



School of Economics
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Audit Committees

*The Implementation of Audit Committees, in
Swedish Companies, and their Influence on the
Independence of the Swedish Auditor*

Bachelor Thesis in Business Administration
Accounting and Finance
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Abstract

**Bachelor Degree in Business Economics, School of Economics and Commercial Law at the Göteborg University
Accounting and Finance, Bachelor Thesis, Spring term 2004**

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Title: Audit Committees - The Implementation of Audit Committees, in Swedish Companies, and their Influence on the Independence of the Swedish Auditor

Background and problem: The recent auditing scandals have provoked new legislation in the United States, the European Union and Sweden. The legislation is intended to restore the public confidence in auditing and financial reporting. Two important events are the U.S. Sarbanes-Oxley Act of 2002 and the proposed modernized EU Eighth Company Law Directive. Both are important affecting Swedish business. In Sweden a proposed Swedish Code follows the legislation tendencies in the world. As a result of the Sarbanes-Oxley Act, the role of the Audit Committee is strengthened. A similar result is expected in both EU and Swedish legislation.

Purpose: The purpose of this thesis is to investigate the effects of the Audit Committee legislations on the independence of the Swedish auditor.

Delimitations: Since auditing is a global and complex issue, this thesis will not scrutinize all auditing aspects. The aim is to investigate the impact on the independence of the auditor in Sweden with the introduction of Audit Committees and to clarify the regulations relevant to the subject.

Methodology: This thesis is based on a hermeneutic approach and is a qualitative study based on a questionnaire.

Results and conclusion: The introduction of an Audit Committee will mainly have positive consequences on the independence of the Swedish auditor. The main issue today is the independence in appearance. The Audit Committee will increase the Swedish auditor's independence in appearance and thereby help restore the public confidence in auditing. However, the only one who can guarantee the independence in fact is the auditor himself/herself.

Suggestions for further research: This thesis investigates a scenario that is not fully tested. It would be interesting to research the same subject, but after a suitable period of time has passed, in order to see if the conclusions of this thesis are accurate.



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1. Introduction

In this chapter the authors will introduce the subject and purpose of this research. The authors will also clarify the delimitations and give an explanation of the disposition of the thesis.

1.1 Background

In an evermore changing global environment laws as well as people can cross borders. This has been the trend in the accounting and auditing world in recent years, not only in the sense of harmonization of accounting and auditing standards such as the proposal to a modernized Eighth Company Law Directive in the European Union, but also in the appearance of rules in the aftermaths of accounting and auditing scandals. Enron was the first large accounting and auditing scandal that affected a greater number of people, but was soon followed by scandals at World Com, Parmalat and Adecco, among others.

The accounting and auditing scandal at Enron was a fact in the fall/winter of 2001 and continuing into 2002. Enron's systematic use of loopholes to improve their financial statements was exposed; this triggered the legislative powers in the United States to take action. Enron filed for bankruptcy in the United States in December of 2001, meaning the cessation of payments to various creditors, and leaving thousands of employees without a job and with worthless pension plans. In the view of many, blame was partially put on the audit firm, Arthur Andersen, which also led to their liquidation (Finansinspektionen, 2002).

The auditing scandals led to a crisis in confidence for the audit profession and the auditing process in general. Demands for an increase in the control and regulation of auditing were heard in both the United States and in the rest of the world. In the United States, the Congress quickly responded and passed legislation concerning corporate governance. The legislation with the short name, Sarbanes-Oxley Act of 2002, was approved by the Congress on the 23rd of January, 2002, with the intention of protecting the capital markets and restoring the investor confidence (Green, 2003).

The Sarbanes-Oxley Act not only regulates companies within the borders of United States but also has an extraterritorial effect, leading to a large number of companies outside the United States being obliged to follow the rules in the Sarbanes-Oxley Act. The European Union has expressed their concern regarding increased difficulties for foreign investors wishing to enter and/or comply with various regulations in the capital markets in the United States. The Sarbanes-Oxley Act has provoked the European Union to modify their regulations in order to protect the member states and the global capital markets (www.fee.be[1], 2002-05-14). The European Union has proposed a modernized Eighth Company Law Directive which also aims to regulate the audit profession.



In Sweden, in the fall of 2002, the Swedish government created a committee with the purpose of improving the confidence in Swedish business and strengthening the audit process. The proposal from the committee has not yet passed as of this writing, but will probably pass later this year (Skog, Kristiansson & Thorell, 2004).

1.2 Problem Discussion

Throughout history the objectives of auditing have been to prevent fraud and defalcations and thereby to protect the investors. Over time the business world has evolved into a more complex environment and therefore the audit process has been forced to change in order to meet the objectives. The intent of the Sarbanes-Oxley Act is to protect the investors in the capital market, i.e. the shareholders (Sarbanes-Oxley Act of 2002). When they are deceived by the management, with help of auditors, as in the case of Enron, the investors lose confidence in the audit profession and financial reporting. In order to prevent such a disaster the American legislative powers decided to write a law, restricting the mobility and flexibility of the auditor, thus strengthening the independence of the auditor (Finansinspektionen, 2002)

One important measure to restore the public confidence for auditing in the Sarbanes-Oxley Act is the improved legislation concerning Audit Committees. The Audit Committee has long been used in the United States. In the regulations of the European Union and Sweden it is a relatively new concept. An Audit Committee works as a supervisory body aiming to guarantee a high quality audit and the independence of the auditor as well as secure the public confidence in auditing.

Having an independent auditor is essential to ensure a high quality audit and to help prevent fraud and defalcations. After the numerous auditing scandals there has emerged a public demand for a means of securing the independence of the auditor. To achieve a satisfactory level of independence is not an easy task. It is a complex issue with many aspects. The Audit Committee has been a part of the solution to achieve this independence. The proposed modernized Eighth Directive in the European Union suggests utilizing Audit Committees for monitoring, controlling and reviewing the auditing and the financial reporting in a company.

In Sweden, the discussion on independence of the Swedish auditor has not been as extensive since the confidence in Swedish legislation has remained strong. However, the proposed Swedish Code introduces Audit Committees even in Swedish companies.

The issue of Audit Committees and their effect on the independence of the Swedish auditor is the focus of this thesis.



1.3 Problem Formulation

In the discussion above, the authors have found several subjects that would be interesting to investigate. However, instead of doing a complete research of American and European legislation, the authors have decided to focus the thesis on only one part. This chosen part is the issue of Audit Committees and their effect on the independence of the Swedish auditor. The authors are well aware of the fact that this is only one of several issues that can influence the independence of the auditor. The main question of this thesis is:

- How will the concept of Audit Committees, implemented in Swedish companies, influence the independence of the Swedish auditor?

In order to make it easier to answer the main question the authors have chosen to subdivide the main question into four sub questions.

- What is the purpose of an Audit Committee?
- What regulations concerning Audit Committees will influence Swedish companies?
- What are the issues concerning the situation of the independence of the Swedish auditor?
- What role will an Audit Committee have in a corporate structure?

1.4 Purpose

The purpose of this thesis is to investigate the effects of the Audit Committee legislation on the independence of the Swedish auditor. The authors aspire to investigate the existing and proposed legislation in the United States, the European Union and in Sweden, in order to understand the differences in legislation on Audit Committees. The authors aim to clarify the conceptions regarding legislations, auditing, Audit Committee and independence in order to be able to describe the effects on the Swedish auditor and his/her independence.

1.5 Delimitations

The authors can not investigate every aspect of audit legislation around the world and have therefore decided to concentrate on the United States, the European Union and Sweden. The authors feel that these are the most relevant regions for an auditor in Sweden. However, this thesis can not fully scrutinize all contained details of legislation and regulations in these regions. Selecting the impact on the independence of the auditor in Sweden with the introduction of Audit Committees has been a



conscious choice by the authors in order to make the research relevant and manageable.

The authors can not interview everyone that could have potentially significant views and experience concerning the topic. The interviewees were carefully selected on the basis of their expertise and because of an active interest in the research subject. Also, the answers and statements of the interviewees are subjective and influenced by their personal opinions and positions in this issue and this has been acknowledged by the authors. Every one of the interviewees has emphasized that his/her opinions are personal and not company policies.

Another delimitation that the authors felt necessary was to focus the thesis on the Audit Committee and no other aspect that could influence the independence of the auditor. American, European and Swedish legislation contain other parts affecting the auditor's independence but these will not be addressed.

This thesis is written for readers with a basic knowledge in business administration. Because of this the authors have chosen a terminology suitable for the readers.

1.6 Disposition

The authors have chosen to divide the thesis into eight chapters. The chapters are not equally important for the analysis but the authors feel that they are all essential to the thesis in order to make the reader understand the research subject properly.

In Chapter 1 the background and a discussion of the problem is presented. It also includes the purpose, delimitation and disposition of the theses.

In Chapter 2 the authors present the choices of methodology made for the outcome of this thesis.

In Chapter 3 the authors give a short presentation of global audit history from antiquity until modern days. The authors have included this chapter in order to give the reader a broader knowledge for the objectives of auditing and thereby gain a deeper understanding for the subject discussed in this thesis.

In Chapter 4 the authors present the audit legislation in the Unites States, the European Union and Sweden. This is to give the reader knowledge about the rules affecting the regional audit processes. The authors believe that it is important to understand how the regulations function in order to fully understand the problem presented in this thesis.

In Chapter 5 the framework for this thesis is presented. The theories concerning the Audit Committee and the independence of the auditor are presented followed by the implementation of these in the regions relevant to this thesis. The agency theory is also presented as the authors consider this theory relevant to the thesis.



In Chapter 6 the authors present the empirical research based on the answers from the interviews.

In Chapter 7 the authors relates the empirical research to the theoretical framework, presented mainly in Chapters 4 and 5, in order to analyze how Audit Committees affect the independence of the auditor.

In Chapter 8 the conclusions drawn from the analysis are presented. It also includes the authors' suggestions for further research related to the subject of this thesis.



2. Methodology

In this chapter the authors present the different options of methodology as well as the choices of methodology made for this thesis. This will give the reader a possibility to understand how and why the authors have taken certain decisions.

2.1 Scientific Approach

There are two main ways of approaching a scientific problem: the positivism and the hermeneutic (Patel & Davidson, 2003). The approaches have several similarities as well as differences. Differences can be based on different ways of understanding mankind, the world, philosophy, science and what can be considered knowledge. The similarities can be based on the same critical view of mankind.

Positivism was named by the French sociologist, Auguste Comte, in the mid 19th century, but is based on thoughts from the 17th and 18th centuries. Physics was the model for the creation of the concept of positivism. Therefore a true positivistic approach is built upon logic and facts, which are the results of measurements. Comte wrote that science should generate knowledge that was positive and useful for mankind (Patel & Davidson, 2003).

The hermeneutic approach is the opposite of the positivism, because the approach is based on interpretation and the understanding of the subject and situation. The approach appeared in the 17th and 18th centuries as a way of interpreting the Bible, but in the 19th century and later in the 20th century, the approach developed into a philosophy that aimed to interpret life. The hermeneutic scientist has a subjective approach as s/he approaches the subject with already a certain amount of knowledge. The scientist tries to have a holistic approach to the subject rather than trying to study the different parts (Patel & Davidson, 2003).

The authors of the thesis have a hermeneutic approach to the subject, as the purpose of the study is to interpret and understand a situation rather than to measure it. The already acquired knowledge and experiences the authors possess are seen as an advantage in the writing of the thesis. The authors believe it necessary to have this approach as the aim of the thesis is to enlighten the reader about the effects of an implementation of an Audit Committee on the independence of the Swedish auditor.

2.2 Research Approach

There are several different research approaches, but the two main ones are the descriptive approach and the explanatory approach.

The explanatory approach is suitable when there is lack of knowledge and the focus is to gather as much information as possible on the subject. The results in an explanatory research are often used as a base for further studies (Patel & Davidson,



2003). The objective of an explanatory research can be to formulate hypotheses. Explanatory research answers a question like: Why? (Arbnor & Bjerke, 1994).

When a certain amount of knowledge and models already exists, the research will be descriptive. The descriptive research limits itself to investigating certain aspects of a phenomenon (Patel & Davidson, 2003). The goal of a descriptive research is to answer questions like: How many? When? Where? How often? (Arbnor & Bjerke, 1994).

In this thesis the authors have used both descriptive and explanatory approaches. The theoretical part of the thesis has a descriptive approach since it describes the legislation concerning Audit Committees in the Sarbanes-Oxley Act, the European Union and Sweden as well as theories concerning the independence of the auditor, such as the agency theory. This is necessary as it is the base of the analysis. The focus of the empirical research is to explain the effects of the Audit Committee; therefore the descriptive approach is relevant. The empirical research also uses an explanatory research method as the purpose of the thesis is to investigate how the independence of the Swedish auditor will be affected by the changes in the auditing legislation.

2.3 Research Method

There are two methods of conducting research: the quantitative method and the qualitative method (Holme & Solvang, 1991).

The usage of measurements in collection of data, statistical process and analysis methods is important in a quantitative research (Patel & Davidson, 2003). The quantitative method is used for describing a cross-section of the population through a statistical research (Holme & Solvang, 1991). The aim of the research is to reach a numerical answer to a question (Backman, 1998).

The qualitative method aims to give a deeper understanding of the problem and has a holistic approach to the context in the problem area (Holme & Solvang, 1991). In a qualitative research the information gathered is very dependent on the respondent. Interviews are frequently used to gather information in a qualitative research (Patel & Davidson, 2003).

This thesis is based on a qualitative method, but is sometimes presented in a quantitative way in the empirical research and analysis. This has been done in order to easier summarize the answers given by the interviewees. Achieving a holistic view of the problem and situation is the aim of the thesis. The authors want to identify the consequences for the Swedish auditors concerning the new and future auditing legislation and the effects on the independence of the auditor. The focus of this thesis is the Audit Committee and its effects on the independence of the auditor in Sweden. The qualitative research consists of an e-mailed questionnaire sent to people with expertise in the subject, but one telephone interview was conducted in accordance to the interviewee's wish. The answers from the interviewees as well as the theoretical



parts presented in the thesis are the basis for the analyses and the authors consider it possible to draw conclusions from this cross section.

2.4 Data Collection

There are two kinds of data that can be collected for a study. Primary data are data that the researcher gathers for a defined purpose. Secondary data are data that have been collected by others for another purpose (Lundahl & Skärvad, 1999). Since it is cost efficient and easier to use data that already exists, secondary data are first used in a study. The usage of secondary data gives the researcher the possibility to read existing material on the subject and to receive a view of the existing models and theories concerning the subject (Eriksson & Wiedersheim-Paul, 1998).

In this thesis the authors have used both secondary and primary data. The theoretical parts of this thesis are based on secondary data, collected from journals, literature, articles and audit frameworks. The primary data the authors have used in the empirical part of the thesis. The primary data are based on the answers from a questionnaire; this will be explained in the following subchapter 2.4.1.

2.4.1 Questionnaire

When gathering primary data for a study there are several options to consider. Depending on level of standardization and structure in the questions, different techniques can be used when designing a questionnaire or interview. In the figure below the options are displayed.

