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December 8, 2010

Michel Barnier
European Commissioner for Internal Market and Services
European Commission
BERL 10/034
B-1049 Brussels
Belgium
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 Federation of Accountants (IFAC) has carefully considered the questions posed in the European Commission's Green Paper, *Audit Policy: Lessons from the Crisis* (the Green Paper), and welcomes the opportunity to respond to the questions raised by the Commission. IFAC's response has been developed in the context of our work as an international organization—one that recognizes that the accountancy profession, including auditors, is a public interest profession. The profession contributes to economic growth and stability across a wide range of activities—contributing to the efficient operations of capital markets and the public sector, supporting the growth of small- and medium-sized enterprises (SMEs), providing strategic and financial direction through professional accountants working within entities, protecting the interests of shareholders and the investing public, and enhancing financial stability.

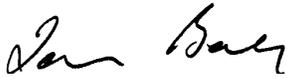
IFAC believes that the experience gained during the recent financial crisis presents a historic opportunity to improve the global financial system. Organizations must work together to reduce the risks that ultimately resulted in a widespread loss of public confidence in many elements of the financial sector. In this respect, we take very seriously the Commission's invitation to consider all matters presented in the Green Paper and urge that this exercise results in a constructive dialogue among the Commission and all relevant stakeholders.

IFAC's response represents a wide range of perspectives including those of the auditing profession, professional accountants in business, small- and medium-sized practices (SMPs), and public sector accountants. Our response also reflects insights from the different regions of the world. While our response has been prepared with input from many of our constituent member organizations (professional accountancy organizations), it does not necessarily reflect the totality of their views. In this regard, this document has been prepared to reflect IFAC's unique perspective as a global organization. Accordingly, IFAC's member organizations, both inside and outside of the European Union, may elect to provide their own responses.

It should also be noted that three of the independent standard-setting boards that operate under the auspices of IFAC and that are independently overseen by the Public Interest Oversight

Board¹—the International Auditing and Assurance Standards Board (IAASB), the International Ethics Standards Board for Accountants (IESBA), and the International Accounting Education Standards Board (IAESB) —plan to submit their own responses to questions pertaining to their mandates.

Sincerely,



Ian Ball

Chief Executive Officer

¹ For a comprehensive understanding of the shared regulatory arrangement that was established in 2005 in respect to the independent standard setting boards of IFAC, please see IFAC's Policy Position Paper #3, *International Standard Setting in the Public Interest*, December 2008.

**EUROPEAN COMMISSION'S GREEN PAPER,
AUDIT POLICY: LESSONS FROM THE CRISIS**

IFAC RESPONSE

1. Do you have general remarks on the approach and purposes of this Green Paper?

- 1.1 IFAC welcomes the Commission's approach to present the Green Paper as an opportunity to solicit feedback and gather information from stakeholders worldwide. The accountancy profession believes that every part of the economic system must be examined to learn from the financial crisis. Enhanced dialogue between regulators, policy makers and the accountancy profession, which is a core aspect of the Green Paper, is essential to maintain macro-economic stability and can help prevent future crises.
- 1.2 We present our responses in the context of several prevailing considerations:
- (a) Today, audit is a truly global service, contributing to all sectors of the economy, including the public sector. Its providers, users and markets are increasingly of a transnational scope. Therefore, any actions taken by the Commission are likely to have implications for jurisdictions outside of the European Union. The resulting action (or inaction) by such jurisdictions will be critical in determining whether the marketplace for audit will continue to grow and develop on a truly international basis. Accordingly, the perspectives of stakeholders both inside and outside of the European Union should be carefully considered.
 - (b) The SME sector is at the core of all national economies and is a key engine of future, sustainable economic growth. This makes the health of the SME sector a public interest priority and, therefore, the relevance and impact of any legislation, regulation or standards must be carefully considered to avoid placing unreasonable burdens on SMEs.
 - (c) IFAC believes that further strengthening audit as a high-quality professional service should be the key objective when evaluating proposals for further consideration. This is especially true of those questions presented in the context of exploring new approaches to market structure and dynamics. All of the approaches described in the Green Paper should be carefully assessed in terms of whether or not they would improve audit quality.
 - (d) The Company Law Directive 2006/43/EC on Statutory Audit (the Directive) has only recently been implemented in most of the European Union Member States and is still in the process of implementation in other Member States. The Commission should allow the necessary time to analyze and observe the extent to which the Directive achieves the intended outcomes. At this date, significant additional legislation, or modifications to the Directive, may not allow markets and their respective governments the time necessary to gauge such outcomes.
 - (e) There is much that the regulatory community can learn from the recent history of the auditing profession, both in terms of failures and successes. As we attempt to consider the full scope of problems and solutions, IFAC encourages the Commission to employ scientific approaches to policymaking, recognizing that the

clearest insights for the future can be gained only from a diligent, balanced, and empirical assessment of the auditing profession in past and present.

2. Do you believe that there is a need to better set out the societal role of the audit with regard to the veracity of financial statements?

- 2.1 Yes, IFAC believes that there is a need to more effectively set out the societal role of the audit. Ultimately, the value of the audit is dependent upon the quality and usefulness of the audited financial statements.
- 2.2 We believe that there is a need for greater public awareness with respect to the objectives and scope of the audit. Any lack of public awareness could result in unreasonable expectations of the audit and consequently in the widespread disregard for other factors that contribute to the core systemic risks (e.g., weak internal control processes and corporate governance arrangements) the Commission seeks to address. It is a public awareness challenge for the accountancy profession, its stakeholders, and political leaders to articulate this to the public at large.
- 2.3 The trustworthiness of financial statements is critical for all major institutions of society, including governments. In June 2010, IFAC submitted a letter to the G20 focused on the need for reforms in public sector finances as a response to sovereign debt crises in several countries. In this respect, we believe that the trustworthiness of financial statements is a public interest priority for both private and public sector institutions, and that the societal role of audit should cover both sectors.
- 2.4 We would note that in many countries the societal role of the audit has been set out through legal provisions that define, and in some countries protect, the auditor or reporting accountant by stipulating their role in safeguarding the public interest (e.g., by the use of expressions such as “representing the public interest”).

