

December 8, 2010

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

Dear Commissioner Barnier,

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

The International Auditing and Assurance Standards Board (IAASB) appreciates the opportunity to respond to the European Commission's (EC) Green Paper, *Audit Policy: Lessons from the Crisis* (GP).

As an independent standard setter, the IAASB's mandate is to serve the public interest by setting high-quality auditing, review, other assurance, related services, and quality control standards, and facilitating convergence with them. The IAASB shares the EC's view that the external audit is an activity of significant public interest. Together with sound regulatory, supervisory and corporate governance frameworks, high-quality auditing standards plays a key role in supporting audit quality and maintaining financial stability and market confidence. Promoting audit quality is central to the IAASB's present and future strategy, and work program.

The IAASB is most directly involved in supporting audit quality through setting high-quality International Standards on Auditing (ISAs). In March 2009, the IAASB reached a milestone by clarifying its suite of 36 ISAs and its International Standard on Quality Control (ISQC). Over the past 18 months, the IAASB has continued to examine areas where the ISAs and its other international pronouncements can be further enhanced. At the same time, the IAASB has also worked to deliver practical guidance to facilitate the effective implementation of the ISAs. Audit quality, however, does not rest on the actions of the IAASB alone. The actions of stakeholders in the financial reporting supply chain, user perceptions and other influences,

including the firm's system of quality control and other environmental factors such as laws and regulations, are also important elements of audit quality.

The IAASB is alert to the challenges facing the auditing profession arising from the global financial crisis. The IAASB therefore continues to focus on active engagement with its stakeholders to understand their needs, and to undertake initiatives to address them. In the coming few months, the IAASB anticipates releasing a consultation paper on its 2012–2014 strategy and work program. As it progresses its deliberations thereon, the IAASB will be following the progress of the EC's consultation on its GP with interest.

In the Appendix to this letter, we are pleased to provide our comments on matters raised in the GP that are directly within the remit of the IAASB. Responses have not been provided to questions posed in the GP relating to, for example, concentration and market structure, which are beyond the IAASB's mandate.

I hope the comments in the Appendix will prove to be helpful. I welcome further dialogue between the EC and the IAASB as we progress our respective initiatives on important topics of mutual relevance raised in the GP.

Yours sincerely,

A handwritten signature in blue ink, appearing to read "Arnold Schilder".

Prof. Arnold Schilder
IAASB Chairman

EUROPEAN COMMISSION'S GREEN PAPER (OCTOBER 2010)

Audit Policy: Lessons from the Crisis

SECTION 1: INTRODUCTION

Q3. Do you believe that the general level of “audit quality” could be further enhanced?

The IAASB shares the EC's view that a robust audit is a key contributor to financial stability, and that therefore, a commitment to continuous improvement in audit quality is of utmost importance. Audit quality, however, is a complex and multi-faceted concept. The IAASB holds strongly the view that a high level of audit quality is best supported and sustained if preparers, audit committees, auditors, standard-setters, professional bodies, and regulators *collectively* work together towards achieving this common goal. This requires frank and open dialogue between these groups towards identifying challenges, recognizing best practices, and formulating effective solutions.

One – but not the only – important element to audit quality is the presence of high quality auditing standards. Revisions made to the ISAs as part of the IAASB's Clarity Project feature enhanced requirements and guidance that are aimed at strengthening practice, resulting in broad recognition of the clarified ISAs as a benchmark for audit quality globally. Stakeholders who responded to the IAASB's strategy survey¹ cited the importance of the adoption and effective implementation of the clarified ISAs at the national level to the quality of audits globally. The IAASB has been active in promoting effective implementation efforts at the national level. It also continues to actively monitor early implementation experiences of the clarified ISAs nationally across entities of varying sizes to gather information for identifying areas for continuous improvements to the standards.

Core to the IAASB's work program are initiatives aimed at supporting and enhancing audit quality. Currently, the IAASB has a project focused directly on the concept of audit quality. In the next few months the IAASB plans to release a thought piece aimed at raising awareness of the concept and its main components. The IAASB hopes this initiative will encourage a broader discussion about audit quality.

Intricately linked to the topic of audit quality is auditor reporting. The IAASB has a project on the topic aimed at gaining an understanding of user's perceptions of the auditor's report. The aim of this project is to help inform the IAASB on whether the standard auditor's report needs to be improved and, if so, how. Matters that the IAASB intends to explore include how users view the current scope of the audit, what information they desire and how the auditor's report may address these needs.

¹ An online survey was launched in April 2010 as the first phase of the IAASB's 18-month consultation process on its 2012–2014 strategy and work program.