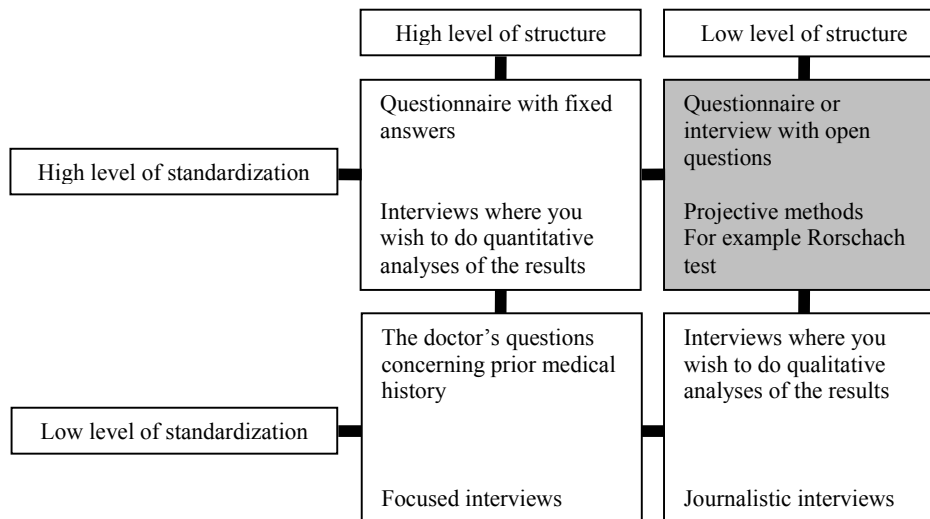


Figure 2.1

Example of different options in interviews and questionnaires depending on the level of standardization and structure

Patel & Davidson 2003 p. 72. (Translated to English)



The level of standardization affects the way the questions are formulated and in what order they are presented. At a high level of standardization the same questions are presented to the interviewee in the same order at every interview. Therefore the results of a completely standardized interview aim to be used when comparison of results and generalizations are made. The low level of standardization is used when you adapt the questions to the interviewee as well as adapt the order of the questions (Patel & Davidson, 2003).

The level of structure defines the possibilities for the answers. At a completely structured interview the answers are fixed, meaning the researcher predicts the possible answers. In the non-structured interview the researcher gives the interviewee the freedom to answer the question in her/his own way. The level of structure is also defined in the formulation of the question. A question where the answer simply can be a “Yes” or “No” is completely structured, even if the question does not have fixed answers as in a questionnaire with given answers. A question more aimed at researching a person’s opinion with a question like: What is your opinion in this matter?, gives the interviewees the possibility to express themselves, and therefore the level of structure is low (Patel & Davidson, 2003).

In this thesis the authors have conducted interviews through a questionnaire. The aim of the thesis is to do a qualitative study, and therefore the low level of structure and standardization is important. The questionnaire (seen in Swedish/English in Appendix 1.) has a low level of structure and a higher level of standardization (see highlighted box in Figure 2.1), due to the importance of the interviewees’ personal opinions. The questionnaire is also used because the people chosen for the interviews are all situated in Stockholm, Sweden, and the authors are situated in Gothenburg, Sweden, and because it gives the interviewees time to well formulate their answers. This is something the authors aspired to and felt positive about.

2.4.2 Interviewees

The people chosen for the interviews have all been taking an active interest in the research subject. The authors have, when reading background material for the thesis, come across their names in several articles, surveys and statements, and therefore the authors have contacted them. The interviewees will be presented in the empirical chapter with full name, title and engagement in the subject.

2.4.3 Implementation

The interviewees were chosen after the authors’ research for experts in the subject. Before sending out the questionnaire and enclosed missive (see Appendix 2) the interviewees were contacted by telephone and informed of the purpose of the thesis and their contribution to the quality of the thesis. The telephone calls were all made by the same person as the wish of the authors was that all the interviewees would be approached in the same way, eliminating negative answers due to differences in persuasion skills. All of the people contacted were willing to respond to the



questionnaire. The answers were sent by email. One person expressed the wish do the interview over the telephone instead. The telephone interview was done over a speakerphone and notes were taken during the call. The conversation was transcribed directly after the telephone call, as the authors did not want to lose any details. All the interviewees were shown the summary of their answer and corrections were accepted. The emailed questionnaire and the telephone interview were conducted in Swedish, being the mother tongue of both the interviewees and interviewers. The answers were then translated to English for the purpose of the thesis.

The answers were later summarized as the authors felt it more adequate to present a general description of the answers in the empirical chapter of this thesis. All the interviewees have expressed that the answers are their own personal opinions and can not be considered a policy of the company or organization they represent. The respondents have had different focus in their answers, but the authors consider them to complement each other and are possible to summarize.

In the questionnaire, question number four, has been omitted. This can be considered an internal loss, as the authors have changed their focus in the thesis and felt that further delimitations were needed. The answers on question number 4 will not be presented in Chapter 6.

2.5 Discussion on Credibility

The credibility of the thesis depends on several different choices the authors were required to make. Since this is a thesis with a qualitative approach, it is possible to question the credibility of the questionnaire and the telephone interview. Since the authors have not met the interviewees, two types of problems may appear: the respondent problem and the interpretation problem. The respondent problem occurs when the interviewee misinterprets the question and the interpretation problem occurs when the researchers misinterpret the answer (Holme & Solvang, 1991). To eliminate these problems, the authors have had contact with the interviewees during the writing process, giving the interviewees and the authors the possibilities to review and revise the answers.

2.5.1 Validity

An important factor in the discussion on validity is to have a well defined problem. The concept of validity is to conduct the research so the received results are actually useful for the thesis (Patel & Davidson, 2003). Internal and external validity are two discussed phenomena in the subject. Internal validity is that the questionnaire or interview actually measures the intended subject. External validity depends on the responses from the interviewees and to what extent they might be distorted or dishonest (Lundahl & Skärvad, 1999).

This thesis has a good validity due to a well defined problem and delimitations (as stated in Chapter 1). The internal validity is improved by the well defined problem



and the external validity is improved by continuing contacts with the interviewees during the writing process. The authors have had no reason to doubt the interviewees and their answers, therefore the authors consider this thesis to have a good external validity. In the questionnaire question number 4 was omitted to improve internal validity as the question fell outside the scope of this thesis.

2.5.2 Reliability

Reliability is the accuracy of the measured results and to what extent they can be replicated (Backman, 1998). To obtain a high level of reliability it is important how the interviews are carried out. Foremost, the interviewer and the interviewees need to be independent (Eriksson & Wiedersheim-Paul, 1998). It is essential that the questions are understood by the interviewees. Before the questionnaire was sent, it was reviewed and revised by the authors' tutor to make sure that the questions were comprehensible. Most interviews were conducted through the emailed questionnaire, but one interviewee wished to have a telephone interview. The telephone interview was made into a transcript by taking notes. This procedure allowed the authors to review the material repeatedly. The potential risk of a loss in objectivity was higher in the telephone interview, but the authors tried to maintain their neutrality. The authors have had the possibility to follow up the answers if and when this was required. The interviewees were also given the possibility to review the summary of their answers, in order to make sure that these had been correctly understood. The purpose of this procedure is to increase the reliability of the thesis. The authors are well aware of the risks related to summarizing the answers, since the summaries are not completely objective. However, the authors have aspired to remain neutral and to summarize the answers as objectively as possible in order to increase the reliability of the thesis.

Part of the thesis is based on the authors' interpretations of literature and other documents. When using such sources it can be difficult to obtain a high level of reliability as different interpretations could be made. However, all sources are fully documented and can be readily obtained by the readers.

2.5.3 Criticism of the Sources

When performing a research it is essential to be critical towards the sources as the result of the study depends on the reliability and accuracy of the information from the sources.

The sources used in this thesis are considered reliable by the authors. The main sources of information have been methodology literature, various articles from peer reviewed journals as well as other journals and several laws and recommendations. National and international legislation can be considered very reliable as they are merely stating existing laws. The personal opinions of the authors of the literature and articles could have a negative effect on the reliability of this thesis (Holme & Solvang, 1991). The authors have therefore tried to eliminate this subjectivity by



comparing different sources. The use of peer reviewed articles has been rather extensive. It can sometimes be difficult to decide whether a journal is to be considered scientific or not. The authors have mainly utilized well-known academic databases to find these articles which simplify the judgment as these databases have criteria as to which journals are to be considered scientific. The empirical results obtained from the interviews are considered reliable by the authors as the interviewees were carefully selected due to their expertise.

Some of the sources utilized in the thesis were originally in Swedish and have been translated into English and therefore there is a risk of mistranslations which could affect the reliability of the thesis negatively. The authors consider themselves to have a good knowledge of both languages which will minimize the risk of mistranslations.

Summary

The authors have in this chapter presented the choices made in methodology. To clarify the choices, the flow-chart below summarizes the choices. The highlighted boxes are the choices made by the authors.

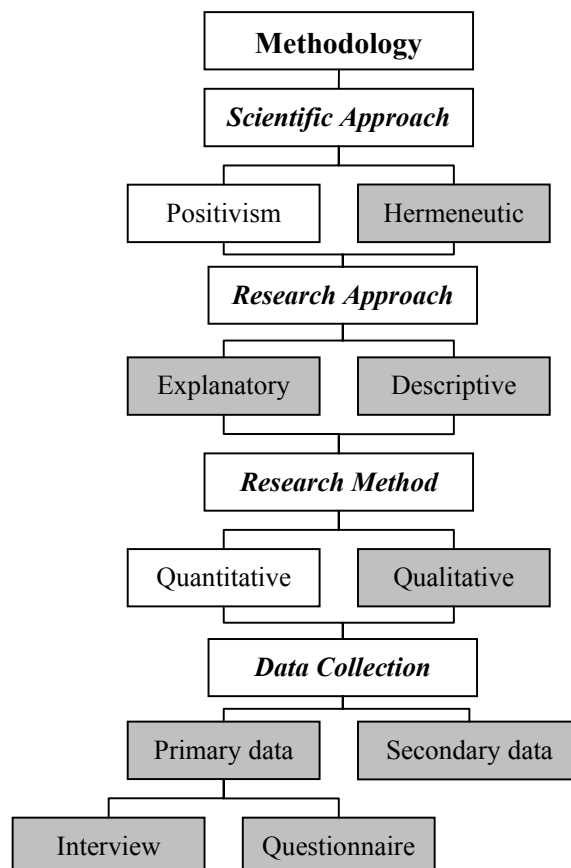


Figure 2.2
The choices of methodology



3. Audit History

In this chapter the authors present the history of auditing in general, in a global perspective. This will give the reader a broader knowledge of auditing and the objectives of auditing. This chapter is a complementary chapter for the reader who wishes to review the basics of auditing.

3.1 Audit – a Historical Perspective

The word audit originates from the Latin word “auditus” that signifies “a hearing” (Fant, 1994). The history of auditing provides the basis for analyzing and interpreting the changes of the audit objectives and techniques. In 1962 R. G. Brown wrote “Changing Audit Objectives and Techniques” and presented his opinion on the future of auditing:

“Auditing in the future will probably consist primarily of a procedural (or system) review, with the analysis of effectiveness of internal controls providing the major basis for the procedural appraisal.”

R. G. Brown, 1962 (p. 1)

R. G. Brown supported his argument with several factors such as the rising costs of public accounting, complexity of the business, requests for additional information and development of new communication and information systems. This is similar to the situation of today, where the same arguments are presented for a stricter internal audit to improve the audit and financial reporting. The importance of internal control has risen and the effectiveness and sufficiency of the internal control structure play an important role in preventing and detecting financial statement fraud (Rezaee, 2002).

The objectives of auditing have changed over time. In the beginning the detection of fraud was the objective and today it is to present a true and fair view of the company’s financial position.

3.1.1 Antiquity to 1500

Auditing is an old science dating back to 2000 BC in China, where the auditor was a well respected and independent official (FAR, 1991). Before the 16th century, accounting and auditing only concerned governmental and family units. Two scribes were usually utilized and they kept independent records of the same transactions preventing fraud and defalcations. A second objective for audit was to assure the accuracy in the reporting. Periodically inventories were carried out to prove the accuracy of the accounting records (Brown, 1962).

In the Roman Empire the emperor held hearings to primarily prevent acts of fraud by the quaestors¹. After the fall of the Roman Empire the Italian City States of Florence,

¹ “Quaestor”: One of numerous ancient Roman officials concerned chiefly with financial administration. (www.webster.com[1], 2004-06-19)



Genoa and Venice first started utilizing auditors to assist in the verification of the accountability of the trade ships. The function of the auditor was foremost fraud prevention. Early auditing techniques were based on detailed verifications of every transaction made (Brown, 1962).

3.1.2 1500 to 1850

In this period the objective of auditing remained the same, detecting fraud, but auditing also developed to include manufacturing activities and not just trade activities. During the early period of the Industrial Revolution it became common for owners to be separated from management and their capital investment and therefore several significant changes in attitude towards auditing occurred (Woolf, 1997). The first change in attitude was the realization of the need for a standardized system of accounting for achieving both an accurate reporting as well as fraud prevention. The second change in attitude was a general acceptance of the need for an independent review of the accounts for the companies. Still, the detailed checking of the accounts was the rule and the generally accepted approach (Brown, 1962).

3.1.3 1850 to 1905

During this period a need for a profession of auditing appeared, as the economic growth in countries such as Great Britain led to large scale operating companies, where the invested capital was separated from management. The owners became concerned about their invested capital, and therefore the need for an independent auditor appeared (Woolf, 1997). In the middle of the 19th century the owners regularly visited the production facilities to attempt to verify the recorded data. These audits were inefficient and expensive as they usually involved complete reviews of the transactions and the preparation of corrected accounts and financial statements. The companies were now so large that a detailed verification of the transactions could no longer be checked. This led to a need to improve the accuracy of reported amounts and to reduce the possibility for fraud. The accounting systems improved and the possibility for sampling was accepted (Brown, 1962).

3.1.4 1905 to 1933

The two major powers in the world at this time, the United States and the Great Britain, started to have different approaches to auditing. In the beginning the audit practice in the United States was based on the practice in Great Britain, but during this period of time the American auditing profession developed independently. The argument was that American business was different from the British, and therefore the British approach was not suitable. British audits were designed for detecting defalcations, while American audits were designed for detecting fraud. The American audit also changed from the usage of a detailed verification to a usage of testing (Brown, 1962).



3.1.5 1933 to 1940

During this period the world was affected by the aftermath of the Great Depression of the late 1920's and 1930's, and laws concerning financial reporting became stricter and more regulated through national agencies. In the United States, during this period, the New York Stock Exchange (NYSE) and various governmental agencies became more influential on auditing. The objectives of auditing changed during this period and the detection of fraud became less important and testing became more routine (Brown, 1962).

3.1.6 1940 to 1960

The audit objectives during this period changed only slightly in the United States. The emphasis continued to shift more towards the determination of fairness of financial statements (Brown, 1962). In Europe the creation of the European Union influenced the financial reporting and accounting, and the creation of the EC Treaty affected the general view on economics in Europe (www.europa.eu.int[1], 2004-05-24).

3.1.7 1960 and Forward

The auditing events from 1960 and forward which have led to the present legislation concerning audit will be presented in Chapter 4. There the authors will investigate the current situation regulating auditing in the three relevant regions to this thesis: the United States, the European Union and Sweden.

Summary

In this chapter the authors have presented a general historical overview of the audit history. The chapter has clarified that already in the early days of auditing the objectives was to prevent defalcations and fraud. The authors wish that the reader will with this information have a deeper understanding of audit and its objectives in order to increase the reader's comprehension of the subject presented in this thesis.



4. Audit Rules

In this chapter the authors will present the current audit legislation in the regions concerning this thesis: the United States, the European Union and Sweden. This will give the reader knowledge about the present rules affecting the audit process. The authors will in this chapter only present the legislation most relevant for this thesis. This has been done due to the extensiveness of international audit legislation.