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

- 3.1 Yes, IFAC believes that the quality of most services (public or private) can be enhanced. Our mission explicitly states IFAC’s commitment to the public interest through contributing to high-quality practices by professional accountants and audit quality is fundamental to this commitment.
- 3.2 Considerations of audit quality should take into account stakeholder needs. There has to be a balance between the costs of an audit and the corresponding benefits to shareholders, investors, and other stakeholders. Audit quality is not enhanced by the performance of work where the related costs exceed the benefits. This applies similarly to services throughout the financial reporting supply chain.
- 3.3 Finally, establishing the meaning of, and uniformly assessing, audit quality is a complex endeavor. The perspectives and expectations of financial statement users and preparers, auditors, audit committees, professional accountancy organizations, regulators, and standard setters may not be fully aligned and therefore enhanced dialogue among these groups is essential to progress in this area. Furthermore, the expectations of stakeholders change over time. It is therefore important that the audit

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is continuously refined to meet stakeholder expectations. This commitment to continuous improvement is an important aspect of audit quality.

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

4.1 Within the framework of the International Standards on Audit (ISAs), the current function of the audit is to provide assurance that the financial statements of companies properly disclose their financial condition and to express any appropriate cautions regarding going concern. The nature and extent of disclosures in the financial statements are driven by management's assessment of an entity's ability to continue as a going concern, along with the disclosure requirements of the applicable financial reporting framework.²

4.2 Subject to appropriate cost/benefit considerations, enhancements to the current framework might include expanded disclosures by those charged with governance on the going concern assumptions used in the preparation of financial statements and the key risks associated with the company's longer term business model. Auditors could provide assurance on these elements in addition to their audit opinion on the historic financial statements. However, this would not replace the analyses currently done by rating agencies and equity analysts which are based on their own expectations concerning the future financial health of a company.

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

5.1 IFAC believes that measures to reduce the expectation gap are desirable, and suggests that at least two levels of research would help shed greater light on this question: 1) Determination of exactly what types of information would be useful and understandable to users and, 2) Determination of the costs (for both the preparer and auditor) that would be required to produce the information needed to supplement the existing audit opinion. Measures that would incur considerable time and expense, especially for small- and medium-sized entities and their auditors, should be avoided unless it is demonstrable that the benefits to stakeholders outweigh the costs involved.

5.2 The Commission notes several approaches to address this issue, including more concise reporting, public justification of the audit opinion, disclosure of any and all information of public interest, and increased frequency in the dissemination of such information. Some additional areas where stakeholder awareness could be enhanced might include:

- (a) A greater understanding of the role of the auditor and the implications of the auditor's work;
- (b) Enhanced disclosure about critical areas of risk which may occur in discussions between the auditor and the audit committee;

² International Auditing and Assurances Standards Board, *Audit Considerations in Respect of Going Concern in the Current Economic Environment*, January 2009
web.ifac.org/download/IAASB_Staff_Audit_Practice_Alerts_2009_01.pdf

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- (c) The criteria used by audit committees and boards for selecting an auditor;
- (d) A greater understanding of the various communications by the auditor beyond the auditor's report (e.g., more comprehensive and detailed communication to those charged with governance).

6. Should “professional skepticism” be reinforced? How could this be achieved?

- 6.1 Yes, professional skepticism should be continually reinforced. IFAC believes that professional skepticism has always been and continues to be a critical aspect of both the auditor's independence³ and of audit quality. Professional skepticism is at the very core of performing an audit in accordance with ISAs. Professional education plays a critical role in equipping the auditor with skills for exercising professional skepticism. International Education Standards (IESs), which are developed by the International Accounting Education Standards Board (IAESB), identify requirements for professional skills, general education, and competence for audit professionals. These standards are developed within an international context and we urge the Commission to support them as part of accounting educational training curricula, in order to contribute to the continual reinforcement of professional skepticism.⁴
- 6.2 IFAC suggests that further research be undertaken to empirically assess the extent to which there is a lack of professional skepticism. In addition, more research should be undertaken to explore the behavioral elements that may compromise professional skepticism: for example, factors that lead individuals to compromise their professional skepticism despite stringent regulations, related oversight and enforcement regimes. Research in this area might well draw on the assessments of audit regulators in a range of countries, including, importantly, those where the financial crisis had relatively less impact.

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

- 7.1 Yes, IFAC believes that the factors leading to the issuance of qualifications in the audit report should be better explained in order to reduce any inappropriately negative perceptions. Assembling the financial statements and auditor's report is an interrogative process designed to form an opinion on whether the financial statements are fairly stated. This involves professional skepticism and often challenging inquiries from the auditor, and is frequently perceived as reflecting tension – but this may or may not be the case. The auditor may choose to issue a qualified opinion, adverse opinion, or disclaimer of opinion; these are, by design, intended to alert the user of an issue(s). However, a greater understanding of the value of audit, the methodologies applied, and qualifications may enable the reader to form an appropriate judgment of the significance of a specific qualified opinion.

³ The International Ethics Standards Board for Accountants, *The Code of Ethics for Professional Accountants* (2009), Section 290.6 includes the concept of professional skepticism as an integral component of independence.

⁴ For further information, please see the International Accounting Education Standards Board's (IAESB) *Handbook of International Education Pronouncements*, International Education Standards #3 and #8, 2010.

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7.2 In addressing this issue certain regulatory barriers require consideration. For example, in some jurisdictions securities regulators require unmodified reports as a prerequisite for the publication of financial statements of listed corporate entities. We suggest research should also be undertaken into the effectiveness of audit reports for public sector entities, where the occurrence of qualifications and disclaimers is relatively more frequent.

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

8.1 IFAC welcomes the dialogue regarding communications between auditors and stakeholders as this can contribute to the resolution of some matters raised in questions #2 and #3. IFAC believes that additional requirements should generally be restricted to listed companies and other public interest entities, since often SMEs have a limited number of stakeholders that need or want to have direct access to such additional information.

8.2 IFAC supports the work currently undertaken by the IAASB, which is exploring user perceptions of the standard auditor's report prepared in accordance with ISA 700.⁵ We hope this research will shed greater light on potential improvements to the auditor's report as well as additional information that might be provided regarding the work of the auditor. The responses that the Commission receives may also be useful in this context. We would be pleased if the Commission would participate in global research that might lead to a common global solution.

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

9.1 Yes, IFAC believes that in most cases there is regular and adequate dialogue among these groups. IFAC would emphasize the importance of applying professional standards in this area and notes that ISAs 260, 265 and 610 provide a robust basis for auditor communications. However, IFAC also believes that potential avenues for enhanced dialogue warrant exploration. This would include the exploration of regulatory and corporate governance practices that would facilitate such dialogue, as well as more frequent required *in camera* (executive) sessions between the audit committee and auditors. IFAC cautions that the need for formal corporate governance practices will likely differ between public interest entities and SMEs. Many SMEs are owner-managed and there is often no difference between those charged with management and those charged with governance. In addition, regulated corporate governance practices could have an excessive impact on SMEs (please refer to IFAC's response to question #8).

