the end of the lease.
Similarly, WorldCom acquired nothing and was not entitled to capitalise these line costs payment because no colourable asset had been acquired as a result of them".[33]

On March, the 11th 2002, WorldCom received a request for information by the Securities and Exchange Commission relating to accounting procedures and loans to officers, together with the audit capital expenditures carried out in 2002 by WorldCom's internal auditors.

Indeed, in this case a gatekeeper "surprisingly" appropriately carried out its functions, detecting misbehaviours conducted for almost one year.
In May 2002, when the internal audit began the aforementioned audit capital expenditures, it detected a weird item within the 2001 financial statements, *i.e.* "prepaid capacity", which had been used in order to explain the differences existing between two sets of schedules.
In reality, this item that internal auditors never heard before referred to the capital accounts to which line costs were being transferred.

The surprising issue in the whole story was that Eugene Morris, one of the internal auditors, developed a software capable of determining how this prepaid capacity account had been

[31] "*Gatekeepers: The Professions and Corporate Governance*" (Coffee Jr., 2006, p.189-197).
[32] It is well represented in the United States Court of Appeals' decision [2004] *In re WorldCom Securities Litigation* 03-9350.
[33] *Ibid.*

created and that was able to uncover the transfer of line costs to capital account in a matter of hours, as highlighted by the United States Court of Appeal's decision *In re WorldCom Securities Litigation*.[34]
This discovery startled WorldCom's management which immediately denied internal auditors access to company's general ledger, in order to prevent them from detecting anything else.

As previously mentioned, Andersen was WorldCom's main external auditor and, also in this case – similarly to what happened with regards to Enron – did not detect anything, for the reasons which will be analysed in the next lines. The stunning issue has been that the internal audit, although being actively prevented by WorldCom's management from detecting anything, managed to succeed in its tasks compared to the "external" and passive Andersen.

Differently from the Enron's case, there is no evidence that Andersen knew of the misbehaviour carried out by WorldCom, but an auditor, either internal or external, shall, in performance of its tasks, execute them with a skeptical mind, doubting of everything, especially the controversial issues.

As emerged by the aforementioned judgement, WorldCom was not sole responsible for a "one-shot transaction engaged in by a reckless chief financial officer", but it "had engaged in other strategies to reduce the apparent magnitude of its line costs".

As analysed in the previous subparagraph, there is no single actor to blame, rather there is the need to conduct a survey considering the different roles each gatekeeper had in the whole affair.

First, investment banks had much more interest in going into business with WorldCom than with Enron, because the former engaged in more extraordinary corporate transactions – such as acquisitions – to be financed.
In particular, Salomon Smith Barney (hereinafter, SSB) was WorldCom's main investment bank, having received more than $116 million in underwritings and investment banking fees by WorldCom's transactions.
SSB and WorldCom, as analysed by the Bankruptcy Examiner and former U.S. Attorney General and Pennsylvania Governor, Richard Thornburgh, engaged in several financial operations, in particular with WorldCom's founder and Chief Executive Officer, Bernard Ebbers, such as those carried out from June 1996 to November 1997, when SSB allocated

[34] United States Court of Appeals' decision [2004] *In re WorldCom Securities Litigation* 03-9350.

more than 748,000 shares in initial public offerings to Ebbers itself, thanks to which the investment bank earned more than $11 million.
This practice produced the WorldCom's reaction to hire SSB for other financial transactions, from which it would have earned more money, clearly leading to a situation of familiarity and collusion against both the shareholders and the market.

SSB's liability must be seen in the light of what is set forth by Section 11 of United States' Securities Act: the underwriter must conduct a reasonable investigation of the statements made by the issuer in its registration statement when the issuer registers securities for public sale.
SSB, notwithstanding a record-setting securities class action with a $2,575 billion settlement, proved to be a "passive gatekeeper" which conducted a perfunctory due diligence before underwriting the two major debt offerings made by WorldCom in 2000 and 2001.

Another key actor in the WorldCom scandal, as mentioned before, has been Andersen, as the firm's main external auditing firm.

Even if not so involved in this financial scandal – as happened with regards to the Enron's case – Andersen contributed to WorldCom downfall thanks to its passive behaviour.
It must be said that WorldCom has regularly blinded Andersen, as seen before with reference to its internal auditors, but from an external auditing firm having access to corporate's ledger, something more is asked.
As happened with reference to Enron, WorldCom's Board of Directors set up a Special Investigative Committee with the task of investigating accounting irregularities carried out from 1999 to 2002, including the involvement of certain members of the Board of Directors.[35]
The committee highlighted that "Andersen's audit approach limited the likelihood it would detect the accounting irregularities", approach which "focused heavily on identifying risks and assessing whether the Company had adequate controls in place to mitigate those risks, rather than emphasizing the traditional substantive testing of information maintained in accounting records and financial statements".
It continued claiming that this approach allowed Andersen to rely on WorldCom's "controls without adequately determining that they were worthy of reliance".

The origin of this behaviour must be found in the fact that Andersen wanted to ingratiate itself with WorldCom, a client to which propose its additional – and more lucrative – non-audit

[35] "*Report of Investigation*" (Special Investigative Committee of the Board of Directors of WorldCom, Inc., 2003).

services.
The same reason stands behind what was highlighted by Denise Cote, United States District Judge, in her January 2005 decision, namely that Andersen appreciated at some level the risk of fraud at WorldCom but did not take adequate steps to detect fraud.

Other key actors to be considered are securities analysts.
WorldCom's securities analyst was Jack Grubman, SSB's expert on telecommunication, very well-known in the late 1990s.

Thornburgh, the Bankruptcy Examiner, found a collusive relationship between SSB and Grubman, according to which the securities analyst handed privileged information under the counter to the investment bank, which used this information to push investors to purchase WorldCom's shares.
But not only Grubman carried out this kind of misbehaviour. Standard & Poor's and Moody's too continued until the very end to support WorldCom's shares, proving all those issues analysed before with reference to Enron, such as conflicts of interests and fear that a downgrading would have seriously affected United States and global economy.

Finally, as stated with reference to the Enron case, also attorneys, in quality of gatekeepers, are worthy of being mentioned.

In 2000 and 2001 WorldCom made the then two largest bond offerings, respectively of $5 billion and $11,9 billion. In both transactions, SSB was the main underwriter, together with J.P. Morgan Chase & Co. (hereinafter, J.P. Morgan).
As mentioned, Section 11 of the 1933 Securities Act provides for a due diligence investigation to be completed when issuers register securities for public sale and, at this end, SSB and J.P. Morgan hired Cravath, Swaine & Moore (hereinafter, Cravath) as their attorney.

Before underwriting WorldCom's securities in both cases mentioned above, Cravath conducted a due diligence investigation on the firm, which was documented later by the Federal District Court in the aforementioned judgement, in particular stating that the underwriter's counsel (Cravath itself) carried out a due diligence in just eight days, in which it reported only few conversations held with Sullivan – WorldCom's Chief Financial Officer – about the future of WorldCom and some operations in which it was involved.
Actually, underwriters relied more on Andersen's opinion about WorldCom's financial statements than their attorney's one, but, as mentioned, Andersen too was conflicted and not

trustworthy, hence SSB and J.P. Morgan, after WorldCom's disastrous financial years, publicly downgraded the firm.

As stated by COFFEE, JR. (2006), "in short, the limited due diligence that was conducted appears to have been constrained by the need not to offend the client; the result was a process more perfunctory and formulaic than searching or investigative.
To be sure, the underwriters and the attorneys did not suppress any information nor suspect any fraud, but neither did they search for it intensively.
As a result, the federal district court hearing the WorldCom class action seems to have implicitly agreed with the plaintiff's allegation that «the underwriters did almost no investigation of WorldCom in connection with their underwriting of the bond offerings for the company…»".[36]

In conclusion, also WorldCom's breakdown, although with some differences, can be attributed to an already established and ascertained gatekeeper's failure, which led almost immediately to the issuance of the Sarbanes-Oxley Act, as will be analysed in the next paragraph.

1.4 The Sarbanes-Oxley Act

In 2002, the United States Government felt the necessity to give a strong signal in response to the financial scandals blown out between the 1990s and the beginning of the 2000s, and it did so by approving the Public Company Accounting Reform and Investor Protection, more commonly known as Sarbanes-Oxley Act (hereinafter, SOX).

Before starting to analyse the main features and the changes this piece of legislation brought, a historical excursion is necessary.

In April 2002, Congressman Michael Oxley (republican from Ohio) put forth the Corporate and Auditing Accountability, Responsibility and Transparency Act (hereinafter, CAARTA).[37]
It had the idea to reassert the principles which inspired the 1933 Securities Act and to enforce the idea that companies were not blameless entities; it was approved by the House of Representatives on 25th April 2005 and then Congressman Oxley sought for approval before the Banking Committee of the Senate.

[36] "*Gatekeepers: The Professions and Corporate Governance*" (Coffee Jr., 2006, p.201).
[37] Available at www.biblioteca.jus.gov.ar/House-3763.pdf.

At the same time, Senator Paul Sarbanes (democrat from Maryland) who was the head of the aforementioned banking committee, put forth a similar proposal, *i.e.*, Senate Bill 2673[38] (hereinafter, SB 2673), which passed firstly before the Banking Committee and then before the U.S. Senate.

In order to reconcile CAARTA and SB 2673, the House of Representative and the Senate jointly set up a Conference Committee, which released, few days after, the Public Company Accounting Reform and Investor Protection Act, renamed as "the Sarbanes-Oxley Act of 2002" which was approved almost unanimously and signed by the then U.S. president George W. Bush, on 30th July 2002.

Moving on to the analysis of the SOX in its most symbolic provisions, ANAND's work (2007) will be taken as a model, in order to better discuss about the piece of legislation at hand. [39]

Section 101 of SOX sets forth the establishment of the Public Company Accounting Oversight Board (hereinafter, PCAOB), aimed at "oversee[ing] the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for companies the securities of which are sold to, and held by and for, public investors. The Board shall be a body corporate, operate as a nonprofit corporation, and have succession until dissolved by an Act of Congress".
As it is clear, the PCAOB overlaps with the AICPA and the SEC concerning the functions performed. While the difference between the scope of application of PCAOB and AICPA stands in that the former's recommendations and opinions apply to Public Corporations, the latter's ones apply to Non-Public Corporations, there are many more differences between PCAOB and the SEC.
Indeed, according to the SOX (Sections 104 and 105), the SEC is given the jurisdiction to oversee the activities of PCAOB. However, it is a limited jurisdiction, not including, for instance, the power to control it or to pursue an investigation against a company PCAOB avoided to investigate on. In addition, the most preeminent power SEC has with regards to PCAOB is that of amending its rules and review its regulations and standards, which by the way has been made in rare occasions.

Before entering into the analysis of SOX, a premise must be made: indeed, SOX addresses to

[38] Available at http://thomas.loc.gov/cgi-bin/query/R?r107:FLD001:S56684.
[39] "*Essentials of Sarbanes-Oxley*" (Anand, 2007).

– and so must be complied with by – all companies which are publicly traded on United States markets, hence including also foreign companies of which securities are traded on the markets at hand.
This premise is necessary in order to fully understand the scope of application of the legislation at hand, in order for every subject to be perfectly compliant with it.

As made clear by the SOX's *travaux préparatoires*, the legislative act at hand is supported by three pivotal principles: integrity, accuracy and accountability, which together are thought to re-establish investor trust.

Starting from the former, the principle of integrity, in order to maintain investor trust, it is vital that companies convey an image of high moral and professional standards. The goal of the Act is that, in time, investors will forgive past transgressions and recover their faith in the companies they invest in.
SOX also seeks to ensure the integrity of financial records in the sense that they are complete and representative. By requiring companies to present all relevant financial information, without exception, SOX hopes to eliminate fraudulent and erroneous reporting.

Then, the principle of accuracy entails that in addition to data integrity, SOX also seeks to ensure that the reported information is reliable and accurate. In the past, investors did not have a clear benchmark standard or a way of comparing security measures, as companies were left to determine their own security levels. By establishing a standard that is applied across the board, SOX seeks to create a system in which corrupt and misleading behaviours are prevented and detected. This provides investors with assurance that security measures are in place to protect the accuracy of the information they receive, thereby protecting their investments.

Finally, principle of accountability derives from the fact that a common theme in past corporate scandals has been the elusive nature of the blameable party. It seemed that within corporations, no members are culpable for the frauds, but rather the system creates an environment where blame can be passed and ignorance can be claimed.
SOX seeks to ensure that when fraudulent or misleading material is released to investors, there is a direct source for culpability and one or more parties will be held accountable. Through this Act, corporate executives and others responsible for financial reporting are answerable for breaches of information integrity and reliability. The motivation behind this principle is to eliminate the "faceless corporation" idea and disclose to both companies and

public, with clear indications, which position is responsible for specific information and information-related tasks.

In order for a public corporation to be compliant with the aforementioned principles – and therefore with the SOX as a whole –, they must release all relevant financial data to ensure the integrity of the information.
Public corporations – in particular the Chief Executive Officer (hereinafter, CEO) and the Chief Financial Officer (hereinafter, CFO), as will be said with reference to Section 302 – must also provide for an effective system of internal controls, which are aimed at securing financial documents from error and misrepresentation, thereby protecting those who rely on the documents' accuracy.

Now this dissertation will focus on some provisions enshrined in the SOX, in order to understand the revolutions it brought in the aftermath of the aforementioned financial scandals which shook the United States – and, more in general, the world – from the foundations.

First, Section 103 regards auditing, quality control, and independence standards and rules, and sets forth, *inter alia*, that all information related to audit reports must be maintained for a minimum of seven years, in order to preserve the details in case an audit report requires verification.
This provision, even if directly addressed to Certified Public Accountants (hereinafter, CPA), can be indirectly referred also to companies themselves, which have to maintain the aforementioned records.

As it will be underlined in the following chapters, also in the European Union there are several provisions of this kind, symbolising how the SOX influenced European lawmakers in their subsequent legislative efforts in the same subject matter.

Then, Section 201 sets forth the regulation of non-audit services to be offered to the audited entity, providing for a list of services[40] that are considered outside the scope of an auditor's prescribed function, with the possibility to expand the list or to create exemptions.

[40] Section 201 of the Sarbanes-Oxley Act:
« (a) PROHIBITED ACTIVITIES.—Section 10A of the Securities Exchange Act of 1934 (15 U.S.C. 78j–1) is amended by adding at the end the following:
''(g) PROHIBITED ACTIVITIES.—Except as provided in subsection (h), it shall be unlawful for a registered public accounting firm (and any associated person of that firm, to the extent determined appropriate by the Commission) that performs for any issuer any audit required by this title or the rules of the Commission under this title or, beginning 180 days

One of the most direct impacts of this section is that the external auditor is unable to communicate compliance expectations to the company. Although the auditor may have a clear idea of whether the company will pass or fail the audit, he or she cannot express concerns; doing so would be considered as "consulting", which is classified as a prohibited activity.[41]

Furthermore, Section 302 – and its following *addendum* – represents the sum of an effort aimed at preventing the release of misrepresentative financial information, in particular by establishing requirements regarding the protection of document integrity.

The section at hand explains that internal procedures must be designed and established to ensure that all financial disclosures are complete and accurate.

Such a mandate is prescribed through this section by assigning responsibility for the accuracy and integrity of financial reports to the company's executive officers. In particular, this section requires that both the CEO and the CFO – as mentioned before – provide a statement that certifies the accuracy of the financial statements and other related disclosures.

This statement must be attached to all company audits.

As mentioned before, Section 302 has been expanded in July 2002 through SEC proposals called "June Proposals".[42]

Those expansions required that the CEO and CFO certify the effectiveness of their internal controls, not only when submitting a company audit, but also when submitting many SEC reports. This requirement further stipulates that the certification must occur within 90 days

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after the date of commencement of the operations of the Public Company Accounting Oversight Board established under section 101 of the Sarbanes-Oxley Act of 2002 (in this section referred to as the 'Board'), the rules of the Board, to provide to that issuer, contemporaneously with the audit, any non-audit service, including—

''(1) bookkeeping or other services related to the accounting records or financial statements of the audit client;

''(2) financial information systems design and implementation;

''(3) appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

''(4) actuarial services;

''(5) internal audit outsourcing services;

''(6) management functions or human resources;

''(7) broker or dealer, investment adviser, or investment
banking services;

''(8) legal services and expert services unrelated to the
audit; and

''(9) any other service that the Board determines, by regulation, is impermissible.

''(h) PREAPPROVAL REQUIRED FOR NON-AUDIT SERVICES.—A registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) of subsection (g) for an audit client, only if the activity is approved in advance by the audit committee of the issuer, in accordance with subsection (i).''.

(b) EXEMPTION AUTHORITY.—The Board may, on a case by case basis, exempt any person, issuer, public accounting firm, or transaction from the prohibition on the provision of services under section 10A(g) of the Securities Exchange Act of 1934 (as added by this section), to the extent that such exemption is necessary or appropriate in the public interest and is consistent with the protection of investors, and subject to review by the Commission in the same manner as for rules of the Board under section 107».

[41] "*Essentials of Sarbanes-Oxley*" (Anand, 2007, p.44-45).

[42] See more at www.sec.gov/rules/proposed/proposedarchive/proposed2002.shtml.

before issuing the report.
As reconstructed by ANAND, according to the SOX amended Section 302, the company's CEO and CFO must certify that:

- controls have been designed, implemented, and tested to ensure the integrity of the financial and related information issued in the quarterly and annual reports. Also, that they are personally certifying that these controls have been effective and that the information is accurate;
- they are responsible for the establishment, maintenance, and evaluation of internal controls. As a direct consequence, the CEO and CFO are culpable, should any internal controls be found to have insufficiencies;
- they have presented all information regarding the efficacy of those controls and any significant changes that have been made in their quarterly and annual reports. The requirement that the CEO and CFO verify either that no changes have been made or that they have disclosed the nature of any relevant changes is meant to ensure that investors are provided only with up-to-date information.

Then, one of the most controversial provisions in the whole SOX is Section 404, which deals with management assessment of internal controls. In particular, it requires that all annual financial reports shall include an Internal Control Report to certify and explain those efforts that have been made to ensure the integrity and accuracy of the financial information.
The aforementioned controversies arose when companies found out that, in order to be compliant with the provision at hand, many efforts in terms of costs and personnel had to be made.

Moving to the substance of Section 404, it requires that each annual report must include a statement by executive officers to the effect that they are responsible for the establishment and maintenance of the internal control structure and other procedures for financial reporting.
In addition, the Internal Control Report must also include an assessment of all internal controls related to the financial information that has been released. This assessment is required to inform investors not only about the structure of the controls, but also about their efficacy.

In order to be perfectly compliant with the aforementioned Section, the CEO and CFO must draft a document that contains these statements and information:

- *Statement of responsibility for establishing and maintaining internal financial reporting controls*.

  This statement is similar to that which is required by Section 302 and certifies that CEO/CFO assumes responsibility and culpability should the internal financial reporting controls not meet standards.

  By placing the responsibility for the establishment of such controls at the top of the company's hierarchy, SOX is working to ensure that those with the most power also have the greatest responsibility.
- *An explanation of the framework used to evaluate the efficacy of internal financial reporting controls*.