The IAASB has also embarked on a project on auditing financial statement disclosures. It is anticipated that a Discussion Paper will be released in the coming few months which will discuss the challenges faced in determining the meaningfulness, completeness, adequacy, and understandability of disclosures, and explore the use of judgment in applying the concept of materiality to them. The IAASB is also cognizant of the linkage between audit quality and developments in corporate reporting that extend beyond the audited financial statements. The IAASB's work in revising ISA 720² is aimed at addressing the auditor's responsibilities relating to information (other than the audited financial statements and the auditor's report) in documents containing or accompanying the audited financial statements and the auditor's report. An exposure draft is anticipated to be released during 2011.

Engaging in dialogue with key stakeholders has always formed an indispensable part of the IAASB's work program. The IAASB would like to take this opportunity to acknowledge the EC's continuous support and contribution to the on-going work of the IAASB through active input at meetings of the IAASB Consultative Advisory Group (IAASB CAG) and participation as observer with speaking rights at IAASB meetings.

In addition to active dialogue with the EC, the IAASB has directed much effort at liaising with the international regulatory community, including the International Forum of Independent Audit Regulators (IFIAR) and the International Organization of Securities Commissions (IOSCO). Equally, the IAASB has continued to strengthen its relationships with the International Accounting Standards Board (IASB), the Financial Stability Board (FSB), the Basel Committee on Banking Supervision, the U.S. Public Company Accounting Oversight Board (PCAOB) and other national standard setters (NSS), and member bodies of the International Federation of Accountants (IFAC). Further, through collaboration with the International Organization of Supreme Audit Institutions (INTOSAI), the clarity ISAs feature in the public sector context, where audit quality in the governmental context has relevance to capital markets and financial stability. The IAASB continues to hold the view that engaging in effective outreach activities, including discussions on issues relevant to audit quality, is core to its work.

SECTION 2: ROLE OF THE AUDITOR

Q4. Do you believe that audits should provide comfort on the financial health of companies? Are audits fit for such a purpose?

Audits performed in accordance with the clarified ISAs provide reasonable assurance regarding the appropriateness of management's use of the going concern assumption in the preparation and presentation of the financial statements. The auditor designs audit procedures so as to be able to conclude whether there is a material uncertainty about the entity's ability to continue as a going concern.

The IAASB welcomes a broadly based discussion on the appropriateness of expanding the mandate of the external audit to directly address the financial health of companies. Such a discussion, however, requires input from preparers, users, regulators, standard setters,

² ISA 720, *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements*

professional bodies, and the audit profession to ensure careful and due consideration is given to matters such as implications on the timeliness and cost of information. The IAASB notes that such discussions also necessarily require considerations of the need for development of a reporting framework, including suitable criteria against which the subject matter would be measured and evaluated. Without such a framework, any form of assurance reporting would be inconsistent and accordingly not in the public interest.

Q5. To bridge the expectation gap and in order to clarify the role of audits, should the audit methodology employed be better explained to users?

Yes. The IAASB agrees that taking steps to narrow the expectation gap and further enhance stakeholders' understanding of the role of the auditor is of continuing importance. The current IAASB work program features a number of initiatives to this end. In the next few months, the IAASB is planning, as part of its Audit Quality project, to issue a thought piece aimed at raising awareness of the concept of audit quality. Among other matters, the thought piece will highlight the importance of the audit process, and the firms' audit methodologies, to audit quality. The IAASB is also seeking insights on user perceptions of the auditor's report, including what additional information they believe might help enhance its communicative value. The IAASB's work program also includes the consideration of a communication to users of financial statements and the related auditors' reports on the meaning of an audit.

The IAASB believes that ultimately, achieving clarity on the role of audits is necessarily a collaborative effort between auditors and the relevant stakeholders, including in particular the audit committee. In this spirit, clarified ISA 260³ requires auditors to communicate an overview of the planned scope and timing of the audit with those charged with governance to promote better understanding of the auditor's work and encourage mutual discussion. It also requires the auditor to evaluate whether the two-way communication between the auditor and those charged with governance has been adequate for the purposes of the audit.

Q6. Should "professional skepticism" be reinforced? How could this be achieved?

Yes. The IAASB shares the EC's view that professional skepticism is a fundamental tenet of any audit. Accordingly, professional skepticism is a central theme that underlies the suite of clarified ISAs. In particular, clarified ISA 200⁴ now explicitly requires auditors to maintain professional skepticism throughout the planning and performance of the audit. The ISA explains that this is necessary in order, for example, to reduce the risks of overlooking unusual circumstances, over generalizing when drawing conclusions from audit observations, and using inappropriate assumptions in determining the nature, timing and extent of the audit procedures and evaluating the results thereof. ISA 200 also contains guidance to assist in appropriately applying this concept. Specifically, it explains that the auditor is alert for matters such as:

- Audit evidence that contradicts other audit evidence obtained.