⁵ The International Auditing and Assurance Standards Board, ISA 700, *Forming An Opinion and Reporting on Financial Statements*

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

- 10.1 Yes, IFAC believes assurance beyond the historical financial statements warrants consideration and we support the notion that auditors should play a leading role in ensuring the reliability of the information companies are reporting in the field of CSR.
- 10.2 Ultimately, there is a public interest value in assurance of information that is of importance to investors and other stakeholders. Therefore, IFAC supports the work currently undertaken by the IAASB to establish a new International Standard on Assurance Engagements (ISAE) that addresses professional accountants' responsibilities with respect to assurance engagements on a Greenhouse Gas Statement. The IAASB is also revising ISAE 3000 on *Assurance Engagements Other Than Audits or Reviews of Historical Financial Information*.
- 10.3 These important developments will assist auditors in expanding the scope of their audits to cover CSR reporting. In providing this assurance, accountancy firms will need to maintain their objectivity and their independence. The involvement of an independent third party assurance provider can be the best way to achieve credibility in CSR (or sustainability) reporting. The standards in respect of assurance of financial reporting, such as standards related to independence and appropriate skills, are equally important for CSR reporting. Independence requirements are provided for in the *IESBA Code of Ethics for Professional Accountants*. Additionally, assurance providers in the CSR reporting space should also be demonstrably competent in the non-financial areas of performance that they might seek to audit.
- 10.4 It should also be noted that the potential scope of assurance provided in relation to CSR reporting can be considered in various dimensions, partly determined by what an organization wishes to gain from the review and assurance process. The scope of the assurance process can be on various levels, such as assessing the accuracy and completeness of data, the appropriateness of data-collection and performance management systems, materiality, and compliance.
- 10.5 The international community has also taken a significant step to establish an integrated reporting framework. IFAC fully supports the International Integrated Reporting Committee (IIRC), launched in August 2010, to create a globally accepted framework for integrated reporting: a framework which will bring together financial, environmental, social and governance information in a clear, concise, consistent and comparable format. This initiative includes regulators, standard setters, preparers and users of financial statements and other stakeholders.

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

- 11.1 IFAC believes that emphasis should be placed on the quality, rather than the frequency, of communication. A reasonable amount of communication with stakeholders is an integral part of a high-quality audit and IFAC supports enhanced dialogue in areas where such communication is useful and relevant to stakeholders.

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- 11.2 The frequency of communication should, to some extent, also be considered with respect to cost-effectiveness and a cost/benefit assessment. The costs required to meet additional reporting intervals and the burdens they would impose on companies would have to be considered in terms of the benefits to be achieved. For example, additional reporting across European Union Member States would need to be synchronized to avoid having too many reporting periods across different jurisdictions. In addition, shorter intervals between reporting could lead to stakeholders making decisions that are short-term and potentially ill-considered.
- 11.3 There needs to be reasonable time between the year end and the date of the audit opinion to allow auditors to obtain sufficient and appropriate audit evidence (including substantive testing that often cannot be begun until after the balance sheet date). At the same time, there will be occasions when even after a reasonable period (e.g., 75 days) the auditor would still not have obtained the evidence that is considered necessary. In those circumstances, the reporting deadline must be extended or, to meet the reporting deadline, the auditor must be able to issue a qualified opinion based on not having obtained evidence needed to support an unqualified opinion. This will depend on the willingness of regulators to accept modified audit opinions.

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

- 12.1 IFAC welcomes further global debate on potential measures that could enhance the value of audits and believes that a primary measure would be the adoption of ISAs throughout the European Union (please see the rationale for adoption of ISAs set forth in our response to question #13). In addition, IFAC believes that this debate should also address how these measures would be developed, evaluated and applied.
- 12.2 It is also important that all stakeholders, including those in the SME sector, understand the value of the audit (in terms of both the real and the perceived benefits). As the audit is often not compulsory for SMEs that are non-public interest entities, they are often likely to decline it. However, the audit can play an important role in assisting enterprises to gain access to financing and, perhaps most significantly, in ensuring that sound financial discipline has been applied.

13. What are your views on the introduction of ISAs in the EU?

- 13.1 The introduction of ISAs in the EU is a critical step in achieving a truly globalized economy. There are several reasons for this:
- (a) The international adoption of a common set of auditing standards will improve the comparability and transparency of financial information. This will ultimately improve the quality of financial information. In the global context, the transparency of financial information is dependent upon the uniformity of its assessment across multiple jurisdictions.
 - (b) ISAs, serving as a common set of standards, may also help alleviate information asymmetries, which occur when auditing and audit reporting in one jurisdiction may vary in depth, scope, and quality from that in another jurisdiction. These asymmetries can give rise to economic uncertainties which also contribute to systemic risks in the marketplace.

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- (c) The introduction of ISAs will enhance the cross-border mobility of professional accountants and the provision of accountancy services.
 - (d) As a single set of auditing standards, ISAs provide a fixed point of reference for global regulatory institutions. This will achieve simplification by reducing the ambiguities and redundancies associated with multiple sets of standards. It is also consistent with monetary and economic policy integration efforts within the European Union and beyond. It will reinforce and further legitimize existing initiatives, including the Basel Accords, the widespread adoption of IFRS, the ongoing convergence of U.S. GAAP and IFRS, and the adoption of general principles within IOSCO.
 - (e) ISAs provide the feature of scalability and proportionality and are applicable for both listed companies and SMEs.
 - (f) ISAs will also provide significant benefits for emerging economies in the EU that have not yet created comprehensive systems of standards for auditing. These countries will not have to “reinvent the wheel” to establish national standards which can be a long and time consuming process. Such technical resources can be more productively redirected to input into the international standard-setting processes and national implementation and monitoring efforts.
 - (g) Adoption of a common set of auditing standards (without carve-outs) will facilitate the European passport identified in question #34 of the Green Paper.
 - (h) The international adoption of a common set of auditing standards will reduce the costs associated with differing sets of standards.
- 13.2 In addition to these points, adoption of ISAs in the EU is consistent with the objectives set forth in the Directive and we believe the Commission should pursue the vision it has already established in law. Adoption of ISAs in the EU is also a critical step in facilitating a truly single European market. A majority of the European Union’s jurisdictions have already adopted or are in the process of adopting ISAs (as are many countries outside of the EU). In addition, ISAs are being used as the basis for global audit methodologies employed by Forum of Firms⁶ members for transnational audits in many countries that have not yet officially adopted ISAs. Upon completion of the Clarity Project in 2009, the IAASB received statements of support from numerous international institutions.⁷
- 13.3 Most recently, the Monitoring Group (which includes the European Commission), which comprises the regulatory and international organizations responsible, *inter alia*, for monitoring the implementation of the 2003 IFAC Reforms, indicated its overall satisfaction with the implementation of the Reforms and continued acceptance of IFAC’s shared standard-setting arrangement and oversight structure.⁸

⁶ Formally established in 2002, the Forum of Firms (FOF) is an association of international networks of accounting firms that perform audits of financial statements that are or may be used across national borders.