4.1 The United States

Since the United States is the largest capital market in the world and has stock exchanges where several Swedish companies are listed, it is important that the reader understands how the American legislation is structured. In 2002 when the Sarbanes-Oxley Act was introduced, there were 15 Swedish companies listed in the United States (Veckans Affärer, 2002). The recent important development in the audit profession has led to a further increase of extraterritorial effects originating from the United States.

The United States is a federation of 50 individual states, each of which has its own legislative body with extensive powers. The right to practice as a public accountant is also regulated by the states and differences in regulations exist. In the United States the role of the auditor is regulated through several standards set by different organizations, in a self-regulatory system. The Securities and Exchange Commission (SEC) has had and has a great influence on the publicly traded companies in the United States and their auditing processes. Publicly owned companies have to register with the SEC and thereby follow their regulation framework concerning corporate governance and auditing.

4.1.1 Legislative Background

The need for auditing arose in the 19th century as a result of the geographically widespread companies as well as the separation of management and ownership in the United States. The railroad companies were at this time the companies with the greatest need for improved auditing, because they were geographically widespread and had several shareholders. The audit in the beginning consisted of detecting fraud and correcting errors, working more as an internal auditing function (Boockholdt, 1983).

In October of 1929 the United States faced the largest economic crisis in its history, when the New York Stock Exchange experienced a great fall and large volumes of stocks were traded. The crash was called Black Thursday and is often mentioned as the start of the Great Depression, affecting the entire world (www.nyse.com[1], 2004-05-24). In the aftermath of the Great Depression a need for stricter regulation arose, to restore the faith of the public in the capital markets. The Congress of the United States passed two acts, the Securities Act of 1933 and the Securities Exchange Act of



1934, to restore the public confidence in the capital markets. Also a federal agency, the Securities and Exchange Commission, was created to supervise the parties in the capital markets (www.sec.gov[1], 2004-05-25). The Acts did not directly regulate the audit process, but the creation of the new agency and its role as a monitoring party affected the audit process.

The next major Act concerning audit and management of publicly traded companies came only in 2002. With the Sarbanes-Oxley Act of 2002, a newer and stricter regulation was implemented concerning corporate governance and financial reporting. A more detailed description of the Act will follow in subchapter 4.1.2.

Auditing has always been self-regulated in the United States. There are several different organizations that affect the practice of auditing in the United States. The Auditing Standards Board (ASB) is one of the most important organizations and is a group under the American Institute of Certified Public Accountants (AICPA). The AICPA also publishes the Generally Accepted Auditing Standards (GAAS), which are composed of three categories of standards: general standards, standards of field work, and standards of reporting (Messier, 1997). The three different categories of standards regulate, for example, the independence and the financial reporting in order to improve the quality of the audit. The ASB issues the Statements on Auditing Standards (SAS), which are considered interpretations of GAAS. Different from the regulations of accounting, which is case based, the regulations of auditing are general and typically only give guidance to the auditors (Messier, 1997).

4.1.2 Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act has been called the most important securities legislation in the United States in 70 years. The Act has had widespread effects and affects both the European Union and Sweden (Svernlöv & B:son Blomberg, 2003).

4.1.2.1 Background

The Sarbanes-Oxley Act of 2002 came as a result of the corporate and accounting scandals in the United States, in the fall/winter of 2001 and following in 2002. Enron was the first large accounting scandal but was soon to be followed by others, including Worldcom and Xerox. They all portrayed a good financial position, but this seemed to be based on results that had been exaggerated, by illegal loans, by losses that had been recorded as earnings, insider trading and overstated turn-overs (Svernlöv & B:son Blomberg, 2003). The accounting scandal of Enron led to the fall of Enron as well as Arthur Andersen, their accounting firm, one of the largest public accounting firms at the time (Finansinspektionen, 2002). This led to that Congressman Michael Oxley and Senator Paul Sarbanes wrote the Act that later carried their name. The Act was signed by President Bush on 30th of July, 2002 (Svernlöv & B:son Blomberg, 2003). The Act is not extremely detailed but has given the right of interpretations to the organizations monitoring the companies affected by



the new Act. This has led to an increased control and monitoring function in the United States.

4.1.2.2 Sections of the Sarbanes-Oxley Act of 2002

The Act applies in general to publicly held companies and their audit firms, and dramatically affects the accounting profession in the United States. Not only are the largest accounting firms affected but also any certified public accountant (CPA) working as an auditor for a publicly traded company (www.aicpa.org[1], 2004-05-25). The Act has eleven Titles and these are divided into sections. Below several different effects of the Act are presented.

Title 1, “Public Company Accountant Oversight Board”, of the Sarbanes-Oxley Act concerns the creation of the Public Company Accounting Oversight Board (PCAOB). The new organization is to investigate and oversee the audits and auditors of public companies. The PCAOB has also been given the right to sanction both firms and individuals for violations of laws, regulations and rules. In Section 106, the PCAOB has also been given the authority to investigate foreign accounting firms conducting audits in publicly traded companies in the United States. A further presentation of the PCAOB follows in Appendix 3. Also more information on the extraterritorial effects of the Act will be found in subchapter 4.1.2.3.

Title 2, “Auditor Independence”, regulates the role of the auditor, the rotation of the auditor, the preapproval of services offered by the auditor to the Audit Committee. The section under this Title has wide effects on the accounting firms due to the now stricter regulation of the audit and non-audit services offered to the clients. The purpose of this regulation is to prevent the possibilities for the auditors to audit their own work.

Title 3, “Corporate Responsibility”, defines the new role of the Audit Committee and demands attestations of financial reports. This is to get management more interested in auditing and to give management a larger responsibility for the financial reporting of the company. A more extensive presentation of the Audit Committee in the United States will be found in subchapter 5.1.1.

The other titles and sections of the Sarbanes-Oxley Act mainly regulate sanctions, white collar crime penalties and other forms of disciplinary actions (Sarbanes-Oxley Act of 2002).

4.1.2.3 Extraterritorial Effects

The Sarbanes-Oxley Act has given the new organization, PCAOB, the right to investigate and approve foreign public accounting firms operating in the United States and with clients publicly traded in the United States. These effects have been much debated, since the European Union considers this a limitation of the free markets. The European Federation of Accountants (FEE) has expressed their



concerns that the new regulation may cause the European accounting firms major problems. The rights of the PCAOB to investigate all the working papers of the auditor are in direct conflict with national laws in some European countries and therefore further problems may appear. The FEE also feels that the United States presumes that identical problems exist around the world (www.fee.be[1], 2002-05-15). The Sarbanes-Oxley Act allows in Title 1, Section 106c, the possibility for the SEC to give exceptions to foreign accounting firms, which has led to an ongoing discussion between the SEC and European Union (Blix, Danielsson, Nihlén & Åkersten, 2002).

4.2 European Union

The European Union has its roots in the Second World War. It was created in an attempt to try to find a form of European integration. In the beginning a large part of the collaboration was about trade and economics but it rapidly spread to other topics such as the environment, liberty, justice, agriculture and many more. This integration is an on-going process which improves with every new directive, recommendation and regulation. Because of this it is important to understand the legislative background in order to comprehend the current proposals. The European Union is an economic, political and monetary union consisting of 25 member states (2004). Each member state is sovereign and has its own legislative body with extensive legislative powers but the European Union has the ultimate decision power in certain issues.

4.2.1 Legislative Background

After the Enron scandal in the United States and the Parmalat scandal in Italy there has emerged a demand within the European member states to make sure the same situation does not arise again. The European Union already had extensive legislation regarding auditor's independence and corporate governance but it was fairly old and needed to be updated. After the creation of the Sarbanes-Oxley Act, with its extraterritorial effects, the European Commission has felt the need to clarify and specify how the member states should act in order to avoid scandals such as Enron.

The European Union's binding regulatory framework on auditing can be divided in to Directives and recommendations. Apart from these, there exist many proposals, communications, Green Papers and other official and unofficial papers regarding auditing. In order to give the reader a complete understanding of all the aspects of the European regulations, the authors will present a summary of the publications most relevant to this thesis.

4.2.1.1 The Company Law Directives

The company law harmonization, which is a major part of the European integration, is based upon the EC Treaty from 1950. After the EC treaty, which functions as a kind of constitution for the European Union (EC Treaty, 1957), the European Council wrote several Corporate Directives during the years that followed. These Directives



aimed to harmonize the company laws for the member states. The demand for statutory auditing was introduced through the Fourth and the Seventh Directives, the so-called accounting Directives (Green Paper, 1996). These were introduced in order to achieve similar rules concerning companies' annual reports.

The Directive of greatest importance to this thesis is the Eighth Directive from 1984, the so-called auditing Directive. The objective of the Eighth Directive was to complete the series of Directives concerning company accounts, defining the qualifications of persons responsible for carrying out the audits of the accounting documents required by the Fourth and Seventh Directives. More specifically the purpose of the Eighth Directive was to establish the basic demands for the auditor's independence, theoretical knowledge and practical experience that would apply in all the member states (Eighth Directive, 1984). The Eighth Directive has functioned as a ground rule for auditing for 20 years and though there have been several amendments, it is still the basic framework for auditing in the European Union.

4.2.1.2 The Green Paper 1996

In the 1990's new conditions of the capital market had arisen which affected the auditing profession. In order to launch a discussion on the need for and scope of further European Community action to define the role of the auditor, the Commission published in 1996 the Green Paper entitled "The Role, the Position and the Liability of the Statutory Auditor within the European Union". This was done to avoid possible serious consequences in the auditing process within the member states with low quality of auditing and problems with establishment of audit firms and difficulties providing audit services throughout the Single Market². It was also done to increase the European Union's ability to influence international audit negotiations by having a unified position (www.europa.eu.int[2], 2004-05-08).

4.2.1.3 The Statutory Audit in Europe: The Way Forward 1998

As mentioned before, the Green Paper was intended to raise the awareness of all interested parties concerning the issues at stake. A first step had been taken and the European Union continued with their integration process. A communication on the future direction of auditing in the European Union was adopted in 1998 by the European Commission: "The Statutory Audit in the European Union: The Way Forward". The communication outlined a work program, the main areas of which would be reviews of auditing standards, audit quality control systems and rules on auditor independence (The Way Forward, 1998).

² Single market: A custom union with common policies on product regulation, and freedom of movement of all the factors of production (goods, services, capital and labour) (www.wordiq.com[1], 2004-06-19)



4.2.1.3.1 Committee on Auditing 1998

The future process that the Commission Communication “The Way Forward” referred to was to be carried out mainly in the framework of a new Committee on Auditing, started in 1998. This worked and still works as a platform where audit regulators from the member states and the countries of the European Economic Area, together with representatives of the audit profession, the internal auditors and the European representatives of the large audit firms, deal with audit matters. The overall objective is to develop a common view on audit at the European Union level, in particular for matters that are not covered by existing European Union legislation (www.europa.eu.int[3], 2004-05-08).

4.2.1.4 Minimum Requirements for Quality Assurance 2000

In November of 2000 the Commission issued: “Recommendation on Quality Assurance for the Statutory Audit in the European Union: Minimum Requirements”. Quality assurance for audit is fundamental for ensuring good audit quality and even though audit quality had been an issue addressed before, it had never been thoroughly regulated. Up to this moment there had not been any internationally accepted standard defining minimum requirements for quality assurance which could be used as a benchmark for national quality assurance systems. After 2001 all the member states had to adjust to the new quality requirements in order to increase the credibility and comparability of the auditor’s work (Recommendation on Minimum Requirements, 2000).

4.2.1.5 Statutory Auditors' Independence in the European Union 2002

In 2002 the Enron scandal brought with it a crisis in the auditing world. The public confidence in and the independence of the auditor was shaken to their very foundations. Although the crisis was not as severe in the European Union as in the United States, it still needed to be addressed and a solution to the problem had to be found. In this matter the European Union had been fore-sighted as in December of 2000 the European Commission had already issued a consultative paper on “Statutory Auditors' Independence in the European Union” on a proposed set of fundamental principles with which auditors should comply when carrying out audits (www.europa.eu.int[4], 2004-05-08). After investigating the matter thoroughly within the member states the European Commission issued a Recommendation on “Statutory auditors' independence in the European Union” in May 2002. The independence of the auditor in the European Union will be explained further in subchapter 5.2.2.

4.2.2 Reaction to the Sarbanes-Oxley Act

The repercussions of Enron and other scandals resulted in the Sarbanes-Oxley Act of 2002 (see subchapter 4.1.2) which regulates the audit profession in the United States. Following the requirements from the Sarbanes-Oxley Act, the PCAOB adopted in April 2003 final rules requiring registration of audit firms with the PCAOB. Failing this, it would be unlawful for audit firms to perform audit work in relation to issuers



in the United States, including some 280 European Union companies with a dual listing in the United States as well as the European Union located major subsidiaries of the United States listed groups. The draft rules imply that all major European Union audit firms will have to register with the PCAOB, that the personal data of tens of thousands people working for the audit firms should be transferred to the United States and that the audit firms have to give access to audit working papers and any audit client document. The European Commission regrets the decision by the PCAOB to require European Union-based audit firms with US-listed clients to register with the PCAOB (www.europa.eu.int[5], 2004-05-08). The European Commission called for a moratorium in April 2003 of the registration of European Union audit firms so that effective transatlantic and international solutions could be agreed to restore confidence in financial markets without imposing disproportionate burdens on European Union businesses and audit firms (www.europa.eu.int[6], 2004-05-08). But this is an issue that still today, in 2004, has not yet been resolved.

4.2.3 The Modernized Eighth Company Law Directive

In May 2003 the European Commission proposed ten priorities for improving and harmonizing the quality of audit throughout the European Union. The objectives were to ensure that investors and other interested parties could rely fully on the accuracy of audited accounts, to prevent conflicts of interest for auditors and to enhance the European Union's protection against Enron type scandals. The plan announced forthcoming proposals for new European Union laws to radically overhaul existing legislation and to extend it. Once adopted, these proposals will, for the first time, provide a comprehensive set of European Union rules on how audits should be conducted and on the audit infrastructure needed to safeguard audit quality. After the proposals are implemented, European companies will no longer have to bother with so many recommendations, communications, green papers and Directives. Since there has emerged new modern capital market within an evolving European Union, the need and demand for a new legislation is imperative. The plan to create this common legislation is divided into short and medium-term priorities. For further information and a more detailed description of the priorities see Appendix 4.

The most important and current priority is the modernization of the Eighth Company Law Directive. The Commission published the modernized Directive on the 16th of March, 2004. It was created to ensure a comprehensive, principles-based Directive applicable to all audits conducted in the European Union. The modernized Directive includes principles on: public oversight, external quality assurance, code of ethics, auditing standards, disciplinary sanctions and the appointment and dismissal of auditors. The authors will further present how the Eighth Directive manages such issues as Audit Committees and the independence of the auditor in subchapters 5.1.2 and 5.2.2.



4.3 Sweden

Sweden is a member state in the European Union and is therefore obliged to follow European legislation but it is also a part of a global capital market and is therefore also affected by the United States. It is a small country with rather limited influence in the global market. However, Sweden already has extensive national legislation, including well elaborated legislation on auditing. The right to practice as an auditor in Sweden is regulated by the “Revisorsnämnden” and the Auditors Act of 2002.

