

December 8, 2010

Michel Barnier  
European Commissioner for Internal Market and Services  
European Commission  
BERL 10/034  
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Belgium  
Delivered electronically: [markt-greenpaper-audit@ec.europa.eu](mailto:markt-greenpaper-audit@ec.europa.eu)

Dear Commissioner Barnier,

**Re: European Commission's Green Paper, *Audit Policy: Lessons from the Crisis***

The International Ethics Standards Board for Accountants (IESBA) welcomes the opportunity to respond to the European Commission's Green Paper – "Audit Policy: Lessons from the Crisis." The IESBA shares the Commission's view that the independence of auditors should be the bedrock of the auditing profession and that it is important to consider whether any lessons can be learned from the global financial crisis.

As an independent standard setter, the IESBA's objective is to serve the public interest by setting high-quality ethical standards, including independence standards, for all professional accountants through the development of a robust, internationally appropriate code of ethics. Such a code enhances the quality and consistency of services provided by professional accountants throughout the world, thus strengthening public confidence in the accounting profession. The IESBA comprises an equal number of practitioners and non-practitioners, many of whom have practical experience in dealing with the ethical issues facing accountants. In developing the Code, the IESBA adheres to due process as approved by the Public Interest Oversight Board to ensure that all decisions reached are in the public interest. Appendix C to this letter contains information on the IESBA and the due process it follows.

The Code of Ethics of the IESBA (the Code), revised in July 2009, with an effective date of January 1, 2011, adopts a principles-based approach, requiring the evaluation of threats to an accountant's compliance with fundamental ethical principles, which are described in the Code, and the application of safeguards to eliminate those threats or reduce them to an acceptable level. The IESBA utilizes this approach in developing the Code and requires accountants to apply the approach when addressing ethics and independence matters that are not addressed in the Code. In certain situations, particularly for entities where the extent of public interest is high (public interest entities), the Code prohibits accountants from entering into certain interests and relationships and identifies situations where the IESBA has concluded that no safeguards would be sufficient to reduce threats to an acceptable level.

Ethical standards, including auditor independence standards, that require the application of a principles-based approach are flexible but also robust. Such an approach accommodates variations in circumstances that create threats to compliance with the fundamental principles and prevents

conclusions that a situation is permitted merely because it is not specifically prohibited. Appendix B to this letter contains a high level summary of the conceptual framework approach and many of the prohibitions in the revised Code that apply to public interest entities.

In the course of revising the Code, the IESBA examined some of the issues raised by the Green Paper, specifically:

- The types of non assurance services that can be provided to an audit client without compromising the auditor's independence;
- The safeguards to be applied to mitigate the familiarity threat created by a long association with an audit client; and
- The actions to be taken to limit the threat of financial dependency when the fees received from a client represent a large proportion of an audit firm's revenue.

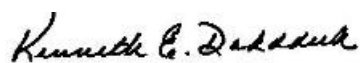
For all of these issues, new requirements and/or prohibitions were introduced in the Code for the audits of public interest entities. In Appendix A to this letter, we have commented on the questions in the Green Paper related to these issues, based on the IESBA's consideration of them as part of its due process procedures.

The IESBA's current agenda includes a significant focus on convergence of international and national ethical standards and, in particular, auditor independence requirements. Convergence to a single set of ethical standards, particularly independence requirements, can enhance the efficiency of the global capital markets by promoting a common understanding of what it means to be independent and make it easier for market participants to select audit service providers. The IESBA is exploring how the Code can be the catalyst to achieve this. In addition, the IESBA's agenda includes providing additional guidance on conflicts of interests and an accountant's response when encountering suspected fraud or illegal acts, reconsidering the inadvertent violation provisions contained in the Code, and determining how the Code could better meet the needs of small and medium sized practitioners and accountants employed by small and mediums sized entities. As we progress through these activities, we would be happy to share our insights with the European Commission as it explores ways to promote a stronger audit environment.

While some matters addressed in the Green Paper are not within the IESBA's purview as an ethics standard setter, such as concentration and market structure, other matters potentially may be, such as the appointment and remuneration of auditors and organizational requirements. We have not commented on those matters, given that the IESBA has not discussed them. However, because we remain alert to evolving issues that warrant our attention, we will be monitoring the responses to the Green Paper to help inform our view on what the IESBA's priorities should be and to help shape our own standard-setting agenda. We would be pleased to engage in further dialogue with the European Commission on these and other matters of mutual interest.