⁷ These institutions included the International Organization for Securities Commissions (IOSCO), the World Bank, the Basel Committee, the United Nations Conference on Trade and Development (UNCTAD), the World Federation of Exchanges, and the Forum of Firms.

⁸ The Monitoring Group’s final report can be found at www.iosco.org/monitoring_group/pdf/MG_Doc_4.pdf.

14. 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)? Alternatively, and given the current widespread use of ISAs in the EU, should the use of ISAs be further encouraged through non-binding legal instruments (Recommendation, Code of Conduct)?

14.1 Yes, IFAC supports that ISAs should be made legally binding throughout the EU consistent with the mandate that was agreed upon in the Directive. We agree that the Commission should also consider an endorsement process; however, it is important to recognize the differences between the ISAs as set by the IAASB and the IFRSs set by the IASB. It is important to note that ISAs, which contain the basic principles and essential procedures to be performed by auditors to provide independent assurance, are more narrowly focused. In this respect, IFAC supports the following:

- (a) The ISAs should be endorsed as one complete package rather than standard by standard.
- (b) Carve-outs should not be permitted in any way as this would compromise the integrity of the full body of ISAs as a complete framework of interrelated, interdependent principles.
- (c) Add-ons should be permissible; however, their application should be clearly disclosed in the auditor's report.
- (d) The input of national standard setters and oversight bodies should be provided to determine the requirements for local add-ons in accordance with the legal environment.

15. Should ISAs be further adapted to meet the needs of SMEs and SMPs?

15.1 No, IFAC believes that the Clarity ISAs as currently issued have been developed with due consideration of and emphasis on the needs of SMEs and SMPs and therefore do not require further adaptation in this respect. IFAC is keenly aware of the disparities in capacity between SMPs and large auditing firms, including manpower, resources, and potentially the range of expertise that can be utilized for the client. However, IFAC believes the application of ISAs can and should be based on one, consistent approach. In this respect, the ISAs should not be further adapted (this includes "carve-outs") to meet the needs of SMEs and SMPs. IFAC strongly supports continued emphasis on SME/SMP perspectives as the IAASB develops new, or reviews existing, auditing and assurance standards.

15.2 IFAC maintains the position that ISAs are designed to be applicable to the audits of entities of all sizes. If auditors intend to issue an ISA-compliant audit report, they must comply with all of the ISAs that apply to the audit of the entity in question. In many cases, certain ISAs—for example, Group Audits, Use of Experts, and Internal Audit—are not likely to be applicable in an SME environment. IFAC's position on this matter is based on the notion that a single set of standards enables a consistent level of assurance to be associated with the word "audit" and allows users to make decisions with a common understanding about the reliability of the financial statements. However, IFAC recognizes that each audit is different and in conducting the audit the auditor must use

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professional judgment. The ISAs focus on the principles to be followed, the objectives to be achieved, and the essential considerations for the auditor in planning, conducting, documenting, and reporting on the audit.

- 15.3 In this respect, ISAs allow for the fact that a requirement within the standards may not be relevant to a particular audit, in which case that requirement is not applicable. In some exceptional circumstances, the auditor may judge it necessary to depart from a relevant requirement and is then required to conduct alternative procedures in order to achieve the aim of that requirement. By applying the standards rigorously and using professional judgment, the auditor can adopt the most effective approach for an audit of a particular entity, regardless of size.
- 15.4 Ultimately, while the audit approach itself may differ, the auditing standards on which it is based and the level of assurance the auditor is required to obtain should not. It is in this sense that “an audit is an audit.” Support for this “scalable” approach to ISAs should be recognized not only by auditors but also by regulators and oversight bodies. In this respect, the ISAs allow for proportionality in respect to the size and complexity of audits for SMEs as compared to public interest entities.⁹ This is evident in the range of varying requirements for audit documentation, choice of audit procedures, and communications processes provided for in the ISAs.
- 15.5 IFAC’s SMP Committee has endeavored to provide more substantive implementation support to help with the proportional application of the ISAs to SME audits. For example, 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.
- 15.6 IFAC also notes the steps taken by the IAASB with respect to the needs of SMEs in the development of ISAs. The IAASB’s standard-setting process aims to ensure that SMP perspectives are taken into account, by seeking input from those in the SME and SMP communities. In addition, the IAASB has committed to providing auditors with a period of at least two years after the effective date of the clarified ISAs during which no new auditing standards would become effective, unless there is an urgent need to respond to new or unforeseen circumstances; this period of stability with regard to the implementation of new or revised ISAs is particularly important for SMPs.
- 15.7 On a broader level, IFAC believes that continued institutional coordination among IFAC, the IAASB, the EU, professional accountancy organizations, and other stakeholders should take place to support the implementation of ISAs at the SMP/SME level. This also includes the need for further research, working papers, and other products that will assist in educating all parties and stakeholders.

⁹ For further information on ISAs and proportionality with respect to SME audits, see The International Auditing and Assurances Standards Board, Staff Questions and Answers: *Applying ISAs Proportionately with the Size and Complexity of an Entity*, 2009.

EUROPEAN COMMISSION'S GREEN PAPER, *AUDIT POLICY: LESSONS FROM THE CRISIS*—IFAC RESPONSE**16. Is there a conflict in the auditor being appointed and remunerated by the audited entity? What alternative arrangements would you recommend in this context?**

16.1 IFAC acknowledges that there may be potential perceived conflict of interest and independence threats in respect of auditor appointment and remuneration. However, IFAC believes that this has been mitigated with certain safeguards that are currently in place in the Directive:

(a) Article 37 of the Directive sets the principle of appointment of the statutory auditor by the general meeting of shareholders, specifying that Member States may allow alternative systems providing they are designed to ensure the independence of the statutory auditors from the audited company's management.

(b) Article 41.3 specifies that, for public interest entities, the board proposal to the shareholders to appoint a statutory auditor is based on a recommendation by the audit committee. In most jurisdictions, comprehensive and appropriate safeguards are in place to mitigate conflicts of interest that may exist, although we must acknowledge that not all of the countries in the European Union are yet at the same stage of evolution in this respect. We believe that the most effective way to address this is to enhance corporate governance as opposed to having appointments made through a regulator.