  This document serves to educate investors and all other applicable parties about those controls that have been implemented within the company. This information must be up-to-date, complete and accurate.
- *Report on assessment results of internal financial reporting controls for the most recent fiscal year.*

  In addition to explaining the nature of the internal controls, this document must grant that these controls have been tested recently and must provide with the results of the assessment. This requirement further ensures that the company has taken every measure to ensure the accuracy of the report's information.

  It is not enough that controls are established; they must be checked and tested routinely to ensure their ongoing efficacy. As the company changes and evolves, these routine tests become even more vital.
- *Report disclosing significant deficiencies that could result in misstatement*.

  Finally, the document must release any gaps within the control framework that could result in a misstatement of the financial information. It is understood that no system can ever offer perfect protection, but when significant risks are present, they must be reported.

  By mandating such a practice, SOX ensures that investors have a complete picture of the company's control system and its efficacy. Depending on their severity, these deficiencies could nullify the CEO/CFO's certification that the internal controls are effective and that the reported information is accurate.

In addition to the executive officers' certification, the auditor must provide a statement to the same effect.

Another pivotal provision, notwithstanding its seeming "programmatic" nature, is Section 406

regarding code of ethics for Senior Financial Officers.
It sets forth that the aforementioned Senior Financial Officers must be compliant with a code of ethics which is adopted by the same company, and so it is peculiar to the company's necessities and peculiarities.
This code of ethics also serves as a vehicle for educating members about the compliance efforts that the company is making by including relevant clauses such as conflicts of interest, honesty and fairness, and reporting unethical behaviour.

As stated before, SOX revolutionised the entire United States share market because of the impact it had on the disclosure of information on behalf of Public Companies.
At this aim, Section 409 provides for directives to issuers to disclose relevant financial information on a rapid and current basis.
The purpose of this disclosure is to ensure that if a major event occurs between the issuance of quarterly reports, investors will have the information in enough time to make sound decisions. Without it, investors would be forced to rely on quarterly reports that could be inaccurate and out of date.

SOX, for the time in which it was issued, was a revolutionary piece of legislation; this greatness is better understood whether considering that every following legislation regarding the same subject matters, such as Directives and Regulations issued in the European Union and the subsequent implementation laws adopted by each Member State in order to welcome the former legislative acts in their legal systems, drew heavily from SOX itself.

1.5 The auditors' liability in the United States

As it will be said with reference to the European Union's pieces of legislation, auditors' liability in the United States is not enshrined under the same acts which regulate other issues about auditors – namely, the 2002 Sarbanes-Oxley Act and the 1934 Securities Exchange Act –, rather it is provided for under both the so-called 1995 Private Securities Litigation Reform Act (hereinafter, PSLRA) and, of course, each Federal State's own legislation.
Since the Big-Four auditing firms, *i.e.*, Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCooper, are all incorporated under the Delaware company register, whenever in the following lines any reference to the legislation of a single federal State will be made, that federal State will be Delaware itself.

In order to better understand the outcomes, a brief historical digression is necessary.

As highlighted by BUSH, FEARNLEY and SUNDER (2007),[43] in the United States, the LLP status for auditing firms has been one of the first and most important victories, because it represented the withdrawal of the unlimited liability.
By the way, the struggles for the obtainment of an auditors' liability limitation did not take into account that in general they exist two kinds of liabilities: a liability toward third parties and the contractual loss suffered by the audited entity.

After the aforementioned 1995 PSLRA, in 1998, the Securities Litigation Uniform Standard Act (hereinafter, SLUSA) was issued, which, combined with the PSLRA, restricted the ability of plaintiffs to bring class action lawsuits against auditors at federal and state level. Claims were restricted to a proportionate liability model, except if the auditors committed a criminal offence, then joint-and-several liability remained. According to those acts, auditors are required to give reasonable assurance of having detected illegal acts in the financial statements, identify related party transactions, and notify the SEC of securities law violations if the company fails to do so within a prescribed time.

By the way, the two aforementioned legislations did not deal with contractual liability; claims at state level by the company and against the auditor continue to be settled under contract law and are subject to jury trial, where the level of damages cannot be predicted, and punitive damages may be awarded.

Audit firms are attempting in different ways to reduce their exposure at state level by including restrictive clauses in their engagement letters to limit the cost of litigation and avoid punitive damages. These clauses include provisions requiring the client companies to agree to have recourse to alternative dispute resolution, jury trial waivers, limitation of liability to the company, and indemnification of auditors against management fraud. These steps represent direct or indirect contractual limitation of liability.

LEE and MANDE (2003)[44] found that no improvement in audit quality followed the adoption of PSLRA, idea upheld also by FRANCIS and KRISHNAN (2002)[45] who found fewer going-concern qualifications after the reform, suggesting that the Act may have changed behaviour.

Indeed, PSLRA, amending Subsection (c) of Section 10A of the 1934 Securities Exchange

[43] "*Auditor Liability Reforms in the UK and the US: A Comparative Review*" (Bush, Fearnley and Sunder, 2007, p.29-36).
[44] "*The Effect of the Private Securities Litigation Reform Act of 1995 on Accounting Discretion of Client Managers of Big 6 and Non-Big 6 Auditors*" (Lee and Mande, 2003).
[45] "*Evidence on auditor risk-management strategies before and after The Private Securities Litigation Reform Act of 1995*" (Francis and Krishnan, 2002, p.144-149).

Act, sets forth that: "No independent public accountant shall be liable in a private action for any finding, conclusion, or statement expressed in a report made pursuant to paragraph (3) or (4) of subsection (b)[46], including any rule promulgated pursuant thereto".

The immediate outcome coming to attention is the clear aim of limiting auditors' liability, a trend which will continue few years later also in the European Union.

Before this reform, audited company's shareholders were entitled to bring a claim against the company and its auditors where share prices had fallen. The respondents, therefore, had to answer of joint and several liability.

By the way, the joint legislative effort brought on by both PSLRA and SLUSA succeeded in eliminating the joint and several liability while replacing it with a proportionate liability model, demonstrating how American legislative experience in some fields of corporate law is at the cutting edge compared to the rest of the world; indeed, as will be mentioned in the next chapters, many years after, the European Union proposed informally to adopt a proportionate liability model, in order to limit effectively auditors' liability.

This cutting-edge legislation is obviously due to the negative experience the United States faced with regards to the aforementioned financial scandals, which put in a difficult situation the Country as a whole and requiring as a consequence an extraordinary legislative effort, which culminated in the pieces of legislation at hand.

However, as mentioned, these efforts have not solved completely the issue at stake because at a state level the auditors' contractual liability has not been limited, exposing them to a harsh joint and several liability of contractual nature with the audited company towards the latter's shareholders.

Moreover, while it is clear that the price and the quality of audit service will come under a downward price pressure in a regime of liability limitation, the consequences for the profitability of the firm are not clear. Liability limitation may cut auditors' legal costs, but in a competitive but highly concentrated market for audit services, it is not clear that auditors will get to carry any of these cost savings to their bottom line instead of transferring them to

[46] "(3) NOTICE TO COMMISSION; RESPONSE TO FAILURE TO NOTIFY.—An issuer whose board of directors receives a report under paragraph (2) shall inform the Commission by notice not later than 1 business day after the receipt of such report and shall furnish the registered public accounting firm making such report with a copy of the notice furnished to the Commission. If the registered public accounting firm fails to receive a copy of the notice before the expiration of the required 1-busi- ness-day period, the registered public accounting firm shall—

(A) resign from the engagement; or

(B) furnish to the Commission a copy of its report (or the documentation of any oral report given) not later than 1 business day following such failure to receive notice.

(4) REPORT AFTER RESIGNATION.—If a registered public accounting firm resigns from an engagement under paragraph (3)(A), the firm shall, not later than 1 business day following the failure by the issuer to notify the Commission under para- graph (3), furnish to the Commission a copy of the report of the firm (or the documentation of any oral report given).

clients in the form of lower prices.

One of the most immediate and widespread methods to limit auditors' liability is putting monetary caps up to which audit firms cannot be held liable anymore.
They can consist either in a fixed amount of money or in a percentage, and, especially in the latter case, they represent a proportionate and secure tool for audited companies to obtain the restoration of a possible damaged suffered as a consequence of auditor's negligence.

By the way, as it can be easily figured out according to the outcomes of the analysis brought on until now, most auditor liability cases are settled before or during a trial for a relatively small portion of the huge reputed amount of damages claimed. The settlements are generally confidential, so no actual determination of negligence or fraud on the auditor's part is ever made. Therefore, no one beyond the parties to the case can learn lessons and apply them going forward. In other words, the rest of the auditing world won't find out how the fraud was missed in the first place.
Therefore, a system like the American one, which is based mostly on the non-judicial dispute resolutions tools – far better than the European one which is based more on the judicial dispute resolution – could represent breeding ground for limitation caps to be fixed by a supranational legislation.
The choice for a supranational legislation to be adopted, rather than different legislative provisions for each State, stands in the attempt to avoid the phenomenon of "forum shopping": it would consist in a migration of either companies to be audited or audit firms to States which provide for more favourable legislations with regards to their exigencies, so respectively higher or lower monetary caps.

Although this marginal consideration, the United States' culture would fit perfectly the idea of a legislative fixed monetary cap – rather than the current situation characterised by a liability limitation drafted on a case-by-case basis between companies and audit firms – because, considering that usually non-judicial settlements are often as low as 5% of overall damages claimed, it would be more convenient for companies to have a legislative foothold higher in the amount and to be reached through considerably lower efforts.

Finally, another important reason for the introduction of monetary caps would be that of the usual lack of sensitiveness and education of United States' juries concerning the complexities of securities laws and auditing standards.
One of the main outcomes from this non-education could be represented by the fact that juries

would reasonably grant to audited companies-plaintiffs huge checks as restoration for damages in exchange of huge financial and reputational losses by the audit firms involved, with the result of another possible downfall which would hinder definitively the audit market.

As will be explained in the last lines, there is an urgent need to widen the audit market, also in order to avoid that another huge financial crisis involving one of the Big Four could let the remaining audit firms to collapse in a domino effect, devastating a sector which is already paying a high toll due to the lack of an effective legislation capable of detecting the real need in the very early days.

CHAPTER II
THE AUDITOR IN EUROPEAN COMPANY LAW

2.1 A general overview

In the context of the European Union, the first Directive to be adopted with regards to statutory audit has been the "Eighth Council Directive" – *i.e.*, Directive 84/253/EEC –, even though it had a limited scope.
Indeed, according to its subtitle, "*based on Article 54 (3) (g) of the Treaty on the approval of persons responsible for carrying out the statutory audits of accounting documents*", this legislation was only aimed at providing for homogeneous conditions with which persons wishing to carry out statutory audit of accounting documents had to comply.

The Eighth Directive has been replaced by Directive 2006/43/EC of the European Parliament and the Council "*on statutory audits of annual accounts and consolidated accounts*" – the so-called "new Eighth Directive" – which represented, at that time, the peak of a process of harmonization of the entire subject matter begun in 1998 with the "Communication from the Commission on the statutory audit in the European Union: the way forward".[47]
Through this work, the Commission itself aimed at giving a certain degree of homogeneity to the accounting profession throughout the Member States by means of the creation of a "Committee on Auditing"[48] which could accomplish the task.

At the beginning of the twenty-first century, the accounting profession was regulated in a fragmented way by many different provisions[49], but the work of the Committee on Auditing started to bear fruit with the issue of the "Recommendation on quality assurance for the statutory audit in the European Union: minimum requirements"[50] in 2000 and of the "Recommendation on Statutory Auditors' Independence in the EU: A Set of Fundamental Principles"[51] in 2002, which led to the new Eighth Directive itself.

The Directive at hand aimed "at high-level – though not full – harmonisation of statutory

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[47] Official Journal of the European Union, C 143, 8.5.1998, p.12.
[48] Recital 4 of Directive 2006/43/EC.
[49] Such as the Fourth Council Directive 78/660/EEC on the annual accounts of certain types of companies, the Seventh Council Directive 83/349/EEC on consolidated accounts, Council Directive 86/635 EEC on the annual accounts and consolidated accounts of banks and other financial institutions, and Council Directive 91/674/EEC on the annual accounts and consolidated accounts of insurance undertakings.
[50] Official Journal of the European Union, L 91, 31.3.2001, p. 91.
[51] Official Journal of the European Union, L 191, 19.7.2002, p.22.

audit requirements" [52] and stated that "statutory auditors and audit firms should be independent when carrying out statutory audits".[53]
Together with many references to the Public Interest Entities – which will be analysed further – this Directive had *in nuce* the requirements for the regulation of the accounting profession.

Directive 2006/43/EC has been recently amended by Directive 2014/56/EU, which called for a different arrangement of the subject matter, first providing for the development of the statutory auditing of Public Interest Entities in another piece of legislation – *i.e.*, Regulation (EU) N. 537/2014 – and then implementing further the scope of the new Eighth Directive. Indeed, along with the "conditions for the approval and registration of persons that carry out statutory audits, the rules on independence, objectivity and professional ethics applying to those persons, and the framework for their public oversight"[54] – already set forth in the previous Directive – there are other needs to be fulfilled within the latter, needs that will be explained in the following paragraph.

2.2 Directives 2006/43/EC and 2014/56/EU: discipline and relations with other provisions

In order to better understand the subject matter, a close examination of Directive 2006/43/EC – as amended by Directive 2014/56/EU – is necessary. Hereinafter, only for this paragraph, we will refer to the new Eighth Directive and the amending Directive together as "the Directive".

As highlighted in the previous paragraph, the first remark to be made is that for which the auditor, either statutory or an audit firm, must be approved by the Member State requiring the statutory audit:[55] at this end, "each Member State shall designate the competent authority to be responsible for approving statutory auditors and audit firms".[56]

Before the examination of the conditions in order for a natural or legal person to be approved as an auditor, a separate mention ought to be made regarding the approval of statutory auditors from other Member States. At this end, the Directive provides for the establishment

[52] Recital 5 of Directive 2006/43/EC.
[53] Recital 11 of Directive 2006/43/EC.
[54] Recital 1 of Directive 2014/56/EU.
[55] Art. 3(1) of Directive 2006/43/EC – as amended by Directive 2014/56/EU: "A statutory audit shall be carried out only by statutory auditors or audit firms which are approved by the Member State requiring the statutory audit".
[56] Art. 3(2) of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

of “procedures”, which shall consist in either an “adaptation period”[57] – of a maximum of three years – or an “aptitude test”.[58] The choice is up to the host Member State.[59]

As mentioned earlier, now the dissertation will move towards the conditions for the approval of auditors.

Beginning from the statutory auditors, they are regulated under Article 3(3) of the Directive, which makes a reference to other provisions in the legislative act itself, such as Articles 4, 6 and 10 as for the conditions to be approved as statutory auditor, along with the main pre-condition, which is that of being a natural person.

The former provision sets forth the need for a “good repute”, a broad notion which leaves room for the freedom of implementation of the Member States.[60]

Then, Article 6 provides for the educational qualifications requirements, basically stating that a natural person – of course this mention can only be made with regards to statutory auditors – must have completed the school career that enables him or her to seek admission to university, must have accomplished a course of theoretical instruction, must have undergone a practical training and finally must have passed a recognised examination of professional competence.

In conclusion, the latter provision examines further the concept of practical training,

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57 As defined under point (g) of Article 3(1) of Directive 2005/36/EC: “’adaptation period’: the pursuit of regulated profession in the host Member State under the responsibility of a qualified member of that profession, such a period of supervised practice possibly being accompanied by further training. This period of supervised practice shall be the subject of an assessment. The detailed rules governing the adaptation period and its assessment as well as the status of a migrant under supervision shall be laid down by the competent authority in the host Member State.

The status enjoyed in the host Member State by the person undergoing the period of supervised practice, in particular in the matter of right of residence as well as obligations, social rights and benefits, allowances and remuneration, shall be established by the competent authorities in that Member State in accordance with applicable Community law”.

58 As defined under point (h) of Directive 2005/36/EC: “’aptitude test’: a test limited to the professional knowledge of the applicant, made by the competent authorities of the host Member State with the aim of assessing the ability of the applicant to pursue a regulated profession in that Member State. In order to permit this test to be carried out, the competent authorities shall draw up a list of subjects which, on the basis of a comparison of the education and training required in the Member State and that received by the applicant, are not covered by the diploma or other evidence of formal qualifications possessed by the applicant”.

59 Art. 14 of Directive 2006/43/EC – as amended by Directive 2014/56/EU:

“1. The competent authorities shall establish procedures for the approval of statutory auditors who have been approved in other Member States. Those procedures shall not go beyond the requirement to complete an adaptation period as defined under point (g) of Article 3(1) of Directive 2005/36/EC of the European Parliament and of the Council (*) or to pass an aptitude test as defined in point (h) of that provision.

2. The host Member State shall decide whether the applicant seeking approval is to be subject to an adaptation period as defined in point (g) of Article 3(1) of Directive 2005/36/EC or an aptitude test as defined in point (h) of that provision.

The adaptation period shall not exceed three years and the applicant shall be subject to an assessment.

The aptitude test shall be conducted in one of the languages permitted by the language rules applicable in the host Member State concerned. It shall cover only the statutory auditor’s adequate knowledge of the laws and regulations of that host Member State in so far as it is relevant to statutory audits.

3. The competent authorities shall cooperate within the framework of the CEAOB with a view to achieving a convergence of the requirements of the adaptation period and the aptitude test. They shall enhance the transparency and predictability of the requirements. They shall cooperate with the CEAOB and with the competent authorities referred to in Article 20 of Regulation (EU) No 537/2014 in so far as such convergence relates to statutory audits of public-interest entities”.

60 As will be said in Chapter 3 with reference to the different ways in which the “good repute requisite” has been implemented.

specifying that, together with a test on the ability to apply put theoretical knowledge into practice, at least three years of practical training are needed, two/thirds of which have to be carried out with approved statutory auditors or audit firms.[61]

Audit firms are recognised by way of a partial derogation from the principle enshrined in Article 3(1), for which “a statutory audit shall be carried out only by statutory auditors or audit firms which are approved by the Member State requiring the statutory audit”.
In order for an audit firm to perform the statutory audit in a Member State different from that in which it has been approved, the key audit partner – a figure which will be analysed further – carrying out the statutory audit on behalf of the firm must comply with the same conditions to which statutory auditors are subject, such as educational qualifications requirements and practical training.
Finally, the audit firm wishing to perform the audit in another Member State must file an application for the registration in the host Member State’s public register.

Before moving on, the analysis of some exceptions is in order. In particular, the focus is on the lack of educational qualifications: for example Member States may provide that a person who obtained university degree – or a degree of equivalent level – in one of the subjects on which the examination referred to in Article 6 is based, may be exempted either from the test of theoretical knowledge or from the test on the ability to apply in practice those knowledge. In the latter case, along with the university degree, a practical training in the abovementioned subjects is required.

Resuming the speech from where it was interrupted – namely, the requisites in order to be approved as an auditor –, now the subsequent phase is that of the registration and updating of information regarding statutory auditors and audit firms in public registers, with a separate mention concerning third-Countries auditors and audit firms.

Now, moving onto the personal requirements an auditor must meet, Chapter IV of the Directive about “Professional Ethics, Independence, Objectivity, Confidentiality and Professional Secrecy” has been reviewed – or better, renewed – for the most part, setting forth many new provisions along with many changes to provisions’ original arrangement.