³ ISA 260, *Communication with Those Charged with Governance*

⁴ ISA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing*, paragraph 15

- Information that brings into question the reliability of documents and responses to inquiries to be used as audit evidence.
- Conditions that may indicate possible fraud.
- Circumstances that suggest the need for audit procedures in addition to those required by the ISAs.

The concept of professional skepticism is further reinforced in other clarified ISAs where it is of particular importance. Examples include the ISAs dealing with fraud in an audit of financial statement,⁵ laws and regulations governing the audited entity,⁶ and related parties.⁷ As important aspects of audit quality, the IAASB’s work program will continue to be focused on the concepts of professional judgement and professional scepticism.

Finally, it is noted that while it is imperative that the auditor maintains professional scepticism throughout the audit, the same may be said of the audit committee in view of the role it plays in the governance of an entity.

Q7. Should the negative perception attached to qualifications in audit reports be reconsidered? If so, how?

The approach on which the clarified ISAs are formulated focuses on “getting the financial statements right” before their issuance. This necessarily involves an iterative process of debate and challenge involving management, those charged with governance (typically the audit committee) and the auditor. Based on the audit evidence obtained, in accordance with the clarified ISAs, the auditor may issue an unmodified opinion or a modified opinion (qualified opinion, adverse opinion or disclaimer of opinion).⁸ Accordingly, the negative perception attaching to qualifications in auditor reports, in one sense, reinforces the need to resolve differences and correct identified material misstatements before the financial statements are finalised.

On the other hand, the IAASB is aware that, without an appreciation of the significant audit effort and dialogue to resolve issues before the financial statements are released, the “binary” opinion in the auditor’s report may appear relatively perfunctory. Therefore, it may be worth considering whether the informational value of the auditor’s report may be further enhanced with greater transparency, achieved through the inclusion of more information regarding the audit and the auditor’s findings in the auditor’s report. However, there would need to be greater acceptance of qualifications in the auditor’s report, which may seem counter-intuitive in those jurisdictions where securities regulators do not permit listed entities to file financial statements with a modified audit report. In contrast, qualifications and disclaimers are relatively more frequently used in the audit reports of public sector entities. Further research on such engagements may offer useful insights to the EC’s considerations in this regard.

⁵ ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

⁶ ISA 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*

⁷ ISA 550, *Related Parties*

⁸ The auditor may also elect to include an Emphasis of Matter paragraph or an Other Matter paragraph to draw users’ attention to matters of fundamental importance to their understanding of the financial statements or of the auditor’s responsibilities or the auditor’s report.

The IAASB welcomes broader debate on how the value of the audit process may be better conveyed.

Q8. What additional information should be provided to external stakeholders and how?

Through its project on auditor reporting, the IAASB is seeking insights on user perceptions of the auditor's report prepared in accordance with ISA 700⁹. The project is at an early stage and as such, it is premature to speculate about likely outcomes. Nevertheless, there have been calls from investors for additional information to be disclosed in the auditor's report to further elaborate the work of the auditor, for example, through highlighting judgments made in relation to areas of financial reporting risks. As it progresses its auditor reporting project, the IAASB intends to explore further, for example, the practice in France whereby the auditor's report includes a so-called 'justification of assessments,' and consider the additional information conventionally provided in public sector audit reports.

Q9. Is there adequate and regular dialogue between the external auditors, internal auditors and the Audit Committee? If not, how can this communication be improved?

The IAASB shares the EC's view that it is critical to ensure regular and mutual dialogue between the external auditor, the internal auditor and the audit committee. During the Clarity Project, emphasis was placed on reinforcing this message in the suite of clarified ISAs in recognition of its effect on audit quality. Although a theme that permeates across all the ISAs, the following standards address specifically the auditor's responsibilities relating to communication with those charged with governance and the internal auditors:

- ISA 260, which requires the auditor to communicate clearly with those charged with governance the responsibilities of the auditor in relation to the financial statement audit including an overview of the planned scope and timing of the audit, significant findings from the audit, the auditor's maintenance of independence, and to obtain from those charged with governance information relevant to the audit. The ISA also requires the auditor to communicate views to those charged with governance about significant qualitative aspects of the entity's accounting practices, including accounting policies, accounting estimates and financial statement disclosures and other matters that, in the auditor's professional judgment, are significant to the oversight of the financial reporting process.
- ISA 265,¹⁰ which requires the auditor to communicate appropriately with those charged with governance and management deficiencies in internal control that the auditor has identified during the audit and that, in the auditor's professional judgment, are of sufficient importance to merit their respective attentions.