4.3.1 Legislative Background

The first known Swedish private audit statement is from 1652 (Cassel, 1996). In Sweden the concept of auditing developed in the 18th century as trade companies became larger and more important for the public, relying on the goods they provided (FAR, 1991).

During the later part of the 19th century it became generally recommended to utilize audits in the new companies. In the Companies Act of 1895 the importance of auditors was mentioned for the first time. A definition of auditing was not given either in the Companies Act of 1895 or in the one of 1910. Not until 1944 was audit defined in the new Companies Act and it was then one could talk about modern legislated auditing in Sweden. This Act was strongly influenced by the economic crises in the beginning of the 1930's such as the fall of the Kreuger Empire. The need for auditing as a fraud prevention instrument as well as a monitoring instrument for discovering defalcations increased (FAR, 1991).

As of 1973, examination as well as supervision of auditors was made by “Kommerskollegium”³. In the Companies Act of 1975 auditing became even more important. For the first time the expression, generally recognized audit standards⁴, appeared. The demands on accounting and auditing were much stricter than in previous acts (FAR, 1991). In Sweden audit became mandatory for all listed companies in 1988 (www.far.se[1], 2004-05-13).

It was not until 1995 that a separate act on auditing was published in Sweden, Auditors Act of 1995. At the same time a new government office, the “Revisorsnämnden”⁵ was created to take over the responsibility of control of the Swedish auditors and audit firms from “Kommerskollegium” (www.revisorsnamnden.se[1], 2004-05-20).

In 2002 the current legislation, Auditors Act of 2002, was adopted. This was developed to comply with European legislation and the Green Paper from 1996 on auditing. Here the Swedish “Analysmodellen” was introduced as a way of securing the independence of the auditor. The “Analysmodellen” is based on a model

³ “Kommerskollegium”: National Board of Trade

⁴ “Generally recognized audit standards”: God revisors- och revisionsse

⁵ “Revisorsnämnden”: The Supervisory of Public Accountants



recommended by the European Commission. Sweden was the first country in the world to adopt laws to secure the independence of the auditor based on such a model (FAR, 2002). A more detailed description of the “Analysmodell” will be found in subchapter 5.2.3.

4.3.2 The Proposed Swedish Code

The accounting and auditing scandals that have shocked the world during the recent years have shown the importance of accurate accounting and auditing and the need for stricter rules in these areas and corporate governance. Around the world different types of legislation have been adopted in order to secure the accuracy of this reporting, such as the Sarbanes-Oxley Act of 2002 in the United States and the modernization of the Eighth Directive in the European Union. The trust in financial reporting is essential and in the international debate the focus on how to restore trust has been on auditing. In Sweden a committee, “Förtroendekommissionen”⁶, was appointed in the fall of 2002 with the objective to propose measures on how to restore trust in Swedish business. The committee appointed a group of experts with the task to prepare a Swedish Code for corporate governance. On the 21st of April, 2004, the Swedish Code as a proposal was finalized and published. It is intended for Swedish companies acting in Sweden and in many aspects is based on previous international codes, such as the British Combined Code. Like most other corporate governance codes the Swedish Code is based on the principle of “comply or explain”, i.e. companies following the code may choose not to comply with the rules but then need to clarify the reason for not complying (Skog et al., 2004).

The Swedish Code on corporate governance is as yet only a proposal to a law that has been given to the Swedish Parliament with hope of being adopted as a law by the fall of 2004. The Swedish business community hopes that the Swedish Code can be implemented in the beginning of 2005 (Skog et al., 2004).

One of the main issues in the corporate governance debate is the strengthening of shareholders’ influence. In order to achieve this, the position of the shareholders’ meeting must be strengthened, mainly in relation to the board of directors (Skog et al., 2004). According to the Companies Act in Sweden, the board of directors and the auditor are selected by the shareholders’ meeting. However, there are no specific rules on the election procedure. The Swedish Code emphasizes the process of nomination and thereby the creation of an election committee, elected by the shareholders meeting to represent the shareholders (SOU 2004:46 Chapter 2.1.1). The board of directors can not appoint the election committee. Concerning the composition of the board of directors and their reimbursement, the Swedish Code is stricter than the Companies Act in Sweden. The shareholders’ meeting is the deciding party and therefore the shareholders have the final say in these matters (Skog et al., 2004).

⁶ “Förtroendekommissionen”: The Commission on Business Confidence



The Sarbanes-Oxley Act requires management to certify several conditions in the company, a so-called management certification presented in Section 302. This means that the chief executive officer (CEO) and the chief financial officer (CFO) have to sign every interim report as well as every annual report in order to certify that the information is correct. In Sweden voices have been raised to impose similar rules. The Swedish Code demands the annual report to be signed by the board of directors and the CEO, in order to clarify the responsibility already existing. Internal controls are also regulated through the Swedish Code. It is the responsibility of the board of directors to make sure that these function and to monitor the accuracy of these (SOU 2004:46 Chapter 3.7).

The debate on corporate governance and how to strengthen the trust in financial reporting has focused on questions on reporting, internal control and the relations with the auditor. The aim has been to clarify the responsibilities of the board of directors and the auditor. Audit Committees have been a way of solving this and are mandatory in the United States as well as in the United Kingdom. The Swedish Code demands the utilization of Audit Committees in Swedish public companies. The function of proposed Audit Committees in Sweden and their responsibilities will be further explained in subchapter 5.1.3. The Swedish Code further regulates the relationship between the board of directors and the auditor by imposing demands on the board of directors to have a meeting with the auditor at least once a year. If the company does not have an Audit Committee the board of directors should meet with the auditor more often (SOU 2004:46).

The Swedish Code focuses on the board of directors and therefore the parts concerning the auditor are relatively short. In Sweden, the “Analysmodellen”, as well as the European Union recommendation on the independence of the auditor, is used to secure the independence of the auditor. The sections in the Swedish Code concerning the auditor regulate election and the reimbursement. The Swedish Code recommends that the auditor, like the board of directors, is to be proposed by an election committee representing the shareholders (Skog et al., 2004).

Summary

In this chapter the authors have presented an overview of existing legislations and current regulations, as well as legislative backgrounds, relevant for this thesis. In the United States it is the Sarbanes-Oxley Act of 2002, in the European Union it is the proposed modernized Eighth Directive and in Sweden it is the proposed Swedish Code. The legislations presented have parts regarding the Audit Committee and the independence of the auditor essential for this thesis. As Sweden and the European Union do not have any binding laws yet, the legislative background gives the reader a better understanding of the situation.



5. Framework

The authors will in this chapter present the different practices and theories relevant to the framework of this thesis. The subchapters begin with a general presentation of the theory and are followed with their implementations in the United States, the European Union and Sweden. The final subchapter discusses Agency Theory, which the authors regard as the most relevant theory for this thesis.

5.1 Audit Committee

An Audit Committee is defined in different ways around the world; the United States has one definition and the European Union another, although they are fairly similar. An Audit Committee is usually mentioned when discussing corporate governance issues. Corporate governance can be viewed as a mechanism of monitoring policies, the actions and decisions of corporations in increasing shareholder value (Rezaee, 2002). It has been defined by the Organisation for Economic Co-operation and Development (OECD) as:

“Corporate governance deals with the rights and responsibilities of a company’s management, its board, shareholders and various stakeholders. How well companies are run affects market confidence as well as company performance. Good corporate governance is therefore essential for companies that want access to capital and for countries that want to stimulate private sector investment. If companies are well run, they will prosper. This in turn will enable them to attract investors whose support can help to finance faster growth. Poor corporate governance on the other hand weakens a company’s potential and at worst can pave the way for financial difficulties and even fraud.”

(www.oecd.org[1], 2004-05-30)

The Audit Committee is a part of the corporate governance structure. Usually the Audit Committee consists of a non-executive and independent board of directors. They have the oversight responsibility for the auditing and the financial reporting process. Being responsible for the oversight of this process, the members of the committee must be financially literate, professionally qualified and functionally independent to be able to fulfill their responsibility (Rezaee, 2002). The Audit Committee should encourage fair reporting from the perspective of stakeholders, creditors and employees (Messier, 1997).

The Audit Committees are important in order to raise the quality of the internal control, the financial reporting and the auditing. They are also a way of strengthening the independence of the auditor in relation to the board of directors. The demand for mandatory Audit Committees therefore means to change the communication between the auditor and the board of directors. With an Audit Committee the contact between the auditor and the board of directors will become more frequent (Carpenter, Fennema, Fretwell & Hillison, 2004).



5.1.1 The Audit Committee in the United States

Audit Committees have long been used in the United States. The role of the Audit Committee has changed over the years. It has had the responsibility for overseeing the corporate governance, the financial reporting, internal control structure and audit functions. The effectiveness of the Audit Committee has differed in companies due to the commitment, attitude, philosophy and practice of the committees (Rezaee, 2002). As a result of the accounting scandals such as Enron and Worldcom, the corporate governance structure in companies has been regulated through the Sarbanes-Oxley Act which has affected the situation for the Audit Committee.

With the adoption of the Sarbanes-Oxley Act, the demand for a more organized and well structured Audit Committee was presented. Section 301, “Public Company Audit Committees”, of the Sarbanes-Oxley Act defines the requirements for the members of the Audit Committee. Each member of the Audit Committee should be a member of the board of directors and should otherwise be independent. Being independent is defined as not receiving any reimbursements from the company except for the service on the board of directors. Exemptions may be made by the SEC, but is made on a case-by-case basis. Further, the Audit Committee is responsible for the appointment, compensation and oversight of the work of the chosen registered public audit firm employed by the company. The Audit Committee should establish procedures for dealing with complaints regarding accounting, internal controls and auditing. The Audit Committee should have the authority to engage independent counsel or advisors, if it considers it necessary to perform its duties. The company is responsible for the funding of the Audit Committee. Further, in Section 407, “Disclosure of Audit Committee Financial Expert”, the requirement that at least one person on the Audit Committee should be a financial expert is stated. The definition of a financial expert is that the person should possess accounting and financial knowledge, but the legislative entities have given the SEC the right to define this.

In Section 204, “Auditor Reports to Audit Committees”, it is stated that the audit firm must report to the Audit Committee all alternative treatments of financial information that have been discussed with management.

The Sarbanes-Oxley Act gives the SEC authority to interpret the new Act and states that the SEC is the organization defining requirements on the Audit Committee (Sarbanes-Oxley Act of 2002).

The NYSE and National Association of Security Dealers (NASD) also have requirements for the Audit Committee, affecting the companies that are publicly traded. Their requirements are similar to the requirements set by the SEC, but are different in minor issues. The NYSE requires at least three persons on the Audit Committee with SEC defined financial expertise, compared to the SEC demand for only one (NYSE Audit Committee Charter, 2003).



5.1.2 The Audit Committee in the European Union

Recent accounting scandals have shown the importance of further strengthening requirements concerning audits. For example, it is suggested that companies have an independent Audit Committee in every public interest entity. This could be a company with listed securities or with relevant businesses (for example, banks and insurance companies) or a large employer. It would be overly burdensome to extend these enhanced requirements to all audited entities. That is why only public interest entities will have to follow these specific rules (The modernized Eighth Directive 2004).

The requirement to utilize an Audit Committee, in Article 39 of the proposed modernized Eighth Directive, will help to monitor the financial reporting process and the audit and also help to prevent any inappropriate influence of the executive management on the financial reporting of the audited client. In order to fulfill its tasks efficiently, the Audit Committee should have at least one independent member who is competent in accounting and/or auditing (The modernized Eighth Directive 2004).

The function of the Audit Committee is to monitor the performance of control activities. It also monitors that communication and reporting processes are adequate both for internal control policies as well as for applicable laws and regulations. The Audit Committee should cooperate with the auditor or audit firm in order to enhance the quality of financial reporting. The key matters on which it should communicate are information about the audit, significant changes in accounting policies, significant risks and exposures facing the company, disagreements with management and several other issues. In Article 43, it is also specified that the Audit Committee should assist in the nomination process for the auditor or audit firm by selecting the auditor or audit firm for the proposal for appointment to the general meeting of the audited entity (The modernized Eighth Directive 2004).

5.1.3 The Audit Committee in Sweden

Audit Committees are not mandatory for Swedish companies, but several companies already have Audit Committees (Skog et al., 2004). In Sweden there has been a demand from different groups, mainly from The Swedish Shareholders' Association for Audit Committees. In the year 2000, 14 Swedish companies listed in Sweden had an Audit Committee (Thorell, 2002). Since there is no existing Swedish legislation on these committees the work they do can differ substantially. With the proposed Swedish Code on corporate governance, which will probably become a law by 2005, Sweden will also have legislation regarding this matter (Skog et al., 2004).

According to the proposed Swedish Code the board of directors is to appoint an Audit Committee consisting of at least three members of the board of directors. However, as the Swedish Code follows the principle of "comply or explain", a company has the possibility not to create an Audit Committee if they can explain why. The members of the Audit Committee have to be independent towards the company and the management and at least one of the members must also be independent towards the



major owners of the company. The president of the board of directors may be a member of the Audit Committee but may not be its president (SOU 2004:46 Chapter 3.8.3). In the Sarbanes-Oxley Act as well as in the proposed European modernized Eighth Directive, there are demands that one of the members in the committee has financial expertise; this demand does not exist in the proposed Swedish Code.

As mentioned above there are no standards on the duties and procedures of Swedish Audit Committees. The proposed Swedish Code presents more specified rules about these. However, there might be a need to modify some of these standards as the new European Eighth Directive is implemented in Swedish legislation (Skog et al., 2004). According to the proposed Swedish Code the Audit Committee should:

- Secure the quality of the financial reporting. It is particularly important that the Audit Committee reviews issues essential to the financial reporting in the company. These questions should also be presented at the shareholders' meeting. It is also recommended that the Committee looks at the financial reports. Further, the Audit Committee should treat questions on internal control and the following of rules which affect the financial reporting.
- Frequently meet with the auditors in order to stay informed on the audit. It is essential that the board of directors and the auditor discuss their view on internal control and risks facing the company. This cooperation should affect the internal work in the company as well as the effectiveness of the audit.
- Decide on which services besides auditing that the auditors may perform for the company. The Code does not specify which services are and are not allowed; instead it is up to the Audit Committee to decide this according to Swedish laws and practice.
- Evaluate the auditors. As mentioned in subchapter 4.3.2, the auditor is to be nominated by an election committee. Before the election the work of the auditor has to be evaluated. This evaluation would be made by the Audit Committee.

(SOU 2004:46 Chapter 3.8.4, translated to English)

5.2 The Independence of the Auditor

The actual definition of independence is according to Webster's dictionary;

Independence : The state or quality of being independent; freedom from dependence; exemption from reliance on, or control by, others; self subsistence or maintenance; direction of one's own affairs without interference.

(www.webster-dictionary.org[1], 2004-05-09)

In other words, being independent is the same as being free from control or influence of others. Applying this to the discussion of auditing, it becomes clear how relevant



and important this issue is. An auditor has to be free from control and/or influence from others when s/he is conducting the audit in order to guarantee the quality and accuracy of the audit process.

A distinction is often made between independence in fact and independence in appearance (Messier, 1997). Independence in fact means that the auditor is completely free from the influence from the client. Independence in appearance means that the auditor should not perform in such a way that her/his independence could be questioned by a third party. Therefore it is not enough that the auditor is independent in fact, s/he must also be perceived to be independent by third parties (Moberg, 1986). If the independence in appearance is not fulfilled users may lose confidence in the auditor's ability to report truthfully on financial statements (Messier, 1997).