First of all, principles of professional ethics of statutory auditors and audit firms are provided for as mandatory to be adopted by Member States, at least with regards to their “public

[61] Art. 7 of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

interest function, their integrity and objectivity and their professional competence and due care”.[62]

Then, a new principle has been introduced in the Directive, namely that of professional scepticism, for which the statutory auditor or the audit firm, while carrying out the audit, notwithstanding the auditor’s past experience of the honesty and integrity of the audited entity, possibly due to previous encounters, shall maintain “an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence”.[63]

Moreover, the independence principle has been strengthened through the renewed Article 22. Independence and objectivity are ensured by avoiding that any person involved in the audit of an entity is also involved in its decision-taking processes, and by the fact that the auditor shall refrain from carrying out the audit when “there is any threat of self-review, self-interest, advocacy, familiarity or intimidation created by financial, personal, business, employment or other relationships” [64] between the auditor and the audited entity.
The independence must be expressed not only through negative behaviours, but even by positive ones, such as that of documenting in the audit working papers any possible threat to the independence and any measure adopted in order to mitigate those threats.
If the independence is effectively undermined, the auditor must, as soon as possible and, in any case, within three months, act to eliminate the threat either by terminating any “dangerous” interest or relationship or by adopting appropriate safeguards.
Furthermore, other warranties to the independence are enlisted in the Directive, such as that for which the auditor cannot hold a top role in the audited entity unless one year has elapsed – two years for Public Interest Entities – since the auditor itself ceased to perform the audit,[65] or that for which Member States must ensure that the auditor, before accepting the mandate to perform the statutory audit, must certify that it complies with the abovementioned provisions,[66] must register any threat to the independence and any safeguard adopted in order to eliminate those threats and certify/guarantee the presence of competent employees and sufficient time to perform the task in an appropriate manner.[67]

Moreover, confidentiality and professional secrecy imposes upon the auditor the obligation to

[62] Art. 21(1) of Directive 2006/43/EC – as amended by Directive 2014/56/EU.
[63] Art. 21(2) of Directive 2006/43/EC – as amended by Directive 2014/56/EU.
[64] Art. 22(1) of Directive 2006/43/EC – as amended by Directive 2014/56/EU.
[65] Art. 22a of Directive 2006/43/EC – as amended by Directive 2014/56/EU.
[66] In particular, with Article 22 of Directive 2006/43/EC – as amended by Directive 2014/56/EU.
[67] Art. 22b of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

protect any information with which it makes contact through the adoption of "adequate rules", complying with the applicable data protection rules.
These provisions are applied with reference to cases in which the audit involves third Countries, either when the audit concerns a group of undertakings of which parent undertaking is situated abroad or when the audit regards an entity issuing its securities abroad.[68]

Chapter IV then introduces provisions regarding the organisation of the statutory auditors and audit firms and of their work as a warranty of independence.
First, the auditor shall adopt appropriate policies and procedures aimed at improving many aspects of the task performed, from the independence itself to the assurance of the quality of the audit. These issues – as well as the others enlisted in Article 24a of the Directive – are evaluated through the establishment of an internal quality control system and they must take into consideration the scale and complexity of the statutory auditor or the audit firm.
Furthermore, before accepting the statutory audit, the auditor must document the respect of some warranties, such as that for which any threat to its independence is prevented and fought through the adoption of appropriate safeguards and that it has competent employees, time and resources to satisfyingly carry out the audit.[69]
Then, the work of the statutory auditor or the audit firm is organised following some principles and criteria enshrined in Article 24b, where, *inter alia*, there is the mandatory appointment – only in audit firms carrying out statutory audits – of at least one "key audit partner", a figure provided with quality, independence and competence, and which is actively involved in the statutory audit itself.
Finally, another method of work is that of recording every activity performed by the auditor, any breach of the relevant provisions at both national and European level, each measure taken up to stem it, or the client account record, even when the audit activity is over.[70]

Now, this dissertation will analyse "Auditing Standards and Audit Reporting", as set forth in Chapter V of the Directive.

This subject matter has been slightly renewed, since it makes clear – *inter alia* – that the Commission shall be empowered to adopt international auditing standards – as long as certain conditions are respected – with which statutory auditors and audit firms must comply.[71]

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[68] Art. 23(5) of Directive 2006/43/EC – as amended by Directive 2014/56/EU.
[69] Art. 22b of Directive 2006/43/EC – as amended by Directive 2014/56/EU.
[70] This is an important profile with reference to the auditors' liability, which we will see in the next paragraphs.
[71] Art. 26(3) of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

Currently, no delegated act[72] has been adopted by the Commission, hence "Member States may apply national auditing standards, procedures or requirements as long as the Commission has not adopted an international auditing standard covering the same subject-matter".[73]

Then, every auditor, at the end of its activity, must submit an audit report containing the results of the statutory audit, which must respect some conditions, such as the identification of the entity, a description of the scope of the statutory audit, a statement on any practical uncertainty and, perhaps the most important aspect, the audit opinion.

The audit opinion, representing the core of the report, shall be either unqualified, qualified or adverse, expressing clearly the position of the auditor with regards to the annual financial statements. When the auditor is unable to express an audit opinion, the report will only contain a disclaimer of opinion, certifying this impossibility.

There are also cases in which the statutory audit is carried out by more than one statutory auditor or audit firm: in this case, they shall agree on a joint report. In case of disagreement between the parties, each of them shall submit their reasoning in a separate paragraph of the report, explaining the reasons for the disagreement.[74]

Finally, other documents to be attached to the audit report are the opinion and statement enshrined in Article 34(1) of Directive 2013/34/EU, regarding the compliance of the management report with the financial statements for the same financial year (opinion) and with the applicable legal requirements (statement).

One of the main problems related to the issuance of opinions – in particular the "going-concern opinion"[75] – is related to the independence of the auditor in assessing any misstatement in the financial statements. This issue has been analysed from a particular point of view by GUIRAL, RODGERS, RUIZ & GONZALO-ANGULO (2015), which stated that: "in every audit, auditors have the responsibility to evaluate the ability of their clients to continue in existence. If doubts exist, they should release a "going-concern" opinion alerting investors and other stakeholders of clients' risk of bankruptcy. This "public watchdog" function is extremely important since the issuance of a warning signal could significantly affect investors and other third parties' investments decisions. Making a going-concern judgment is generally viewed as one of the most complex tasks in auditing.

[72] As set forth in Art. 48a of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

[73] Art. 26(1), second subparagraph of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

[74] Art. 28 of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

[75] Referred to in Art. 28(2), letter (f) of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

The "public watchdog" function demands that auditors maintain total independence from the client at all times and requires their complete fidelity to the public trust. However, the professional obligation of auditors often competes with their self-interest since they are hired and fired by their own clients. One of the most important conflicts of interest is the so-called "self-fulfilling prophecy effect", which may bias auditors' reporting behaviour. This effect is the fear that the issuance of a warning signal may precipitate client's failure because of its negative impact on current and potential investors, creditors, suppliers, and customers. […]
Moral seduction theory suggests that judgment bias operates at a subconscious level and that the cause of auditors' failure should be interpreted as an unconscious rather than a deliberate bias. In a recent experimental study, [the authors] connected an ethical model to the moral seduction theory and demonstrated that auditors' judgments unconsciously may be induced by the self-fulfilling prophecy effect that, in turn, may help explain auditors' reluctance to issue going-concern opinions. Whether or not biases in auditor judgment are more often the result of an unintentional mechanism, there are important implications for international audit regulation since current rules of independence may not be effective against an unconscious and unintentional bias. Therefore, more regulation increasing penalties for corruption and punishing corrupt auditors (*e.g.*, Sarbanes–Oxley Act) may not be the appropriate way to solve the auditing problem. […]

Assuming that unconscious bias distorts the auditor function, more regulation that increases penalties for corruption and that punishes corrupt auditors may not be appropriate for solving the auditing problem. Instead, we explore whether cognitive skills such as expertise may reduce the negative impact of conflicts of interest faced by auditors.
Expertise has been described as the advancement of individuals' knowledge structures during the development phases from novice to experts. […]
Higher expertise, in terms of technical knowledge and problem-solving ability, leads auditors to perceive the "public watchdog" function as a critical professional duty in comparison with their perception of the self-fulfilling prophecy effect. […]
Auditors with higher expertise are less seduced by conflicts of interests and make more skeptical judgments on the ability of the company to continue in existence.
Auditors with higher expertise are more willing to issue going-concern opinions".[76]

Hence, the authors focused on a method to find a solution to this conundrum, and they found it in the expertise of the auditors – which is, by the way, the same solution envisaged by the Financial Reporting Council in order to find a solution to the problem of independence of the

[76] "*Can expertise mitigate auditors' unintentional biases?*" (Guiral, Rodgers, Ruiz and Gonzalo-Angulo, 2015, p.105-117).

audit committee from the entity to which it belongs, as will be analysed further.[77]

Further on, an important element to assess the integrity of statutory auditors and audit firms is the quality assurance system. This system is subject to certain conditions enlisted in the Directive, which allow to better define the key aspects of the discipline.

In particular, it is stated that the quality assurance system shall be independent from the auditor and subject to public oversight, provided with sufficient resources, formed by professional, well-prepared, trained and experienced persons. It shall be aimed at publishing annually overall results and issuing quality assurance reviews at least every six years when the statutory audit is required by Union law.

Anyway, the auditor shall seriously take into consideration the reviews and the overall results within a reasonable period of time, otherwise it could be subject to investigation and penalties.[78] [79]

Moving on, public oversight authorities are often defined as "gatekeepers' watchmen", which is such a figuratively way to introduce this topic, but it goes right at the gist of the question.

These authorities are established (or indicated, whether already existing) by Member States, having a mixed composition between practitioners – with specific tasks – and non-practitioners – which shall be the majority.

Every auditor, either statutory or audit firm, is mandatorily subject to their supervision, in every phase of its "life": starting from the approval in public registers to their dismissal or resignation.

In order to better attain their objectives and to have a global (or rather, a European) perspective, public oversight systems cooperate with each other through the establishment of the Committee of European Auditing Oversight Bodies (CEAOB),[80] having the role to strengthen EU-wide audit oversight.

Every competent authority established by Member States with the abovementioned purposes, must cooperate with each other bearing in mind the obligation of professional secrecy, providing that sensitive information "may be disclosed to any other person or authority except

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77 See paragraph 2.3 below.

78 Art. 29 of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

79 Later on, this dissertation will dedicate a separate and exhaustive mention to the matter of investigations and sanctions, with a particular reference to liability profiles.

80 Art. 30 of Regulation (EU) No 537/2014, about which we will discuss in the next paragraph.

by virtue of the laws, regulations or administrative procedures of a Member State".[81]

If any competent authority finds evidences of an infringement of the Directive, it must, without undue delay, making the Member State's competent authority aware of the issue, which must take appropriate measures or investigations in reaction to the infringement itself.
In particular, inspections are carried out seeking the necessary cooperation from the other Member States' competent authorities.
Here the mention is to inspections and not to investigations because the difference between them helps to highlight the real scope of the provision at hand (Article 36). As the 2009 EGAOB[82]'s "Guidance Paper on the Cooperation Between Competent Authorities within the EU" states that inspections usually take place on a regular basis, that they should contribute to enhance audit quality in an inspected statutory auditor or an audit firm and that they should have a preventative nature, while investigations cover circumstances where there is suspicion of infringement or possible violation of laws, rules or regulations.
Competent authorities called upon to cooperate with their counterparts in other Member States can legitimately refuse to grant their help upon given conditions.[83]

It is interesting to notice that the list of conditions enshrined in Article 36(6) envisages two different classes of conditions, born with different scopes: while the second and the third one – *i.e.*, the refusal to cooperate due to a judicial proceeding already initiated in respect of the same action against the same person and to a final judgement already been passed – are perceived simply as "procedural hindrances", the first one, namely the refusal to cooperate due to concerns of sovereignty, security or public order, may be seen as a "safety clause", *i.e.* an open provision to which Member States may cling whether, for a variety of reasons, they do not want to cooperate with other Member States' competent authorities.
Throughout the European Union legislation, many examples like this one can be easily found because of the historical struggle between the two natures of the European Union, namely the intergovernmental and the supranational one. In this case, there is a compromise in which the balance clearly tilts in favour of the supranationalism.

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[81] Art. 36(2) of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

[82] European Group of Auditors' Oversight Bodies, the predecessor of CEAOB.

[83] Art. 36(6), fourth subparagraph of Directive 2006/43/EC – as amended by Directive 2014/56/EU: "The competent authorities may refuse to act on a request for an investigation to be carried out as provided for in the first subparagraph, or on a request for its personnel to be accompanied by personnel of a competent authority of another Member State as provided for in the second subparagraph, where:

a) such an investigation might adversely affect the sovereignty, security or public order of the requested Member State; or
b) judicial proceedings have already been initiated in respect of the same actions and against the same persons before the authorities of the requested Member State; or
c) final judgment has already been passed in respect of the same actions on such persons by the competent authorities of the requested Member State."

Notwithstanding the plain controversy nature of the provision, which may anchor the consent to a cooperation request to almost any issue raised by a Member State, no issue of refusal to cooperate has been raised until today.

Statutory auditors from a Member State wishing to perform their activity in another Member State – notwithstanding the abovementioned analysis over the recognition principles regulating this particular subject matter – are still regulated following the principle of home Country regulation and oversight while audit firms are subject to a quality assurance review in their home Member State and the public oversight in the host Member State.

With reference to the recognition of third-Countries' statutory auditors and audit firms, it is worth to be highlighted that they shall respect the same conditions with which EU auditors must comply, along with the respect of further conditions provided for under the Directive.[84]

This entire system of recognition is based upon the principle of reciprocity: whether, for instance, the third-Country auditor is subject to the same public oversight, quality assurance, investigation and penalties than those provided for in the Member State in which the audit is carried out, the abovementioned conditions for the recognition may be derogated in the name, indeed, of the principle of reciprocity.
The third-Country of origin of the auditor and the Member State in which it wishes to carry out the audit must cooperate, also by means of the transfer of documents related to the public oversight or any investigation brought on against the auditor itself.

In conclusion, this dissertation cannot refrain from shed light over some practical issues, such as that of the appointment and the dismissal of the statutory auditor or the audit firm.

In order to ensure the independence of the auditor from the executive members of the administrative body or from the managerial body of the audited entity, the Directive states that the statutory auditor or the audit firm shall be appointed by the general meeting of shareholders or members of the audited entity or through alternative systems provided for by the Member States.[85]
However, dismissal and resignation of the auditor shall be based on proper grounds – amongst which divergence of opinions on accounting treatments or audit procedures cannot be – and communicated to the competent public oversight authority, giving an adequate reasoning for

[84] Art. 44 of Directive 2006/43/EC – as amended by Directive 2014/56/EU.
[85] Art. 37 of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

the issue.[86]

This provision, together with many others contributing to lay the foundations of this subject matter, makes things clear about the fact that, in order to ensure the independence and objectivity of the statutory audit, its result cannot be questioned by the audited entity, otherwise this kind of situations would lead to "conditioned audits", basically depending on the sole will of the audited entity itself.

2.3 The statutory audit of Public Interest Entities

In the introduction to this dissertation, Public Interest Entities were said to be deemed worthy of a separate mention, since even the European legislator decided not to include their discipline in Directive 2006/43/EC – as amended by Directive 2014/56/EU.

The relevant legislation to be considered is Regulation (EU) No 537/2014 (hereinafter, only for this paragraph, the Regulation), deriving from a period of public consultations started with the issue of a Green Paper entitled "Audit Policy: Lessons from the Crisis".
It highlighted the need for a separate and common approach to the statutory audits of Public-Interest Entities, in order to improve "the integrity, independence, objectivity, responsibility, transparency and reliability of statutory auditors and audit firms carrying out statutory audits of public-interest entities, contributing to the quality of statutory audits in the Union, thus to the smooth functioning of the internal market, while achieving a high level of consumer and investor protection. The development of a separate act for public-interest entities should also ensure consistent harmonisation and uniform application of the rules and thus contribute to a more effective functioning of the internal market".[87]

After analysing why the European Union felt the need to include in a separate act the discipline of the audit of Public-Interest Entities, the dissertation must focus on the meaning of Public-Interest Entities and why it is so important to provide for further warranties for their statutory audit.
The definition of Public-Interest Entities is set forth in Directive 2014/56/EU – amending Directive 2006/43/EC – where, in point 13 of Article 2, there is a list of entities referable to the abovementioned figure:

"*«public-interest entities» means:*

[86] Art. 38 of Directive 2006/43/EC – as amended by Directive 2014/56/EU.
[87] Recital 5 of the Regulation (EU) No 537/2014.

(a) *entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC;*[88]
(b) *credit institutions as defined in point 1 of Article 3(1) of Directive 2013/36/EU*[89] *of the European Parliament and of the Council, other than those referred to in Article 2 of that Directive;*
(c) *insurance undertakings within the meaning of Article 2(1) of Directive 91/674/EEC,*[90] *or*
(d) *entities designated by Member States as public-interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees*".

The key point to stress here is that, since the notion is contained in a Directive, every Member State has implemented it in a different way, hence providing for a different interpretation of the same notion in each Member State, with easily understandable consequences on a cross-border basis.[91]
Probably, the European legislator would have been wiser if it had enshrined the definition of Public-Interest Entity into a regulation, since it is a regulation itself to cover the subject matter at hand. By doing so, it would have ensured to avoid those problems of different implementations of the notion with which Member States must face, in particular with regards to cross-border issues.

Anyway, now the dissertation can move towards the analysis of the most remarkable

[88] "'Regulated market' means a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with the provisions of Title III".
[89] "'credit institution' means credit institution as defined in point (1) of Article 4(1) of Regulation (EU) No 575/2013" which we display here for clarity reasons:
'credit institution' means an undertaking the business which is to take deposits or other repayable funds from the public and to grant credits for its own account".
[90] "The coordination measures prescribed by this Directive shall apply to companies and firms within the meaning of the second paragraph of Article 58 of the Treaty which are:
a) undertakings within the meaning of Article 1 of Directive 73/239/EEC, excluding those mutual associations which are exclude from the scope of that Directive by virtue of Article 3 thereof but including those bodies referred to in Article 4 (a), (b), (c) and (e) thereof except where their activity does not consist wholly or mainly in carrying on insurance business;
b) undertakings within the meaning of Article 1 of Directive 79/267/EEC, excluding those bodies and mutual associations referred to in Articles 2 (2) and (3) and 3 of that Directive; or
c) undertakings carrying on reinsurance business.
In this Directive, such undertakings shall be referred to as insurance undertakings".
[91] The impact of the different implementations will be analysed in the following Chapter.

differences between the discipline of the statutory audit of Public-Interest Entities and that of any other entity.

First of all, in the Regulation there are more stringent provisions with regards to the audit fees. Indeed, the first warranty refers to, as Directive 2006/43/EC – as amended by Directive 2014/56/EU – set forth, the prohibition for audit fees to be "contingent", namely to be related to the results gained by the auditor itself. It is clearly a measure aimed at ensuring the independence of the auditor, since the fees are a sensitive part of the requirements upon which the discipline is based.