⁹ ISA 700, *Forming An Opinion and Reporting on Financial Statements*

¹⁰ ISA 265, *Communicating Deficiencies in Internal Control to Those Charged with Governance and Management*

- ISA 610,¹¹ which requires the auditor in determining whether the work of the internal auditors is likely to be adequate for purposes of the audit, to evaluate whether there is likely to be effective communication between the internal auditors and the external auditor.

The IAASB is currently seeking public input on its proposals for revising ISA 610.¹² These proposals aim to achieve more effective interaction between the external auditor and the internal auditor by encouraging the external auditor to proactively engage with the internal audit function throughout the course of the audit to leverage, as appropriate, on the internal auditor's understanding of the entity and its environment.¹³

Q10. Do you think auditors should play a role in ensuring the reliability of the information companies are reporting in the field of CSR?

Yes. The IAASB is alert to the increasing demand for standards relating to assurance in broader areas, such as entities' social and environmental reporting responsibilities. To date, the IAASB has responded by undertaking a project to develop a new International Standard on Assurance Engagements (ISAE) that addresses professional accountants' responsibilities with respect to assurance engagements on a Greenhouse Gas Statement. An exposure draft of the proposed ISAE is expected to be released in the next few months.

The topic of sustainability also surfaced in the responses to the IAASB's strategy survey.¹⁴ Stakeholders suggested the IAASB evaluate the appropriateness of developing a new ISAE addressing assurance on sustainability reporting. The IAASB intends to invite respondents to share their views in a more formal manner, in the upcoming Strategy Consultation Paper – through a specific question on whether and, if so, how a potential project on sustainability should be prioritized in the IAASB's forward strategy. The IAASB is also monitoring the growing interest in an integrated reporting framework and the calls for assurance on the elements within it.

More broadly, one cannot anticipate where users' demand for assurance will arise. Accordingly, the IAASB believes that a robust framework for the provision of a wide range of assurance services is critical. The IAASB's current work to revise ISAE 3000¹⁵ is aimed at achieving this outcome.

¹¹ ISA 610, *Using the Work of Internal Auditors*

¹² The exposure draft of the proposed revised ISA 610 was issued in July 2010 and is located at <http://www.ifac.org/Guidance/EXD-Details.php?EDID=0141>

¹³ The IAASB proposes a requirement in ISA 315 for the external auditor to make inquiries of the internal audit function about information of which they are aware that is relevant to identifying and assessing the risks of material misstatement due to fraud or error. This is aimed at enabling the external auditor to more fully leverage the internal auditor's understanding of the entity and its environment. This is distinct from using the work of internal auditors which is directly addressed in ISA 610.

¹⁴ See footnote 1.

¹⁵ ISAE 3000, *Assurance Engagements Other than Audits or Reviews of Historical Financial Information*

Q11. Should there be more regular communication by the auditor to stakeholders? Also, should the time gap between the year and the date of the audit opinion be reduced?

The IAASB believes that two-way dialogue between auditors and those charged with governance and management is essential to ensuring a high level of audit quality. This message is reinforced throughout the suite of clarified ISAs. The IAASB welcomes broader debate on whether there should be more regular communication between the auditor and other stakeholders, if so in what form, and how the benefits weigh in relation to costs. Notably it is the quality and communicative value of the communications that is important, not necessarily the frequency of the communications. Of equal importance is dialogue between the auditors and regulatory authorities. It is noted that the extent and nature of the auditors' communications with regulators (for example, bank regulators) may, in some cases, be governed by national laws and regulations rather than being stipulated in the auditing standards.

Regarding the question of whether the time gap between the year and the date of the audit opinion should be reduced, the IAASB believes it is important to bear in mind the need to safeguard audit quality. Adequate time must be allowed for the auditor to perform the audit procedures necessary in the circumstances so as to arrive at the appropriate audit opinion on the financial statements. In this context, ISA 200¹⁶ indicates that the inherent limitation of audit arise from the need for the audit to be performed within a reasonable period of time and at a reasonable cost, in addition to the nature of financial reporting and audit procedures.

Q12. What other measures could be envisaged to enhance the value of audits?