If you have questions, please contact Ken Dakdduk (+1-973-236-7239) or Isabelle Sapet (+33 1 49 97 62 56).

Yours truly,



Kenneth E. Dakdduk

Chair

International Ethics Standards Board for Accountants

## EUROPEAN COMMISSION'S GREEN PAPER (OCTOBER 2010)

### Audit Policy: Lessons from the Crisis

#### SECTION 3: GOVERNANCE AND INDEPENDENCE OF AUDIT FIRMS

*Q18. Should the continuous engagement of audit firms be limited in time? If so, what should be the maximum length of an audit firm engagement?*

The Code requires rotation of all key audit partners serving on the audit engagement for a public interest entity after seven years. The IESBA believes that rotation of key audit partners is an effective safeguard to mitigate the familiarity threat created by the long association of those partners with the audit of public interest entities. The rotation of key audit partners appropriately balances the need for a fresh look on the audit with the need to maintain continuity of knowledge of the client and its environment in order to maintain audit quality.

When the IESBA exposed for public comment the proposed revisions to the Code addressing partner rotation, no respondent proposed mandatory firm rotation. The IESBA believes that a decision to require firm rotation would necessitate consideration of a number of factors, including understanding the cost to the client of educating a new audit firm on the client's business each time it is required to hire a new auditor, such as the potential disruption to the client's operations as its personnel take time away from their core activities to inform a new auditor, and the difficulties that are particularly inherent in doing this for a large global client. The impact that firm rotation would have on a client's choice of audit and non-assurance service providers would also need to be considered, since in order to remain eligible to become the auditor, the client would need to refrain from engaging other firms for certain non-assurance services.

*Q19. Should the provision of non-audit services by audit firms be prohibited? Should any such prohibition be applied to all firms and their clients or should this be the case for certain types of institutions, such as systemic financial institutions?*

Providing non-assurance services to audit clients may create self-review and self-interest threats. The Code prohibits those non-assurance services that create too significant a threat. The Code contains additional provisions that reflect the greater extent of public interest in certain entities and, therefore, differentiates between audit clients that are public interest entities and those that are not public interest entities. Appendix B to this letter provides an overview of the non-assurance services that a firm is prohibited from providing to a public interest entity audit client.

During its deliberations of the revision to the Code, the IESBA considered what types of non-assurance services are commonly provided by professional accountants in various parts of the world. The IESBA considered each category of non-assurance service and concluded that for some of these non-assurance services the self review threat could not be appropriately mitigated by safeguards, especially for public interest entities. Providing these non-assurance services to

audit clients is therefore prohibited (see Appendix B to this letter). When the proposed revisions were exposed for comment, no respondent proposed that the threat be addressed by a complete ban on the provision of non-assurance services to an audit client, and the IESBA did not consider it necessary to prohibit all non-assurance services.

To further address the self interest threat associated with providing non-assurance services to an audit client, the Code prohibits key audit partners from being evaluated or compensated based on their success in selling non-assurance services to their audit clients.

*Q20. Should the maximum level of fees an audit firm can receive from a single client be regulated?*

The IESBA agrees that when the total fees from an audit client represent a large proportion of the total fees of the firm, the dependence on that client and concern about losing the client create a self-interest or intimidation threat. To address this threat with respect to audit clients that are public interest entities, the Code requires, a pre- or post-issuance review of the audit, equivalent to an engagement quality control review, if for two consecutive years the total fees from the client represent more than 15% of the total fees of the firm. The review must be performed by a professional accountant who is independent of the firm expressing the opinion or by a professional regulatory body.

When the IESBA exposed this provision for public comment, no respondent proposed that the threat be addressed by prohibiting the firm from performing the audit. The IESBA believes that the prescribed safeguard is effective by bringing additional scrutiny to the audit, which promotes objective judgment on the part of the auditor, accommodates temporary situations, and facilitates SMPs entering and remaining in the PIE audit market.

## Appendix B

### IESBA Code of Ethics Prohibitions Applicable to Audits of Public Interest Entities

The Code contains prohibitions and restrictions determined by the IESBA by applying the *conceptual framework* set out in the Code in its evaluation of independence matters in the context of the audit of public interest entities. . Given the level of public interest in such entities, the IESBA concluded that no safeguards could reduce to an acceptable level the threats created by the specific service, interest, or relationship that is prohibited.