The main point to stress is that the differences between the two sets of provisions stand in that the Regulation sets forth further conditions to be respected, specifying what was *in nuce* in Article 25 of Directive 2006/43/EC.
For instance, Article 4(2) claims that, whether the auditor performs, along with the statutory audit to the audited entity, its parent undertakings or its controlled undertakings, non-audit services – not prohibited under the Regulation (as will be analysed further) – the total amount of fees paid for such services shall be limited to no more than 70% of the average of the fees paid in the last three consecutive financial years for the statutory audits of the audited entity.
Another example is that set forth in Article 4(3), providing that, "when the total fees received from a public-interest entity in each of the last three consecutive financial years are more than 15% of the total fees received by the statutory auditor or the audit firm", the auditor must report this issue to the audit committee and discuss with it about the possible threat to their independence and any appropriate measure adopted to secure this risk, including a quality control review by another statutory auditor or audit firm prior to the issue of the audit report.

With this provision, there is the introduction in the system of an organ, the "audit committee" provided for under Article 39 of Directive 2006/43/EC – as amended by Directive 2014/56/EC –, which basically claims that each Public-Interest Entity shall have an audit committee, namely either a stand-alone organ (*i.e.*, having its own autonomy) or an organ depending from the administrative and supervisory body, composed of non-executive members of the administrative and supervisory bodies, together with other members appointed by the general meeting of shareholders of the audited entity.
The importance of the audit committee, in particular of independent non-executive members, has been highlighted in a survey conducted by ALZEBAN & SAWAN (2015) about the interaction between the audit committee and internal audit in the UK listed companies. As said, they put the accent on the independence of the audit committee, stating that: "AC [audit

committee] independence promotes greater effectiveness in the monitoring of internal controls and a firm's financial reporting, since members are more likely to want to preserve their own reputation, less likely to be influenced by the wishes of others whose interests might be served by partisan reporting, and more likely to require higher audit quality. The need to sustain personal reputations and to avoid risks associated with litigation arising from incorrect reporting, predisposes members who can act independently to require more assurance, thereby prompting greater investment in the IAF [Internal Audit Function]. [...] a more effective external audit is possible when the AC is independent. [...]
The tendency of independent ACs to demand deeper IAF scrutiny of organizational procedures enhances the scope of activities, improves internal controls, and makes the IAF more effective overall. Where AC members are independent, there is less encouragement for them to counter any mismanagement that might negatively influence a firm's financial performance. [...]
There is a positive relationship between independence of the audit committee and perceptions of implementation of internal audit recommendations".[92]

The work brought on by the scholars was – and currently is still – supported by the Guidance on Audit Committees, lastly revised on April 2016, which is a document issued by the Financial Reporting Council (FRC), the UK's and Republic of Ireland's independent regulator for the promotion of high quality corporate governance and the report to foster investment. About the independence of the audit committee's members, the Guidance underpinned that it is fostered by a high expertise of members, which is guaranteed by the fact that "the nominations committee and board [of the audited entity] should have regard to ensuring a range of skills, experience, knowledge and professional qualifications to meet the requirements of the Code [*i.e.*, the UK's Corporate Governance Code]".[93]
Member States may provide for cases in which Public-Interest Entities may be exempted from being equipped with an audit committee, and still, in these cases, the audited entity must explain the reasons behind the choice not to have the organ at stake.
Finally, the Directive enlists the variety of functions fulfilled by the audit committee, amongst which there is the obligation to inform the administrative or supervisory body of the audited entity of the outcomes of the audit and explain the precise role the audit committee itself played in the performance of the task, or the duty to monitor the effectiveness of the entity's internal quality control, risk management systems and the warranties for its independence.[94]

[92] "*The impact of audit committee characteristics on the implementation of internal audit recommendations*" (Alzeban and Sawan, 2015, p.61-71).
[93] "*Guidance on Audit Committees*" (United Kingdom and Republic of Ireland. Financial Reporting Council, 2016).
[94] Art. 39 of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

In the previous paragraph, reference was made to non-audit services and, in particular, to their prohibition.

Indeed, the Regulation sets forth the obligation for the auditor – and for any member belonging to the network to which it belongs – not to carry audit certain categories of so-called "non-audit services" in the period in which it is carrying out the audit and in the financial year immediately preceding the audit.

The Regulation provides for an exhaustive list of services defined as "prohibited non-audit services",[95] which can be extended by the Member States with other services.

Inter alia, in this provision there is a heterogeneous set of services, ranging from tax services such as calculation of taxes or tax advice, to legal services or human resources services.

Though, there are still limitations to the issuance of non-audit services not enlisted in the Regulation. Indeed, the auditor must communicate this issue to the audit committee which shall assess any threat to the independence and safeguards applied in the cases at stake.

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[95] Art. 5(1), second subparagraph of Regulation (EU) No 537/2014:

"For the purposes of this Article, prohibited non-audit services shall mean:

a) tax services relating to:
   (i) preparation of tax forms;
   (ii) payroll tax;
   (iii) customs duties;
   (iv) identification of public subsidies and tax incentives unless support from the statutory auditor or the audit firm in respect of such services is required by law;
   (v) support regarding tax inspections by tax authorities unless support from the statutory auditor or the audit firm in respect of such inspections is required by law;
   (vi) calculation of direct and indirect tax and deferred tax;
   (vii) provision of tax advice;
b) services that involve playing any part in the management or decision-making of the audited entity;
c) bookkeeping and preparing accounting records and financial statements;
d) payroll services;
e) designing and implementing internal control or risk management procedures related to the preparation and/or control of financial information or designing and implementing financial information technology systems;
f) valuation services, including valuations performed in connection with actuarial services or litigation support services;
g) legal services, with respect to:
   (i) the provision of general counsel;
   (ii) negotiating on behalf of the audited entity; and
   (iii) acting in an advocacy role in the resolution of litigation;
h) services related to the audited entity's internal audit function;
i) services linked to the financing, capital structure and allocation, and investment strategy of the audited entity, except providing assurance services in relation to the financial statements, such as the issuing of comfort letters in connection with prospectuses issued by the audited entity;
j) promoting, dealing in, or underwriting shares in the audited entity;
k) human resources services, with respect to:
   (i) management in a position to exert significant influence over the preparation of the accounting records or financial statements which are the subject of the statutory audit, where such services involve:
   — searching for or seeking out candidates for such position; or
   — undertaking reference checks of candidates for such positions;
   (ii) structuring the organisation design; and
   (iii) cost control."

As analysed before, the auditor, before accepting the engagement for a statutory audit of a Public-Interest Entity, must certify the respect of specific conditions. Directive 2006/43/EC – as amended by Directive 2014/56/EU – provided for some of them, such as the arrangement of safeguards to any possible threat to the independence or the existence of adequate employees, time and resources with reference to the task to perform.
The Regulation provides for further elements to be attested, such as the integrity of the members of the supervisory, administrative and management bodies of the audited Public-Interest Entity. These warranties must be documented once per year and there must be the will to cooperate– auditor and audited entity – in order to promptly detect and neutralise any threat to the independence of the statutory auditor or the audit firm.[96]

Another important warranty of the quality of the audit is that for which the statutory auditor or the audit firm, before issuing the final reports expressing an opinion over the audit, must be subject to an engagement quality control review, aimed at assessing "whether the statutory audit could reasonably have come to the opinion and conclusions expressed in the draft of these reports".[97]
This review must be carried out by a statutory auditor which has not been involved in the audit of the Public-Interest Entity and, if this cannot be possible – perhaps because in an audit firm every statutory auditor has been involved in the audit or because a statutory auditor is not connected in a network – there is the obligation to arrange for another statutory auditor to perform a review.
Basically, the engagement quality control review must assess, *inter alia*, the existence of adequate safeguards in order to properly fight any threat to the independence of the auditor, the subjects discussed between the auditor and the audit committee or the administrative or supervisory body or with the competent authorities.[98]
Finally, the reviewer communicates the results of its review to the statutory auditor or the audit firm, and the latter shall establish procedures aimed at resolving the issues arising from the review.

As emerged in the previous paragraph, the activity of the auditor entails also the issue of a report after a given period of time in which the audit has been carried out.
The report includes every element[99] described under Directive 2006/43/EC – as amended by Directive 2014/56/EU –, with supplementary ones, such as a complete analysis over any risk

[96] Art. 6 of Regulation (EU) No 537/2014.
[97] Art. 8(1) of Regulation (EU) No 537/2014.
[98] Art. 8(5) of Regulation (EU) No 537/2014.
[99] See paragraph 2.2, page 6.

of material misstatement in which the auditor incurred, and the indication of any additional service – including permitted non-audit service – eventually provided to the audited entity.

Differently from the report for any other entity, the one concerning the audit of Public-Interest Entities must encompass also an additional report to the audit committee – or to the body performing equivalent functions – whether the audited entity is not equipped with such organ.
This additional report shall contain the results of the audit and, *inter alia*, the declaration of independence of the statutory auditor or the audit firm, the report of any activity delegated by the auditor to any other statutory auditor or audit firm, any information about every contact between the auditor and the audit committee, the distribution of tasks amongst the auditors – if of course there was more than one auditor –, whether all required explanations and documents were provided by the audited entity, any significant difficulty encountered in the course of the audit and any significant matter arising from the statutory audit.
This report shall create a discussion between the audited entity, the audit committee and the auditor.[100]
Furthermore, another additional document set forth only in the Regulation is the report to supervisors of Public-Interest Entities, namely the public authorities provided with the power to carry out an oversight on these entities.
This report, along with the establishment of an effective dialogue between the supervisory authorities and the statutory auditor or the audit firm, must contain every finding of any material breach of law or regulations ruling their activity, any material threat to the continuous functioning of the Public-Interest Entity or any refusal to issue an audit opinion.[101]

Together with the aforementioned report, if the auditor has a suspect of irregularities, it must refer the issue to the audited entity so that it can investigate and eventually take any appropriate measure[102].

Differently from the previous statements, the auditor must document, at least four months before the end of each financial year – through the transparency report – a general overview of the statutory auditor or the audit firm, in order for the public to be aware of the methods through which the auditor performs its tasks.
This documentation must assess a variety of information, such as its legal structure, the composition and the ownership, its total turnover, the quality assurance system and the internal quality control system, along with the list of Public-Interest Entities toward which the

[100] Art. 11 of Regulation (EU) No 537/2014.
[101] Art. 12 of Regulation (EU) No 537/2014.
[102] Art. 7 of Regulation (EU) No 537/2014.

auditor carried out the audit.[103]

Finally, the auditor must make available to the competent public authorities any information concerning revenues[104] and must store any document or report analysed until then for at least five years.[105]

The Regulation on Public-Interest Entities has brought many revolutions in particular in the subject matters of the appointment, duration and dismissal of statutory auditors or audit firms of Public-Interest Entities, due to the importance with which these issues are vested.
Indeed, as analysed in the previous paragraph with regards to the appointment of the statutory auditor or the audit firm, the principle to be followed is that of the centrality of the general meeting of shareholders of the audited entity, with residual room for the opinion of the administrative or supervisory body.

Focusing in particular on the appointment of auditors of Public-Interest Entities, the Regulation recalls Article 37 of Directive 2006/43/EC – as amended by Directive 2014/56/EU – which lays down general conditions of appointment, such as that mentioned above (*i.e.*, the centrality of the general meeting).

The aforementioned revolution in the topic at hand is perceived in many provisions introduced by the Regulation, such as the introduction of a precise system through which the appointment of the auditor can be performed. It is actually a revolution because, for a precise choice of the European legislator, the Directive did not provide for any of the aforementioned process.
First, the audit committee of the audited entity shall submit a recommendation of appointment of statutory auditors or audit firms with at least two choices to be made to the administrative or supervisory body. The audit committee shall express a choice between the proposed auditors.
Then the Regulation sets out the procedure through which the recommendation is prepared, giving the start to a real tender process: first, the possibility to have access to the tender cannot be precluded to any statutory auditor or audit firm, except for those who received more than 15% of the total audit fees from Public-Interest Entities in the Member State concerned in the previous calendar year; then, the entity to be audited must provide for a precise tender process, which must be laid down in a document accessible to any statutory auditor or audit

[103] Art. 13 of Regulation (EU) No 537/2014.
[104] Art. 14 of Regulation (EU) No 537/2014.
[105] Art. 15 of Regulation (EU) No 537/2014.

firm which would engage in the statutory audit; finally, the entity to be audited shall choose the statutory auditor or audit firm strictly having regards of the procedure laid down by itself, preparing a report on the conclusion of the tendering process.
There are some entities which can be exempted by the obligation of the tendering process and the above-mentioned procedures to be followed, namely Small-Medium Enterprises[106] and companies with reduced market capitalisation.[107] [108]

Another point which was totally revised with respect to the discipline set forth in the Directive 2006/43/EC – as amended by Directive 2014/56/EU – is the duration of the audit engagement.

It is curious to notice that, as brilliantly highlighted by CORBELLA, FLORIO, GOTTI & MASTROLIA (2015), "there are two primary schools of thought regarding long audit firm tenure. One school believes that audit firms with relatively longer tenure have greater knowledge of the company's business and industry, thereby providing a higher quality and more efficient audit. The other school believes that audit firms with relatively longer tenure provide an increased likelihood of familiarity (or even friendships) forming between the audit staff members and client staff members, an increased likelihood of a stale audit program, and a decreased likelihood that the auditor will make decisions contrary to the prior year decisions, thereby providing a lower quality and less efficient audit Interestingly, this latter school of thought is driven primarily by perceptions not empirical evidence".[109]

Perhaps, the explanation to this phenomenon could be found in the frequent references made by the European Union to the so-called "preventive principle". It can be found in many other EU judgements and legislative provisions, but it must not be confused with the preventive principle, which is a general principle of the Union law usually referred to in the environmental matter. This principle entails that if an action or policy has a suspected risk of causing harm to the public, in the absence of scientific consensus about its dangerousness, the action or policy must not be taken.

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[106] Art. 2(1), letter (l) of Directive 2003/71/EC – as amended by Directive 2010/73/EU: "'small and medium-sized enterprises' means companies, which, according to their last annual or consolidated accounts, meet at least two of the following three criteria: an average number of employees during the financial year of less than 250, a total balance sheet not exceeding EUR 43 000 000 and an annual net turnover not exceeding EUR 50 000 000".

[107] Art. 2(1), letter (t) of Directive 2003/71/EC – as amended by Directive 2010/73/EU: ""company with reduced market capitalisation" means a company listed on a regulated market that had an average market capitalisation of less than EUR 100 000 000 on the basis of end-year quotes for the previous three calendar years".

[108] Art. 16 of Regulation (EU) No 537/2014.

[109] "*Audit firm rotation, audit fees and audit quality: The experience of Italian public companies*". (Corbella, Florio, Gotti and Mastrolia, 2015, p. 46-66).

This is a sensitive issue in particular in the legislative choices of a State (or an Institution, as in this case), hence, in my opinion, the Union decided, in the absence of empirical studies demonstrating that a long audit firm tenure has no relation with the development of a "familiarity" between the audited entity and the auditor itself.

Resuming the speech from where it was interrupted – namely the issue of the duration of the audit engagement – when the tendering process ends – or the alternative process, whether the Public-Interest Entity can have access to it – the entity must appoint the statutory auditor or the audit firm for a period of at least one year, which can be renewed.
Though, amongst the most important provision there is that for which the period of the engagement of the auditor cannot exceed 10 years – or less, whether a Member State shall decide so.[110] At the expiry of this time limit, neither the same statutory auditor or audit firm, nor auditors part of the same network can be engaged for the audit of the Public-Interest Entity at hand within the following four-years period– the so-called "cooling-off period".
There are also some exceptions, such as the fact that Member States may provide that the maximum duration can be extended to twenty years whether the abovementioned tendering procedure has been observed, or twenty-four years if more than one statutory auditor or audit firm is engaged and that they submit a joint report[111] at the end of the statutory audit.
Furthermore, the time limit can be extended of a maximum of two years whether – on a not better defined "exceptional basis" – a request is forwarded to competent authorities, meeting conditions set forth in paragraph 6 of Article 17 of the Regulation.

In order to fulfil the independence requirement, the key audit partner must cease any of its participation in the audit firm carrying out the statutory audit to the Public-Interest Entity at least seven years before the engagement for the audit – or earlier, whether the Member State concerned provides so.

One of the most effective revolutions was the one brought by the so-called "mandatory audit firm rotation", through which any "statutory auditor or audit firm shall establish an appropriate gradual rotation mechanism with regard to the most senior personnel involved in the statutory audit, including at least the persons who are registered as statutory auditors. The gradual rotation mechanism shall be applied in phases on the basis of individuals rather than of the entire engagement team. It shall be proportionate in view of the scale and the

[110] This partial derogation has been introduced with the aim of allowing some Member States – like Italy and the Netherlands – to maintain their existing rotation requirements of nine years and eight years respectively.
[111] Art. 28 of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

complexity of the activity of the statutory auditor or the audit firm".[112]

The determination of the date in which the engagement began must be determined with relations to the audit engagement letter. Whether the beginning of the period is uncertain – for instance due to mergers or other exceptional events –, it must be communicated to the competent authorities which will provide to determine the relevant date.

Finally, as previously analysed with regards to the dismissal and resignation of the statutory auditor or the audit firm of any entity under Directive 2006/43/EC – as amended by Directive 2014/56/EU –, the authorities referred to in paragraph 2 of Article 20 of the Regulation must assure to forward to competent authorities – referred to in paragraph 1 of Article 20 of the Regulation – any information and explanation regarding the dismissal or resignation of the statutory auditor or the audit firm.[113]

As anticipated above, there are two different types of competent authorities according to the Regulation: in particular they are enlisted under Article 20.

The provision at hand, in the first paragraph, sets forth a list[114] amongst which the competent authority may be chosen, making references to already established authorities enshrined in other provisions; while, the second paragraph puts forward an exception to the former, according to which "Member States may decide that the responsibility for ensuring that all or part of the provisions of Title III of this Regulation are applied is to be entrusted to, as appropriate, the competent authorities referred to in: […]"[115], providing for another list of competent authorities enlisted in other Directives.[116]

The competent authorities must be independent from statutory auditors and audit firms and must keep professional secrecy over their activity.

Moreover, Article 23 of the Regulation sets forth the powers of competent authorities: amongst them, there is for instance the power to have access to data and obtaining

[112] Art. 17(7), third subparagraph of Regulation (EU) No 537/2014.

[113] Art. 19 of Regulation (EU) No 537/2014.

[114] Art. 20(1) of Regulation (EU) No 537/2014: "Competent authorities responsible for carrying out the tasks provided for in this Regulation and for ensuring that the provisions of this Regulation are applied shall be designated from amongst the following:

a) the competent authority referred to in Article 24(1) of Directive 2004/109/EC;
b) the competent authority referred to in point (h) of Article 24(4) of Directive 2004/109/EC;
c) the competent authority referred to in Article 32 of Directive 2006/43/EC."

[115] Art. 20(2) of Regulation (EU) No 537/2014: "

a) Article 48 of Directive 2004/39/EC;
b) Article 24(1) of Directive 2004/109/EC;
c) point (h) of Article 24(4) of Directive 2005/109/EC;
d) Article 20 of Directive 2007/64/EC;
e) Article 30 of Directive 2009/138/EC;
f) Article 4(1) of Directive 2013/36/EU."

[116] Article 23 of Regulation (EU) No 537/2014.

information concerning the statutory audits of Public-Interest Entities, the power to initiate administrative proceedings due to any infringement found in the investigations brought on, and so on.[117]

The competent authorities shall, finally, cooperate with each other, both at national and at European Union level.