16.2 Considering the various parts of the entity involved in the appointment and remuneration process—assuming that the overall system of corporate governance is properly constituted and working effectively—these safeguards should be sufficient.

16.3 Potential enhancements could include corporate governance initiatives that emphasize the importance of the selection, appointment, and remuneration of the auditor being independent of management and/or executive directors. Strengthening the role and responsibilities of the audit committee (assuming that it is largely composed of non-executive directors) in this respect could be contemplated. Strengthening the direct role of the shareholders in the selection of the auditor could also be considered.

17. Would the appointment by a third party be justified in certain cases?

17.1 No, IFAC strongly supports the rationale that the shareholders and audit committee are generally in the best position to determine which auditor to appoint based on their assessment of the business model, industry knowledge, organizational structure, and risk management issues. As noted in question #16, IFAC believes that there are adequate safeguards available to mitigate independence threats within the current framework. Appointment by a third party, such as a regulator, would undermine shareholder rights and potentially introduces new conflicts such as the independence of the regulator from the audited entity.

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

18.1 No, engagement of audit firms should not be time-limited. Substantially all research in this area indicates that mandatory firm rotation can undermine audit quality.¹⁰ Considering the safeguards noted in questions #16 and #17 as well as those provided in the IESBA *Code of Ethics for Professional Accountants* with respect to rotation of key audit partners for public interest entities, IFAC does not believe mandatory firm rotation would bring an incremental benefit to auditor independence that would outweigh the risks to audit quality.

18.2 From another perspective, the commonly applied public sector practice of the appointment of a single audit organization in perpetuity also suggests that auditor rotation is not essential to audit quality.

19. 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?

19.1 No, IFAC does not believe that the absolute prohibition on the provision of non-audit services is appropriate. IFAC supports the IESBA *Code of Ethics for Professional Accountants*, which includes detailed conditions related to the provision of non-audit services to audit clients and specifically prohibits non-audit services to audit clients when the auditor would audit his/her own work (self review threat). For audit clients that are public interest entities, the provisions regarding non-audit services are even more restrictive. Further threats to the independence of the auditor should be mitigated by safeguards and if no safeguards can reduce the threats to an acceptable level, the auditor is prohibited from carrying out the work.

19.2 Auditing is a highly complex multi-disciplinary service. In performing both audit and non-audit services, audit firms obtain complementary knowledge and competence that ensures that each of these services can be provided efficiently and to the expected quality. Audit firms need to have internal experts who ask critical audit questions around many elements of business relevant to the audit of financial statements. If the audit firm does not have experts in these areas, (e.g., valuation experts, actuaries, pension specialists, etc.) it has fewer resources to call upon when difficult audit issues arise.

¹⁰ SDA Università Bocconi, *The impact of mandatory audit rotation on audit quality and on audit pricing: the case of Italy*, 2002

The United States General Accounting Office, *Mandatory Audit Firm Rotation*, 2003

The International Chamber of Commerce, *Policy Statement: The Adverse Effects of Compulsory Audit Firm Rotation*, 2005

The European-American Business Council, *EABC Policy Paper: EABC Opposes Mandatory Audit Firm Rotation*, 2007

The Committee of Sponsoring Organizations of the Treadway Commission (COSO), *Fraudulent Financial Reporting 1998 – 2007: An Analysis of U.S. Public Companies*, 2010

www.coso.org/documents/COSOFRAUDSTUDY2010.pdf

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19.3 Our views on the provision of non-audit services are strengthened by the outcome of the recent UK Auditing Practice Board (APB) consultation on auditors providing non-audit services to the entities they audit. The overwhelming majority of respondents to the consultation (which included numerous companies and investors) endorsed the retention of the threats and safeguards approach to auditor independence requirements, together with disclosure to investors and other stakeholders, to allow them to make their own assessment of whether proper governance has been exercised in this area. This is a critical endorsement of an approach which in our view is most likely to result in a proportionate balance of cost to business and investor confidence.

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

20.1 Yes, IFAC agrees that financial dependence on a single audit client creates a potential threat to the auditor's independence. IFAC supports the provisions in the IESBA *Code of Ethics for Professional Accountants* that limit the proportion of total fees that can be received from a single audit client. The provisions require that audit firms consider the threats posed when a large proportion of fees are derived from one audit client and, if necessary, that they act upon those threats. For public interest entity audits, the provisions require specific safeguards of independent review and discussion with those charged with governance when any one audit client exceeds 15% of total fees.

21. Should new rules be introduced regarding the transparency of the financial statements of audit firms?

21.1 IFAC supports the measures for increased transparency of audit firms as provided under Article 40 of the Directive, which requires audit firms auditing public interest entities to publish a transparency report, as an adequate baseline.

21.2 It is important to note that, depending upon the jurisdiction, more audit firms have become limited liability partnerships or limited liability companies. All limited liability entities (including limited liability audit firms), must comply with the requirements of the EU Fourth and Seventh Company Law Directives. As a result, in some jurisdictions this will inevitably require the audit and publication of financial statements of audit firms. In addition, some audit firms publish their financial statements on a voluntary basis. It therefore may be useful for the Commission to evaluate whether or not these practices add greater usefulness or benefits to the marketplace.

21.3 In general, audited financial statements naturally reinforce the notions of enhanced transparency and good governance. However, in assessing whether further mandatory requirements for audit firms should be instituted, consideration should be given to the real (as opposed to perceived) utility of such financial disclosures, and to whom the disclosures should be made. In jurisdictions where independent audit oversight bodies for listed entities exist, we would support transparency of firm financial information to such bodies and recommend that they determine the type of financial and risk information necessary for assessing the audit firm's stability and sustainability.

21.4 From a different perspective, if there is sufficient reason for an audit committee to need the audit firm's financial information, they can certainly request it and, together with the

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audit firm, determine the appropriate level of information to share based on the specific circumstances.

22. What further measures could be envisaged in the governance of audit firms to enhance the independence of auditors?

22.1 IFAC supports efforts to ensure that the governance of audit firms enhances the independence of auditors. In this respect, IFAC encourages principles-based approaches to corporate governance at the firm level. The “comply or explain” format represents an appropriate and reasonable approach. IFAC would also support the exploration of the appointment of independent non-executives within the governance structures of audit firms. However, IFAC believes that the issue of scale represents an important consideration, especially in respect to smaller firms. SMPs could face unreasonable costs to comply with certain measures, many of which would not necessarily be useful to their stakeholders. In this respect, IFAC believes that further corporate governance measures should pertain only to audit firms responsible for public interest entities.