Many parts of the Code call for accountants to apply the conceptual framework, which entails identifying threats to independence, evaluating the significance of the threats, and applying safeguards, when necessary, to eliminate the threats or reduce them to an acceptable level. For example, a service, interest, or relationship that is not prohibited must be evaluated by the accountant using the conceptual framework. This includes situations where the Code does not address the service, interest, or relationship.

A requirement for accountants to apply the conceptual framework helps to ensure that a service, interest, or relationship is not automatically deemed to be permissible simply because it is not prohibited by the Code. This makes the Code stronger than one determined using a purely rules-based framework.

Conclusions regarding compliance with independence requirements and the substance of relevant discussions are to be documented when safeguards are required and when a threat required significant analysis to determine whether safeguards were necessary and the accountant concluded that they were not because the threat was already at an acceptable level. This promotes careful thought and analysis when evaluating the

independence implications of a matter.

### Summary of prohibitions

#### **Prohibited non-assurance services**

##### *Prohibited without regard to materiality*

- Assuming a management responsibility.
- Serving as General Counsel.
- Accounting services
- Bookkeeping services
- Payroll services
- Preparing the financial statements and related financial information.
- Promoting, dealing in, or underwriting client shares.
- Negotiating for the client.
- Recruiting directors/officers, or senior management who will have significant influence over accounting records or financial statements.
- Evaluating or compensating a key audit partner based on that partner's success in selling non-assurance services to the partner's audit client.

##### *Prohibited if material to the financial statements*

- Valuation services
- Calculations of current/deferred taxes.
- Tax or corporate finance advice that depends on a particular accounting treatment/financial statement presentation for which there is reasonable doubt as to its appropriateness.
- Acting as an advocate before a public tribunal or court to resolve a tax matter.
- Internal audit services relating to internal controls over financial reporting, financial accounting systems, or financial statement amounts/disclosures.
- Designing/implementing financial reporting IT systems.
- Estimating damages or other amounts as part of litigation support services.
- Acting as an advocate to resolve a dispute.

#### **Prohibited interests and relationships**

- Financial interests in the client.
- Financial interests in an entity in which the client has a material interest and can significantly influence.
- Loans from a client lending institution that have not been made under normal lending procedures, terms, and conditions, or from a client that is not a lending institution and are material.
- Material loans to a client.
- Deposits with a client that are not held under normal terms.
- Close business relationships with a client that are significant or entail a material financial interest.
- Audit team members whose immediate family member is a client director/officer, or an employee able to significantly influence the accounting records or financial statements.
- Former audit team members or a partner joining the client if significant connections with the firm remain.
- A key audit partner or senior/managing partner joining a client before a defined period of time.
- A key audit partner serving on the audit longer than 7 years.
- An individual being on the audit team if during the period covered by the audit the person was a client director/officer, or an employee able to significantly influence the accounting records or financial statements.
- Partners/employees serving as a client director or officer.
- Contingent fees for an audit or assurance engagement and, when material to the firm, for a non-assurance service to the audit client.
- Accepting gifts or hospitality from the client that are other than trivial and inconsequential.

## Background on IESBA

The IESBA develops the Code of Ethics for Professional Accountants (the Code) under a shared standard-setting process involving the Public Interest Oversight Board (PIOB), which oversees the activities of the IESBA, and the IESBA's Consultative Advisory Group (CAG), which provides public interest input into the IESBA's activities, in particular its development of the Code.

The IESBA comprises eighteen members, three of whom are public members. The IESBA is composed of an equal number of practitioners and non-practitioners. A member of the PIOB attends each meeting as an observer. There are three other observers: the Chair of the CAG, a representative from the European Commission, and a representative from the Japanese Financial Services Authority.

In developing the Code, the IESBA adheres to due process as approved by the PIOB to ensure that the decisions reached are in the public interest. The due process includes consideration of issues identified through the IESBA's research in meetings that are open to the public, exposure for public comment of all proposals, and consideration in open meetings of significant issues raised by respondents to the IESBA's exposure drafts.

The Code applies to all professional accountants, not only to auditors but also to professional accountants in public practice and those in business. This reflects the importance that professional accountants in the business reporting supply chain have in financial reporting, whether they are in public practice or in business.

The Code is widely used by the 164 member bodies of IFAC in more than 125 countries. In accordance with their membership obligations, member bodies are required to have standards that are no less stringent than the standards in the Code. Additionally, firms that are members of 22 accounting firm networks, (the "Forum of Firms") have agreed to have policies and procedures that are consistent with the standards in the Code for all transnational audits. In total, approximately two and half million accountants around the world are subject to the Code.