Amongst the most important tasks which competent authorities are entrusted with, there is that of guaranteeing an effective system of audit quality assurance system.

It is carried out through an analysis of the risks performed *vis-à-vis* Public-Interest Entities every three years – or every six years whether the Public-Interest Entity is a small[118] or medium-sized[119] undertaking.

This task shall be carried out through investigations and inspections performed by an adequately qualified inspector, namely someone who is familiar with statutory auditors. Besides inspectors, a competent authority may also contact experts for carrying out specific inspections when the number of inspectors is not sufficient.

As already mentioned, the task to be carried out by inspectors and experts is that of assuring that any Public-Interest Entity is compliant with the internal quality control system: it is properly carried out through the compliance by the Public-Interest Entity of applicable auditing and quality control standards, ethical and independence requirements, as well as relevant laws, regulations and administrative provisions of the Member States concerned.

Any activity carried out by the competent authorities – either by means of an inspector or by an expert – must flow into a report.

2.4 The auditors' liability

As mentioned in the previous paragraph, investigations and sanctions are at the core of the subject matter considered by this dissertation, because they contribute to lend credibility to

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[117] Article 3(2) of Directive 2013/34/EU: "Small undertakings shall be undertakings which on their balance sheet dates do not exceed the limits of at least two of the three following criteria:

a) balance sheet total: EUR 4 000 000;
b) net turnover: EUR 8 000 000;
c) average number of employees during the financial year: 50.

Member States may define thresholds exceeding the thresholds in points (a) and (b) of the first subparagraph. However, the thresholds shall not exceed EUR6000000 for the balance sheet total and EUR 12 000 000 for the net turnover."

[118] Article 3(3) of Directive 2013/34/EU: "Medium-sized undertakings shall be undertakings which are not micro-undertakings or small undertakings and which on their balance sheet dates do not exceed the limits of at least two of the three following criteria:

a) balance sheet total: EUR 20 000 000;
b) net turnover: EUR 40 000 000;
c) average number of employees during the financial year: 250.

the overall system, based on many principles like, *inter alia*, independence, professional ethics and objectivity.
Chasing the ideals set forth in the Recitals of the amending Directive, this topic has been completely reviewed, being replaced by new – and more effective – measures aimed at hindering any negative practice performed by statutory auditors and audit firms.

In Directive 2006/43/EC – before the amendments brought by Directive 2014/56/EU – the discipline of auditors' liability was provided for under Article 31, stating that:

> "*Before 1 January 2007 the Commission shall present a report on the impact of the current national liability rules for the carrying out of statutory audits on European capital markets and on the insurance conditions for statutory auditors and audit firms, including an objective analysis of the limitations of financial liability. The Commission shall, where appropriate, carry out a public consultation. In the light of that report, the Commission shall, if it considers it appropriate, submit recommendations to the Member States.*"

On January 2007, the Commission actually issued a report on the state of the art of the national liability rules, giving rise to a public consultation which ended on 15 March 2007.
At the end of the consultation period the Commission, on 5 June 2008, issued Recommendation 2008/473/EC "*concerning the limitation of the civil liability of statutory auditors and audit firms*".

This dissertation will now move towards the analysis of the report issued by the Commission following Article 31 of Directive 2006/43/EC, and then of the Recommendation.

The report took into consideration a study carried out by London Economics, which analysed in detail the situations of auditors' liability in the – then – twenty-eight Member States and the impact of different options for limiting the liability.
The study focused on the fact that the liability risks could, preventing auditors to accept the engagement,
affect indirectly the capital markets. The report, indeed, highlighted that the so-called "Big Four"[120] were involved in outstanding statutory audits which could give rise to claims of a

[120] Deloitte Touche Tohmatsu, Ernst & Young, KPMG and PricewaterhouseCooper.

great value; the majority of these matters arose in the EU: issues which could be dangerous for the audit firms, implying possibly several and serious financial consequences, hence jeopardising the markets.

At that time, only five Member States[121] demonstrated to be aware of the issue, putting a cap over auditors' liability; in these Countries, both auditors and companies were – and are still – jointly and severally liable only up to the cap provided for by their respective legislations.
One of the main issues felt by the auditors was that they were seen as a "deep pocket" by plaintiffs, as insurances to rely upon for any problem arisen in the audit: hence the problem was actually the "joint and several liability".
All of these reasons, together with the EU problem of an oligopoly market dominated by the aforementioned Big Four,[122] brought up the need for reforming measures to be adopted.

The report, *inter alia,* analysed two kinds of problems: the problem of the oligopoly, which is something the world is still facing – with little hope that things will change –, and then that of the auditors' liability, which has been one of the most noticed issues. The Commission enshrined in its report a list of possible reforms about which the stakeholders – invited by the Commission itself to submit their proposals – had to give their opinion, attaching the motivation for each of the questions. There were actually four proposals on the table: 1) one single monetary cap at European Union level; 2) a cap depending on the company's size; 3) a cap depending on the audit fees charged to the company; 4) proportionate liability.[123]

The first one perhaps considered a situation way too far from the reality, implying that a single cap would fit to any company – notwithstanding its size or its turnover –; moreover, finding the right cap would have been very challenging and it would have been subject to many changes, which would suffer of the slowness of many legislative apparatus.

The second one, differently from the former, considered more the differences existing between the variety of companies in the EU and would have fitted better with the last proposal, *i.e.*, that of a proportionate liability.

[121] Austria, Belgium, Germany, Greece and Slovenia.
In 2006, UK allowed companies – prior to the approval of the meeting of shareholders – to put a contractual limitation to the auditors' liability.
[122] The London Economics study differentiated two different types of market for statutory audits, namely: a market of Small-Medium Enterprises – in which the market was shared both by the Big Four and the mid-tier audit firms – and an international market for the provisions of audit services to listed and large unlisted companies – in which the market was shared only amongst the Big Four.
[123] "*Commission Staff Working Paper: Consultation on Auditors' Liability and its Impact on the European Capital Markets*". (European Union. Directorate General for Internal Market and Services, 2007).

The third one was an alternative to the second because it would have anchored the cap to other data – namely that of the fees charged to the audited entity – and it would have produced a sort of protection against catastrophic claims.

The reasons for putting a cap – regardless of which of these three patterns was to be followed – must also be linked to a major availability of sufficient liability insurances. This issue perfectly explains the effects produced by auditors' liability on the market surrounding this professional figure.

The last one was the most acclaimed from the stakeholders, because it was felt as the most effective way to limit auditors' liability. It envisaged the withdrawal of the joint and several liability in favour of a regime for which each party is liable only for the portion of loss corresponding to its degree of responsibility. The methods figured by the report provided that either national Courts had to award damages benchmarked to the portion of loss corresponding to the auditors' degree of loss or contractual arrangements had to be allowed as to be negotiated by the entity to be audited – in particular, by the meeting of shareholders – and the auditor. Notwithstanding these contractual arrangements, national Courts had to retain the power to deem whether those agreements had to be considered fair and reasonable.

As stated before, the reports – and the public consultation period which followed – were only preparatory steps to the adoption of a Recommendation, as Article 31 of Directive 2006/43/EC – prior of the amendments brought by Directive 2014/56/EU – set forth.
Recommendation 2008/473/EC (hereinafter, only for this paragraph, the Recommendation) represented the first signal launched by the Commission for the Member States to adopt a better regime concerning auditors' liability, though through a non-binding act.[124]

The Recommendation addresses "auditors and audit firms carrying out a statutory audit of the consolidated or annual accounts of a company which is registered in a Member State and the securities of which are admitted to trading on a regulated market in a Member State".[125]
Hence, the legislation at hand had a narrower scope than that envisaged by the Commission's report, though the most relevant cases of claims – *i.e.*, the catastrophic ones – mostly involved auditors carrying out the audit of listed companies.
The core scope of the Recommendation lies in that the civil liability of auditors arising from a breach of their professional duties should be limited, with the exception represented by the

[124] Art. 288 TFEU.
[125] Point 1 in Recommendation 2008/473/EC.

intentional breach of duties.[126]

The Commission, then, enshrined in the Recommendation what envisaged in the report, namely the variety of reform proposals forwarded to the stakeholders in order to limit auditors' liability: there is the possibility for the Member States to establish a maximum financial amount or a formula allowing for the calculation of such amount, to establish a set of principles for which the auditor cannot be deemed responsible for damages beyond its actual contribution, or to provide for a contractual arrangement of limitation of civil liability amongst the audited company and the auditor. In this case, the decision shall be subject to a judicial scrutiny, shall be proposed to the meeting of shareholders by the administrative or supervisory board of the audited company and these contractual arrangements shall be published in the notes to the accounts of the audited company.[127]

This Recommendation raised warm reactions and some criticism. In particular, BARCELLONA (2017) stated that limiting auditors' liability must be contextualised in the light of overall conditions of relevant legislative system, first of all through the possibility to compensate this limitation with (effective) administrative/criminal sanctions. In absence of these conditions and in regime of statutory audit (and not voluntary audit), the limitation of auditors' liability might clash with fundamental principles of market economy, first the unlimited responsibility for any damage caused, with the unavoidable consequence of the exposition to the bankruptcy risk.[128]

In the next paragraph, this dissertation will analyse the concrete impact that this Recommendation had on the Member States and the different ways in which it has been welcomed in national legislations, showing the differences of some national legislation and highlighting how the Recommendation itself has been crucial for that harmonisation process which began with Directive 84/253/EEC – *i.e.*, the Eighth Council Directive.

[126] Points 2, 3 and 4 in Recommendation 2008/473/EC.
[127] Points 5, 6 and 7 in Recommendation 2008/473/EC.
[128] "*Diritto societario europeo e internazionale*". (Barcellona, 2017, p.550-551).

CHAPTER III
A COMPARATIVE PERSPECTIVE THROUGHOUT THE EUROPEAN UNION

In the previous chapter, this dissertation analysed the role of auditors from a supranational point of view, through the reference to Directives and Regulations.
Even though Regulations have no need to be implemented into national legislations through the adoption of *ad-hoc* legislative acts, Directives – such as 2006/43/EC, 2014/56/EU or 2013/34/EU –, in order to produce direct effects into Member States, need to be implemented.
Hence, this is exactly the scope of this chapter, namely that of analysing the different methods through which supranational laws at hand have been integrated into national legislative environments, in particular in order to catch the influences of Member States traditions on the institutions illustrated in the previous chapter.

This dissertation will focus in particular on the national experiences of Italy, France and Germany.

3.1 The Italian experience

Italy has demonstrated for a long time to be aware of the concerns of statutory audit, since it has been one of the first Member States to introduce the mandatory rotation for audit firms, as mentioned in the previous chapter.

Notwithstanding the caution characterising Italy nowadays, it has not been always so.
Indeed, in the Country at hand the subject matter of statutory audit has been introduced thanks to the pressures made by foreign companies which wished to have an adequate control on their subsidiaries' accounts.
This pressure led to the issue of Law n° 216/1974 "concerning provisions relating to securities market and tax treatment of shares", which instituted the national competent authority for companies and stock exchange (CONSOB). As it is clear, the subject matter of our interest was hit only incidentally by this legislation, which set forth that any company wishing to sell to the public shares or obligations had to preventively communicate that to CONSOB, had to issue a prospectus illustrating the overall situation of the company and had to make available to a pre-approved audit firm last year's financial account, in order for it to be audited and, eventually, approved.[129]
The legislation at hand laid down also "recommendations" for provisions to be adopted with

[129] Art. 1 of Law n° 216/1974, converting in law art. 18 of Legislative Decree n° 95/1974.

regards to the improvement of statutory audit of audit firms.[130]

In 1975, the Italian legislator caught the signals launched with the aforementioned provision and issued the Presidential Decree n° 136/1975 “concerning audit and financial statements' certification of listed public limited companies”.
It provided that only listed public limited companies had to mandatorily have their accounts audited by an audit firm registered under the national register established by the legislation at hand.[131]
Notwithstanding the narrowness of the scope of the provision at hand, it has been one of the firsts to regulate the statutory audit in an autonomous way.

In 1998, Legislative Decree n° 58/1998 – *i.e.*, the Single Text on Financial Intermediation (TUIF) – was issued, giving a different arrangement to statutory audit and supervisory boards.
In particular, concerning statutory audit, audit firms approved following the procedure laid down in the legislation at hand[132] became the only entities to be entitled with the power to carry out the statutory audit of listed public limited companies, [133] while, concerning supervisory boards, more powers were conferred upon them, also with reference to controls to be made on the audit firm.[134]

In 2003, Italian company law was revolutionised by a huge reform – *i.e.*, Legislative Decree n° 6/2003 (*“Vietti Reform”*) – which, by the way, extended the duty to carry out statutory audit toward the major part of limited companies, with the introduction in the Italian Civil Code of an *ad-hoc* Title.[135]

Moreover, as analysed in the previous chapter – and this will be one of the *leitmotif* of the comparison carried out in this chapter –, many Directives kept replacing each other.
In particular, at the time of issuance, Directive 2006/43/EC was seen as the most important one, replacing the cornerstone of statutory audit, namely the Eighth Directive,[136] and then Directive 2014/56/EU partially modified the former.
They were implemented in the Italian legislative system through, respectively, Legislative Decree n° 39/2010 and Legislative Decree n° 135/2016, and now the analysis will fall on the

[130] Art. 2 of Law n° 216/1974.
[131] Art. 1 of Presidential Decree n° 136/1975.
[132] Art. 161 of Legislative Decree n°58/1998, *i.e.*, Single Text on Financial Intermediation.
[133] Art. 155 of Legislative Decree n°58/1998, *i.e.*, Single Text on Financial Intermediation.
[134] Art. 151 of Legislative Decree n°58/1998, *i.e.*, Single Text on Financial Intermediation.
[135] Fifth Book, Fifth Chapter, Fourth Title of Italian Civil Code.
[136] Directive 84/253/EEC

different ways in which the Directives at hand were implemented in Italy and how its legislative tradition influenced the recognition of those supranational provisions. For practical reasons, this chapter will refer to these provisions together as "the Legislative Decree", as well as to Directive 2006/43/EC and Directive 2014/56/EU together as "the Directive".

First, with reference to the approval, continuing education and mutual recognition, as mentioned in the previous chapter, the need for "good repute" which a statutory auditor must carry – set forth in Article 2 of the Legislative Decree – is provided for by a regulation adopted by the Ministry of the Economy in conjunction with the Italian authority for companies and stock exchange (CONSOB).[137]

This regulation recalls the classic interpretation that Italian legal tradition gives to the notion at hand, stating that a natural person wishing to become a statutory auditor could not have been condemned for a set of crimes, thoroughly enlisted in the regulation at hand.[138]

Then, there is a slight difference in the way in which the Legislative Decree interpreted the Directive when it sets forth that "at least two thirds of such practical training shall be completed with a statutory auditor or an audit firm approved in any Member State".[139]

Instead, the implementing measure states that "the practical training must be completed with a statutory auditor or an audit firm approved in any Member State with the capacity to ensure the ability to apply theoretical knowledge in practice to the trainee",[140] leaving space for thinking that in Italy the whole practical training must be completed with a statutory audit or an audit firm.

Another difference is that concerning continuing education, to which Italy reserved a provision full of details through which an approved auditor has the duty to be constantly updated in the course of his or her activity.[141]

Furthermore, as mentioned in the previous chapter, the Commission have not adopted yet a set of international accounting principles – as sketched out in the Directive[142] –, therefore it is up to the Member States to adopt, in the meantime, accounting principles to be followed by national auditors.

Italy did so by issuing a determination – adopted by the Ministry of the Economy – recently renewed, stating that Italian statutory auditors and audit firms shall apply the accounting

137 Decree of the Ministry of the Economy 20th June 2012, n. 145.

138 Art. 3 of the Decree of the Ministry of the Economy 20th June 2012, n. 145.

139 Art. 10 of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

140 Art. 3 of Legislative Decree n° 39/2010 – as amended by Legislative Decree n° 135/2016.

141 Art. 5 of Legislative Decree n° 39/2010 – as amended by Legislative Decree n° 135/2016.

142 Art. 26, paragraph 3 of Directive 2006/43/EC – as amended by Directive 2014/56/EU.

standards enlisted therein.[143]

Finally, the Italian legislator – as in every other Member State – provided for the maximum duration of the engagement of statutory auditors and audit firms auditing entities different from those of public interest – as will be stated further –, which is set in three years.[144]

As it is clear, there have been very little differences in this first part of comparison, since Member States, in implementing Directives, must pursue the *effet utile* of supranational legislations, hence with few possibilities to remove or to add important provisions.

Notwithstanding this statement, the Legislative Decree added few important provision to the overall system of Italian audit legislation, first responding to the "call" made by Recommendation 2008/473/EC "*concerning the limitation of the civil liability of statutory auditors and audit firms*", then, on one hand, implementing the definition of Public-Interest Entities, as set forth in Directive 2014/56/EU – amending Directive 2006/43/EC and, on the other hand, introducing many provisions regarding Public-Interest Entities, notwithstanding the existence of an *ad-hoc* Regulation.
While with reference to the first topic this dissertation will dedicate a separate mention in the next subparagraph, the latter has to be analysed now in order to properly understand the impact of Regulation (EU) 537/2014 (hereinafter, "the Regulation") on the overall Italian juridical system.

As recalled in the previous chapter, Article 2, point 13 of the Directive states that:

> "*«public-interest entities» means:*
> *(e) entities governed by the law of a Member State whose transferable securities are admitted to trading on a regulated market of any Member State within the meaning of point 14 of Article 4(1) of Directive 2004/39/EC;*[145]
> *(f) credit institutions as defined in point 1 of Article 3(1) of Directive*

[143] Determination 4993 of 12th January 2018, issued by Ministry of the Economy, Department of General Accounting Office.
[144] Article 13 of Legislative Decree n° 39/2010 – as amended by Legislative Decree n° 135/2016.
[145] "'Regulated market' means a multilateral system operated and/or managed by a market operator, which brings together or facilitates the bringing together of multiple third-party buying and selling interests in financial instruments – in the system and in accordance with its non-discretionary rules – in a way that results in a contract, in respect of the financial instruments admitted to trading under its rules and/or systems, and which is authorised and functions regularly and in accordance with the provisions of Title III".

2013/36/EU[146] *of the European Parliament and of the Council, other than those referred to in Article 2 of that Directive;*

(g) *insurance undertakings within the meaning of Article 2(1) of Directive 91/674/EEC,*[147] *or*

(h) *entities designated by Member States as public-interest entities, for instance undertakings that are of significant public relevance because of the nature of their business, their size or the number of their employees*".

Hence, whilst with reference to letter *a)*, *b)* and *c)* there is nothing to point out, letter *d)* gives the possibility to Member States to enlarge the scope of application of the Regulation, by giving the possibility to provide for any entity with a "significant public relevance" to be considered as a Public-Interest Entity.
Notwithstanding this latter provision, Italy did not take advantage of the opportunity.