22.2 Additionally, IFAC supports the provisions of ISQC 1, which requires establishment and maintenance of a quality control system to ensure that audit firms comply with professional standards and applicable legal and regulatory requirements. IFAC urges adoption of ISQC 1 at the European Union level and encourages that any additional measures build on and be consistent with ISQC 1.

23. Should alternative structures be explored to allow audit firms to raise capital from external sources?

23.1 Yes, IFAC supports exploring alternative structures to allow audit firms to raise capital from external sources, provided that such structures are voluntary and that provision is made to ensure that effective safeguards for auditor independence and protections for audit quality are put in place; however, more information on the legal provisions for raising capital for audit firms throughout different regions of the world will be needed to further explore this question. Also, empirical research should be undertaken on the effect of such structures where they already exist.

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

24.1 IFAC supports the framework set forth in ISA 600 (Revised and Redrafted), *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*. This ISA specifies the objectives and responsibilities of the group audit.¹¹

¹¹ The International Auditing and Assurances Standards Board, ISA 600 (Revised and Redrafted), *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, 2007, p.p. 7–8

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

25.1 Before tangible measures for further integration and cooperation on audit firm supervision can be considered, IFAC believes that the EU should address the more fundamental steps that must be taken. These more immediate measures include:

- (a) The EU should articulate and act upon a strategy for adoption and implementation of international professional standards for auditing, accounting, education, and ethics throughout the EU Member States. A single set of standards in each of these areas would assist the convergence of oversight systems from national to regional structures and eventually to international structures. In addition, a single set of standards will fill in the gaps left by “regulatory asymmetries,” which arise from the differences in the scope and degree of laws as well as the punitive measures among national jurisdictions.¹²
- (b) Supplying the audit oversight bodies provided for in the Directive with implementation guidance and support in regards to the single sets of standards noted in the Directive. This would also facilitate consistency in the performance of quality controls by oversight bodies.
- (c) IFAC generally supports the principles stated in Chapter 3, Articles 32 through 35 of the Directive. These principles emphasize the nature of cooperation that must exist in public oversight and regulatory arrangements between Member States and the designated authorities within each state charged with administering the Directive. Further description regarding the institutional linkages, chains of communication, and responsibilities might be more helpful if a policy of adoption and implementation of international professional standards is established.
- (d) While undertaking a strategy for the implementation of single sets of professional standards, the EU should simultaneously consider long-term approaches to directly engaging with the U.S. PCAOB and other countries’ audit standard setters regarding global convergence and adoption of standards. Also, please refer to the answer provided for question #38.

26. How could increased consultation and communication between the auditor of large listed companies and the regulator be achieved?

26.1 IFAC believes that achieving greater effectiveness of communication—rather than frequency of communication—should be the focus, and that building mutual respect and trust is essential for more effective communication. More effective dialogue may be achievable in several ways:

- (a) The EU should consider the development of additional mechanisms and/or opportunities for dialogue to occur between auditors, regulators and financial

¹² DIRECTIVE 2006/43/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 17 May 2006 acknowledges the objective of singular sets of standards for audit, education and ethics in member states Article 251, Section 32.

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institutions. The nature of such dialogue should be based on a two-way process, respecting the roles of both regulators and auditors.

- (b) This dialogue should be structured around addressing a number of topics including systemic risks, industry-specific concerns, and audit issues that may exist beyond the formal components of the reporting process.
- (c) This dialogue should also be structured around addressing ongoing challenges in the reporting process itself. This will be especially helpful as the EU undertakes the implementation of the ISAs, and will provide firms and regulators with opportunities to discuss the effectiveness of, and potential improvements to, such processes.

27. Could the current configuration of the audit market present a systemic risk?

27.1 IFAC believes that there is a need for compelling empirical research before we could conclude that the current market configuration presents any systemic risk. Any potential research on this question should address the commonly posed scenarios, including:

- (a) The extent to which a collapse of one of the “Big 4” would result in a reduction in the availability of high-quality audit services to an unacceptable level, such that the limitation of choice would render audit services inaccessible or unreasonably costly;
- (b) That any one of the Big 4 is “too big to fail,” in the context that the collapse of such a large supplier would threaten the existence or commercial viability of other suppliers (when it may be equally possible that such a collapse could facilitate greater market entry for mid-tier international networks); and
- (c) That the biggest risk to the global capital markets in terms of the failure of a Big 4 audit firm stems from the litigation culture and legal systems in certain countries where auditor liability is unlimited and uninsurable. The European Commission should continue to explore the extent to which liability reform in the auditing profession will result in less risk for the marketplace. Liability reform would likely be a significant factor in lowering entry barriers for mid-tier and smaller firms and thus enhancing competition in the audit market.

27.2 While there may be potential for disruption of the capital markets, the demise of a Big 4 firm is highly unlikely to have the same impact on the capital markets as the failure of a major bank, for example. As audit firms are not economically connected, the dissolution of a network will mean that network units would likely be absorbed by other networks with perhaps only slight interruption to the entities they serve. However, other issues, such as availability of choice, will likely be adversely affected.

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28. Do you believe that the mandatory formation of an audit firm consortium with the inclusion of at least one smaller, non systemic audit firm could act as a catalyst for dynamizing the audit market and allowing small and medium-sized firms to participate more substantially in the segment of larger audits?

28.1 In responding to this question, IFAC understands an audit firm consortium to be an arrangement involving more than two audit firms, as distinct from a joint audit, which is an arrangement of two audit firms.

28.2 In respect to joint audits, a regulatory intervention of this type across all EU Member States would require further evidence and market analyses to demonstrate that it would achieve the intended purpose. Current evidence points to a mixed record of effectiveness of such arrangements, depending upon the jurisdiction. Therefore, joint audits should not be mandated until further research is undertaken. Further evidence would be helpful in determining the following:

- (a) That such a model would achieve a reasonable balance of costs and benefits in terms of the pricing of such services, the time required to execute such joint audits, and most importantly, the quality of the audit;
- (b) Whether the joint audit model is compatible with the legal, regulatory, and economic systems of each jurisdiction and could be implemented accordingly throughout the Member States; and,
- (c) Whether such market intervention would have other negative consequences, which—due to the lack of research currently available—remain unrecognized or not yet understood.

28.3 In respect to mandatory consortia, IFAC does not have any knowledge of such a model being implemented in any EU state at this time. Therefore, without any viable evidence to assess its performance in practice, IFAC cannot consider the mandatory consortia model unless further research can be facilitated.

29. From the viewpoint of enhancing the structure of audit markets, do you agree to mandatory rotation and tendering after a fixed period? What should be the length of such a period?