The debate about the independence of the auditor has never attracted more attention than during the last couple of years. Since the recent auditing scandals that shocked the world there has emerged a vivid discussion of the need for and the current lack of legislation regulating independence. But this is not a new occurrence. It has been an important issue within the auditing and accounting world since the beginning of economics (Brown, 1962). It is only recently that the topic has become one of the major problems in the public eye. A general perception is that audit firms have dealt with this problem for many years and the absolute majority of audit firms work internally for their auditors to be independent so that they can guarantee a high quality work. It is the same thing with the individual auditor; s/he works to achieve the independence that will give him or her credibility. But since there are those who have violated this trust, a demand for increased regulation has turned up in the business world. Different nations and institutions have come up with various measures of approaching the subject but so far there is no global uniform legislation on controlling the auditor's independence.

5.2.1 The Independence of the Auditor in the United States

The independence of the auditor is an issue that has been regulated for a long period of time in the United States. In the Code of Conduct from the AICPA the independence of the auditor is regulated. There they present several situations where the independence of the auditor is threatened, such as when a loan is given to the auditor and/or when there is a family member working in management.

In the Sarbanes-Oxley Act Title 2, "Auditor Independence", there are several sections concerning the independence of the auditor, limiting the auditor's services, the rotation of the auditor and defining conflicts of interest. The Act has limited the auditors and their activities.

In Section 201, "Services Outside the Scope of Practice of Auditors", the non-audit services prohibited by the Sarbanes-Oxley Act are presented.



The PCAOB may, on a case-by-case basis, exempt from these prohibitions any person, issuer, public accounting firm, or transaction, subject to review by the SEC (Sarbanes-Oxley Act of 2002). The SEC has said that services approved by the Audit Committee will not be unlawful (www.sec.gov[2], 2004-05-26)

In Section 203, “Audit Partner Rotation”, the time of the ordinance is limited to five years. Further in Section 206, “Conflicts of Interest”, the CEO, CFO, controller, chief accounting officer or person in a similar position may not have been employed by the company’s audit firm during one year preceding the audit (Sarbanes-Oxley Act of 2002).

In Section 204, “Auditor Reports to Audit Committees”, it is stated that all alternative treatments of financial information that have been presented to management must be reported to the Audit Committee from the audit firm.

In the Sarbanes-Oxley Act it is stated that the Audit Committee is responsible for the nomination, evaluation and oversight of the auditor. The Audit Committee controls the auditor as well as limits the services offered by the audit firm (Sarbanes-Oxley Act of 2002).

5.2.2 The Independence of the Auditor in the European Union

On the 16th of March, 2004, the European Commission presented a “proposal to a directive of the European Parliament and of the Council on Statutory Audit of Annual Accounts and Consolidated Accounts and Amending Council”, also called the modernized Eighth Company Law Directive. It considerably increases the capacity of the former Eighth Directive by clarifying the duties of auditors, their independence and ethics, by introducing a requirement for external quality assurance, by ensuring public oversight over the audit profession and by improving collaboration between oversight bodies in the European Union (The modernized Eighth Directive, 2004).

The basic principle of auditor independence included in the Commission Recommendation on Auditor Independence from 2002 is incorporated into Article 23 of the proposal of modernized Eighth Directive. The Directive establishes the principle that:

“a statutory auditor or an audit firm must be independent from the audited entity and shall in no way be involved in management decisions of the audited entity.”

(www.europa.eu.int[7], 2004-05-15).

This means that any audit assignment which would endanger the auditor’s independence may not be accepted. An auditor must also refuse any non-audit engagement which might compromise his/her independence as an auditor. The auditor must document all significant threats to his/her independence as well as the



measures taken to eliminate those treats. The ultimate measure is to resign from the audit or to not accept a non-audit service.

The proposal also contains guidelines for the fee of an auditor and how it should be adequate to guarantee audit quality. The fee cannot be based on any form of eventuality and it cannot be influenced by the provision of additional services apart from the audit.

The procedures for appointing an auditor or audit firm must guarantee that the auditor is independent from those who set up the financial reports and of the client. The proposal for the Directive does not explain further how the appointment and dismissal of the auditor should be carried out in order to ensure the independence, but refers to the Commission Recommendation on Auditor Independence from 2002 (www.europa.eu.int[7], 2004-05-15). In this recommendation the entire discussion on auditor's independence is regulated in detail and functions as a uniform guidance for the member states.

5.2.3 The Independence of the Auditor in Sweden

With the Swedish Auditors Act of 2002, there emerged a new way of regarding the independence of the auditor. There are no longer lists of forbidden actions, and instead there is a model, the "Analysmodellen", that needs to be followed. This model states that the auditor himself/herself needs to secure his/her independence. For this model to work, it is essential that the education of auditors has a high standard. Responsible for the authorization of auditors is "Revisorsnämnden". It is also responsible for the development and the preservation of generally recognized auditing standards. The Act establishes that the judging of whether the auditor is able to take on the assignment is to be made by a hypothetical informed and reasonable third party, with knowledge of all relevant circumstances. This means that the independence of the auditor "in fact" is more important than the independence "in appearance". The previous law could oblige the auditor to resign from an assignment if the independence did not exist "in appearance" even if it was there "in fact". With the new law this is no longer an issue. Again this shows a very high confidence in the ability and knowledge of the auditor. If the "Analysmodellen" is properly used it should be a powerful aid for the auditors as well as for the "Revisorsnämnden" to secure the independence of the auditors, although it creates very high demands on the entire industry and its competence. The "Revisorsnämnden" has even more responsibility than earlier to understand and control how the auditing is carried out within the audit firms in Sweden (FAR, 2002).

The Swedish Companies Act (see FARs Samlingsvolym Del 1, 2004) presents the grounds for disqualifications of an auditor. If an auditor fails to reach the requirements s/he may not be appointed auditor or will become unauthorized to continue the assignment. Except for the non-negotiable grounds for disqualification, there are also threats to the independence of the auditor defined in the "Analysmodellen". The process described in the "Analysmodellen" can be divided



into three steps: 1) Identifying possible circumstances that could threaten the independence of the auditor, 2) Judging, while taking into account the actual assignment, if there is reason to question the independence of the auditor, 3) Documenting the decision process.

While conducting this procedure, described in the “Analysmodellerna”, assessment must be made as to whether or not the auditor may accept the assignment, if any of the following threats to the independence of the auditor exist. These are defined as quoted below (FAR, 2002):

Self-interest: Confidence is threatened as a result of direct or indirect financial interest in the audit client.

Self-review: The auditor is to review advice given by himself/herself or another person within the audit firm network, which does not constitute audit business, but was given on a matter covered by the audit assignment.

Advocacy: Confidence may be undermined because the auditor in another context is acting, or had acted, in support of or in opposition to the client’s standpoint on a legal or financial matter.

Familiarity or trust: Threats due to strong personal relations with a person covered by the audit, for example in the client’s management.

Intimidation: Threats due to the auditor feeling intimidated as a result of the client’s dominance or external pressure.

Other circumstances: Where some other circumstance exists that may undermine confidence in the independence of the auditor. The development of professional ethics for accountants is expected to provide further guidance as to the circumstances that may come under this point.

(FAR, 2002)

If none of the threats above exists, the assignment can be accepted. If any of the threats do exist, the significance of the threats must be assessed. It is not necessary to resign from or decline the assignment, if the circumstances of the individual case are such that there is no reason to question the independence of the auditor. If the threats give reason to doubt the independence of the auditor the assignment must be declined. The analysis leading up to the decision to accept or to decline the assignment has to be documented (FAR, 2002).

See the flow-chart of the “Analysmodellerna” in Appendix 5.

5.3 Agency theory

Agency theory is a theory that treats the relationship between a principal and an agent and how to make the agent act in a way that is in the interest of the principal, i.e. the way in which the owners, “the principals”, control the management, “the agent” (Smith, 2000).



The agency relationship between the owner and the manager generates a natural conflict of interest caused by the asymmetric information that exists because of the absence of the owner. Asymmetric information means that the manager generally possesses more information about the actual financial position and results of the company than the owner does (Macintosh, 1994). If both parties strive to maximize their own self-interest, the manager might not act in the best interest of the owner. The manager may, for example, manipulate reports in order to obtain a larger bonus. In order to make sure that the manager performs his/her responsibilities correctly, the two parties may agree that the manager report periodically how s/he has managed the owner's assets. However, the owner has no means on determining the accuracy of these reports and this is where the demand for auditing occurs. The auditor's role is to determine whether the reports prepared by the manager are accurate (Messier, 1997).

"The appointment of an Audit Committee is an important development intended to 'create space' between auditors and the directors [managers, authors' remark] of the companies they audit"

Woolf, 1997 (p.14)

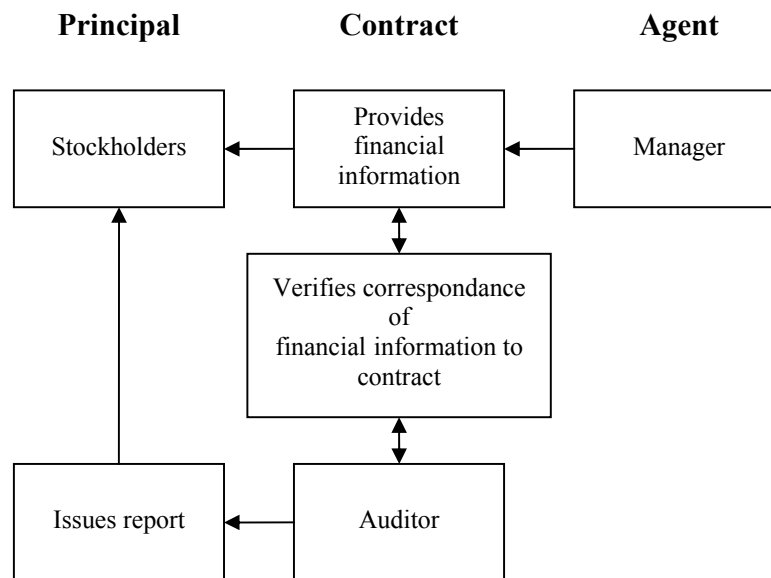


Figure 5.1

Overview of the Agency Relationship Leading to the Demand for Auditing
Messier, 1997 p. 7

Summary

In this chapter the authors have presented theories on the Audit Committee and the independence of the auditor and their practice in the United States, the European Union and Sweden. The authors have also explained the agency theory and briefly explained how this theory is applicable to Audit Committees. A more extensive application of the agency theory to the Audit Committee will be found in the analysis.



6. Empirical Research

In this chapter the authors will present the answers from the interviews. The questions from the questionnaire and telephone interview will be presented and the answers will be summarized by the authors.

6.1 General remarks

Since the interviewees differ somewhat in background and competence in this particular field of knowledge, the authors felt it more adequate to present a general description of the interviewees' answers rather than give each individual answer separately. Given that the general view on these issues are more important to the thesis than each individual answer, this also justifies this method of presenting the answers.

The interviewees have all emphasized that the answers given by them are their own personal opinions and not their respective companies' or organizations' public policies. Since the interviewees are specialized in somewhat different areas and/or have differences in background, the answers presented by them vary slightly. The answers differ in length and the interviewees have focused on different aspects of the questions. However, the authors feel that the answers have been similar enough to summarize.

All the interviews except one were conducted through an e-mailed questionnaire. One interview was conducted over the telephone as this was the wish of the interviewee.

Question number four has been omitted due to the change in focus of the thesis. During the writing process of this thesis, the authors have felt the need for further delimitations and therefore the fourth question is no longer relevant for the thesis.

6.2 Interviewees

Clas Blix is a certified public accountant at Ernst & Young AB and is responsible for activities concerning corporate governance within the firm. This includes questions that concern Audit Committees, the Sarbanes-Oxley Act, confidence in auditing and international development. He has been involved in groups commissioned by FAR to investigate effects on Sweden of the Sarbanes-Oxley Act as well as Audit Committees. He was also a bit involved in the work with the Swedish Code.

Dan Brännström is the general secretary of FAR. He was formerly active as a certified public accountant at Ernst and Young AB.

Åke Danielsson is an authorized public accountant at Öhrlings Pricewaterhousecoopers AB and the president of the FAR Committee on Auditing.



He was a part of the group commissioned by FAR to investigate the effects on Sweden of the Sarbanes-Oxley Act.

Björn Markland is the secretary of the Nordic Federation of Public Accountants and technical advisor in the IFAC Board. He is the former general secretary of FAR, technical advisor of FEE Council and expert in “Revisionsbolagsutredningen” that wrote the present Swedish Auditors Act.

Jan-Hugo Nihlén is a partner at Deloitte AB and has been working as an authorized public accountant since 1986. At Deloitte he is responsible for independence and regulatory issues. He is also a member of FAR committee on ethics. Nihlén was a part of the group commissioned by FAR to investigate the effects on Sweden of the Sarbanes-Oxley Act.

Anders Strömqvist is a legal counsel at Öhrlings Pricewaterhousecoopers AB.

Peter Åkersten is a legal counsel and member of the ethics and independence group at KPMG Bohlins AB. He was a part of the group commissioned by FAR to investigate the effects on Sweden of the Sarbanes-Oxley Act.

6.3 Answers

Here the authors will present the summarized answers, question by question. All the answers are anonymous as the authors believe that the general view is of greater importance than the personal opinions of the interviewees. The quotes are also presented anonymously.

6.3.1 Question 1

What is your opinion on the new rules on Audit Committees and do you believe that they fulfill their purposes i.e. strengthening the independence of the auditor as well as the public confidence in auditing?

“The independence of the auditor and the confidence for auditing are related.”

Anon.

“I believe that the Audit Committee can have a positive effect on both the auditor’s independence (another body indirectly supervises the company by controlling the auditor) and it should give increased public trust.”

Anon.

“The advantage would be to move some of the influence over the auditing (... ..) from management to a part of the board of directors, and thereby closer to the owners.”

Anon.



Most of the interviewees were positive toward the idea of an Audit Committee. They were in general positive about the idea of an improved communication between the board of directors and the auditor and the possibly increased involvement of the board of directors in auditing. The board of directors has the responsibility for questions concerning risk management, internal control and accounting and therefore there exists a need for documentation of the duties and responsibilities of the board of directors.

Concerning the relation between the board of directors and the Audit Committee, the opinions went in somewhat different ways. One respondent felt that the Audit Committee should help the board of directors in its work, another that in the best case scenario the board of directors is supposed to deal with the issues, which are now supposed to be dealt with by the Audit Committee. A third respondent emphasized that most of the positive effects appear in the cases where the major part of the members in the Audit Committee are not members of the board of directors.

The independence of the auditor and the public confidence have a co-dependent relationship. Many expressed their opinion that an Audit Committee can and/or will increase the independence of the auditor, but one interviewee expressed the risk of a decrease in independence. The interviewee supported his argument with the situation where the Audit Committee will have a large influence on the aim and extent of the audit and therefore the independence of the auditor can be threatened. The public confidence for auditing lies in the independence of the auditor. Some expressed the opinions that the public confidence for financial reporting and auditing will increase with the implementation of an Audit Committee as a new corporate supervisory body.

6.3.2 Question 2

What pros and cons can you see with the implementation of Audit Committees concerning the fulfillment of their purposes?

The interviewees generally agreed on the positive factors that will follow the Audit Committee. The negative aspects were much more diverse.