As claimed in the previous chapter, Italy – along with the Netherlands – has been one of the first Member States to be aware to the problem of "familiarity" of the auditor with the audited entity, providing for a set of rules aimed at avoiding this independence threat, way before the European Union's legislative intervention.
These rules represent new standards for the subject matter of statutory audit, because they extend some requisites, such as the mandatory firm rotation and the "cooling-off period", to every entity, either Public-Interest ones or not.
Indeed, the Legislative Decree states that "the audit engagement shall have a maximum duration of nine exercises for audit firms and seven years for statutory auditors. It cannot be renewed or conferred again whether at least four exercises passed from the expiry of the previous engagement"[148] There are some considerations to make, such as on one hand, the Italian provision set a lower maximum duration with respect to the ten-year period indicated in Article 17 of the Regulation and, on the other hand, it did not provide for the possibility to

[146] "'credit institution' means credit institution as defined in point (1) of Article 4(1) of Regulation (EU) No 575/2013" which we display here for clarity reasons:
'credit institution' means an undertaking the business which is to take deposits or other repayable funds from the public and to grant credits for its own account".

[147] "The coordination measures prescribed by this Directive shall apply to companies and firms within the meaning of the second paragraph of Article 58 of the Treaty which are:
undertakings within the meaning of Article 1 of Directive 73/239/EEC, excluding those mutual associations which are exclude from the scope of that Directive by virtue of Article 3 thereof but including those bodies referred to in Article 4 (a), (b), (c) and (e) thereof except where their activity does not consist wholly or mainly in carrying on insurance business;
undertakings within the meaning of Article 1 of Directive 79/267/EEC, excluding those bodies and mutual associations referred to in Articles 2 (2) and (3) and 3 of that Directive; or
undertakings carrying on reinsurance business.
In this Directive, such undertakings shall be referred to as insurance undertakings".

[148] Art. 17(1) of Legislative Decree n° 39/2010 – as amended by Legislative Decree n° 135/2016.

extend the period thereof, as it happened in the aforementioned Article.[149]
In addition, there is also a maximum duration for the engagement of key audit partners, which is set in a maximum of seven exercises, with no possibility for its engagement to be conferred again whether less than three exercises from the expiry of the previous have passed.[150]

Now, this dissertation will analyse what could be defined as a defect of coordination between the Regulation and the Directive, since the latter enshrines the provision of mandatory appointment of audit committees (*comitato per il controllo interno e la revisione contabile*) in Public-Interest Entities.[151]
It states clearly the duty of cooperation between the audit committee and the administrative body of the Public-Interest Entity audited, enlisting a set of tasks that the former must accomplish, amongst which there is the duty to inform the administrative body about the outcomes of the audit, submitting to the organ at hand the additional report that the auditor must submit to the audit committee itself.[152]
GAREGNANI & PASCALI (2017) highlighted the close relationship between the audit committee and the statutory auditor, by claiming that "reading the provision, together with the following letters *b)* and *c)* of first paragraph of Article 19, it emerges that the European legislator, aware of the centrality and the relevance of the activities performed by the audit committee and the statutory auditor, wanted to highlight two relevant profiles: the cooperation between the audit committee and the statutory auditor, and the communication of their activities' results to the administrators.
[…]
The audit committee, therefore, must provide for a schedule of periodical meetings with the statutory auditor within which becoming aware of the different phases of the audit from the very beginning, providing the auditor with the information in its possession, which could be useful for the audit (in particular, sharing with the auditor the information in its possession with regards to the corporate risks and the impacts on the financial statement), learning the main outcomes emerged from the audit.
[…]
Perhaps, the only case in which the audit committee could (*rectius*, must?) express its opinion with regards to the audit report[153] *in se*, in its report to the administrative body on the *outcome*

[149] Art. 17 of Legislative Decree n° 39/2010 – as amended by Legislative Decree n° 135/2016 – sets forth the possibility to extend the maximum ten-year period to a twenty-year or a twenty-four-year period whether, respectively, a tendering process is in place or two or more auditors are simultaneously engaged. These cases are not provided for under the Legislative Decree, hence there is no extension provided for.
[150] Art. 17(3) of Legislative Decree n° 39/2010 – as amended by Legislative Decree n° 135/2016.
[151] Art. 19 of Legislative Decree n° 39/2010 – as amended by Legislative Decree n° 135/2016.
[152] Art. 11 of Regulation (EU) 537/2014.
[153] Art. 10 of Regulation (EU) 537/2014.

of the audit, is that […] in which it identifies non-compliance between the audit report's content and the additional report; but the timing provided for under the provision seems to be in contrast with this assumption, given that, following Article 11 of the Regulation, the additional report must be submitted to the audit committee "*not later than the date of submission of the audit report*" and since also that the auditor will be allegedly able to issue the additional report only after the conclusion of its activities and so at the same time of the issuance of the audit report itself.

Then, it would seem anyway inconsistent to recognize in the report on the *outcome* of the audit to the administrative body from the audit committee the need that the audit committee itself goes into details of the audit report, for obvious reasons of separation of roles and related responsibilities."[154]

One of the main news introduced by the Legislative Decree has been that of the "entities subject to an intermediate system",[155] which are described in a work of DE ANGELIS & BOZZA (2016), who stated that "[entities subject to an intermediate system] are, for instance, companies issuing securities which, notwithstanding they are not listed in regulated markets, are widely distributed among the public, SGRs, SIMs, financial intermediaries referred to in art. 106 TUB.

Therefore, to the list of public-interest entities referred to in art. 16 of Legislative Decree 39/2010 are deleted entities different from banks, insurances and listed companies which remain the only subject classified as Public-Interest Entities and, as such, subject to the Regulation (EU) 537/2014.

[…]

Entities subject to an intermediate system are enlisted in the new art. 19-*bis* and, notwithstanding they are deleted from the list of the Public-Interest Entities, they remain subject to more binding supervisory obligations compared to entities different from Public-Interest ones. This different graduation of supervisory obligations has been performed on the basis of the impact that interested subjects' financial statements have on markets and financial stability needs.

Just like for Public-Interest Entities, also in entities subject to an intermediate system, in companies controlled by these and in those controlling entities subject to an intermediate system, statutory audit cannot be performed by the supervisory board.

To entities subject to an intermediate system, besides provisions related to Public-Interest Entities, these provisions are applied:

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[154] "*I compiti del comitato per il controllo interno e la revisione contabile definiti dall'art. 19 del d.lgs. n. 39/2010, così come modificato dal d.lgs. n. 135/2016*" (Garegnani and Pascali, 2017, p.243).

[155] Art. 19-*bis* of Legislative Decree n° 39/2010 – as amended by Legislative Decree n° 135/2016.

- provisions concerning independence and duration of audit engagement referred to in art. 17 of Legislative Decree 39/2010 for Public-Interest Entities;
- provisions on audit fees and non-audit services, borrowed from articles 4, 5 and 6 of the Regulation;
- provisions on the relationships held by the statutory auditor with subjects who cooperate to the audit and organs of the audited entity, borrowed from articles 7, 8 and 12 of the Regulation."[156]

This contribution is crucial in order to fully understand the real scope of this category introduced *ex novo* by the Legislative Decree.

Finally, the Legislative Decree brought many changes to the previous arrangement of the Italian Civil Code, introducing, *inter alia*, Article 2409-*bis*, which is aimed at harmonising the Italian corporate governance system (*i.e.*, the "traditional system") with the requisite of an audit carried out by a statutory auditor or an audit firm:

> "1. *The statutory audit of the company's accounts is carried out by a statutory auditor or an audit firm enrolled in the dedicated register.*
> *2. The by-laws of companies not required to draft consolidated financial statements may provide the possibility to entrust the statutory audit with the supervisory board. In this event the board of statutory auditors is composed by statutory auditors enrolled in the dedicated register*".

3.1.1 The Italian auditors' liability: between Recommendation 2008/473/EC and Legislative Decree 135/2016

One of the main changes brought by Legislative Decree 135/2016 has been that of the introduction of Article 15 concerning the auditors' liability.

Article 15 reads as follow:

> *"1. Statutory auditors and audit firms are jointly and severally liable with the administrators toward the audited company, its shareholders and third parties for damages caused by non-compliance with their obligations. In the internal relations between joint debtors, they are liable in the limits of their effective*

[156] "*Revisione Legale: le nuove regole*" (De Angelis and Bozza, 2016, p.9-10).

contribution to the damages caused.

2. The person in charge of the audit and the employees who cooperated to the statutory audit are jointly and severally liable together with the audit firm for damages caused by non-compliance or unlawful acts toward the audited entity and damaged third parties. They are liable in the limits of their effective contribution to the damages caused.

3. The action for damages toward the persons liable referred to under this Article is subject to a statute of limitation of five years from the date of the audit report, which is issued at the end of the audit to which the action for damages refers".

Prima facie, through the comparison between the aforementioned Article and the text of the Recommendation at hand, it emerges the outline followed by the Italian legislator.

It may be useful to briefly recall point 5 of the supranational invite to a limitation of auditors' civil liability: it is up to Member States to choose between three options: a) the establishment of a maximum financial amount or of a formula allowing for the calculation of such an amount; b) the establishment of a set of principles by virtue of which a statutory auditor or an audit firm is not liable beyond its actual contribution to the loss suffered by a claimant and is accordingly not jointly and severally liable with other wrongdoers; or c) a provision allowing any company to be audited and the statutory auditor or audit firm to determine a limitation of liability in an agreement.

Italy seemed not to acknowledge the Recommendation at hand – or at least seemed not to follow strictly the European indications, since a piece of legislation in the subject matter considered has been actually adopted –, as argued by SALERNO (2013): "the serious crisis which invested the economic system from several years and that, as notoriously known, forced many undertakings to drop out of the market, entailed, amongst other several consequences, a significant increase of the number of bankruptcy proceedings, traditionally the steps coming before action for liability against companies' management and supervisory organs.

In such context, also actions brought against auditors turned out to grow; actions which are nowadays regulated by art. 15 of Legislative Decree 27th January 2010, n. 39 (hereinafter, art. 15), which took the place of repealed articles 2409-*sexies* of Italian Civil Code and 164 TUF, which used to concern, respectively, the liability of persons in charge of the audit of companies regulated by the Civil Code and the audit of companies with listed shares.

[…]

In truth, comparing the (repealed) articles 164 TUF and 2409-*sexies* with the discipline set forth in art. 15, the latter distinguishes itself for having provided for:

a) under the first paragraph, that statutory auditors and audit firms are liable for damages deriving from non-compliance of their duties, severally and jointly among them and with the administrators, toward the audited company, its shareholders and third parties. This provision poses again what already set forth under art. 2409-*sexies*, first paragraph, of Italian Civil Code, which was referred to a joint and several liability toward the audited entity, shareholders and third parties, resulting from a non-compliance of their duties. It was not enshrined neither in art. 2409-*sexies*, nor in art. 164 TUF, the clarification – now set forth in art. 15, first paragraph – for which «in the internal relations between joint debtors» they are liable in the limits of their effective contribution to the damages caused. Furthermore, while the repealed provisions made reference to statutory auditor and audit firm at singular, art. 15, paragraph 1, uses the plural («statutory auditors and audit firms»);
b) under the second paragraph, that the person in charge of the audit and the employees who cooperated to the statutory audit are jointly and severally liable together with the audit firm for damages caused by non-compliance or unlawful acts toward the audited entity and damaged third parties. Here again, the provision has a repetitive nature, in particular of art. 164, paragraph 2, TUF, finally becoming clear why the reference was made only with regards to the audited company and third parties and not (as in the precedent paragraph 1) to shareholders too. Instead, a news not retraceable in art. 164 TUF (and also in art. 2409-*sexies*) *is* represented by the addition in this paragraph of the specification «[t]hey are liable in the limits of their effective contribution to the damages caused »;
c) under the third paragraph, that the action for damages is subject to a statute of limitation of five years from the date of the audit report, which is issued at the end of the audit to which the action for damages refers, where previously the *dies a quo*, as for members of companies' organs, started from the suspension of the engagement".[157]

These modifications have not revolutionised the subject matter but, instead, they managed to make it more uncertain.

In the Italian experience – like in every other Member State – the audited company, the shareholders and the interested third parties can bring an action against the auditors. The legal basis for the action brought on by the former is the contractual liability, while for shareholders and third parties it is undefined. The case-law tilts in favour of a non-contractual liability, as

[157] "*La responsabilità del revisore tra nuove incertezze e vecchi problemi*" (Salerno, 2013, p.985).

stated in many judgements,[158] instead scholars, while on a first moment agreed majorly with the aforementioned case-law, they changed their minds in favour of a contractual liability-oriented thesis. Notwithstanding these struggles, there are little differences on a practical – and judicial – basis between auditors' contractual and non-contractual liability; differences which have been substantially eliminated through the use of presumptions.

The interpretative problems raised by the difference between these two types of liabilities was solved, at a first glance, by a reference to article 2407 of Italian Civil Code[159] in the repealed articles 2409-*sexies* and 164 TUF, namely referring to the members of supervisory boards' liability (hence to the administrators' liability). Then, as can be seen, art. 15 deleted the reference to the abovementioned article 2407, raising interpretative issues not so easy to riddle.

This change in the provision's arrangement, as said, caused many problems, in particular in the case in which the statutory audit is carried out by the supervisory board of the audited company (following article 2409-*bis* of the Italian Civil Code[160]) and, of course, of the respective liability. In this case it is clear how the members of the supervisory board carrying out the statutory audit are subject directly to article 2407, while, with reference to the case in which the statutory audit is carried out by an external auditor there would be a different treatment hardly justifiable from the point of view of an organic system – as that wanted through the Directives.

That of a "reinforced" supervisory board, with the possibility to carry out the statutory audit, is an Italian peculiarity, probably not taken into consideration in the *travaux préparatoires* of Directives by the European legislator.

However, the erasure of the reference to article 2407 must be analysed from an organic point of view, as the liability system wishes to be. Indeed, while before the issuance of art. 15, the reference to article 2407 aimed at broadening the possibility to bring an action against the auditors with the same legislative instruments which could be used against the administrators – and consequently against the members of the supervisory board –, the aforementioned erasure complicated the discipline.

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[158] Italian Cassation Court, 18th July 2002, n. 10403, in Giur.it., 2003, 672; Milan Tribunal, 21st October 1999, in Giur.it., 2000, 533.

[159] Article 2407 of Italian Civil Code: "1. The supervisory board must fulfil its duties with the professionalism and diligence required by the nature of the office. The members of the supervisory board will be liable for the truthfulness of their statements and must keep confidential the facts and documents of which they have knowledge because of their office.

2. The members of the supervisory board are jointly and severally liable with the administrators for actions or omissions of the latter, where damages would not have occurred had the auditors supervised pursuant to the duties of their office.

3. In the case of an action of liability filed against the member of the supervisory board, such action shall be regulated by the provisions of articles 2393, 2393-*bis*, 2394-*bis* and 2395, where applicable".

[160] Article 2409-*bis* of the Italian Civil Code: "1. The statutory audit of the company's accounts is carried out by a statutory auditor or an audit firm enrolled in the dedicated register.

2. The by-laws of companies not required to draft consolidated financial statements may provide the possibility to entrust the statutory audit with the supervisory board. In this event the supervisory board is composed by statutory auditors enrolled in the dedicated register".

Nowadays, the erasure gave birth to many interpretative issues, such as the uncertainty about the possibility for company's creditors to bring an action against the auditors, thus the extension of art. 2394[161] to the case at stake.
By the way, the majority of scholars tends to admit that the company's creditors can hang on the action which can be initiated by interested third parties.

Nowadays the majority of scholars and consolidated case-law tend to tilt for the possibility to extend the range of actions for liability which can be initiated against the administrators (and thus, the members of the supervisory board) also to auditors, such as those provided for under articles 2393,[162] 2393-*bis*[163] and 2394.
Article 2395,[164] instead, represents a "stand-alone case", regulating the action for damages which can be proposed by an individual shareholder or an interested third party when they are directly damaged by negligent or intentional actions carried out by the administrators.
The origin of this action and of that provided for under article 2394 is the same, both deriving from the violation of the duties required from the administrators by the law and by the articles

[161] Article 2394 of the Italian Civil Code: "1. The administrators are liable toward companies' creditors for non-compliance of duties relating to the integrity of the companies' assets.
2. The action can be proposed by creditors when the companies' assets result to be insufficient to the creditors' satisfaction.
3. The withdrawal of the action by the company do not prevent companies' creditors from the exercise of the action. The transaction can be challenged by companies' creditors only with the revocatory action when it is possible".
[162] Article 2393 of the Italian Civil Code: "1. Any action for liability against the administrators is proposed following a shareholders' meeting's resolution, also in the case in which the company is in liquidation.
2. The resolution concerning the administrators' liability can be taken when discussing the budget, also if it is not enlisted in the list of topics to discuss about, when it is referred to a fact of competence of the exercise to which the budget refers.
3. The action for liability entails the removal of the administrators against which it is proposed, as long as it is taken with at least one fifth of capital of votes in favour.
4. The action can be initiated within five years of the termination of the administrators' appointment.
5.The resolution to bring an action for liability entails the removal from office of the administrators against whom is brought, provided that it is adopted by votes in favour from at least one fifth of the company capital. In this case, the shareholders' meeting will provide for their replacement.
6. The company can waive exercising its rights of action for liability and can settle, provided that this waiver and settlement are approved by an express resolution of the shareholders' meeting and provided that there is no opposing vote of a minority of shareholders representing at least one fifth of the company capital, or in the event of companies that resort to the risk capital market, at least one twentieth of the company capital, or the extent envisaged in the articles of association for exercising company liability action in accordance with paragraphs 1 and 2 of article 2393-*bis*".
[163] Article 2393-*bis* of the Italian Civil Code: "1. The company action for liability may also be exercised by the shareholders representing at least one fifth of the company capital or a different percentage specified in the articles of association, in any case no higher than one third.
2. Companies which resort to the capital market, the action specified in the above paragraph may be exercised by shareholders representing at least one twentieth of the company capital or the lower extent specified in the articles of association.
3. Civil suit must be brought against the company and the summons served to it must also be served to the chairman of the supervisory board.
4. Shareholders who intend to file action must appoint, using a majority of owned capital, one or more common representatives to file the action and to perform the related acts.
5. If the suit is granted, the company will repay the plaintiffs the court costs and those costs incurred to determine the facts which the judge has not charged to the losing parties or whose collection cannot be enforced following assignment.
6. The shareholders who had initiated the action may abandon it or settle; any compensation for the waiver or settlement must be to the benefit of the company.
7. The provisions of the last paragraph of the previous article apply to the action described in this article".
[164] Article 2395 of the Italian Civil Code: "1. Provisions of the precedent articles do not compromise the right to compensation of the individual shareholder or of the third party directly damaged by intentional or negligent actions carried out by the administrators.
2. The action can be taken within five years from the performance of the action which caused a prejudice against the shareholder or the third party".

of association, and they distinguish from each other for the only fact that while the action provided for under article 2394 produces a damage to the company capital, the action set forth under article 2395, instead, produces a direct damage to the shareholders' or third parties' assets.

In particular, according to the consolidated case-law, article 2395 would be in a relation of *species* with regards to the *genus* of article 2043,[165] and this speciality would stand in that, while article 2043 allows in abstract to ask for the compensation of damages suffered in a mediated and indirect way, article 2395, on the contrary, limits the possibility to bring the action only in the cases in which the administrators provoked with their illicit behaviour a direct prejudice to the shareholder's or the third party's individual asset.

Substantially, the legislator felt the necessity to introduce article 2395 in order to complete the discipline of the administrators' liability, thus realising a complementarity of norms and a unitarity of system which articles 2409-*sexies* and 164 TUF preserved also with reference to the auditors' liability.