29.1 No, IFAC does not support the mandatory rotation of audit firms after a fixed period. However, for public interest entities, IFAC does support mandatory partner rotation after a fixed period of time. To address the concerns of independence and conflicts of interest, please see IFAC's response to question #18 of this paper, whereby IFAC states its position in reference to the IESBA *Code of Ethics for Professional Accountants*. Several studies of mandatory firm rotation—include one undertaken by the Università Bocconi¹³—demonstrate that it can have an adverse impact on the marketplace. Some adverse affects noted include:

¹³ SDA Università Bocconi, *The impact of mandatory audit rotation on audit quality and on audit pricing: the case of Italy*, 2002

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- (a) Reduction in audit quality;
 - (b) Increases in market concentration for audits of listed companies; and,
 - (c) Increases in total audit costs.
- 29.2 Audit committees and/or shareholders should have the authority to make the decision to change audit firms at any time. If research can demonstrate that periodic tendering will open up the market for audit in the context discussed in the Green Paper (by leading to more appointments of SMPs), one area that could be explored is a comply or explain mechanism for audit committees in regards to their periodic tendering considerations. Such periodic tendering would only be justifiable over long intervals of time, as it could be potentially costly and time-consuming. It would also be important to ensure that audit oversight bodies include a review of the tendering process and its outcome in their inspection programs.

30. How should the “Big Four bias” be addressed?

- 30.1 Assuming that this refers to the notion that firm size is proportionate to the quality of the audit service provided, then inspections should cast light on whether such bias is warranted. That being said, the Big Four bias is a perception problem throughout the market, including among audit committees, corporate boards, investors, regulators, and the general public. IFAC believes this perception can be addressed in several ways:
- (a) Regulators should not express in any context a view that correlates size and audit quality, other than evidence-based assertions.
 - (b) Public awareness initiatives should be undertaken by governments, regulatory institutions, professional accountancy organizations, business leaders, and other parties, directed at every level of the marketplace.
 - (c) Audit committees should be encouraged to widen their criteria when making their selection of audit firms and be open to the notion that many mid-tier firms possess capacities comparable to their Big Four counterparts.

31. Do you agree that contingency plans, including living wills, could be key in addressing systemic risks and the risks of firm failure?

- 31.1 Although IFAC is not convinced that the current market configuration represents a systemic risk (please see IFAC's response to question #27), IFAC nevertheless believes that there is value to the concept of contingency plans. IFAC suggests the following:
- (a) Enhanced communications would likely be of equal value to contingency plans (please refer to our response to question #26).
 - (b) Rather than structuring contingency plans on specific types of responses, perhaps they should be focused on how and when a specific group of organizations/institutions will convene; the scope and nature of responses that should be considered; and the parameters that will be in place for governments, regulatory bodies or other organizations to mount an effective response.

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- (c) In any case, the actors, institutions, and directives outlined in such contingency plans should be transparent before, during, and after their implementation, so as to ensure accountability and trust.
- 31.2 In addition, IFAC believes that the contingency measures mentioned in the Green Paper require greater research. Several points should be considered:
- (a) The notion of living wills and similar contingency plans raises the specter of creating a “too big to fail” class of firms. This would promote the continuation of what some consider to be undesirable in the marketplace: a tier of providers that possess a relatively inflexible degree of market share. In addition, it could inadvertently ensure a resultant class that is “too small to succeed.”
- (b) Contingency plans could obstruct the very kind of dynamics the Commission seeks in making the marketplace for audit more accessible to suppliers of different sizes. Such plans imply that supplier choice would be, at least by default, influenced not by normal drivers of consumer selection but rather by the succession dictated in the contingency plan for each audit firm. In this respect, who or what factors would dictate choice of successor? What decisions would remain outside of the purview of the consumer regarding successor choice?
- 32. Is the broader rationale for consolidation of large audit firms over the past two decades (i.e., global offer, synergies) still valid? In which circumstances, could a reversal be envisaged?**
- 32.1 Yes, IFAC believes that the rationale for consolidation of large audit firms over the past two decades is consistent with the realities of today’s global marketplace. IFAC notes the following:
- (a) Consolidation has been a natural response to environmental factors in the global marketplace such as the emergence of transnational commerce, the emergence of greater regulatory complexities, and the growth of investor markets worldwide. These factors have given rise to the need for audit firms that possess the greater capacity necessary for the audit of the very largest global public companies. In accordance with this logic, it would be extremely difficult and counter-productive to attempt to reverse this consolidation. It may well be that any action designed to remediate the perceived hazards of consolidation should work with rather than against these factors.
- (b) The consolidation of audit firms reflects the widespread, globalized growth of the large public companies they serve. However, should environmental factors change in a manner which necessitates localization, audit firms may either decentralize or deconsolidate to achieve the optimal benefits associated with such factors.
- 32.2 It is important to note, however, that SMEs and SMPs continue to represent a critical part of the audit marketplace. The sustainability of this sector represents an equally pressing policy consideration. A reversal of the consolidation of large audit firms is difficult to envisage; more dynamic approaches to improving the market share for mid-tier firms and SMPs should be considered.

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32.3 IFAC notes the following in regard to improving the competitive dynamics of mid-tier firms and SMPs with respect to the Big 4 Firms:

- (a) The EU should facilitate greater cross-border service provision of practitioners and firms. A focus on simplifying education, licensing, and registration requirements could be an important first consideration.
- (b) The EU should consider the positive impact that adoption of a single set of professional standards will have on harmonizing education, licensing and regulation.
- (c) The EU should consider facilitating greater public awareness regarding the comparative capabilities and benefits of small, mid-tier and large firms.
- (d) The EU should pay greater attention to the impact that regulation and regulatory change has on SMPs with respect to their capacities to deliver comparable services. Accordingly, impact assessments should be conducted in advance to determine the effects of proposed EU regulation.

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

33.1 IFAC supports the view that enhancing cross-border mobility is desirable, and believes that the key enabler is the adoption of international professional standards for audit, accounting, education and ethics. In terms of licensing and registration, adoption of international professional standards would reduce the costs and complexities associated with having professional accountants licensed to certify audits in each national jurisdiction. Licensing, and other qualifications required for certification of audits, are safeguards intended to ensure compliance with national standards and procedures. A single set of standards would remove or alleviate many such barriers, as compliance measures would evolve to become more regional/international than national in nature, thereby facilitating the mobility of professionals qualified to certify audits beyond their own jurisdictions.

33.2 Equally important is the emphasis that should be placed on IESs issued by the IAESB. The cross-border mobility of audit professionals will be enhanced by the successful implementation of the IESs, which can act as an international benchmark for the development and maintenance of competence for the audit professional. The cross-border mobility of audit professionals can also be facilitated by mutual recognition agreements (MRAs) between professional accountancy organizations. This has been exemplified by several European professional accountancy organizations that have initiated a common content program which can be used to reduce differences in audit qualifications.