The IAASB welcomes broader debate on whether, and if so what, other measures could be taken to further enhance the value of audits keeping in mind that the scope of an audit is often defined by local laws or regulations. Alongside such considerations, it is also important to consider first whether additional steps should be taken to help further educate users about the value of audits as they are designed today. Only with a full understanding of the value of today's audits can such debates work towards constructive enhancements. The IAASB's work program therefore includes the consideration of a communication to users of financial statements and the related auditors' reports on the meaning of an audit. Importantly, the IAASB is of the view that enhancement of users' understanding of the value of today's audits is an on-going process, and is best supported and sustained if preparers, audit committees, auditors, standard-setters, professional bodies, and regulators *collectively* work together towards achieving this common goal.

The GP indicated that, "the Commission wishes to explore the case for 'going back to basics' with a strong focus on substantive verification of the balance sheet and less reliance on compliance and systems work." The IAASB considered the role of substantive procedures in its project that resulted in the issuance of its audit risk ISAs in 2003.¹⁷ The IAASB's deliberations benefited from research undertaken in collaboration by Canada, the United Kingdom (UK) and

¹⁶ ISA 200, paragraph A45

¹⁷ ISA 300, *Planning an Audit of Financial Statements*, ISA 315, *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment*, ISA 330, *The Auditor's Responses to Assessed Risks* and ISA 500, *Audit Evidence*

the United States (US) which highlighted the benefits of a business risk approach to auditing.¹⁸ As opposed to mandating a full ‘business risk’ approach in the ISAs, the IAASB sought to provide a framework for auditors to enable them to best determine the appropriate balance between controls and substantive testing in the circumstances of the audit. The following considerations are relevant:

- The clarified ISAs do not deter auditors from performing substantive testing. They guide the auditor, when designing such procedures, to focus on areas in the audit that are considered to be of higher risk.¹⁹ Indeed, the auditor is *specifically required* to perform substantive procedures to respond to risks that are identified by the auditor to be significant.²⁰ Depending on the circumstances of the audit, in some cases, more substantive work may be performed than was previously the case.

Notably, while the consideration of risk is inevitably judgmental, some consideration of it will always be needed, even in a fully substantive audit, in order to determine sample sizes for the procedures to be performed.

- Consideration of a ‘back to basics’ approach should be conducted in the view of current business realities. Notably, large companies with complex transactions do not naturally lend themselves to an audit that is focused on substantive testing. Indeed, the volume of transactions in many large businesses and the way they are processed (by complex computer systems) raise the challenge of the feasibility and effectiveness of audit approaches that do not rely, to some degree, on internal controls and where present, the internal audit function.
- It is usual for reporting entities, particularly those of a larger size, to issue their financial statements soon after the financial year end. To accommodate such timetables, the audit approach will often necessarily involve interim audits and reliance on internal controls. Greater focus on substantive procedures in audit engagements will likely move the work load to after the year end which will have implications for the timely issuance of the auditor's report and consequently, the question raised in the GP on whether the auditor's report may be “too little too late.”

Finally, the GP refers to compliance and systems work as “tasks that should ... in the main be covered by internal audit.” It is not always the case that an internal audit function is present. Where present, internal auditors, unlike external auditors, are not independent of the entity and accordingly, work of the internal auditors, where relevant to the external audit, cannot be used as part of the external auditor's audit evidence without due consideration. The auditor's responsibilities when determining whether the work of the internal audit function can be used

¹⁸ The Research Paper, “Developments in the audit methodologies of large accounting firms” by Lemon, Tatum and Turley explored the evolution of audit methodologies and the case for ‘business risk’ auditing. It identified the benefits of a business risk approach as lying in audit effectiveness, audit efficiency, addressing technological change and the needs of those charged with governance.

¹⁹ For example, ISA 240 and ISA 330

²⁰ For example, paragraph 18 of ISA 330 requires the auditor to perform substantive procedures for each material class of transactions, account balance and disclosure irrespective of the assessed risks of material misstatement, and paragraph 21 of ISA 330 requires substantive testing for those assertions which are assessed as involving ‘significant risks’, and, as a failsafe.

for purposes of the audit is set out in ISA 610. Further research in this regard would be particularly useful to the EC's forward consideration.

SECTION 2.2: INTERNATIONAL STANDARDS ON AUDITING

Q13. What are your views on the introduction of ISAs in the European Union (EU)?

Indications from early adopters regarding their experiences in implementing the clarified standards²¹ are encouraging. Information obtained through the IAASB's ISA Implementation Monitoring project²² and liaison efforts reveal that most adopters welcome the changes introduced in the clarified ISAs and share the reflection in the GP that, "the clarified ISAs might be seen as more robust."²³ The IAASB would like to take this opportunity to acknowledge the EC's contribution to the IAASB's Clarity Project.