This discussion can help to make anyone aware about the significance of the reform and how reforming such a delicate issue can be problematic.

3.2 France and the statutory audit

In France, the first entities which were subject to statutory audit were limited companies which were required by the July 1867 law to appoint one or more auditor to audit their financial statements. Over the years, the scope of the entities subject to statutory audit has grown regularly, taking into account the size and the nature of the entities. Such an extension of the scope of statutory audit has led to the audit being present in all sectors of the economy.

The discipline of statutory auditors (*commissaires aux comptes*) is provided for under the Second Title of the Eighth Book of the French commercial code (*Code de commerce*), unlike, for instance, Italy in which the provisions at hand are enshrined in many legislative provisions, such as the Civil Code and Legislative Decrees.

The first issue which arises from the aforementioned Code is that, under Article L820-1, there is a large list of what can be intended under French law as "Public-Interest Entity", namely, credit institutions, insurance and reinsurance undertakings, pensions institutions, mutual companies, entities whose securities are admitted to the listing on regulated markets, some

[165] Article 2043 of the Italian Civil Code: "Any intentional or negligent fact provoking unfair damages to anyone oblige the one who committed the fact to compensate the damage".

companies whose balance exceeds thresholds provided for by a decree, such as holdings where one of their subsidiaries is a credit institution, “mixed” holdings where one of their subsidiaries is a Public-Interest Entity, insurance company groups, and so on.
It is apparent how the French legislator – unlike the Italian one – has taken advantage of letter d), point 13 of Article 2 of Directive 2006/43/EC – as amended by Directive 2014/56/EU –, according to which Member States have the possibility to include in the notion of Public-Interest Entity many other entities, such as “undertakings that are of significant public relevance”.

Another topic worthy of mention is that of independence, to which French legislator dedicated a well-structured provision.
Article L820-3 claims, indeed, that the statutory auditor, before accepting the audit engagement, must inform the audited entity of any belonging to national or international networks, in order for the audited entity – and the supervisory authorities – to assess the presence of the independence requirement. Together with this communication, the auditor has the duty to inform the audited entity of the audit fees which he or she will charge to the latter – which will be communicated to the shareholders – and the list of additional service performed as a corollary of the statutory audit – whether the services at hand are allowed under French law. While, concerning Public-Interest Entities, information at hand must be communicated to the audit committee of the audited entity.

Concerning the public supervisory authority endowed with the power to make a general control over auditors, France, unlike Italy, created an *ad-hoc* independent authority, namely the High Council for the Audit Profession (*Haute Conseil du commissariat aux comptes*), entrusted with many tasks, such as that of supervising the conditions for the approval of auditors or submitting to the Minister of Justice opinions concerning the smooth functioning of the profession at hand, along with many others.[166]

[166] Article L821-1 of the French Commercial Code: “An independent public authority endowed with a legal personality, known as the High Council for the Audit Profession has been created by the Minister of Justice, with the following mission:
- to provide supervision for the profession with the support of the National Company of Auditors instituted by Article L. 821-6;
- to ensure respect for professional ethics and the independence of auditors.
Consistent with this mission, the High Council for the Audit Profession performs the following tasks, among others:
- to identify and promote good professional practices;
- to give an opinion on the rules of professional practice drafted by the National Company of Auditors prior to their approval via an order of the Minister of Justice;
- to effect registration of auditors in its capacity as an appeals authority for decisions of the regional commissions referred to in Article L. 822-2;
- to deal with disciplinary issues relating to auditors in its capacity as an appeals authority for decisions of the regional chambers referred to in Article L. 822-6;

Together with the creation of a new independent authority, French legislator provided for the so-called National Company of Auditors (*Compagnie nationale des commissaires aux comptes*), namely a public company endowed with the tasks of promoting and supervising good practices in the profession and protecting honour and independence of its members.[167]

The two aforementioned organs must carry out, *inter alia*, for checks and inspections, either periodical or occasional, which are necessary in order to maintain all the requisites an auditor must carry, primarily that of the independence.[168]

Moreover, these controls are also necessary to assess any misbehaviour carried on by the auditor in the performance of its tasks, with a particular reference to auditors' liability, about which this dissertation will focus in the next subparagraph.

While concerning registration of statutory auditors there is nothing in particular to notice, in the subject matter of ethics and independence of the auditor there is a really well-structured set of provisions.

The first one is that for which the "three quarters of the voting rights of auditing firms must be held by auditors or auditing firms registered on the list" of registered auditors "or professionals duly certified in another European Union Member State for the practice of statutory auditing", or that for which at least three quarters of the members of management or

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- to define the framework and the guidelines for the periodic controls specified in Article L. 821-7 (b) that it implements directly, either by delegating this exercise practice to the National Company of Auditors and to the regional companies, or which are performed by the National Company and the regional companies, according to the terms set out in Article L. 821-9;

- to supervise the controls set out in Article L. 821-7 (b) and (c) and issue recommendations in the context of their monitoring;

- to supervise the proper performance of the controls set out in Article L. 821-7 (b) and where they are performed at its request, in compliance with point (c) of the same article;

- establish relations with the authorities of other States exercising similar functions.

The duties defined in the tenth and eleventh paragraphs of this article are exercised under the conditions set by a Conseil d'État decree guaranteeing the independence of the functions of auditing and of discipline".

[167] Article L821-6 of the French Commercial Code: "A National Company of Auditors, a public corporation with legal personality instituted under the aegis of the Minister of Justice and directed to the public benefit, is tasked with representing the auditing profession in its dealings with the public authorities.

It contributes to the promotion of good practice in the profession, the supervision thereof and the protection of the honour and independence of its members.

A regional company of auditors with legal personality shall be created under the jurisdiction of the Cour d'Appel in each region.

However, the Minister of Justice may carry out mergers of the interested regional companies on the proposal of the National Company and after consultation by the latter of.

The resources of the National Company and the regional companies are provided mainly through an annual subscription collected from the auditors".

[168] Article L821-7 of the French Commercial Code: "While practising their profession, auditors are subject to:

a) The inspections referred to in Article L. 821-8;

b) Periodic checks organised on the basis of parameters defined by the High Council;

c) Occasional checks decided by the National Company or the Regional Companies or carried out at the request of the High Council.

The persons participating in the checks and inspections mentioned in this article are bound by a professional duty of confidentiality".

supervisory bodies must be auditors or auditing firms registered on the aforementioned list.[169] It is a pivotal provision in order to understand the crucial role of professional auditors in firms which are aimed to carry out such a delicate task.

Finally, moving to appointment, withdrawal and dismissal of auditors, a topic to point out is for sure that of the duration of the engagement for entities different from those of public interest, for which the French legislator provided for a maximum duration of six fiscal years, which is twice the term the Italian legislator set.

3.2.1 The auditors' liability under the Code de commerce

Article L822-17 of the French Commercial Code sets forth the discipline of auditors' liability which, like its Italian equivalent, have not taken in consideration Recommendation 2008/473/EC, for the reason why the French provision at hand has been issued in 2005.[170] The provision reads as follows:

> *"The auditors are responsible, with regard to the person, the entity or third parties for the harmful consequences of the errors and negligence committed by them while fulfilling their duties.*
> *However, they shall not be held liable for facts reported or disclosed while carrying out their task.*
> *They are not civilly liable for breaches committed by the managers*

[169] Article L822-9(1) and (2) of the French Commercial Code: "The auditing profession is practised by natural persons or by firms created by such persons in whatever form.
Three quarters of the voting rights of auditing firms must be held by auditors or auditing firms registered on the list specified in Article L. 822-1 or professionals duly certified in another European Community Member State for the practice of statutory auditing. Where an auditing firm has an equity interest in another auditing firm, shareholders or partners who are not auditors cannot hold more than one quarter of the total voting rights of the two firms".
The duties of manager, president of the board of directors or executive board, president of the supervisory board and chief executive officer must be performed by the statutory auditors registered on the list specified in Article L. 822-1 or duly certified in another European Community Member State for the practice of statutory auditing. At least three quarters of the members of management, governance, executive or supervisory bodies must be auditors or auditing firms registered on the list specified in Article L. 822-1 or professionals duly certified in another European Community Member State for the practice of statutory auditing. The permanent representatives of auditing firms organised as partnerships or shareholders must be auditors or auditing firms registered on the list specified in Article L. 822-1 or professionals duly certified in another European Community Member State for the practice of statutory auditing.
In registered auditing firms, the auditing functions must be performed, on behalf of the firm, by auditors who are partners, shareholders or executives of that firm who are natural persons. Such persons can only perform auditing functions for one auditing firm. The members of the board of directors or of the supervisory board can be employees of the company without limitations based on their number or on the seniority of their employee status.
In the event of the death of an auditor who is a shareholder or a partner, his beneficiaries have two years in which to sell their shares to an auditor.
The admission of any new shareholder or member is subject to prior approval which, under the terms and conditions of the constitution, can be given either by a general meeting of shareholders or partners, or by the board of directors or the supervisory board or the management, as applicable.
Notwithstanding these provisions, the exercise of these functions may be performed concurrently within one auditing firm and a second auditing firm in which the first firm holds more than half of the share capital or if at least half of the partners of the two firms are common to both".

[170] Article 18 of Ordinance n°2005-1126 of 8th September 2005.

and corporate officers, unless they failed to indicate such breaches in their report after gaining knowledge thereof to the general meeting or to the competent body mentioned in Article L. 823-1[171]*".*

It is apparent how there is no mention to any limitation of liability, as foreseen in the Recommendation at hand, neither in the form of a cap up to which the auditor can be considered liable nor in the possibility to have a contractual clause providing for such limitation.

One of the most interesting questions on this topic is that about the subjects which can be held liable; more precisely, if the auditors' liability is personal or is up to the audit firm as a whole. Of course, only cases of audit firms are considered in the assumption at stake.

As highlighted by BIROBENT (2010),[172] the French Cassation Court stated that "auditors who signed the audit report face individual liability".[173] In favour of this assumption there is a provision regulating companies established among professionals, for which each associate is liable with his or her assets for professional actions he or she accomplishes.[174]

The aforementioned provision carries with it some interpretative problems understanding whether it is applied exclusively to companies established among professionals.

Indeed, where, concerning audit firms, the French Commercial Code does not provide for anything about the company model the firm must adopt, someone could ask himself or herself whether the provision at hand can be extended to companies not established exclusively among professionals.

For the sake of completeness, arguments in favour of the assumption for which there is a firm's liability and not an individual one can be found in the French Commercial Code itself, where Article L822-9 states that "in registered auditing firms, the auditing functions must be performed, on behalf of the firm, by auditors who are partners, shareholders or executives of that firm who are natural persons", implying that the liability is up to the company, where it is said that the auditors carry out their functions "on behalf of the firm".

On the other hand, other legislative provisions tilt in favour of an individual liability, where the aforementioned Article L822-17 states that "the auditors are responsible, with regard to the person, the entity or third parties for the harmful consequences of the errors and negligence committed by them while fulfilling their duties", implying that the auditors individually must be held responsible for the actions they perform in the fulfilment of their

[171] Article L823-1 of the French Commercial Code.

[172] "*La responsabilité civile personnelle du commissaire aux comptes*" (Birobent, 2010).

[173] Cour de cassation, civile, Chambre commerciale, 23 mars 2010, 09-10.791.

[174] Article 16 of Law n° 90-1258 of 31st December 1990.

duties.

In particular, before the issuance of the abovementioned judgement from the French Cassation Court, there was a bit of confusion among the thesis to be followed. Indeed, the Rennes Court of Appeal[175] stated the exclusive firm's liability, the Paris and Versailles Courts of Appeal[176] [177] tilted in favour of a joint liability between the firm and the auditor, while, finally, Orléans Court of Appeal[178] – which is, by the way, the decision from which the French Cassation Court issued the aforementioned one – upheld the assumption for which the liability must be attributed to the auditors signing the audit report.

Finally, moving to the heart of the French Cassation Court's judgement, the decision for which the auditor who sign the audit report is personally liable for the statutory audit carried out by the audit firm as a whole was founded on Articles L822-9,[179] L822-17 of the French Commercial Code, and on Article 1382[180] of the French Civil Code. These grounds were criticised by many scholars, including the aforementioned one, for the reason why the French Cassation Court stated that, since the inexistence of a particular principle affirming the individual auditors' liability, a general principle can be drawn out by Article 1382 of the French Civil Code.

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[175] Cour d'Appel de Rennes, 1ère, B, 16/09/2005, n° 03/06260.

[176] Cour d'Appel de Paris, 14ème, C, 08/11/1991, n° 90-016070. Cour d'Appel de Paris, 1ère ch., section A, 21/01/2003, n° 2002/08297.

[177] Cour d'Appel de Versailles, 13e ch., 07/03/2002, n° 00/06958.

[178] Cour d'Appel de Orléans, 06/05/2008, n° 08/01782.

[179] Article L22-9 of the French Commercial Code: "The auditing profession is practised by natural persons or by firms created by such persons in whatever form.

Three quarters of the voting rights of auditing firms must be held by auditors or auditing firms registered on the list specified in Article L. 822-1 or professionals duly certified in another European Community Member State for the practice of statutory auditing. Where an auditing firm has an equity interest in another auditing firm, shareholders or partners who are not auditors cannot hold more than one quarter of the total voting rights of the two firms.

The duties of manager, president of the board of directors or executive board, president of the supervisory board and chief executive officer must be performed by the statutory auditors registered on the list specified in Article L. 822-1 or duly certified in another European Community Member State for the practice of statutory auditing. At least three quarters of the members of management, governance, executive or supervisory bodies must be auditors or auditing firms registered on the list specified in Article L. 822-1 or professionals duly certified in another European Community Member State for the practice of statutory auditing. The permanent representatives of auditing firms organised as partnerships or shareholders must be auditors or auditing firms registered on the list specified in Article L. 822-1 or professionals duly certified in another European Community Member State for the practice of statutory auditing.

In registered auditing firms, the auditing functions must be performed, on behalf of the firm, by auditors who are partners, shareholders or executives of that firm who are natural persons. Such persons can only perform auditing functions for one auditing firm. The members of the board of directors or of the supervisory board can be employees of the company without limitations based on their number or on the seniority of their employee status.

In the event of the death of an auditor who is a shareholder or a partner, his beneficiaries have two years in which to sell their shares to an auditor.

The admission of any new shareholder or member is subject to prior approval which, under the terms and conditions of the constitution, can be given either by a general meeting of shareholders or partners, or by the board of directors or the supervisory board or the management, as applicable.

Notwithstanding these provisions, the exercise of these functions may be performed concurrently within one auditing firm and a second auditing firm in which the first firm holds more than half of the share capital or if at least half of the partners of the two firms are common to both".

[180] Article 1382 of the French Civil Code: "Any action or negligence committed by anyone, causing damages to another, obliges the one for which the damage occurred, to repay it".

Scholars criticised in particular this position, because, according to them, the provision at hand is too general to be used in such a particular case, and that there is the need for a specific provision, hence leaving the firm's liability in case of any damage caused by the statutory audit.

Finally, it is important to mention other opinions and judgements in order to understand better every facet of the subject matter at hand.

First, according to the French Cassation Court, [181] the audit engagement constitutes an "obligation of means", rather than an "obligation of results", but, notwithstanding this, the auditor must be held liable whether he or she has performed its tasks with negligence or with inexperience or has used "minimal procedures or methods".

Moreover, since the auditor has several tasks to accomplish when carrying out the statutory audit, there are many different cases in which he or she can be held liable, such as that of "drawing a picture" of the financial situation in which the audited entity lies, or informing the management and supervisory boards about the audit, eventually through the activation of a "warning procedure" sketched out in Article L234-1 of the French Commercial Code.[182]

These duties affect inevitably the way in which the liability must be assessed by a Court, in particular when assessing the different elements of the liability.

In particular, together with the considerations about the type of misbehaviour the auditor carried out, also any damage occurred to the audited entity and the link between them must be assessed, as highlighted, *inter alia*, by the Paris Court of Appeal, for which "the audit of company's financial statements is a crucial element for an investments company's decision to invest, therefore the insufficient diligence on their behalf entails their liability".[183]

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[181] Cassation commerciale 27 octobre 1992 C. / SARL C.R. pourvoi n° 90-21.127.

[182] Article L234-1 of the French Commercial Code: "If, in the performance of his duties, the auditor of a société anonyme notes facts likely to compromise the continuity of the business continuity, he shall inform the president of the board of directors or the executive board president thereof as prescribed in a Conseil d'État decree.

If no reply is received within fifteen days or if the reply received does not provide complete assurance of such continuity, the auditor shall urge the president of the board of directors or of the executive board, in a letter copied to the presiding judge of the Tribunal de Commerce, to submit the facts noted to the board of directors or the supervisory board for discussion. The statutory auditor shall be called to attend this meeting. The minutes of the board of directors' meeting or supervisory board meeting shall be sent to the presiding judge of the Tribunal de Commerce and to the works council or, failing this, to the employee representatives.

Where the board of directors or the supervisory board has not met to deliberate on the facts identified or where the statutory auditor has not been called to this meeting or if the auditor notes that the continuity of the business remains in jeopardy despite the decisions taken, a general meeting shall be called under the conditions and within the time limit defined by a Conseil d'État decree. The statutory auditor shall draw up a special report, which shall be presented at this meeting. This report shall be sent to the works council or, in the absence of a works council, to the employee delegates.

If, after the general meeting, the auditor finds that the decisions taken do not ensure the continuity of the business, he shall inform the presiding judge of the Tribunal de Commerce of his actions and send him his results.

Within six months from the beginning of the warning procedure, the statutory auditor may resume the procedure from the stage where he had thought it possible to terminate it, when, despite the elements that justified this assessment, the continuity of the business is still in jeopardy and urgency requires the immediate adoption of measures".

[183] Cour d'appel Paris 5ème ch. A 8 septembre 1999 B. et autre / SA Editions A. et autres n° Lexbase A7565A3L.

Finally, the action for liability can be brought by many subjects, such as the audited company as a whole, the single shareholder or company's creditors; the latter are entitled to bring an action "as long as they suffer an individual prejudice formally distinct from the collective or companies' one", as stated by the French Cassation Court.[184]

3.3 The statutory audit in Germany

Germany, just like France, adapted its Commercial Code (*Handelsgesetzbuch*) to Directives 2006/43/EC and 2014/56/EU, hence without providing for separate legislative acts, and the discipline of statutory auditing (*Prüfung*) is enshrined in the Third Chapter of the Second Title of the Third Book.

In an opposite way compared to France, Germany chose to adopt few concise provisions, not drifting too much away from the texts of the Directives, respecting its legal tradition.
Now, this dissertation is going to highlight the few differences the German legislator opted for.

First, there is some additional provision with regards to the auditor's appointment and removal, such as that for which the auditor must be appointed within the end of the financial year, otherwise a Court – triggered by the supervisory board or one of the administrators – must fulfil the task in place of the entity to be audited, or that for which he or she must be reimbursed of reasonable out-of-pocket expenses, apart from the payment of the remuneration.[185]

Another interesting provision is that for which the auditor may be exceptionally exempted from the requirement set forth in the first subparagraph of Article 4(2) of Regulation (EU) 537/2014,[186] sending a request to the Federal Office of Economics and Exports Control. The exemption is granted for a maximum of one financial year and only up to 140 per cent of the average fees referred to in the first subparagraph of the aforementioned Article.[187]

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[184] Cassation commerciale 28 juin 2005 Société T. / Société K. F. de France pourvoi n° 03-13.112.