Pros

- An Audit Committee can/will increase the independence of the auditor and the public confidence in auditing.
 - The most common reasons for the positive answers, if motivated, given by the interviewees:
 - Another supervising body reviews the auditing.
 - The risk of defalcations and fraud in accounting and financial statements may decrease.
 - The selection and appointment of the auditor is transferred from the management to the board of directors and thereby closer to the owners (in the Sarbanes-Oxley Act; authors' remark).
 - There will be further control of management.



Cons

- Members of the board of directors who are not in the Audit Committee risk becoming less interested in auditing issues. This has been the main argument from the audit profession against Audit Committees according to one respondent.
- Administrative duty will affect audit clients negatively as it can be time-consuming.
- Costs for auditing will exceed benefit.
- By increasing the auditor's independence one risks suffering negative consequences on the auditing quality, i.e. increasing auditor's independence by rotation could decrease the audit firm's overall knowledge and understanding of the audit client.
- Regulations concerning Audit Committees have to adapt to the national corporate governance legislation.
- There is no clear line between the responsibilities of the board of directors and the auditor. There has to be a clear structure of responsibility.

6.3.3 Question 3

How are you affected by and how do you handle these new Audit Committee rules in your company?

This question was only answered by the interviewees employed at audit firms.

The different audit firms have different ways of handling these questions. Most of the interviewees seem to handle the clients affected by these rules on a case-by-case basis. The audit firms follow the relevant legislation when this is required. However the firms seem to be using somewhat different methods to handle these new Audit Committee rules. One firm has created a world wide database where all client companies are listed. In this database several standardized documents for the auditing process as well as registered auditors of each client can be found. This is to facilitate for example mandatory preapproval procedures. One other firm utilizes a flow-chart as an aid in decision processes concerned with Audit Committees.

6.3.4 Question 4

For some years Sweden has used the "Analysmodellen", recommended by FAR, at the appointment of an auditor. This is an example of when laws and recommendations differ. While applying either Swedish or American/European rules a company may violate the rules in another set of legislation. What are your opinions on this possible problem with dual legislation and dual sanctions?

Omitted. See subchapters 2.4.3 and 6.1 for explanation.



6.3.5 Question 5

What changes do you see in the future concerning Swedish Audit Committees?

Most of the respondents saw changes in the near future. They mentioned the proposed Swedish Code as well as the proposed legislation in the European Union when discussing the implementation of Audit Committees in Swedish public interest entities. The respondents have different point of views on the history of Audit Committees in Sweden. One respondent said that this was a new occurrence, but was going to be standard and another interviewee said that Audit Committees had long been used in larger Swedish companies.

Many of the respondents mentioned the problem with the differences in legislation concerning Audit Committees in the United States, the European Union and in Sweden and expressed the importance of adaptation of the Swedish legislation to the European and the American legislation. Several of the interviewees expressed their concern on the increasing formalism and administration with the new legislation.

6.3.6 Question 6

These new Audit Committee rules are adapted for American companies. Do you believe that they will complicate or facilitate the process of auditing in Sweden?

In certain aspects they will facilitate the audit process as there is an organization to discuss these issues.

Anon.

In this question the respondents have in general expressed a positive view on new or modified legislation in Sweden. It has been expressed that it is of great importance that the Swedish Audit Committees will have a regulation framework coherent with Swedish legislation or that Swedish legislation will fully adapt to international legislation. Several of the interviewees have stated that it is desirable to harmonize the legislation concerning corporate governance, at first within the European Union.

Some interviewees had opinions on the difficulties that might arise with the implementation of the Audit Committee. The differences in corporate governance legislation between the different European member states as well as between the European Union and the United States are a problem. One respondent stated that it is important to remember the discussions between the PCAOB and the European Commission on the Sarbanes-Oxley Act. These discussions are yet to be finished and the outcome may affect the audit process in Sweden. There is a risk that the imposed formalism will increase the bureaucracy. The respondents also illustrated some negative consequences that could follow the implementation of the Audit Committee in Sweden such as an increase in audit fees due to a more extensive and complicated audit process.



On the matter of facilitating the process of auditing in Sweden, most interviewees did not give any concrete answers. However they did cast some light on the possible positive consequences that could come from the implementation of the Audit Committee. The increased communication between the board of directors and the auditor or the increased quality of the audit are two examples of this. The increased quality of audit would be based on that audit will be of greater importance in the companies' corporate governance structure.

6.3.7 Question 7

Do you feel that there are existing problems concerning the independence of the auditor in Sweden today?

“Yes, there are problems mainly concerned with the visible independence (in appearance) due to an ‘expectancy gap’ between on the one hand the auditors and the audit firms and on the other hand the public opinion on the visible independence.”

Anon.

“It is important to establish that it is the auditor himself/herself and nobody else who is responsible for the assessment of the independence. This can in no way be put on somebody else.”

Anon.

“... the “Analysmodellen”, stated in the Auditors Act, is probably the most important step towards solving such arising problems, until now.”

Anon.

The problem of the independence of the auditor is not a new issue; it has only recently been more debated. Auditors solve problems concerning independence on a daily basis and only the auditor can confirm his/her independence. One respondent even stated that no regulation can replace the personal integrity of an auditor, who understands his/her role.

One respondent explained the recent discussion on independence with that there are problems in appearance, due to different expectations on audit of the auditors/audit firms and the public. He continued to explain that auditors have a more pragmatic point of view than the public and that the personal experiences of the auditors are what actually affect the independence in fact.

Many of the interviewees thought that “Analysmodellen” was a functioning model for solving independence issues. The Swedish Code was also mentioned as a new solution for existing problems. One respondent expressed the view that independence issues were best solved with the “Analysmodellen” and the implementation of quality control systems.



6.3.8 Question 8

How do you think the independence of the auditor in Sweden will be affected by these new conditions, i.e. the appointment of and control of the auditor? Do you believe that the auditor's independence will be strengthened, weakened or remain the same? Why?

“The auditor himself/herself must want to preserve his/her independence and integrity. There is no one else who can do this. There are no rules in the world or any Audit Committees that can replace the personal integrity of an auditor who understands his /her role”

Anon.

“It is good that there is a body “within” the company with the mission to focus on independent audit.”

Anon.

One of the respondents emphasizes the fact that the Sarbanes-Oxley Act rules differ greatly from Swedish legislation in this matter. Swedish law states that the auditor is to be appointed by the owners which is in direct conflict with Sarbanes-Oxley Act.

Some of the respondents believe that the Audit Committee will strengthen the independence of the auditor as regulation increases. There will be an authority within the company to focus on the auditor's independence. There will also be clearer regulations and an increase in control of the external quality controls. On the negative note, a fear is expressed that knowledge and experience will be lost because of new rules, for example rotation policies and non-audit services. This will give the auditor a disadvantage in knowledge towards the management and this may jeopardize the auditor's independence.

One of the respondents points out that the effects from Sarbanes-Oxley Act in Sweden are minor; the effects influenced by the European Union and the modernized Eighth Directive are much more likely to have an impact. But there is a possibility that the modernized Eighth Directive will be influenced by Sarbanes-Oxley Act.

Finally it was stated that the independence of an auditor can be confirmed only by the auditor himself/herself. There is no regulation or legislation that can replace the personal integrity of an auditor that understands his/her role.

Summary

In this chapter the authors have presented the results of the empirical research. This will be used together with the theoretical research in the following chapter in order to fulfill the purpose of the thesis.



7. Analysis

The authors will in this chapter connect the theoretical and empirical research in order to fulfill the purpose and answer the questions in the problem formulation. The minor questions are first answered and discussed and will conclude with a discussion on the main question and focus of the thesis. The first and second sub questions are analyzed together as they are strongly related and will give a more adequate answer together.

What is the purpose of an Audit Committee?

What regulations concerning Audit Committees will influence Swedish companies?

An Audit Committee is an important part of the corporate governance structure, since it is one of the means of controlling a company and its financial reporting. The objectives of an Audit Committee are monitoring, controlling and reviewing the financial and the audit processes. These objectives are the same in the United States, the European Union and Sweden, although the definitions and details differ slightly and the specific duties of Audit Committees may not be identical. When comparing the United States and the European Union, it is clear that the regulations concerning Audit Committees are similar. The main difference is that the Sarbanes-Oxley Act is a binding legislation while the modernized Eighth Directive still is a proposal. The proposed Swedish Code is similar to the proposed modernized Eighth Directive in parts regarding Audit Committees. If changes to the proposed modernized Eighth Directive concerning Audit Committees were made, the Swedish Code might have to be revised. The authors do not consider this likely, since the research has not indicated any such tendencies.

The United States has a direct as well as an indirect influence on Swedish business. The direct influence on publicly traded European companies listed on the American stock exchanges is that of the extraterritorial effects of the Sarbanes-Oxley Act on the companies as well as their audit firms. The number of European companies directly influenced by the Sarbanes-Oxley Act is small, but the indirect impact on European business is great. The indirect influence which the authors consider more important than the direct influence, of corporate and auditing scandals in both the United States and in the European Union, is reflected in the public demand for improved regulations.

The most current international change affecting the Swedish auditor is that of the proposed modernized Eighth Directive. The European legislation will be binding once the European parliament and the European Council approve the proposal and thereby surpass Swedish legislation. The differences in Swedish, European and American legislation are several, but the authors have chosen to exemplify the differences with the case of the appointment of the auditor. The authors consider this



to be the greatest difference in the duties of the Audit Committee between Swedish, European and American legislation. The proposed modernized Eighth Directive and the proposed Swedish Code differ to some extent in the case of the appointment of the auditor, but the authors' opinion is that they do not contradict each other. The Sarbanes-Oxley Act does contradict Swedish legislation in this matter and this creates a problem for the dual listed Swedish companies. According to the Sarbanes-Oxley Act, the appointment of the auditor is to be carried out by the Audit Committee but in the case of Sweden this procedure is the responsibility of the shareholders' meeting. Providing an answer on how to resolve this and similar problems is impossible since this is still a current issue on an international level. In the issue of the extraterritorial effects of the Sarbanes-Oxley Act the European Commission and the SEC are still having a dialogue.

What are the issues concerning the situation of the independence of the Swedish auditor?

“It is important to establish that it is the auditor himself/herself and nobody else who is responsible for the assessment of the independence. This can in no way be put on somebody else.”

Anon.

The authors feel that this quote can summarize the debate on the independence of the auditor. Legislation can not replace the fact of that in the end the auditor himself/herself is the only one who can certify his/her independence. When discussing the issue of independence it is also important to remember that the independence in fact and independence in appearance are two different realities. In the interviews this has been the opinion of several respondents. The independence in appearance is important for the public confidence for auditing, but in the end it does not really say anything about the independence in fact.

The interviewees expressed that there are no major problems concerning the independence of the Swedish auditor. They also indicated that the issue of independence is not a new problem, but has always been an issue in the audit profession. The research has also shown that in the history of audit the need for an independent auditor has always existed. The current discussion on the independence has been a discussion on the independence in appearance and not on the independence in fact. This was also the view of some respondents, who emphasized that the discussion on independence is a discussion on independence in appearance, which has been the result of several auditing and accounting scandals. In general the purpose of a law is to limit the possibility of fraud. This implies that an auditing law aims to certify the independence in fact. However, the authors believe that legislation, like the Sarbanes-Oxley Act, first and foremost aims to certify the independence in appearance. In the United States the Sarbanes-Oxley Act was a very quick response to the public demand for stricter regulation and a means of restoring the public



confidence in the audit. Naturally there existed a need for further legislation improving the independence in fact, but what was much more imminent and obvious was the need for improvement of the independence in appearance.

Due to the indirect as well as the direct effects originating from the situation in the United States, the lack of public confidence in auditing became apparent in the European Union. The proposed modernized Eighth Directive will function as an important part in the process of securing independence in fact as well as in appearance.

Sweden has adopted legislation to certify the independence of the auditor with the “Analysmodellen”. It has been a solution to an old problem and has been well received by the auditors in Sweden.

“... the “Analysmodellen”, stated in the Auditors Act, is probably the most important step towards solving such arising problems, until now.”

Anon.

Several respondents expressed their confidence in the “Analysmodellen” and its method of certifying the independence. The “Analysmodellen” is a modern way of thinking and Sweden is the first nation in the world implementing a model like this. The authors believe that the “Analysmodellen” is a well structured and carefully prepared solution and a truthful auditor can use the model to resolve any issues on independence in fact. The “Analysmodellen” was a means to improve the independence in fact but not so much in appearance. In comparison to the United States and the European Union, Sweden has not had the same discussion on independence in appearance as the prior legislation was rather efficient. With the proposed Swedish Code, the authors believe that this issue will be addressed, seeing how the international crises indirectly create a demand for similar actions.

The authors want to emphasize the fact that independence has always been an issue from ancient times until today in the audit profession. In the interviews the authors have learned that issues of independence are discussed on a daily basis in audit firms and solved on a daily basis by the auditor himself/herself in the audit profession. The authors feel that this is a much more important way of improving the independence in fact than what new legislation accomplishes.

To summarize the authors’ opinions on independence of the auditor, the independence in fact is the relevant issue. The problems in independence of the auditor recently debated have been a discussion on the independence in appearance with the demands for new legislation as a result of a few auditors’ lack of independence in fact. The authors consider that in Sweden there are no fundamental structural problems, as the “Analysmodellen” is a well prepared legislation and problems that may appear are based on an auditor’s lack of personal integrity.



What role will an Audit Committee have in a corporate structure?

“The advantage would be to move some of the influence over the auditing (... ...) from management to a part of the board of directors, and thereby closer to the owners.”

Anon.

The Audit Committee has, as already mentioned, an important part in the company's corporate governance structure. The Audit Committee will first and foremost monitor, control and review the audited financial reports. The agency relationship in the company plays an important role in the understanding of the relationship between Audit Committee, auditor, management and owners. The authors have through the interviews verified the agency relationship and the role of the Audit Committee. The answers given expressed the role of the Audit Committee as a new supervising body, as something positive. One respondent especially mentioned the increase in supervision and control of management and thereby confirmed the argumentation of the authors regarding the agency theory relationship.

As management in a company is the executive body and therefore is occupied with the operational issues, they have the advantage of having complete information in the financial matters. The risks related to the advantage in information are that the advantage might be used for their own purposes. Obviously, the owners would like to eliminate this risk. The owners are represented in the company by the board of directors as well by the Audit Committee, and through these functions they can be a monitoring party. Management has been given the responsibility, through an agency relationship, to manage the company and in order to prove that this has been done, the management presents periodic financial reports to the owners. This fulfilling of the agency theory contract between the owners and management is to be reviewed to prove its accuracy. The reviewing is performed by the auditor. With the appointment of an Audit Committee there is another review body in the agency relationship.

The objectives of the Audit Committee are to monitor, control and review the financial reporting, the internal control as well as to some extent the auditor. With the Audit Committee, the credibility of the control of the management and of the auditing should increase. The authors believe that the role of the Audit Committee in Sweden will become more focused on the reviewing process and less on the monitoring and controlling functions of the auditor. In the Swedish Code it is stated that the Audit Committee should evaluate the auditor before the nomination process and thereby is not obliged to conduct periodical controls of the auditor. However, this does not mean that the Audit Committee will not have any contact with the auditor during the fiscal year. The authors want to clarify the agency relationship, with the Audit Committee included, by placing the Audit Committee in figure 5.1 as presented earlier.