As noted in the GP, the EC's consultation in 2009 indicated "the overall support of EU stakeholders to an adoption of the ISAs at the European Union level," citing that "common standards in the EU under the form of the clarified [standards] would contribute to harmonized and qualitative audits." Besides the matters pointed out in the GP,²⁴ the following areas have also been strengthened in the clarified standards:

- Maintenance of professional skepticism throughout the planning and performance of the audit.
- Materiality in planning and performing an audit, and its use in evaluating misstatements.
- Risk assessment, and the gathering and evaluation of audit evidence, in relation to an entity's use of a third party service organization.
- Audit evidence considerations in relation to external confirmations and written representations (including implications for engagement acceptance considerations).
- Using the work of others, in relation to audits of group financial statements, including the work of component auditors and work of an auditor's expert.
- Communication with those charged with governance.
- Communicating deficiencies in internal control.
- Auditor reporting, in relation to modifications to the auditor's opinion and Emphasis of Matter paragraphs in the auditor's report.
- Audit and reporting considerations in the context of special engagements.

²¹ The clarified ISAs and ISQC 1, *Quality Control for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements*

²² Refer to response provided to Q1 above.

²³ More information on these findings can be found are detailed in the progress report—*Implementation of the Clarified International Standards on Auditing (ISAs)*—released by the IAASB in November 2010 on the first phase of its project to monitor the implementation of its clarified ISAs. The report is located at <http://web.ifac.org/clarity-center/isa-implementation-monitoring>

²⁴ Areas cited include fair value accounting, reporting of estimates and sensitivities and transaction with related parties.

These improvements are examples of the IAASB's focus on proactively responding to calls from stakeholders regarding specific areas in the ISAs that require improvements.

The EC's June 2009 consultation on the adoption of clarified ISAs in the EU provided a platform for broad discussion of the governance and accountability of standard setting bodies, which the current GP proposes to further develop. The IAASB welcomes the indication in the consultation paper that the Commission services consider, "the current governance of the IAASB has matured to a stage where it may be justifiable to adopt ISAs in the EU" and the reasons provided in justification of this conclusion.²⁵ The November 2010 final report published by the Monitoring Group on the outcomes of the review of IFAC Reforms (Reforms), while noting certain proposals for further enhancement, indicates that virtually all of the changes called for by the Reforms have been implemented.

Q14. Should ISAs be made legally binding throughout the EU? If so, should a similar endorsement approach be chosen to the one existing for the endorsement of International Financial Reporting Standards (IFRS)?

The IAASB welcomes the EC's continuing commitment to consider the introduction of the clarified ISAs in the EU and its broader consideration in the context of the GP regarding when and how to do so. This aligns with the EC's mandate to pursue the creation of a single market in the EU and in doing so to ensure, among other things, that the marketplace is served by a contemporary framework of auditing standards.

Regarding the adoption of the clarified ISAs at the national level, the IAASB continues to hear of positive developments globally. A number of countries including Australia, Brazil, Canada, Dubai, Hong Kong, Malaysia, Singapore, South Africa and New Zealand have adopted the clarified ISA in line with the IAASB's effective date. Other countries including China, India, Japan and Mexico will do so in 2011/2012. In Europe, a majority of individual EU Member States have either already adopted the clarified ISAs or are moving ahead with adoption plans.²⁶ The IAASB is committed to continue to engage in dialogue with individual EU countries, in particular those that have yet to fully adopt the clarified ISAs. In the United States (U.S.), standards issued by the Auditing Standards Board (ASB) of the American Institute of Certified Public Accountants (AICPA) applicable for private company audits in the U.S. are generally based on the clarified ISAs.²⁷

With respect to financial audits in the public sector, INTOSAI recently endorsed the use of International Standards for Supreme Audit Institutions (ISSAIs) by Supreme Audit Institutions.

²⁵ See Section 3 "Governance and Due Process" of the EC's publication, *Consultation on the Adoption of International Standards on Auditing*,

²⁶ At the time of writing this response, at least 17 EU Member States have set out their initiatives to adopt the ISAs within their jurisdictions, noted in the GP as a majority of EU Member States, and the clarified ISAs are also being applied by the major networks of audit firms.

²⁷ As indicated in the AICPA ASB'S publication, *International Convergence Plan* (February 2008). The publication can be accessed at:
http://www.aicpa.org/InterestAreas/AccountingAndAuditing/Resources/AudAttest/AudAttestDueProc/DownloadableDocuments/ASB_Convergence_Plan.pdf

In so doing, it encouraged Supreme Audit Institutions to adopt and implement the ISSAIs in their respective jurisdictions. Each ISSAI is made up of an ISA and a Practice Note.