[185] Section 318(4) and (5) HGB.

[186] First subparagraph of Article 4(2) of Regulation (EU) 537/2014: "When the statutory auditor or the audit firm provides to the audited entity, its parent undertaking or its controlled undertakings, for a period of three or more consecutive financial years, non-audit services other than those referred to in Article 5(1) of this Regulation, the total fees for such services shall be limited to no more than 70% of the average of the fees paid in the last three consecutive financial years for the statutory audit(s) of the audited entity and, where applicable, of its parent undertaking, of its controlled undertakings and of the consolidated financial statements of that group of undertakings".

In particular, the German exception leverages on the third subparagraph of the abovementioned provision: "Member States may provide that a competent authority may, upon request by the statutory auditor or the audit firm, on an exceptional basis, allow that statutory auditor or audit firm to be exempt from the requirements in the first subparagraph in respect of an audited entity for a period not exceeding two financial years".

[187] Section 319a(1a) HGB.

Furthermore, a topic linked to that of the auditor's liability is that for which, in case of insolvency proceedings instituted with regards to the audited entity, shareholders and creditors can inspect the audit reports of the last three financial years, in order to eventually detect any misbehaviour by the auditor which led to a distorted perception of the audited entity's financial situation.[188]

The last issue to remark is for sure the fact that, while in Italy or in France the respective administrative organs – such as CONSOB, for instance – issue auditing standards which are recognised in the system thanks to express legislative references, in Germany there is no such a universally recognised organ issuing auditing standards, for several reasons, such as that for which there is no legislative reference in the German legislative system to an organ drafting standards.

It is nonetheless true that there is an organ in Germany drafting auditing standards, namely the *IDW* (*Institut der Wirtschaftsprüfer in Deutschland*) which, however, is not recognised, as mentioned, by any legislative provision, thus its standards have no formal legislative value.

This assumption is held by both case-law and scholars, but, while the latter are unanimously oriented toward the theory at hand, case-law has been historically divided.

Indeed, in a first moment, many courts held that actually the IDW had no power to issue legally binding standards, which, whether in contrast with a legislative provision, could not be applied.

In particular, Duisburg's Superior Court in 1994 stated that the auditing standards thereof cannot prevail on the interpretation of a legislative norm set forth by a Court,[189] by the way the same position was taken by Stuttgart's Tribunal.[190]

Instead, Braunschweig's Court of Appeal[191] and Frankfurt's Tribunal[192], respectively in 1995 and in 1997, stated that the auditing standards issued by the IDW find their legislative legitimation in the fact that they are "audit technical norms", hence having a "*de facto* binding effect".

Scholars, as argued, unanimously tilted in favour of the assumption for which the IDW, being a private entity constituted among professionals in order to carry on their interests, cannot be considered as an organ whose opinions and statements have legislative power. National courts may only take those standards in consideration as long as those are seen as minimum

[188] Section 321a(1) HGB.

[189] Duisburg's Superior Court, 31st December 1993, n° 23 HRB 3193, in Der Betrieb, 1994, 466, 467.

[190] Stuttgart's Tribunal, 8th December 1975, n° 14 O 504/73

[191] Braunschweig's Court of Appeal, 10th July 1994, n° 4 U 177/94, in Wirtschaftsprüferkammer-Mitteilungen 1995, 209 ss., 210.

[192] Frankfurt's Tribunal, 8th April 1997, n° 2/18 0 475/95, in Betriebs-Berater, 1997, 1682, 1684

standards to be kept by statutory auditors in the performance of their tasks.
In conclusion, in order to endorse the aforementioned assumption, there is also another organ, namely the Professional Order of Statutory Auditors, which periodically issues auditing standards to be followed by professionals, hence producing a confusion, being clearly incompatible with any theory suggesting the legislative binding nature of those standards.

3.3.1 The German auditors' liability

The discipline at hand in enshrined in Section 323 of the German Commercial Code, which reads as follows:

> "*1. The statutory auditor, his assistants and legal representatives of an audit firm involved in the statutory audit are required to perform the statutory audit in a scrupulous and impartial way and to observe the duty of secrecy; what set forth under Section 57b of the Regulation of statutory auditors shall be without prejudice. Taking advantage of commercial and corporate secrets which they learn in the performance of their activities is prohibited without prior authorisation. Those who violate, voluntarily or with negligence, those duties must restore the damage occurred to the audited company and, eventually, to the associated companies.*
> *2. The liability of those acting with negligence is limited to one million euros for each statutory audit. In the case of the statutory audit of a limited liability company whose shares are admitted to the trading on regulated markets, the liability of those acting with negligence is limited, contrarily to what stated in the previous sentence, to four million euros for each statutory audit. The same applies whether the statutory audit is carried out by more than one statutory auditor or more than one action or negligence entailing a liability has been performed, and aside from any fraud of other subjects involved.*
> *3. The duty of secrecy remains, whether an audit firm acts as a statutory auditor, also with regards to the supervisory board and the members of the supervisory board of the audit firm.*
> *4. The duty to restore the damage set forth under these provisions cannot be excluded or limited by means of a contract between the parties.*"

As it is evident, German legislator caught the alarm launched by the European Union through the issuance of Recommendation 2008/473/EC, with the aim of limiting auditors' liability.
This aim has been reached – at least on paper – through the provision of a monetary cap, with all the consequences highlighted in the previous chapter, but without providing for a contractual limitation of liability – on the contrary expressly prohibiting it.

While it is out of question that the auditor must be held liable for the violations of its duties, more complicated is comprehending which these duties are, as highlighted, by the way, by KINDLER (2016).[193]
Some scholars argue that the duties to which Section 323 makes reference are only those enlisted in the first paragraph thereof, namely those of secrecy, of not taking advantage of commercial and corporate information of which they become aware in the performance of their duties and of performing their tasks in a scrupulous and impartial way. Instead, some others state that the interpretation of the topic at hand should tilt in favour of those enlisted in Section 317 HGB, namely those audit acts *stricto sensu* in the statutory audit as a whole.

However, the prevailing opinion is that for which the auditor shall be liable for every activity carried out in the performance of the statutory audit, providing for "two levels of liability", namely that for the non-observance of the aforementioned tasks – *i.e.*, duty of secrecy, duty of not taking advantage of commercial and corporate information of which they become aware in the performance of their duties and the duty of performing their tasks in a scrupulous and impartial way – and that for the violation of other norms concerning statutory audit – such as any damage deriving from an incorrect report, omitted complaint of misstatements, unjustified delay in the issuance of the audit report or misstatements in general.

Another interesting difference may be that between *dolus* and *culpa*, where the German legislator assumes that the statutory auditor can be held liable only when he or she does not accomplish the tasks for which the mandate is conferred upon him or her.
According to the wording of the German Commercial Code, the voluntariness is present whether the statutory auditor, aware of the facts, violates intentionally his or her duties, or whether he or she considers its illicit behaviour as possible but accepting the damage that it will produce. In the major part of the cases, auditors misbehave with negligence and not intentionally.

[193] "*La responsabilità dei revisori legali e delle società di revisione legale: un confronto tra le discipline italiana e tedesca*" (Kindler, 2016, p.1124).

Negligence, instead, consists in the non-observance of the due diligence in the juridical relationships.

Then, according to German Commercial Code, the auditor's liability can be diminished or excluded whether the audited company is liable too.
Since the auditor carries out its tasks for the going concern of the company and for the interests of the shareholders, administrators' liability does not exclude automatically the auditor's liability. This principle is a German peculiarity, because, for instance, it cannot be found in the Italian legislative system which is harder in attributing the liability to the auditor – and which did not implement the aforementioned Recommendation.
In order to endorse this assumption, Saarbrücken's Court of Appeal[194] in 2013 completely excluded auditor's liability for the reason that the audited company's administrator committed false accounting and that no serious negligence could be ascribed to the auditor.

Auditor's liability extends to any audited company's patrimonial damage, for instance whether the auditor expresses a positive judgement in its report on an incorrect financial statement and the audited company, basing on the results at hand, decides to distribute dividends to shareholders.

Furthermore, the statute of limitation is set in three years starting from the end of the financial year in which the auditor committed the negligence at stake. Whether the active subject does not become aware of the right born upon him or her and this cannot be ascribed to his or her serious negligence, the respective statute of limitation is set in ten years from the day in which the subject actually becomes aware of the right.

Germany, in an opposite way with respect to Italy, does not provide that the action for auditor's liability can be brought by interested third parties. For now, this dissertation will analyse which subject can be considered as such, and then the dissertation will discover any legal basis for the action at hand.

The general definition is that for which an interested third party is the one who has credits towards the audited company. For instance, also the minority shareholder can be considered as an interested third party whether he or she has not contributed to the appointment of the statutory auditor and complain about a damage suffered by the audit.

[194] Saarbrücken's Court of Appeal, 18th July 2013, n° 4 U 278/11-88, in Deutsches Steuerrecht - Entscheidungsdienst, 2014, 186.

Among the main companies' creditors there are suppliers of goods or services, bondholders and credit institutions.

One of the reasons for which the German legislative system does not provide for an action which can be brought by interested third parties may be that of the so-called "flood gate", according to which allowing expressly such an action would produce unpredictable economic effects toward the statutory auditor. On the contrary, Section 323 at hand provides for a monetary cap up to which the statutory auditor cannot be held liable.
For these reasons, both case-law and scholars agreed in considering impossible to bring such an action for lack of formal legal basis. Indeed, the German Court of Cassation considered the engagement contract between the auditor and the audited entity as an "exclusive agreement", where there was no room for any third parties' claims.
A really known judgement denying the contractual nature of the action for damages is that of the Federal Court issued in 2006. It held basically that the legislator's will not to provide for the possibility for third parties to bring a claim against the statutory auditor must be respected, therefore closing the doors to any interpretation about the issue at hand.
Finally, it can be said that the only legal basis for such an action can be found in the action for damages deriving from torts, which, although being very wide in the different provisions, leaves little room for the real possibility to obtain restoration.

3.4 Final considerations

The analysis brought on until now about the auditors' liability and the methods with which Recommendation 2008/473/EC has been implemented (or the ways in which it has been reformed, whether it has not been welcomed in the national systems) highlighted many interesting issues, which can pull the trigger for a discussion about the opportunity to carry out further reforms.
The remarks which will be highlighted in the next few lines refer exclusively to the cases of absence of *dolus* in the auditors' liability.

In the analysis of these proposals, the fact that the auditor carries out a pivotal task for the market and the investors – current or potential – must be kept in mind in order to fully understand the exceptions borne to the ordinary discipline of civil liability.

First, the general introduction of a monetary cap up to which the auditor cannot be held liable would be a good starting point.
Taking into consideration the German experience, the previous subparagraph highlighted how

Section 323(2) HGB provided for two kinds of monetary caps, the former setting forth a general cap of one million euros for the audit of every entity and the latter providing for a specific cap of four million euros for the statutory audit of listed public limited companies.
One of the first faults to be detected can be that, already brought out by London Economics – as highlighted in the previous chapter –, for which a single monetary cap could be considered as a risk, for the reason that it does not consider the differences among the different audited entities or the different audit fees charged on the aforementioned entities.
Indeed, putting a general cap may present again the problem analysed in the previous chapter, *i.e.*, that of the "flood gate"; it is the issue perceived by auditors worldwide according to which, whether the boundaries of their liability is not well defined, problems of excessive damages claimed by those entitled to bring relative actions may rise. Hence, putting a general cap may be dangerous for relatively small audit firms, whose stakeholders could be entitled to bring actions up to cap representing enormous amount of money for the aforementioned auditors.

A solution may be represented by the introduction of a "proportioned cap", with different ranges of monetary boundaries related to different ranges of audit firms' annual turnover or related to the audit fees charged by audit firms to audited entities.
The cap may be anchored also to other elements, such as the degree of liability detected by the competent Courts, so that the amount of money actually paid by the auditor can be proportionate to the actual contribution to the loss suffered by the claimants – as set forth in the aforementioned Recommendation. Of course, the damage suffered by the claimants must be restored also by those subjects which are jointly and severally liable together with the auditor.

Another delicate issue is that of the joint and several liability, which is not dealt with directly by the Recommendation at hand, hence creating a dangerous vacuum.
This vacuum can be interpreted by Member States either with the possibility to introduce – or to maintain – the joint and several liability within their auditors' liability system or to delete it.

A foreseeable solution can be that of maintaining – or to introducing *ex novo* – a joint and several liability together with a limitation of auditors' liability tied to the degree of auditors' liability detected by a Court, so that auditors could have the right to bring an action of recourse against the other joint liable debtors, *i.e.*, administrators and members of the supervisory board.
A general problem detected, which is related to the actions of recourse brought by auditors

against the aforementioned joint liable debtors, lies in that they cannot completely afford the claims brought by competent claimants.
This issue can be solved through an obligation to be extended upon companies be mandatorily covered by an insurance scheme in order to face these kinds of claims, so that auditors can successfully bring their actions of recourse against administrators and members of supervisory boards.

Furthermore, as analysed in the previous chapter, there is the possibility for Member States – completely given up by Germany – to introduce a contractual limitation of auditors' civil liability, according to which the audited entity and the auditor can draft the terms of the their liability, for instance providing any eventual monetary cap or the cases in which the auditor cannot be held liable, bearing in mind that there is no possibility for auditor to be held liable as a consequence of the outcomes of his or her activities.
This proposal is really dangerous for many factors, such as that for which there is the risk that most of the agreements could be deemed as null and void under many liability related norms. For instance, there is the possibility for which an audited entity, thanks to its contractual strength, may insert in the contract a clause for which it cannot be held liable in any case, so invalidating the engagement draft terms.

3.4.1. The need for competition and the issue of conflict of interests

Many scholars, together with the practical experience, highlighted an urgent need to widen the auditors' market.
At the beginning of the 80's, there were eight huge audit firms (The Big Eight), while nowadays there are only four of them. This drop is due to both the enormous claims for damages against which audit firms went and to the lack of control that national – and European – competition authorities had to carry out.

Referring in particular to lawsuits, one need only to think that, for instance, just in the last two years two different legal actions – but concerning the same object – of a total amount of $ 8 billion have been filed against PwC.
A failed US mortgage lender, Taylor, Bean & Whitaker in 2016, and the Federal Deposit Insurance Corporation in 2018, filed a lawsuit against PwC for failing to detect a massive fraud carried out by the plaintiff's executives to be in cahoots with Colonial Bank, one of the main company's lender.

Furthermore, London Economics performed an analysis on the state of the art of the market of audit firms' competitiveness, highlighting the oligopoly in which the aforementioned Big Four lie.

Indeed, by 2004 – but the situation has not changed at all – the European Union was latched in an oligopolistic vice, by which the Big Four concentration ratio was among 83% and 100%. This concentration is due, *inter alia*, to the barriers to penetrate the market, which are represented by many factors, such as that of the enormous claims for damages or the fact that entities to be audited rely in a more favourable way upon experienced audit firms rather than new and relatively small auditors.

An interesting solution has been brought on by the FINANCIAL TIMES in a 2018 article.[195]

In order to fully understand this proposal, a case involving a British company, Carillion Plc, must be briefly explained.

At the beginning of 2018, on the petition of the companies' directors, a compulsory liquidation order was made against Carillion. Following a UK Parliamentary investigation, all of the Big Four turned out to have an involvement, more or less meaningful, in advising on different aspects the company.

The competent Parliamentary Committee – *i.e.*, the Work & Pensions and Business committees – proposed to the British Competition & Market Authority to consider a break up that would separate Big Four's audit division from their lucrative consulting business.

Coming back to the article mentioned above, its author, on the basis of the considerations highlighted above, envisaged a series of reasons for which a break-up of the kind described would be better for both preventing many conflicts of interests to arise – in both internal and external dimensions – and for the assurance of competition in the audit field.

Multiple market failures need to be addressed. The most obvious problem is that audit quality is invisible to those whom it is intended to benefit: the shareholders. It is difficult to differentiate good and bad audits. Even when questions are raised about the quality of audits, shareholders almost always vote to retain auditors, with most receiving at least 95% support. Last year, 97% of Carillion shareholders voted to re-appoint KPMG.

Lack of scrutiny creates space for conflicts of interest. Auditors who feel accountable to company executives rather than shareholders will be less likely to challenge them. These conflicts are exacerbated when audit firms also sell other services to management teams, particularly if that consultancy work is more profitable.

The dominance of the Big Four in large company audits is another concern: when large and

[195] "*Should the Big Four accountancy firms be split up?*" (Financial Times, 2018).

powerful firms are able to exclude high quality competitors from the auditors' market, the damage is lasting.

Taken together, these failures have resulted in a dysfunctional audit market that needs a broad revamp. Splitting audit from consulting would prevent the most insidious conflict of interest. When non-audit work makes up around 80% of fee income for the Big Four, the influence of this part of the business is huge. Current limits on consulting work have not eliminated this problem. They are often set too high or can be gamed, while auditors can still be influenced by the hope of winning non-audit work after they relinquish the audit mandate. There is quite simply no compelling reason why shareholders should accept these conflicts and the resulting risks to audit quality introduced by non-audit work. But other reforms are necessary.

Notwithstanding this issue is something scholars and civil society brought on many years ago, starting with the outcomes of the Enron case and the need for audit firms to provide for their audit and non-audit services in a strictly separated way, barely nothing changed until now.

By the way, the author interestingly highlighted that the barriers to entry in the audit market for competitors different from the Big Four are represented not only by the virtues and the already established international experience they carry, but also by the global most important and large firms which tend to crowd out new competitors, also maybe pursuant to some tacit agreements between them.

David Sproul, Chief Executive Officer of Deloitte, told the Financial Times in March that it is undeniable that audit firms are an oligopoly and that the market will change for sure in the future; for this reason, he continued, they have to reduce the level of conflicts and demonstrate why they are manageable and why the public and the investors should trust them. PwC said it had "a documented business continuity plan covering a range of scenarios that could threaten the existence of the firm".
EY said that: "working alongside regulators and standard setters, the profession can evolve to best serve business, investors and stakeholder needs."
Bill Michael, chairman of KPMG's UK business, said his firm had been thinking about break-up scenarios "for some time".[196]

These statements highlight how the Big Four actually considered the radical idea of being either split up or forced to create two different legal entities in order to, *inter alia*, prevent

[196] "*Big Four accountancy firms plan for UK break-up*" (Financial Review, 2018).

competition authorities to address them with heavy fines, but anyway it is always needed a triggering event to force Big Four to think about solutions to the cartel through which they split the market.

As envisaged, a solution may be represented by national and/or European incentives – respecting the European discipline on state aids – in order to revive the auditors market and to let other audit firms grow and acquire more reliability.
Another idea may be represented by a project based on a first moment in which Big Four are split up in smaller audit units and a second moment in which they begin to compete with other firms with some legislative guarantee, such as that provided for by France in the early 2000s, according to which each listed company had to be audited by two different audit firms.

Reforms like the one just mentioned may represent a very important incentive – apart from the mere economic ones – for smaller competitors which struggle to emerge in a market which, as exhaustively analysed, is divided among Big Four and largest firms, with the creation of a dangerous cartel which produced the disastrous effects which are under everyone’s eyes.

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