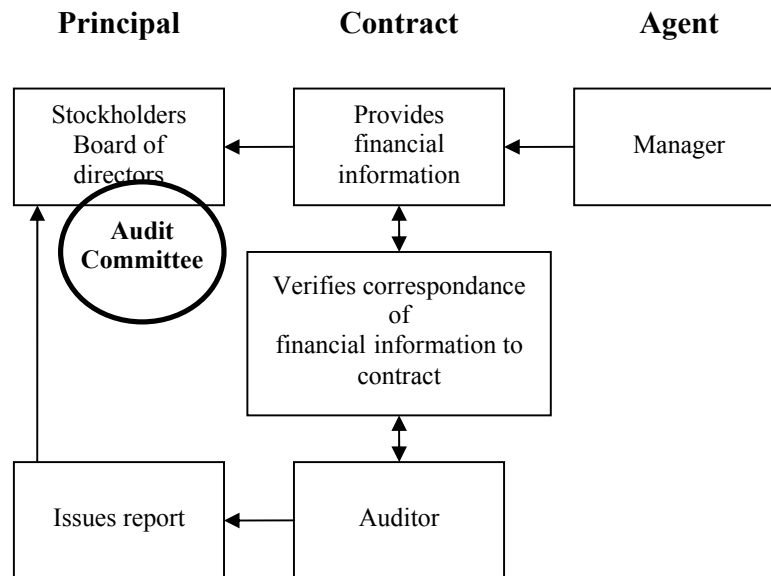


Figure 7.1
The Audit Committee in the agency theory
Based on Messier's model (See figure 5.1)

With the placement of the Audit Committee the authors have displayed its position and role. No arrows have been used as the role of the Audit Committee in the agency theory relationship is more of a supervising body. The Audit Committee plays the same role as the auditor but the difference is that the Audit Committee is not an outside party, but the principal itself.

Several respondents have expressed the view that an Audit Committee can improve the communication between the auditor and the board of directors. The authors consider it positive that an Audit Committee can increase the interest for auditing and communication with the auditor from the board of directors. The role of the Audit Committee will therefore be more important as it also will serve as a link between management, board of directors and auditors. The main argument against the implementation of Audit Committees from the Swedish audit profession has been that the members of the board of directors not involved in the Audit Committee might lose their interest in audit issues.



How will the concept of Audit Committees, implemented in Swedish companies, influence the independence of the Swedish auditor?

Returning to the main question, the authors feel, after doing the research and interviews, that an Audit Committee will have a positive influence on the auditor's independence since the purposes of an Audit Committee are to monitor, review and control the audit process. When an Audit Committee prevents the auditor from being influenced by others it helps to increase independence.

“The auditor himself/herself must want to preserve his/her independence and integrity. There is no one else who can do this. There are no rules in the world or any Audit Committees that can replace the personal integrity of an auditor who understands his/her role”

Anon.

In this quote the authors feel that the very essence of the whole debate on Audit Committee's effects on independence is captured. No regulations in the world can regulate efficiently every auditor and every financial report. The auditor himself/herself must aspire to be independent in order to gain the public confidence and to perform a high-quality audit. But in the case of an auditor not behaving appropriately, the authors feel an Audit Committee would make it more difficult for the auditor to betray trust. The Audit Committee should work as a supervisory controlling body with the intent to prevent fraud and defalcations and thereby strengthen the independence of the auditor.

The question at hand is how the Audit Committee affects the independence. It is not enough to simply give a positive answer as the question is more complicated than that. The advantages of an implemented Audit Committee in order to increase the independence in fact in Sweden are counterbalanced by many disadvantages and complications. The Audit Committees could create a time-consuming bureaucracy, higher audit fees, where the costs exceed the benefits of the legislation. One respondent even expresses a possible disadvantage that could exist when the board of directors has a more significant influence on the audit, it could affect the independence of the auditor negatively.

The most important goal of the Audit Committee in Sweden is to increase the independence in appearance in order to establish a stronger public confidence in auditing. Since the “Analysmodellen” is utilized in Sweden, the introduction of an Audit Committee will not affect substantially the independence in fact even if it obviously helps and brings with it more positive consequences than negative ones. The independence in appearance is often a harder problem to solve. In the United States there has been a crisis in public confidence, which has arisen from the accounting and auditing scandals, and this lack of public confidence has spread throughout the world. So the problem at hand in Sweden is not that of independence in fact but independence in appearance. By increasing the independence in appearance, the public confidence in auditing will follow. In conclusion the



introduction of the Audit Committee will increase the independence in appearance and thereby also the public confidence.

In order to answer the research question the authors wish to summarize their opinions. In the matter of increasing the independence of the auditor, the Audit Committee increases the independence in appearance far more than the independence in fact. The only one who can guarantee the independence in fact is the auditor himself/herself. The Audit Committee can only limit the possibility of misinterpretation or fraud. The authors believe that the implementation of an Audit Committee in Sweden will not revolutionize the independence of the auditor but it will have a positive effect.



8. Conclusion

In this chapter the authors present their summarized answers to the problems presented in the first chapter of this thesis. The paragraphs in the conclusion are presented in the same order as in the analysis with the first paragraph answering the first as well as the second sub question.

The authors have had one main question and four sub questions in order to fulfill the purpose of the thesis. The thesis aimed to clarify the effects of an Audit Committee on the independence of the auditor. The answers to the sub questions provided the authors with the information needed in order to answer the main question.

An Audit Committee is a supervisory body representing the shareholders, since the Audit Committee consist of non-management members of the board of directors. The Audit Committee has the purpose to monitor, control and review the financial reporting and audit process. In Sweden the Audit Committee will focus more on the review of the auditor, as legislation demands the Audit Committee review the nominated auditors. In comparison with the United States, where the Audit Committee appoints the auditor, the role of the Audit Committee is more important in the corporate governance structure. In the European Union the Audit Committee does not appoint the auditor but it should assist in nomination process. This is stated in the proposed legislation which will require public interest entities to implement Audit Committees. The authors therefore want to emphasize the unavoidable fact that international changes in legislation affect the Swedish auditors.

The concept of the independence of the auditor can be divided in to two separate parts: the independence in fact and independence in appearance. Both are important in restoring the public confidence in auditing, but the independence in appearance is of greater importance in this issue. After the accounting and auditing scandals and the following crisis in public confidence for auditing there has emerged a need for an improvement of independence in appearance of the auditor. This has forced the legislative powers to take action to restore the public confidence for auditing through the more detailed and increased legislations. Naturally this increased legislation also has positive consequences that benefit the independence in fact. However, in the end, the independence in fact can only be guaranteed by the auditor himself/herself which has been the conclusion reached in the empirical study.

The Audit Committee has an important role in the company. The authors consider the role of the Audit Committee in Sweden less important than the role of the Audit Committee in the United States. Placing the Audit Committee in an agency relationship, gives the conclusion that the role of the Audit Committee is to give the principal, the stockholders, another form of control of management. The authors believe the Audit Committee in Sweden, considering its purposes, will not be the most important part in the agency relationship as the auditor still plays the main role in monitoring and controlling management.



In the main question on how an Audit Committee will affect the independence of the auditor the authors conclude the effect to be positive. This was verified through the empirical research where several respondents stated their belief that the implementation of an Audit Committee will limit the possibility for fraud. Thereby, independence in appearance could be strengthened as the Audit Committee would be accepted by the public as a new supervisory body. This will be positive as the recent scandals have negatively affected the audit profession and this will be a step towards settling the current debate. The authors also want to emphasize that the independence in fact would not be revolutionized by the implementation of an Audit Committee as the only one who could secure the independence in fact is the auditor himself/herself.

Suggestions for further research

In this section the authors will give suggestions for further research on the subject. This thesis has examined the concept of Audit Committee and its influence on the independence of the Swedish auditor. While conducting the research, the authors have discovered interesting angles and new phenomena that can be studied, both in the field of Audit Committees as well as independence. All this is not considered in this thesis and is still left to be investigated.

- Since the thesis has examined an issue that has been recently regulated and not yet thoroughly tested in Swedish companies, a suggestion for further research could be to investigate the implemented Audit Committee in the Swedish company when a suitable period of time has passed. It would be very interesting, in a couple of years, to see what influence the implementation of the Audit Committee had on the Swedish auditor and if the authors' conclusions in this thesis were accurate.
- A comparison to other countries and regions could also be of interest. Have other European member states experienced the same difficulties and advantages as the Swedish business and how have they handled this?
- An interesting issue to study further might be whether or not the increased legislation regarding auditing fulfilled its purpose. This thesis has aimed to investigate a possible future situation, seeing how the European and Swedish legislations still are proposals. The global problem with public confidence is of current interest and a new approach would have to be carried out when a substantial time-period had passed. Did the independence of the auditor increase and was the public confidence in auditing restored?



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Blix Clas, Ernst & Young AB

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Appendix 1 Questionnaire

1. Questionnaire in Swedish

Audit Committee

Sarbanes-Oxley Act presenterar specifika regler när det gäller Audit Committee som påverkar svenska företag noterade på den amerikanska marknaden. Även EU har under senare tid föreslagit liknande rekommendationer rörande revisionskommittéer och dess utnämning och arbete.

1. Vad är er åsikt om de nya Audit Committee reglerna och tycker ni att de uppfyller sina syften, både att stärka revisorns oberoende och att öka förtroende för revision?
2. Vilka fördelar/nackdelar ser ni med införandet av "Audit Committee" när det gäller att uppfylla sina bägge syften?
3. Hur påverkas ni av och hanterar dessa nya Audit Committee/revisionskommitté regler i ert företag?
4. Sverige har sedan tidigare använt sig av den s.k. "analysmodellen", rekommenderad av FAR, vid tillsättandet av revisor. Detta är ett exempel på när lagar och rekommendationer skiljer sig åt. Vid tillämpning av antingen svenska eller europeiska/amerikanska regler kan ett företag komma att strida mot lagstadgade paragrafer i endera lagen. Hur ser ni på detta uppkommande problem med dubbel-lagstiftning och dubbel-bestrafning?
5. Vad ser ni för förändringar i framtiden angående svenska revisionskommittéer?
6. De nya "Audit Committee" reglerna är anpassade för amerikanska företag. Tror ni att dessa kommer att komplicera eller underlätta revisionsprocessen i Sverige?

Revisorns oberoende

Ett av de viktigaste syftena med de nya Audit Committee reglerna är att stärka revisorns oberoende. Efter flera redovisningsskandaler har det uppkommit en stark efterfrågan på kvalitetssäkrande lagstiftningar för att just stärka revisorns oberoende. Även Sverige lägger vikt vid en oberoende revisionsprocess, vilket sedan tidigare garanterats genom den s.k. "analysmodellen".



7. Anser ni att det finns befintliga problem rörande revisorns oberoende i Sverige idag och i så fall, hur hanteras dessa?
8. Hur tror ni revisorns oberoende i Sverige påverkas av de nya förhållandena, dvs tillsättandet och granskningen av revisorn? Kommer detta leda till att oberoendet stärks, försvagas eller förblir oförändrat, och i så fall varför?

Övriga frågor

För att kunna fånga upp era personliga reflektioner i ämnet lämnar vi nedan några öppna frågor där ni fritt kan skriva vad som faller er in rörande revisionskommittéer och revisorns oberoende.

9. Har ni några tips eller idéer över litteratur som kan vara relevanta för ämnet?
10. Övriga frågor och synpunkter som inte behandlats?

För att öka uppsatsens trovärdighet ber vi er fylla i följande uppgifter:

- Namn:
- Befattning och engagemang i ämnet:

Adresser

Svaren och eventuella frågor kan skickas per mail eller brev till följande adresser:

sarbanes-oxley@spray.se (gemensam adress till författarna)

elisabeth@forseth.se

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alt.

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2. Questionnaire in English

Audit Committee

The Sarbanes-Oxley Act presents specific rules concerning Audit Committees that will affect Swedish companies listed on the American market. The European Union has also presented similar recommendations concerning Audit Committees and their work and nomination.

1. What is your opinion on the new rules on Audit Committees and do you believe that they fulfill their purposes i.e. strengthening the independence of the auditor as well as the public confidence in auditing?
2. What pros and cons can you see with the implementation of Audit Committees concerning the fulfillment of their purposes?
3. How are you affected by and how do you handle these new Audit Committee rules in your company?
4. For some years Sweden has used the “Analysmodellen”, recommended by FAR, at the appointment of an auditor. This is an example of when laws and recommendations differ. While applying either Swedish or American/European rules a company may violate the rules in another set of legislation. What are your opinions on this possible problem with dual legislation and dual sanctions?
5. What changes do you see in the future concerning Swedish Audit Committees?
6. These new Audit Committee rules are adapted for American companies. Do you believe that they will complicate or facilitate the process of auditing in Sweden?

The independence of the auditor

One of the main purposes of the new Audit Committee rules is to strengthen the auditor's independence. After several accounting scandals a need for legislation on this matter has emerged. Also in Sweden the issue of independence of the auditor is important. This has earlier been guaranteed by the “Analysmodellen”.

7. Do you feel that there are existing problems concerning the independence of the auditor in Sweden today?



8. How do you think the independence of the auditor in Sweden will be affected by these new conditions, i.e. the appointment of and control of the auditor? Do you believe that the auditor's independence will be strengthened, weakened or remain the same? Why?

Further questions

In order to capture your own ideas about this topic we hereby leave some open questions where you may write whatever you feel interesting concerning Audit Committees and the independence of the auditor.

9. Do you have any tips or ideas on literature that may be relevant to the subject?
10. Any other questions or thoughts that have not been treated?

In order to increase the credibility of the thesis we hereby ask you to fill in the following information:

- Name:
- Position and involvement in the subject:

Addresses

The answers and any questions you might have can be sent by mail or e-mail to the following addresses:

sarbanes-oxley@spray.se (gemensam adress till författarna)

elisabeth@forseth.se

fredricholm@spray.se

h_alsterlind@hotmail.com

alt.

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Solrosgatan 6C lgh14
416 51 Göteborg
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411 34 Göteborg
0705-465638

Hanna Alsterlind
Blidvädersgatan 67
418 30 Göteborg
0704-737737



Appendix 2 Missive

1. Missive in Swedish

Göteborg 2004-04-28

Ärende: Diskussionsfrågor angående Sarbanes-Oxley Act of 2002 och liknande internationella regleringar, samt revisorns oberoende.

Hej!

Efter vårt telefonsamtal skickar vi nu ett antal frågor rörande revisorns oberoende som kommer att diskuteras i vår uppsats.

Vi, Hanna Alsterlind, Elisabeth Forseth och Fredric Holm, läser sista året på civilekonomutbildningen på Handelshögskolan vid Göteborgs universitet. Vi skriver uppsatsen inom ämnesområdet International Accounting, eftersom den internationella synen på redovisning har de senaste åren aktualiserats. Information som erhålles från samtliga intervjuer kommer att sammanställas och analyseras i vår kandidatuppsats, vilken vi gärna skickar till er på begäran.

Under sommaren 2002 inleddes en debatt angående revision och redovisning, vilket torde vara en konsekvens av de redovisningsskandaler som inträffade i USA. Detta föranledde att strängare regler utarbetades i USA inom revisionområdet, för att skydda investerarna. Under 2003 utredde EU förslag till liknande lagstiftning rörande revision. Även i Sverige har liknande utredningar genomförts, den senaste är Förtroendekommissionen.

Syftet med vår uppsats är att undersöka vad Sarbanes-Oxley Act of 2002, EU och Sverige säger rörande Audit Committee/Revisionskommitté, för att öka revisorns oberoende. Vi ämnar fokusera uppsatsen på hur revisorns oberoende förändras genom ny lagstiftning. Vi vill också åskådliggöra den uppfattning som finns i revisionsbranschen rörande de nya lagstiftningarna och hur detta förändrar revisionsarbetet.