34. Do you agree with “maximum harmonization” combined with a single European passport for auditors and audit firms? Do you believe this should also apply for smaller firms?

34.1 There are many underlying assumptions stated in the Green Paper with respect to the premise of both maximum harmonization and a single European passport. These

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assumptions bypass problems that the Commission must seek to resolve before considering this idea. These include:

- (a) The terms “harmonization” and “convergence” generally have slightly different meanings. The former implies an alignment of policies that can co-exist with one another and function mutually and effectively in multiple jurisdictions. The latter implies the acknowledgement and use of one policy across multiple jurisdictions. IFAC supports the concept of convergence as the primary objective in inter-jurisdictional cooperation.
 - (b) The concept of a single European passport reflects many of the ideals associated with globalization; however, IFAC does not see how the passport could function effectively without the underpinning of single sets of international professional standards (auditing, accounting, education, and ethics) for the accountancy profession within the EU, all of which provide a centralized basis for training, licensing, and regulation.
 - (c) Indeed, the passport would help firms overcome a hurdle of regulatory complexity with respect to licensing and movement, but there are other factors to consider which may still impede firms such as the resources (staff, local expertise, language, office space, etc.) required for cross-border coverage.
 - (d) Articles 3 and 14 of the Directive acknowledge the licensing redundancies, but one must scrutinize the underlying reasons behind why Articles 3 and 14 were included. Each Member State has its own laws, regulatory institutions, commercial environment, language(s), and cultural preconditions. Competence assessment and licensing processes in each country are extensions of these factors. Unless single sets of international professional standards, can be agreed upon, there is no fixed point of reference to overcome the differences that exist as a result of these local features. Thus, the adoption of a single set of professional standards should feature more prominently in this debate.
 - (e) From an educational perspective, the passport would be greatly assisted if the EU recognized a common set of requirements with regard to skills, training, current knowledge, capabilities, common examination standards and outcomes-based work experience. This would create an environment where the market would have greater confidence in auditors moving from state to state. The IESs clearly provide such a framework (see IFAC’s response to question #33).
 - (f) This debate should also carefully consider SMP perspectives and whether passport requirements should be mandatory—this area represents an opportunity to apply the “think small first” principle and consider requirements only for those firms that aspire to deliver cross-border services.
- 34.2 There are also natural barriers that cannot be legislated. An example is the barrier which arises from the use of different languages within the EU. To some extent this might be mitigated by allowing the use of a choice of languages when performing a competence assessment of candidates.

EUROPEAN COMMISSION'S GREEN PAPER, *AUDIT POLICY: LESSONS FROM THE CRISIS*—IFAC RESPONSE**35. 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 prepared the accounts?**

35.1 IFAC recognizes that SMEs are key players in the global economy. Entities and users of their financial information have diverse business reporting and information needs, and this is especially true for SMEs. However, IFAC holds the position that an audit is an audit and that it is not in the public interest to develop a “light audit” that requires only a portion of the procedures required for an audit, while offering the same form of audit report assurance (for additional rationale, please see IFAC’s response to question #15).

35.2 IFAC would favor a service requiring different procedures by the independent external professional accountant and a different form of report providing less assurance than that provided by an audit. The IAASB is currently developing standards and reporting requirements for services such as reviews and compilations, and IFAC encourages the Commission to participate in the debate on these proposals.

35.3 While suitably qualified internal professional accountants can produce reliable financial statements, we do not believe that internal professional accountants can or should provide independent assurance on the financial statements they have prepared.

36. Should there be a “safe harbor” regarding any potential future prohibition of nonaudit services when servicing SME clients?

36.1 With respect to the provision of non-audit services, IFAC supports adherence to the specifications of the IESBA Code of Ethics for Professional Accountants. The IESBA Code does not delineate restrictions regarding audit and non-audit services based on the size of the entity, but rather on whether or not the entity is a public interest entity. The approach taken is principles-based and applied within a framework of safeguards (see question #19).

36.2 With respect to a policy decision at the EU level regarding potential future prohibition of non-audit services for SME clients, IFAC believes any such action should conform with provisions set forth in the Code, which has comparatively less restrictive prohibitions on the provision of non-audit services to non-public interest entities. The needs of SME clients often differ from those of public interest entities. However, the principles-based approach of the Code provides a sensible approach to addressing such realities.

37. 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?

37.1 No, IFAC supports the rationale that ISAs can be applied in a manner proportionate with the size and capacity of the entity. International Standard on Quality Control (ISQC) 1 covers all assurance and related services, including review, and is scalable in this regard. It is also important to consider that oversight should also be proportional to the relative levels of assurance embodied in these services.

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- 37.2 In July 2010, IFAC issued the *Guide to Quality Control for Small- and Medium-Sized Practices* (QC Guide).¹⁴ This implementation guide reinforces the notion that ISQC 1 is applicable for SMPs by providing information that helps SMPs understand and efficiently apply the redrafted ISQC 1.
- 37.3 IFAC cautions that the provision of quality control or oversight measures that would treat SMEs differently from public interest entities or treat SMPs differently from other audit firms risks the creation of “first class” and “second class” auditors and audits. This would not likely be conducive to one of the primary aims of the Green Paper: integrating all size firms into a dynamic audit market and improving the competitive dynamics of mid-tier firms and SMPs with respect to the Big 4 Firms.

38. What measures could in your view enhance the quality of the oversight of global audit players through international co-operation?

- 38.1 In addition to the arguments set forth throughout this document on the global adoption of professional standards for auditing, accounting, education and ethics (please see our responses to questions #13 and #34); IFAC proposes the following:
- (a) Greater institutional cooperation—IFAC believes that all institutions involved directly or indirectly with the accountancy profession must ensure that dialogue takes place at all levels: standard-setting, oversight, the business community, professional accountancy organizations, governments, academia, and small, medium and large firms. Each must be consulted to ensure that perspectives have been considered.
 - (b) Greater empirical research—IFAC believes that many of the issues under discussion in the Green Paper, as well as the corresponding questions, require sound empirical research and policy impact analyses. There is a pressing need for this type of research to be undertaken both by institutions in the accountancy profession and its stakeholders.
 - (c) Greater understanding of the differences that exist among cultures—IFAC believes that one of the largest obstacles standing in the way of the profession, with respect to its efforts toward true globalization, is the lack of understanding that exists between jurisdictions, arising from cultural differences.

¹⁴ For more information see web.ifac.org/publications/small-and-medium-practices-committee/implementation-guides.