Q15. Should ISAs be further adapted to meet the needs of small- and medium-sized entities (SMEs) and small and medium practices (SMPs)?

It is in the public interest that users of audited financial statements have confidence that audits of entities – whether small or large, simple or complex – have been performed to the same high standards. In clarifying the ISAs the IAASB paid particular attention to that overarching objective. At the same time, however, the IAASB was alert to the needs of those who audit SMEs, which are the engine of growth in every national economy and which are particularly sensitive to standards-overload. Accordingly, in developing its clarified ISAs, the IAASB was mindful of the importance of setting *principle-based* standards that are capable of being applied in a manner proportionate with the size and complexity of an entity.

The clarified ISAs include useful guidance that assists the auditor in understanding or applying specific requirements in the ISAs in the context of an SME audit. In particular, it highlights aspects of the ISAs that are specially geared towards facilitating SME audits, such as guidance labeled as “Consideration Specific to Smaller Entities.” The IAASB Staff Questions & Answers publication, *Applying ISAs Proportionately with the Size and Complexity of an Entity*, explains this important consideration in greater detail.²⁸

The IAASB’s primary focus is, and will remain, on standard setting, IFAC’s SMP Committee has worked to provide useful implementation support for SMPs. In particular, the SMP Committee recently released the second edition of its *Guide to Using International Standards on Auditing in the Audits of Small- and Medium-Sized Entities* (ISA Guide) based on the clarified ISAs.

The IAASB recognizes that some EU Member States and similarly, some other jurisdictions around the world, have provided audit exemptions for smaller businesses. Despite this, lenders and regulators frequently demand some form of assurance on the financial statements of such entities. For this purpose, the IAASB has undertaken to revise its standard on review engagements. It anticipates that an exposure draft of the revised International Standard on Review Engagement (ISRE) 2400²⁹ will be released in the next few months.

Notwithstanding these actions, ensuring the applicability of the ISAs to SME audits will continue to be a core focus of the IAASB. In 2010 as part of its ISA implementation monitoring project, the IAASB initiated a survey of SMPs in a number of countries (including a number of European countries) that have adopted the ISAs, to obtain information about their experiences of using the clarified ISAs.

²⁸ The publication is located at <http://web.ifac.org/media/publications/e/applying-isas-proportionate/applying-isas-proportionate.pdf>

²⁹ ISRE 2400, *Engagements to Review Financial Statements*

SECTION 3: GOVERNANCE AND INDEPENDENCE OF AUDIT FIRMS

Q24. Do you support the suggestions regarding Group Auditors? Do you have any further ideas on the matter?

Few would debate the growing prominence of group audits in today's increasingly borderless marketplace. The functioning of capital markets is, among other things, contingent on the quality of these cross-border audits. Accordingly, national regulators have been focused on ensuring quality group audits. As a matter of course, the spotlight is on ascertaining the rigor and consistency of national auditing standards that address such audits and the role of the group auditor.

The IAASB shares the EC's views that, "group auditors should be involved in and have a clear overview of the complete audit process to be able to support and defend the group audit opinion." Indeed, this was the IAASB's objective when formulating the clarified ISA 600.³⁰ ISA 600³¹ emphasizes that regardless of the involvement of component auditors in the circumstances of the audit engagement, the group engagement partner or the group engagement partner's firm is responsible for the group audit opinion.

The assumption underlying the ISA is therefore that the group auditor has available access to the component auditor.³² Some firms have raised with the IAASB through its ISA Implementation Monitoring project³³ that it is not always the case that auditors have unrestricted access to the component auditor, although such cases are expected to be relatively rare. Potential impediments, for example legal or national restrictions on access by the group auditor to the component auditor, may be present. The IAASB continues to monitor developments in this regard by encouraging dialogue among adopters and actively engaging with them to obtain feedback. The IAASB is also active in its support for, and participation in, initiatives aimed at promoting the exchanging of views on practical solutions to challenges unique to auditing in a group environment.³⁴ The IAASB encourages the EC to give due consideration to this matter as it progresses consultation on the GP.

SECTION 4: SUPERVISION

Q25. Which measures should be envisaged to improve further the integration and cooperation on audit firm supervision at EU level?

A common set of auditing and quality control standards is essential to an integrated and cooperative system of audit supervision. The IAASB believes in the importance of actively engaging with audit supervisory bodies such as IFIAR and the European Group of Auditors'

³⁰ ISA 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*

³¹ ISA 600, paragraphs 11 and A8–A9

³² ISA 600, paragraph A11

³³ Refer to response provided to Q1 above.