Deltagandet från er sida är mycket viktigt för uppsatsen, då detta kommer att ge oss och uppsatsens läsare en djupare förståelse av synen på Audit Committee/Revisionkommittéer. Vi hoppas att era synpunkter kommer att klargöra hur branschen ställer sig till de förändringar som genomförts.

Vi kommer att använda oss av namn på intervjupersoner i uppsatsen, men de uppgifter ni lämnar kommer ej att ses av någon utomstående. Frågor och svarsadresser finner ni i den bifogade bilagan. Då vi arbetar under ett pressat schema vore vi tacksamma att ni återkommer med era svar så snart ni kan.

Tack på förhand!

Med vänliga hälsningar

Elisabeth Forseth

Hanna Alsterlind

Fredric Holm



2. Missive in English

Gothenburg 2004-04-28

Subject: Discussion and questions regarding the Sarbanes-Oxley Act of 2002 and similar international regulations, as well as the independence of the auditor.

Hello!

After our telephone call we hereby send a number of questions regarding the independence of the auditor that will be discussed in our thesis.

We, Hanna Alsterlind, Elisabeth Forseth and Fredric Holm, are last year students at the Program of Economics at the School of Economics and Commercial Law at the Göteborg University. We are writing the thesis in the field of International Accounting, since the international view on accounting has been made topical over the last couple of years. The information obtained by all the interviews will be summarized and analyzed in our thesis, which we would be more than happy to send you on your request.

During the summer of 2002 a debate was started about auditing and accounting, which is a consequence of the accounting scandals that occurred in the United States of America. These caused stricter audit rules to be prepared in the United States, in order to protect the investors. During 2003 the European Union investigated the possibility of similar legislation concerning audit. Also in Sweden similar investigations have been carried out, the latest of these being the "Förtroendekommissionen".

The purpose of our thesis is to investigate what the Sarbanes-Oxley Act of 2002, the European Union and Sweden say regarding Audit Committees, in order to increase the independence of the auditor. We intent to focus the thesis on how the independence of the auditor will change through new legislation. We also intent to focus the thesis on the perception from the audit profession on the new legislations and how this alters the audit process.

Your participation is very important for the thesis, as this will give us and the reader a deeper understanding of the view on the Audit Committee. We hope that your point of view will clarify how the audit profession position itself to the changes that have been made.

We will use the names of the interviewees in the thesis, but the opinions you provide will not be seen by any outsider. Questions and addresses will be found in the enclosed appendix. Since we are working on a tight schedule we would appreciate if you could send your answers as soon as possible.

Thank you!

Best regards

Elisabeth Forseth

Hanna Alsterlind

Fredric Holm



Appendix 3 Institutions

1 Institutions in the United States

1.1 The Congress of United States

The Congress of United States was created by Article I, section 1, of the Constitution, adopted by the Constitutional Convention on September 17, 1787 (<http://usgovinfo.com>[1], 2004-05-23). The Congress is a branch of government with the formation of a bicameral Congress, with the House of Representatives and the Senate (<http://bensguide.gpo.gov>[1], 2004-05-23). The Senate consists of 100 members, two senators per state. The House of Representatives consists of 435 members representing a constituency. The Congress has rarely taken a direct interest in accounting matters, but has relied on the SEC to protect the public interest (Parker & Nobes, 2003). The major legislative decisions concerning auditing and financial accounting are *The Securities and Exchange Act of 1934* and *The Sarbanes-Oxley Act of 2002*.

1.2 Securities and Exchange Commission (SEC)

The primary mission of the SEC is to protect the investors and regulate the securities markets. It was founded in 1934 after the Congress passed the *Securities and Exchange Act of 1934*, which was the result of the need for investor protection after the economic crash and depression in October of 1929. Today the SEC has the goal of ensuring that the investors, big institutions or private persons, should all have the same access to certain basic facts of the investment before investing. The SEC also oversees other parties on the securities market, such as stock exchanges, broker-dealers, investment advisors and mutual funds, to protect the investors interacting with them ([ww.SEC.gov](http://www.SEC.gov), 2004-05-23).

1.3 Public Company Accounting Oversight Board (PCAOB)

The Sarbanes-Oxley Act established the PCAOB to oversee the audits of public companies and similar matters, in order to protect the investors. The PCAOB works to further the public interest in the preparation of accurate, informative and independent audit reports (www.whitehouse.gov[1], 2004-05-23). In Section 103a of the Sarbanes-Oxley Act the PCAOB is given the responsibility to establish auditing standards, attestation standards, quality control standards and ethics standards to be used in registered public accounting firms. The PCAOB is controlled by the SEC and the standards are to be approved by the SEC. The rules of the PCAOB are established to improve the auditor's independence (The Sarbanes-Oxley Act of 2002).



1.4 Financial Accounting Standards Board (FASB)

The FASB was founded in 1973 and is currently the designated organization in the private sector to establish standards of financial accounting and reporting. The published standards of the FASB are officially recognized as authoritative by the SEC and the AICPA. The standards are essential for the trust of the economic reports by the investors, creditors, auditors and others relying on credible, transparent and comparable financial information. The FASB consists of a board of seven members, who have to possess knowledge of accounting, finance and business. There is also a staff of 40 people that assists the Board in their work. The mission of the FASB is to establish and improve standards of financial accounting and reporting, as well as provide guidance and education of the public (www.fasb.org[1], 2004-05-22). The organization is financed by contributions from public accounting firms, industry, investors and creditor organizations. The contributions are limited to ensure the independence of the FASB (Parker & Nobes, 2002).

1.5 The American Institute of Certified Public Accountants (AICPA)

The American Institute of Certified Public Accountants has developed since 1887 and today their mission is to provide members with the resources, information and leadership to enable the Certified Public Accountants (CPA) to offer their clients and the public a high competence (www.aicpa.org[1], 2004-05-26). To practice as an accountant is not regulated through the AICPA, but through the individual states (Parker & Nobes, 2002). The organization has several areas where they give guidance to their members, working as standards setters for the auditing profession in the U.S.

1.6 The Audit Standards Board (ASB)

The ASB is a committee of the AICPA that is responsible for publishing audit, attestation and quality control standards (www.aicpa.org[2], 2004-05-26). The future of this board has been discussed since the foundation of the PCAOB which had been given essentially the same duties.

2 Institutions in the European Union

2.1 European Commission

The European Commission is the driving force and executive body of the European Union. It is the institution that does most of the day-to-day work within the European Union. It sets up proposals for new laws and makes sure that the European laws and treaties are followed and implemented correctly. The Commission presents their proposals to the Council and to the Parliament and the president of the Commission is selected by the member states' governments but has to be approved by the Parliament. The Commission acts independently of the governments of the member states (www.europa.eu.int[1], 2004-05-07).



2.2 European Council

The Council of the European Union functions as the voice of the member states. The Council used to be called the Council of Ministers and it is the main legislative and decision-making body in the European Union. This is where the representatives of the member states, who are elected in their countries, can meet in order to express the views, demands and wishes of the population in their countries. Depending on the topic in question, they meet regularly at the level of working groups, ambassadors, ministers or - when they decide the major policy guidelines - at the level of presidents and prime ministers, i.e. as the European Council (www.europa.eu.int[1], 2004-05-07).

2.3 European Parliament

If the European Council functions as the voice of the member states then the European Parliament functions as the voice of the people. The members of the Parliament are elected directly every five years and they are not seated in national blocks but in seven political groups. Each group reflects the political ideology of the national parties to which its members belong. There are also some members of the Parliament who are not attached to any political group.

The main purposes of the European Parliament are examining and adopting European legislation, approving the European Union budget, exercising democratic control over the other European Union institutions and agreeing on important international issues such as the introduction of new member states (www.europa.eu.int[1], 2004-05-07).

2.4 The European Federation of Accountants (FEE)

The Fédération des Experts Comptables Européens (FEE) is the representative organization for the accountancy profession in Europe. FEE consists of 41 accountancy organizations from 29 countries. FEE member bodies represent more than 500,000 accountants in Europe (www.fee.be[1], 2004-05-07).

2.5 The International Federation of Accountants (IFAC)

The IFAC is a global organization for accountancy. It works together with 158 member organizations in 118 countries and its main purpose is to create a high quality accounting around the world (www.ifac.org[1], 2004-05-07).

2.6 International Auditing and Assurance Standards Boards (IAASB)

The IAASB functions as an independent standard setting body under the guidance of the International Federation of Accountants (IFAC). The purpose of the IAASB is to establish high quality auditing, quality control and related services standards, thereby strengthening public confidence in the global auditing profession (www.ifac.org[2], 2004-05-07).



3 Institutions in Sweden

3.1 The Swedish Parliament (Riksdagen)

The Swedish Parliament is a one chamber parliament with 349 members. The members are chosen every four years in general elections. The parliament is the legislative body in Sweden and it is responsible for the enactment of laws as well for the determination of state expenditure and revenue (www.riksdagen.se[1]).

3.2 The Supervisory Board of Public Accountants (Revisorsnämnden)

The Supervisory Board of Public Accountants was created in 1995 and is a Government Office responsible for the examination of applicants to the profession as well as the supervision of members of the profession. The aim of the Supervisory Board of Public Accounts is to ensure that the profession acts with high technical quality and ethical conduct and that society's need for qualified, independent external auditors and audit firms is met (www.revisorsnamnden.se[1]).

3.3 FAR

Founded in 1923, FAR is the professional institute for authorized public accountants, approved public accountants and other highly qualified professionals in the accountancy sector in Sweden. FAR has a main role in the progress of education, information and professional standards of the auditing profession in Sweden. FAR also publishes books, journals and newsletters and organizes seminars and conferences on professional topics (www.far.se[1]).



Links to appendix 3

www.aicpa.org[1] < http://www.aicpa.org/about/mission.htm >	2004-05-15
www.aicpa.org[2] < http://www.aicpa.org/members/div/auditstd/about_asb.htm >	2004-05-15
www.europa.eu.int[1] < http://www.europa.eu.int/abc/index3_en.htm >	2004-05-10
www.far.se[1] < http://www.far.se/english.asp >	2004-05-15
www.fasb.org[1] < www.FASB.org >	2004-05-15
www.fee.be[1] < http://www.fee.be/secretariat/Introduction.htm >	2004-05-12
www.ifac.org[1] < http://www.ifac.org/About/ >	2004-04-25
www.ifac.org[2] < http://www.ifac.org/IAASB/ >	2004-05-12
www.revisorsnamnden.se[1] < http://www.revisorsnamnden.se/infoenglish.htm >	2004-04-15
www.riksdagen.se[1] < http://www.riksdagen.se/english/work/uppgifter.asp >	2004-04-16
www.whitehouse.gov[1] < http://www.whitehouse.gov/omb/fedreg/2004/040226-a94_appx-c.pdf >	2004-04-16
http://bensguide.gpo.gov [1] < http://bensguide.gpo.gov/9-12/government/national/legislative.html >	2004-04-10
http://usgovinfo.com [1] < http://usgovinfo.about.com/cs/uscongress/a/aboutcongress.htm >	2004-04-12



Appendix 4 Ten priorities for improving and harmonizing the quality of statutory audit

(www.europa.eu.int[1])

Summary of the short-term priorities:

1. *Modernizing the Eighth Company Law Directive*

The Commission proposed the modernized Directive on the 16th of March 2004. When it is expected to become a law depends on the European Parliament and the Council, but both have indicated repeatedly that they regard these issues as a priority. The Commission hopes that both institutions will consider the proposal in detail in the second half of 2004 with the aim of fast adoption by mid-2005. There would then be a period of 18 months for member states to implement it in national law. But many member states are already taking legislative and regulatory action on the lines of the changes proposed by the Commission.

2. *Reinforcing the European Union's regulatory infrastructure*

The proposals for a modernised Eighth Directive also include the creation of an Audit Regulatory Committee. In the modernised Eighth Directive there are several underlying principles which will be implemented by the Commission and the Audit Regulatory Committee in accordance with comitology⁷ procedures. The present European Union Committee on Auditing, founded in 1998 and composed of representatives of member states and of the profession, will be renamed the Audit Advisory Committee and will continue its work as an advisory committee.

3. *Strengthening public oversight of the audit profession*

The Commission, together with the Audit Advisory Committee, will analyse the existing systems of public oversight in the member states and develop minimum requirements for public oversight. The Commission will define a co-ordination mechanism at European Union level to link up national systems of public oversight into an efficient European Union network.

4. *Requiring International Standards on Auditing (ISAs) for all European Union statutory audits*

The Commission and the Audit Advisory Committee will work to prepare the implementation of ISAs from 2005. These will include: an analysis of European Union and member state audit requirements not covered by ISAs, the development of an endorsement procedure, a common audit report and high-quality translations. The Commission will work towards further improvements to the IFAC/IAASB audit standard setting process, especially by ensuring that public interest is taken fully into account. In the year 2005 the implementation of ISAs will become mandatory in member states.

⁷ "Comitology": the term refers to the procedures under which the Commission executes its implementing powers conferred to it by the legislative branch (the European Parliament and the Council), with the assistance of "comitology" committees consisting of member state representatives.



Summary of the medium-term priorities:

5. *Improving disciplinary sanctions*

The Commission and the Audit Advisory Committee will evaluate national systems regarding disciplinary sanctions to determine common approaches and will introduce an obligation for member states to co-operate in cross border cases.

6. *Making audit firms and their networks more transparent*

The Commission and the Audit Advisory Committee will develop disclosure requirements for audit firms, covering among other things their relationships with international networks.

7. *Corporate governance: strengthening audit committees and internal control*

The Commission and the Audit Advisory Committee will work on the appointment, dismissal and fee of statutory auditors, and on communication between the auditor and the company that is being audited. The Commission and the Committee will also examine the auditors' involvement in evaluating and reporting on internal control.

8. *Reinforcing auditor independence and code of ethics*

The Commission will carry out a study of the impact of a more restrictive approach on additional services provided to the audit client. The Commission will continue the European Union –United States dialogue on auditor independence, with the aim of getting the United States to recognize the correspondent European Union approach. The Commission and the Audit Advisory Committee will analyse existing national codes of ethics and the IFAC code of ethics and consider further appropriate action.

9. *Deepening the internal market for audit services*

The Commission will try to facilitate the establishment of audit firms by proposing to remove the restrictions in the present eighth Directive concerning ownership and management. The Commission will carry out a study on the European Union audit market structure and on access to the European Union audit market.

10. *Examining auditor liability*

The Commission will also study the economic impact of auditor liability regimes. Already in 2001 the Commission carried out “a study on systems of civil liability of statutory auditors in the context of a Single Market for auditing services in the European Union”(www.europa.eu.int[2]). The purpose has been and still is to create a homogeneous legislation for the auditor's liability throughout the European Union.

Links to Appendix 4

www.europa.eu.int[1]

<http://europa.eu.int/rapid/start/cgi/guesten.ksh?p_action.getfile=gf&doc=IP/03/715|0|AGED&lg=EN&type=PDF> 2004-05-10

www.europa.eu.int[2]

<http://www.europa.eu.int/comm/internal_market/en/company/audit/docs/auditliability.pdf> 2004-05-10



Appendix 5 “Analysmodellerna”

(<http://www.far.se/doc/Flow-chart%20-%20Analysmodellerna.ENG.doc> , 2004-06-19)