³⁴ For example, the Forum of Firms Symposium held in September 2010 aimed at promoting the exchanging of views on challenges unique to auditing in a group environment. The related press release is located at <http://press.ifac.org/news/2010/10/forum-of-firms-focuses-on-practical-application-of-group-audit-standard>

Oversight Bodies (EGAOB) and other key stakeholders with immediate responsibilities for audit quality.

Through its ISA Implementation Monitoring Task Force, the IAASB has been actively liaising with stakeholders including IFIAR to gather information to help it evaluate the effective and consistent implementation of the clarified ISAs. Liaison relationships have also been established with some national audit inspection groups. The IAASB would be pleased to explore with the EC whether a similar linkage should be established with European inspection groups perhaps for example, through the auspices of the EGAOB. Such input is important to the IAASB's continual efforts to evaluate the robustness of its ISAs.

SECTION 6: CREATION OF A EUROPEAN MARKET

Q33. What in your view is the best manner to enhance cross border mobility of audit professionals?

The IAASB notes that a common set of auditing standards at the national level is one element that facilitates increased mobility of audit professional across jurisdictions. There are of course many other factors that need to be considered that are beyond the mandate of the IAASB.

SECTION 7: SIMPLIFICATION: SMALL- AND MEDIUM- SIZED ENTERPRISES AND PRACTITIONERS

Q35. Would you favor a lower level of service than an audit, a so called "limited audit" or "statutory review" for the financial statements of SMEs instead of a statutory audit? Should such a service be conditional depending on whether a suitably qualified (internal or external) accountant preparing the accounts?

The IAASB believes that "an audit is an audit." It is therefore committed to issuing principle-based ISAs that can be applied in a manner proportionate with the size and complexity of an entity. The IAASB, however, recognizes that there is market demand for services other than the audit that are capable of meeting the unique needs of SMEs and of the users of their financial information. In addition, in some countries, including some within the EU, regulators have introduced exemptions from audit for entities based on their type, size or other characteristics. The IAASB believes that appropriate standards should be in place to support these services. Of equal importance is that stakeholders understand the distinguishing features between these services. These have been particular considerations of the Board as it progresses its standard setting priorities.

In response to these developments that the IAASB is undertaking a project to revise its international standards for review and compilation³⁵ engagements. A first milestone was reached in this project with the publication in October 2010 of an exposure draft of the proposed

³⁵ International Standard on Related Services (ISRS) 4410, *Engagements to Compile Financial Statements*

revised ISRS 4410.³⁶ Further progress is expected with the anticipated approval by the IAASB in December 2010 of an exposure draft of the proposed revised ISRE 2400.³⁷

Q37. Should a “limited audit” or “statutory review” be accompanied by less burdensome internal quality control rules and oversight by supervisors? Could you suggest examples of how this could be done in practice?

ISQC 1, which deals with a firm’s responsibilities for its system of quality control for audits and reviews of financial statements, and other assurance and related services engagements, reflects this objective. Consistent with the IAASB’s commitment to issuing standards that are capable of being applied in a manner proportionate with the size and complexity of an entity, ISQC 1 has been developed based on principles and includes specific guidance designed to enable the application of the standard in the SMP context in an efficient and effective manner.

Regardless of the nature or extent of required quality control policies and procedures, achieving the objectives of engagement standards (whether the ISAs or standards for engagements other than the audit) rests on one important factor – the people who actually perform the engagement. This is at the heart of ISQC 1 through its focus on leadership responsibilities for quality with firms, ethical requirements, human resources, engagement performance, and monitoring. It is the practitioner’s understanding and implementation of the standards that will make a real difference in the quality of the outcome of any audit. Further, many of the requirements in professional standards often rely on professional judgment. Without the exercise of appropriate and sound professional judgment, achieving a high-quality audit is simply not possible.

Accordingly, while a consideration of the proportionality of quality control standards is important, ultimately what will achieve a successful engagement is the quality of the auditors themselves. IFAC’s SMP Committee recently released in July 2010 the second edition of its *Guide to Quality Control for Small- and Medium-Sized Practices*³⁸ that is based on the clarified ISQC 1, and the revised and redrafted *Code of Ethics for Professional Accountants* of the International Ethics Standards Board for Accountants (IESBA). Guidance have also been made available at the national level to assist SMPs to implement the standard effectively and efficiently, and not become overly burdensome.

³⁶ Proposed ISRS 4410 (Revised), *Compilation Engagements*

³⁷ ISRE 2400, *Engagements to Review Financial Statements*

³⁸ The publication is located at <http://web.ifac.org/publications/small-and-medium-practices-committee>